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Proposals for a Securities Market Law for Canada

Volume 3

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Proposals for a Securities Market Law for Canada

Volume 3
Background Papers

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Preface

This volume contains the papers prepared by the consultants to the Securities Market Study to provide an analytical and policy background for the development of the *Proposals for a Securities Market Law for Canada* as set out in the preceding two volumes. The consultants were retained in 1973 and 1974 and detailed outlines and preliminary drafts of the papers were prepared. These drafts formed the basis of a meeting of the complete study group in November 1975 at which the basic outlines of the *Proposals* were defined. The consultants then prepared the final drafts of their papers, contemporaneously with the drafting of a preliminary version of the *Proposals.*

The final versions of the papers were submitted between September 1976 and September 1978 as they were completed. Although the footnotes to the papers have been edited to achieve a consistent form of citation throughout this volume, no attempt has been made to update the references contained in them. Thus, for example, legislative references are to the statutes and bills current when each paper was completed. The date of completion has therefore been included on the title page of each paper. The views and factual material presented are the responsibility of the authors and do not necessarily bear any endorsement of Consumer and Corporate Affairs Canada.

Although acknowledgements have been made in the general preface to the *Proposals* (Volume 1), the efforts of a number of

people mentioned there were especially important in the production of this volume. In particular, Jean R. Lajoie of the Quebec Securities Commission carefully reviewed the French translations of the papers and Mark Zigler, a recent graduate of the Faculty of Law at the University of Toronto, put the footnotes into consistent form.

October 1978

Table of Abbreviations Used in This Work

This table lists, in the left-hand column, short forms for documents, reports and books that are frequently cited in the *Proposals for a Securities Market Law for Canada.* Short forms for titles of reports appear in large and small capital letters, thus: ALI FEDERAL SECURITIES CODE; KIMBER REPORT. The short form for books is given by the author's name in large and small capitals: L. LOSS. Statutes and regulations are shown in upper and lower case Roman letters. Background papers in this volume are cited by the author's name, in italics.

Legislation

1. *Statutes*

CANADA

Alberta Securities Act	Alberta Securities Act, R.S.A. 1970, c. 333, as amended
Bank Act	Bank Act, R.S.C. 1970, c. B-1, as amended
British Columbia Securities Act	British Columbia Securities Act, S.B.C. 1967, c. 45, as amended

Canada Business Corporations Act	Canada Business Corporations Act, S.C. 1974–75, c. 33, as amended
Canada Corporations Act	Canada Corporations Act, R.S.C. 1970, c. C-32, as amended
Criminal Code	Criminal Code, R.S.C. 1970, c. C-34, as amended
Federal Court Act	Federal Court Act, R.S.C. 1970, 2d Supp., c. 10
Income Tax Act	Income Tax Act, S.C. 1970–71, c. 63, as amended
Interpretation Act	Interpretation Act, R.S.C. 1970, c. I-23
Manitoba Securities Act	Manitoba Securities Act, R.S.M. 1970, c. S50, as amended
New Brunswick Securities Act	New Brunswick Securities Frauds Prevention Act, R.S.N.B. 1973, c. S-6
Newfoundland Securities Act	Newfoundland Securities Act, R.S.N. 1970, c. 349, as amended
Northwest Territories Securities Ordinance	Northwest Territories Securities Ordinance, R.O.N.W.T. 1971, c. 17
Nova Scotia Securities Act	Nova Scotia Securities Act, R.S.N.S. 1967, c. 280, as amended
Ontario Business Corporations Act	Ontario Business Corporations Act, R.S.O. 1970, c. 53, as amended
Ontario Securities Act	Ontario Securities Act, R.S.O. 1970, c. 426, as amended
Ontario Bill 154	Bill 154, The Securities Act, 1972, Ontario, 29th Legis., 2d Sess. (First Reading, June 1, 1972)

Ontario Bill 75	Bill 75, The Securities Act, 1974, Ontario, 29th Legis., 4th Sess. (First Reading, June 7, 1974)
Ontario Bill 98	Bill 98, The Securities Act, 1975, Ontario, 29th Legis., 5th Sess. (First Reading, May 30, 1975)
Ontario Bill 20	Bill 20, The Securities Act, 1977, Ontario, 30th Legis., 4th Sess. (First Reading, April 5, 1977)
Ontario Bill 30	Bill 30, The Securities Act, 1977, Ontario, 31st Legis., 1st Sess. (First Reading, June 29, 1977)
Ontario Bill 7 (2d reading)	Bill 7, The Securities Act, 1978, Ontario, 31st Legis., 2d Sess. (Second Reading, April 6, 1978) (Reprinted for consideration by the Administration of Justice Committee)
Ontario Securities Act, 1978	Bill 7, The Securities Act, 1978, Ontario, 31st Legis., 2d Sess. (Third Reading, June 23, 1978)
Prince Edward Island Securities Act	Prince Edward Island Securities Act, R.S.P.E.I. 1974, c. S-4
Quebec Securities Act	Quebec Securities Act, R.S.Q. 1964, c. 274, as amended
Saskatchewan Securities Act	Saskatchewan Securities Act, 1967, S.S. 1967, c. 81, as amended
Telecommunications Act	Telecommunications Act, Bill C-24, 30th Parl., 3d Sess. (First Reading, January 26, 1978)
Yukon Securities Ordinance	Yukon Territories Securities Ordinance, O.Y.T. 1971, c. 1

UNITED STATES

Administrative Procedure Act	Administrative Procedure Act, 60 Stat. 237, 5 U.S.C., ss. 551–706
Investment Advisers Act of 1940,	Investment Advisers Act of 1940, 54 Stat. 847, 15 U.S.C., ss. 80b-1 - 80b-21
Investment Company Act of 1940	Investment Company Act of 1940, 54 Stat. 789, 15 U.S.C., ss. 80a-1 - 80a-52
Securities Act of 1933	Securities Act of 1933, 48 Stat. 74, 15 U.S.C., ss. 77a–77aa
Securities Exchange Act of 1934	Securities Exchange Act of 1934, 48 Stat. 881, 15 U.S.C., ss. 78a–78jj
Securities Reform Act of 1975	Securities Acts Amendments of 1975, 94 Pub. L. 29

2. *Regulations*

Alberta Securities Regulations	Alberta Securities Regulations, Alta. Reg. 80/72, as amended
British Columbia Securities Regulations	British Columbia Securities Regulations, B.C. Reg. 193/67, as amended
Canada Business Corporations Regulations	Canada Business Corporations Act Regulations, SOR 75-682, P.C. 1975-2820, Dec. 12, 1975, as amended
Canada Corporations Regulations	Canada Corporations Act Regulations, SOR 76-22, P.C. 1975-3001, Jan. 14, 1976, as amended

Manitoba Securities Regulations	Manitoba Securities Regulations, R.R. Man., Reg. S50-R1, as amended
Ontario Business Corporations Regulations	Ontario Business Corporations Regulations, R.R.O. 1970, Reg. 492/70, as amended
Ontario Securities Regulations	Ontario Securities Regulations, R.R.O. 1970, Reg. 794/70, as amended
Saskatchewan Securities Regulations	Saskatchewan Securities Regulations, Sask. Reg. 241/67, as amended

3. *Self-Regulatory*

ALI FEDERAL SECURITIES CODE	AMERICAN LAW INSTITUTE, FEDERAL SECURITIES CODE, Proposed Official Draft (March 15, 1978) (L. Loss, Reporter)
ALI FEDERAL SECURITIES CODE, Tent. Drafts Nos. 1–6	AMERICAN LAW INSTITUTE, FEDERAL SECURITIES CODE, Tentative Drafts Nos. 1–6 (1972–77) (L. Loss, Reporter)
ALI FEDERAL SECURITIES CODE, Reporter's Revision of Tent. Drafts Nos. 1–3	AMERICAN LAW INSTITUTE, FEDERAL SECURITIES CODE, Reporter's Revision of Text of Tent. Drafts Nos. 1–3 (1974) (L. Loss, Reporter)

Government Documents

1. *Reports*

CANADA

BUSINESS CORPORATIONS PROPOSALS	R. DICKERSON, J. HOWARD & L. GETZ, PROPOSALS FOR A NEW BUSINESS CORPORATIONS LAW FOR CANADA, vol. I, Commentary; vol. II, Draft Act (1971)

Canadian Mutual Fund Report	Report of the Canadian Committee on Mutual Funds and Investment Contracts (1969)
Kimber Report	Report of the Attorney-General's Committee on Securities Legislation in Ontario (J.R. Kimber, chairman, 1965)
Mutual Fund Proposals	J. Baillie & W. Grover, Proposals for a Mutual Fund Law for Canada (vols. 1–2, 1974) (Consumer and Corporate Affairs Canada)
Ontario Securities Commission Disclosure Report	Ontario Securities Commission, Report of the Committee of the Ontario Securities Commission on the Problems of Disclosure Raised for Investors by Business Combinations and Private Placements (1970)
Parizeau Report	Report of the Study Committee on Financial Institutions (Jacques Parizeau, chairman, Québec, 1969)
Porter Report	Report of the Royal Commission on Banking and Finance (Dana Porter, chairman, 1964)
Windfall Report	Report of the Royal Commission to Investigate Trading in the Shares of Windfall Oils and Mines Limited (Ontario, 1965)

UNITED STATES

Institutional Investor Report	Securities and Exchange Commission, Institutional Investor Study Report, 92nd Cong., 1st Sess., House Doc. No. 92-64 (5 vols., 1971)
Special Study Report	Securities and Exchange Commission, Report of Special Study of Securities Markets (parts 1–6, 1963)
Wheat Report	Disclosure to Investors: A Re-appraisal of Federal Administrative Policies under the '33 and '34 Acts (Francis M. Wheat, commissioner, undated: 1969)

UNITED KINGDOM

Renton Report	Committee Appointed by the Lord President of the Council, Report: The Preparation of Legislation, Cmnd. 6053 (Sir David Renton, chairman, 1975)

Texts

P. Anisman	P. Anisman, Takeover Bid Legislation in Canada: A Comparative Analysis (1974)
K. Davis	K. Davis, Administrative Law of the Seventies (1976)
L. Gower	L. Gower, The Principles of Modern Company Law (3d ed., 1969)
D. Johnston	D. Johnston, Canadian Securities Regulation (1977)

L. Loss	L. Loss, Securities Regulation (2d ed., vols. 1–3, 1961 & Supp., vols. 4–6, 1969)
J. Williamson	J. Williamson, Securities Regulation in Canada (1960)
J. Williamson, Supp.	J. Williamson, Securities Regulation in Canada, Supplement (1966)

Article

Anisman	Anisman, *Insider Trading under the Canada Business Corporations Act*, in Meredith Memorial Lectures 1975: Canada Business Corporations Act 151 (1976)

Background Papers in This Volume

Anisman & Hogg	Anisman and Hogg, *Constitutional Aspects of Federal Securities Legislation*
Cleland	Cleland, *Applications of Automation in the Canadian Securities Industry: Present and Projected*
Connelly	Connelly, *The Licensing of Securities Market Actors*
Dey & Makuch	Dey and Makuch, *Government Supervision of Self-Regulatory Organizations in the Canadian Securities Industry*
Grover & Baillie	Grover and Baillie, *Disclosure Requirements*
Hall	Hall, *Continuing Disclosure and Data Collection*

Hebenton & Gibson	Hebenton and Gibson, *International Aspects of Securities Legislation*
Honsberger	Honsberger, *Failures of Securities Dealers and Protective Devices*
Howard	Howard, *Securities Regulation: Structure and Process*
Iacobucci	Iacobucci, *The Definition of Security for Purposes of a Securities Act*
Jenkins	Jenkins, *Computer Communications Systems in Securities Markets*
Leigh	Leigh, *Securities Regulation: Problems in Relation to Sanctions*
Williamson, Capital Markets	Williamson, *Canadian Capital Markets*
Williamson, Financial Institutions	Williamson, *Canadian Financial Institutions*
Yontef	Yontef, *Insider Trading*

Canadian Capital Markets

J. Peter Williamson

June 1978

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Chapter I
Introduction

Since a nation's capital markets make possible the transfer of surplus funds from savers to those who can profitably invest in real assets – such as homes, factories, machinery, roads, or hospitals – their importance to the economy needs no explanation.

This introduction therefore begins with a discussion of the adequacy of savings in the Canadian capital market, including an examination of rates of saving, allocation of savings and investment funds among governments and private industry in Canada, and the relative importance of various sources of these funds. The role of financial institutions as suppliers of capital is considered in detail in a later paper in this volume.[1]

A. ADEQUACY OF SAVINGS

Table 1 presents some historical statistics on saving in Canada. The ratios display no particular trend, other than some increase in personal saving as a percentage of personal income. It is

The author is grateful for contributions to and critical reviews of portions of this paper by his colleague Professor Dennis Logue and by Professor Calvin C. Potter of Concordia University and wishes to acknowledge the help of his Research Assistant, Paula Eberhardt, in the preparation of this paper.

1 *See Williamson, Financial Institutions*, ch. I.

Table 1
Savings in Canada

1972–76
In millions of dollars

	Gross national product	Net national income	Personal income	Personal saving	Gross saving	Investment by non-financial private corporations
	(1)	(2)	(3)	(4)	(5)	(6)
1972	$105,234	$ 79,694	$ 83,767	$ 5,015	$23,405	
1973	123,560	94,651	97,832	7,230	29,481	
1974	147,175	113,850	117,055	9,568	38,013	$19,872
1975	165,445	130,031	136,345	12,246	40,045	17,068
1976	190,027	147,838	155,795	13,398	45,552	21,613

Savings and investment ratios

	(4)/(3)	(5)/(2)	(5)/(1)	(6)/(1)
1972	6.0%	29.4%	22.2%	
1973	7.4	31.1	23.9	
1974	8.2	33.4	25.8	13.5%
1975	9.0	30.8	24.2	10.3
1976	8.6	30.8	24.0	11.4

Source: Statistics Canada, *National Income and Expenditure Accounts*, 13-001, first quarter 1977.

always hard to compare such statistics among countries, but the savings and investment ratios in table 1 seem to be higher than those for the United States and most other industrialized countries except for Japan. Table 3 shows ratios for selected countries and table 2 shows productivity growth for those countries.

There has been a good deal of discussion in both Canada and the United States, particularly in the latter, about an impending capital shortage and the need for diversion of private consumption into investment and of government spending into business investment. Much of what has been said and predicted has been contradictory, but a rather succinct summary of conclusions was presented in the hearings before a United States congressional committee in November 1976. The summary describes conditions in the United States, but its relevance to Canada is clear.

With respect to investment, Henry C. Wallich, a member of the Board of Governors of the Federal Reserve System, said:

> "On the whole, the studies conclude that the historic shares of GNP which have been devoted to total private investment and to the sub-category of business fixed investment of about 15% and 10.5% respectively need to be raised moderately. An additional one-half to one percentage point of GNP, or about $10–20 billion a year, seems to be a reasonable number. The effort required to bring about such a change is not a minor one since in an economy working close to capacity other claims on the GNP would have to be reduced. From the point of view of the Bill, it is the share of business fixed investment in particular that needs to be borne in mind.
>
> "There are factors that raise investment requirements as well as others that reduce them. Additional requirements are called for by energy needs, environmental requirements, health and safety oriented installations, construction for the needs of a growing number of elderly persons, and general investment to make up for any shortfalls in recent years as well as possible declines in the productivity of capital. Partially offsetting these new requirements are demographic variables implying reduced construction activity."[2]

Wallich was not specific about where the extra business investment might come from. He did refer with enthusiasm to recently rising business profits and internal financing, the funding of business short-term debt into long-term debt and U.S.

2 *Investment Policy Act of 1976, Hearing on S. 3693 before the Senate Comm. on Banking, Housing and Urban Affairs,* 94th Cong., 2d Sess. 16 (1976).

Table 2
Average Annual Rate of Productivity Growth

1960–73

	Gross domestic product per employed person	Manufacturing output per man-hour
United States[a]	2.1%	3.3%
Japan	9.2	10.5
West Germany	5.4	5.8
France	5.2	6.0
Canada	2.4	4.3
Italy	5.7	6.4
United Kingdom	2.8	4.0
11 OECD countries	5.2	6.1

a. See note (a), table 3.
Source: U.S. Department of the Treasury.

Table 3
Investment as Percent of Real National Output[a]

1960–73

	Total fixed[b]	Non-residential fixed
United States	17.5%	13.6%
Japan	35.0	29.0
West Germany	25.8	20.0
France	24.5	18.2
Canada	21.8	17.4
Italy	20.5	14.4
United Kingdom	18.5	15.2
11 OECD countries	24.7	19.4

a. OECD concepts of investment and national product include non-defence government outlays for machinery and equipment in the private investment total, which require special adjustment in the U.S. national accounts for comparability. National output is defined in this U.S. Treasury department study as "gross domestic product", rather than the more familiar measure of gross national product, to conform with OECD definitions.
b. Including residential.
Source: U.S. Department of the Treasury.

legislation that has encouraged equity financing of business, including the legislation offering tax incentives to Employee Stock Ownership Plans. Sidney L. Jones, Assistant Secretary for Economic Affairs of the Department of the Treasury, added to Wallich's testimony the importance of federal government deficits. He pointed out that during the decade 1968 through 1977, the U.S. federal government had withdrawn from the capital markets $1.5 trillion, and said: "I think it's equally obvious that the balance of savings and investment Governor Wallich mentioned is made extremely difficult when fiscal policy withdraws $1-1/2 trillion in a single decade."[3]

Wallich identified as the principal sources of capital within the private sector: personal savings, corporate retention of profits, and business depreciation allowances. On forecasts of personal savings, he said:

> "The average of these savings projections is very close to the historical average of 5% of disposable personal income prevailing from 1965 to 1974. During 1976, the personal savings rate has been close to 7%. Some studies of savings behaviour have hypothesized that the savings rate may decline as the relation of assets to income recovers from the attrition that it has suffered through the inflation. It has also been hypothesized that the savings ratio has been adversely affected by more satisfactory provision for old age through social security and Medicare."[4]

With respect to corporate savings, including depreciation allowances, Wallich commented that when profits were corrected for inflation, domestic nonfinancial corporations in 1974 paid out in dividends more than they earned, so that there were no real retentions. Commenting on the longer run, he said:

> "Nevertheless, inflation-adjusted after-tax profits for domestic non-financial corporations as published by the Department of Commerce have averaged only about 2.3% of GNP in recent quarters. During the middle 1960s, when capacity was growing rapidly, they averaged about 4%."[5]

The hearings included a statement made by Jones in February 1976 before the Subcommittee on Financial Markets of the Senate Finance Committee. In that statement he commented on the relatively low level of total United States fixed investment as

3 *Id.* at 18.
4 *Id.* at 16.
5 *Id.*

Table 4
Savings and Investment in Canada

1974–76
In millions of dollars

	1974	1975	1976
Persons and unincorporated businesses			
Savings	14,632	17,516	19,484
Investment	6,009	7,700	9,418
Net lending	8,623	9,816	10,066
Non-financial private corporations			
Savings	11,906	12,550	14,391
Investment	19,872	17,068	21,613
Net lending	−7,966	−4,518	−7,222
Non-financial government enterprises			
Savings	1,295	1,053	1,453
Investment	4,417	6,699	7,176
Net lending	−3,122	−5,646	−5,723
Monetary authorities			
Savings	1	1	1
Investment	17	11	9
Net lending	−16	−10	−8
Banks and near banks			
Savings	421	678	705
Investment	227	255	310
Net lending	194	423	395
Insurance companies and pension trusts			
Savings	29	32	35
Investment	121	125	156
Net lending	−92	−93	−121
Other private financial institutions			
Savings	242	648	655
Investment	75	71	34
Net lending	167	577	621
Public financial institutions			
Savings	−46	−121	67
Investment	163	251	54
Net lending	−209	−372	13
Federal government			
Savings	2,053	−2,430	−1,608
Investment	1,029	1,232	1,331
Net lending	1,024	−3,662	−2,939

	1974	1975	1976
Provincial and local governments and hospitals			
Savings	4,354	3,017	2,592
Investment	4,843	5,966	5,774
Net lending	−489	−2,949	−3,182
Social security funds			
Savings	1,775	1,999	2,175
Investment	0	0	0
Net lending	1,775	1,999	2,175
Foreign sources			
Savings	2,052	5,274	4,733
Investment	539	495	546
Net lending	1,513	4,779	4,187
Total			
Savings	38,714	40,217	44,683
Investment	37,312	39,873	46,421
Net lending	1,402	344	−1,738
Residual error in net lending	1,402	344	−1,738

Source: Statistics Canada, *Financial Flow Accounts*, 13-002, first quarter 1977.

Table 5
Net New Issues of Securities

1972–76
In millions of dollars

	Government of Canada		Provincial bonds	Municipal bonds	Non-financial corporations	
	Bonds	Bills			Bonds	Common and preferred stock
1972	1,269	330	2,990	445	941	445
1973	−677	530	2,614	399	712	442
1974	3,272	940	3,785	553	1,210	466
1975	3,397	570	6,752	1,119	2,149	871
1976	2,588	1,645	8,980	1,240	2,258	1,050

Source: *Bank of Canada Review*, various issues, tables 28, 31, 32 and 34.

a percentage of real national output, and the relatively low productivity growth of the United States, as shown in tables 2 and 3.[6]

Savings and investment in Canada are shown in table 4 by sectors of the economy. Personal savings (including savings of unincorporated business) are very important. They accounted for 38% of gross savings in 1974, 44% in 1975 and 42% in 1976. There seems to be no evidence of a significant shift here (the ratio was 38% in 1970). Nonfinancial private corporations accounted for 53% of total investment in 1974, 43% in 1975, and 48% in 1976. Again, there seems to be no evidence of a trend away from industrial investment (the ratio was 47% in 1970).

Foreign sources of savings have become more important, rising from 5% to 13%, and then declining to 10% of total savings over the three years (foreign sources were negative in 1970).

B. NEW ISSUES OF SECURITIES

Table 5 shows for five years ending in 1976 net new securities issues of the federal government, provincial and municipal governments, and nonfinancial corporations. Aggregate new issue financing increased at a rate of about 22% a year and the shares taken by the governments and corporations remained remarkably stable. The federal government accounted for 25% of net new issues in 1972 and 1976. Municipal governments accounted for 7% in both years. Provincial governments increased their share from 46% to 47% over the five-year period while nonfinancial corporations decreased their share from 22% to 21%. At least for this five-year period, there seems to be no basis for a fear that governments are "crowding out" the private sector.

Table 4 shows evidence of a growing dependence on foreign sources of saving. This can also be seen in table 6. The federal government has in recent years (until 1978) restricted its new financing to the Canadian securities market. A substantial amount of that new financing has been in the form of Canada Savings Bonds. Provinces and municipalities, on the other hand, have turned increasingly to the United States and to the Eurobond markets. In 1976 both the provinces and municipalities raised over half of their new capital outside Canada. About 40% came from the United States and somewhat under 20% from other foreign sources. Corporations relied even more heavily on foreign sources in 1976, although they were slower to turn to these sources than were the provinces and municipalities. But in 1976 corpora-

6 *Id.* at 25, 26.

tions raised only about 30% of their new issue capital in Canada and over 40% in the Eurodollar market.

C. CORPORATE FINANCING

Table 7 provides a breakdown of net new corporate financing through the capital markets into bonds, preferred and common stock. The bulk of the financing has been in the form of bond issues, with the bond proportion remaining constant from 1972 through 1975 and then jumping in 1976.

The federal budget introduced in October 1977 proposed two income tax changes to make equity investments more attractive to individual Canadians. The first $1,000 of interest and dividend receipts had been excluded from taxable income, but capital gains had not qualified for the exemption. (One half of capital gains is included in taxable income.) Beginning in 1977, taxable capital gains have been included in the $1,000 interest and dividend deductions.

Second, the effective dividend tax credit has been increased by a combination of an increased gross-up from 33-1/3% to 50% of net dividends received, and a reduction in the credit from 4/5 to 3/4 of the gross-up. The effect of this is an increase in the tax credit amounting to 13/120 of the dividend received or 11%. Since the taxable dividend is increased by 1/6 or 16.7% the change is beneficial unless the investor's tax rate exceeds 11/16.7 or about 66%, which is beyond the highest personal income tax rate and just about at the highest combination of federal and provincial income tax.

The result should make equity financing a little more attractive, relative to debt financing. Compared to the United States, however, Canada seems already to have a tax structure favouring equity financing. The subject is discussed further in chapter III.

Table 8 compares external and internal sources of funds for nonfinancial corporations in Canada. The comparison suffers from the fact that the two sets of sources are reported in different publications of Statistics Canada, and there are bound to be some differences in the corporations included in the two sets. Internal sources can be seen to have accounted for 61% of all sources in 1974, 65% in 1975, and 57% in 1976 (the ratio was 58% in 1970).

A heavy reliance on internal sources works well when profits are high and taxation not burdensome. One forecast of savings and investment needs over future years has reached the conclusion that the share of total private fixed investment to be supplied by business savings will decline in the period after 1980, due to inadequate capital consumption allowances for replacement in-

Table 6
Canadian and Foreign Financing of Canadian Governments and Corporations: Net New Issues of Bonds

1972–76
In millions of dollars

	Government of Canada [a]			Provinces		
	Canada	Foreign		Canada	Foreign	
		U.S.	Other[b]		U.S.	Other[b]
1972	1,270	−2	0	2,119	485	362
1973	−588	−2	−88	2,087	551	−24
1974	3,317	−45	0	2,295	1,039	441
1975	3,434	−37	0	3,864	2,202	730
1976	2,590	−2	0	3,682	3,333	1,058

Municipalities			Corporations		
Canada	Foreign		Canada	Foreign	
	U.S.	Other[b]		U.S.	Other[b]
374	−43	115	1,551	84	−13
370	−69	98	1,577	−16	−7
393	128	32	1,565	227	−1
642	286	193	2,300	259	374
535	481	236	1,336	1,188	1,836

a. Includes Canada Savings Bonds.
b. Including Eurodollar issues.
Source: *Bank of Canada Review*, various issues, tables 29 and 30.

Table 7
Net New Corporate Financing: All Canadian Corporations

1972–76
In millions of dollars

	Bonds		Preferred	Common
1972	$1,623	72%	$199	$420
1973	1,554	72	84	527
1974	1,791	71	435	303
1975	2,932	70	743	485
1976	4,360	78	627	568

Source: *Bank of Canada Review*, various issues, table 33.

Table 8
Sources of Funds of Canadian Non-Financial Corporations

1974–76
In millions of dollars

	1974	1975	1976
External sources			
Bank loans	2,889	1,307	2,991
Other loans	569	905	720
Short-term paper	783	90	592
Mortgages	500	332	757
Bonds	1,457	2,112	2,132
Stocks	856	960	1,170
	7,054	5,706	8,362
Internal sources			
Net income	9,226	8,694	8,478
Less dividends	3,199	3,414	3,523
Retained earnings	6,027	5,280	4,955
Depreciation and depletion	5,012	5,507	6,130
	11,039	10,787	11,125
Total sources	18,093	16,493	19,487

Sources: Statistics Canada, *Financial Flow Accounts*, 13-002, first quarter 1977 and *Industrial Corporations Financial Statistics*, 61-003, first quarter 1977.

vestment and to business income taxation. As business is required to turn more heavily to external funds, financial intermediation and capital markets will become much more important.[7]

D. PRIMARY AND SECONDARY MARKETS COMPARED

Table 9 shows gross new issues of securities in Canada for governments and corporations and the volume of secondary trading in those securities. The primary market, the "new issue" market, is smaller than the secondary market particularly in equities. The latter is not surprising since equity capital is more or less permanent (some preferred issues are paid off) while debt matures and is replaced with new issues. And as we have seen, internal sources furnish the bulk of new equity to corporations.

E. CANADA IN AN INTERNATIONAL CAPITAL MARKET

For many years Canadian capital markets and financial institutions have had close linkages with markets and institutions in other countries, particularly the United States. As table 10 shows, over the past decade Canada has been a fairly consistent importer of long-term capital and a fairly consistent exporter of short-term capital. Corporations and provinces have raised substantial and rapidly growing amounts of long-term debt abroad, although until 1978 the federal government pretty much restricted its net financing to Canadian sources. (Direct investment on the other hand has been much smaller and has been declining.) The year 1970, when the Minister of Finance requested a reduction in foreign borrowing, brought a sharp decline in the total inflow of long-term funds. But by 1975 the flow was fully restored.

In 1974 there was a significant inflow of short-term capital, largely accounted for by nonbank holdings of foreign currencies abroad. These balances had been declining for some years but showed a very large increase in 1974. Apparently nonresidents have consistently moved short-term funds into Canada while residents have been moving funds out of Canada.[8]

So far as outstanding securities are concerned, recent years have seen a fairly consistent net purchase of Canadian stocks and net sales of foreign securities by Canadian residents. The pattern may be due in part to the imposition in 1971 of restrictions on ownership of foreign securities by Canadian pension funds. A

7 McCracken, *Bridging Canada's Predictable Pitfalls*, 5 PLANNING REV. 8 (1977).

8 *See* E. CLENDENNING, THE EURO-CURRENCY MARKETS AND THE INTERNATIONAL ACTIVITIES OF CANADIAN BANKS (Ottawa, Economic Council of Canada 1976).

Table 9
Primary and Secondary Markets in Canada, Excluding Obligations with a Maturity of Less Than One Year

1973–76
In millions of dollars

	Federal Government[a]		Provincial[b]		Municipal	
	Gross new issues	Secondary trading	Gross new issues	Secondary trading	Gross new issues	Secondary trading
1973	1,910		2,474		798	
1974	2,850		3,203		854	
1975	2,400	4,917	4,924	5,377	1,440	607
1976	3,950	8,339	6,334	7,130	1,450	589

Table 10
Canadian Balance of International Payments: Capital Account[a]

1966–76
In millions of dollars

	1966	1967	1968	1969
Long-term				
Net direct investment	785	566	365	350
Net new stocks	53	36	62	210
Net new corporate bonds	620	167	353	421
Net new Canada bonds	–171[a]	–75	231	–43
Net new provincial bonds	383	701	776	972
Net new municipal bonds	81	121	64	89
Net outstanding securities	–641	–477	–423	157
Other long-term	57	316	224	177
Total long-term	1,167	1,355	1,652	2,333
Total short-term	–364	–836	–1,223	–1,355

Corporate			
Debt		Equity	
Gross new issues	Secondary trading	Gross new issues	Secondary trading [c]
2,053		512	9,402
2,507		730	6,593
4,045	4,884	1,180	5,809
4,750	6,353	1,242	6,953

a. Excludes Canada Savings Bonds.
b. Excludes purchases by Canada Pension Plan.
c. Stock exchange trading.
Note: Gross new issues are those distributed by Canadian investment dealers and include some payable in foreign currency. The secondary trading shown is almost entirely in Canadian dollar issues.
Source: Investment Dealers Association of Canada.

1970	1971	1972	1973	1974	1975	1976
540	660	225	−50	−90	−20	−950
66	18	44	36	10	86	43
352	12	172	27	287	765	2,898
−131	6	−14	−98	−47	96	25
416	407	932	646	1,511	3,141	4,467
−28	−73	71	−5	143	371	649
−110	−34	491	59	−44	307	506
−363	−514	−264	−242	−734	−640	−90
742	482	1,657	373	1,036	4,106	7,548
−328	−11	−967	−858	631	455	−2,697

a. − (minus) indicates cash flow from Canada.
Sources: E. Clendenning, *The Euro-Currency Markets and the International Activities of Canadian Banks*, (Ottawa: Economic Council of Canada, 1976), pp. 78–80, for 1966–74, and *Bank of Canada Review*, for 1975–76.

government white paper issued in November 1969 announced an intention to prohibit pension plans and registered retirement savings plans from investing over 10% of their assets in foreign securities. In June 1971 the famous Bill C-259 included the change in the form of a penalty for investments beyond 10% (at cost) in foreign assets including stock or debt of foreign corporations. The legislation is contained in section 206 of the Canada Income Tax Act and the penalty is a monthly tax of 1% on the excess foreign investments.

The economics of the flow of capital into and out of Canada, including implications for economic growth, inflation, and Canadian control of the Canadian economy, are dealt with in a 1972 government publication.[9] For purposes of this paper the international capital market is simply an extension of the domestic market – an additional source of capital for Canadian users of capital and a source of investment opportunities for Canadian investors.

The principal foreign market for Canadian securities, both of corporations and governments, has for many years been the United States. In recent years, however, Canadian issuers have looked to other foreign markets, particularly the German market. The Eurobond market has become increasingly valuable to Canadian bond issuers,[10] as can be seen in table 11. It is a truly international market. Offerings are not aimed at investors in any particular country. London is probably the most convenient place from which to launch a Eurobond offering but the purchasers will be located around the world. As table 11 indicates, the United States dollar is the most popular denomination for Eurobonds, with Canadian dollars and deutschemarks the next most popular. Most Canadian issuers that have used this market have denominated their bonds in Canadian or United States dollars but the City of Montréal has made substantial deutschemark bond offerings.

The Eurobond market has opened up a substantial source of long-term capital to Canadian corporations and governments. The options now facing a Canadian issuer include the Canadian securities market, the United States securities market, private placements in either country, perhaps private or public offerings in another foreign country, but more likely a Eurobond offering in any one of three currencies. The choice is likely to depend on interest rates in different markets and for different currencies, the maturities that are feasible (in the Eurobond market there is still some reluctance on the part of investors to accept maturities

9 GOVERNMENT OF CANADA, FOREIGN DIRECT INVESTMENT IN CANADA (Ottawa 1972).

10 St-Pierre, *Eurobonds Strong Magnet for Canadians*, 84 CANADIAN BANKER 23 (January-February 1977).

Table 11
Eurobond Issues by Currency of Denomination

1963–76
In millions of U.S. dollars

	Total	U.S. dollar		Deutschemark		Canadian dollar		Others[a]	
1963	$ 164	$ 102	62.2%					$ 62	37.8%
1964	719	485	67.5	$ 200	27.8%			34	4.7
1965	1,041	726	69.7	203	19.5			112	10.8
1966	1,142	921	80.6	147	12.9			74	6.5
1967	2,002	1,780	88.9	171	8.5			51	2.5
1968	3,573	2,554	71.5	914	25.6			105	2.9
1969	3,156	1,723	54.6	1,338	42.4			95	3.0
1970	2,966	1,775	59.8	688	23.2			503	17.0
1971	3,642	2,221	61.0	786	21.6			635	17.4
1972	6,366	3,908	61.4	1,160	18.2			1,298	20.4
1973	4,193	2,447	58.4	1,025	24.4			721	17.2
1974	2,134	996	46.7	344	16.2	$ 60	2.8%	734	34.4
1975	8,567	3,738	43.6	2,278	26.6	558	6.5	1,993	23.3
1976[b]	10,763	6,656	61.8	2,012	18.7	1,239	11.5	856	8.0
Total	50,428	30,032	59.6	11,266	22.3	1,857	3.7	7,273	14.4

a. Includes the Dutch guilder, the French franc and composites such as EUA, EMU and EURCO.
b. First nine months.
Source: Morgan Guaranty Trust Company of New York, *World Financial Markets.*

Table 12
Characteristics of the Eurobond Market

1975–76
In millions of U.S. dollars

	Issue volume (annual rate)	Size of issue		Final maturity[a] (number of years)		Yield[b]	
		Average	Largest individual	Average	Longest	Average	Lowest
1975							
Third quarter	$3,700	$31.1	$100	5.5	10	9.43%	9.00%
Fourth quarter	4,200	33.0	100	6.6	10	9.45	9.00
1976							
First quarter	10,300	47.9	300	6.9	12	8.98	8.32
Second quarter	9,000	49.5	500[c]	8.1	15	9.05	8.35
Third quarter	7,600	40.5	300	9.3	15	8.73	8.25
Fourth quarter	9,900	43.4	125	8.4	15	8.53	7.75

a. Excludes convertible issues.
b. Excludes convertible issues and floating rate notes.
c. Private placement.
Source: International Monetary Fund, *IMF Survey*, vol. 6, April 4, 1977.

as long as those that are customary in North America), and size of issue. Table 12, from the International Monetary Fund, shows some of the parameters for Eurobond offerings.

The international nature of a Eurobond offering may permit a rather low level of disclosure. Avoidance of the prospectus requirements of regulatory commissions in the United States, Britain and Canada is a usual feature. Offering circulars giving basic financial information are common, but so far as disclosure is concerned the Eurobond market seems to be substantially free of regulation.

Whether the Eurobond market is a net addition to the financing capacity of Canadian issuers depends, of course, on the extent to which Canadian investors purchase Eurobonds. There do not seem to be any statistics on Canadian investment in Eurobonds, but it seems unlikely that Canadians buy Eurobonds in anything like the volume in which they sell them. The principal reason for tapping the Eurobond market is to finance at a lower interest cost than would be required in Canada. So there is little reason to expect Canadian investors to purchase Eurobonds at lower interest rates than they could obtain at home.

F. WEAKNESSES IN THE CANADIAN MARKETS

A study undertaken in 1972 by a Canadian government working group found four gaps and weaknesses in the Canadian capital markets: there was a lack of (1) venture capital for new and small firms, (2) expansion capital for small and medium-sized Canadian-controlled firms, (3) large pools of capital for major resource exploitation and other capital-intensive projects under Canadian control, and (4) capital for general development in regions of slow economic growth. Coupled with this statement was a claim that lenders generally tend to give preference to foreign controlled firms, probably because of their generally greater size and credit-worthiness. [11]

The study attributed the gaps and weaknesses not necessarily to any lack of investment capital but to inadequacies of the marketplace itself. Specifically, the study said, "the shortage of entrepreneurship in the financial industry frustrates the kind of industrial intermediation - the drawing together of financing and all the many other components to bring a new enterprise into being - which could permit a larger proportion of major projects to be undertaken in Canada by Canadians".[12] The report commented

11 FOREIGN DIRECT INVESTMENT IN CANADA, *supra* note 9, at 92-93.

12 *Id.* at 93.

that merchant banking and venture capital services were not sufficiently developed in Canada to channel adequate funds to new ventures,[13] and concluded that while Canada does need foreign capital, it would need less if the quality of its own capital markets were improved.

Commenting on the attractiveness of Canadian capital markets to institutions, the study observed that pension funds and mutual funds complained of the absence of liability trading by Canadian brokers (a topic dealt with in some detail in chapter II of this paper). The institutions also complained of high brokerage costs in Canada, compared to those in the United States.[14]

On the securities industry itself, the study commented that the capitalization of the industry was not great and that this must inevitably affect its ability to assume risk and to engage in entrepreneurial activity. The study said, "the point here is not that the Canadian industry is necessarily reacting in more conservative fashion to a particular risk, but that the risk itself is perceived differently because of much smaller capitalization".[15] Underwriting activity was singled out as lacking the benefits of competition. The study said, "indeed, the absence of vigorous competition within the securities industry, and from other parts of the financial sector, is such that most securities firms feel little need to protect their position by aggressively taking on new kinds of financing challenges. Also, the competitive environment probably has adverse implications for the price that users have to pay in raising money, which, in turn, affects their competitiveness".[16]

The study observed that there is no indication that Canadians are less willing to make risky investments than are Americans, reinforcing the conclusion that what the capital market needs is better financial institutions to channel savings into new and medium-sized enterprises.[17]

Some of the devices used by the federal government to influence the allocation of capital within Canada are referred to in the study. Tax policy, methods of deficit financing, transfer payments to provinces and individuals and the pattern of federal government expenditures are examples. The direct role of the government through public financial institutions can be seen in Central

13 *Id.* at 97.

14 *Id.* at 98. This topic is discussed at length in ch. III of *Williamson, Financial Institutions.*

15 FOREIGN DIRECT INVESTMENT IN CANADA, *supra* note 9, at 99. Capitalization of securities firms is discussed in ch. II of *Williamson, Financial Institutions.*

16 FOREIGN DIRECT INVESTMENT IN CANADA, *supra* note 9, at 101.

17 *Id.* at 103.

Mortgage and Housing Corporation, the Industrial Development Bank and the Canada Development Corporation.[18]

Some might argue that this study exaggerated deficiencies in the Canadian capital markets, and that in any case there has been improvement since 1972. An unpublished paper prepared within the federal Department of Finance in 1973 reviewed the financial problems of small and medium-sized businesses in Canada, the United States and Britain, and commented that the markets in all three countries had been criticized for failing to meet the needs of this part of the economy. All three countries had struggled with the problem and Canada seemed to have done as much as the other two. The paper went further to argue that there was neither a shortage of capital for small business, nor a lack of financial intermediaries, but rather a lack of viable investment opportunities. Studies of small business failures repeatedly identify poor management and lack of experience as major causes of failure, and the failure rate of businesses that have achieved the goal of a first public financing is high.

G. CONCLUSIONS AND POLICY IMPLICATIONS

Statistics through 1976 do not suggest any deficiencies in saving or adverse trends in saving. At the same time Canada, like the United States and the United Kingdom, has been experiencing rather lower growth in productivity than have Japan, France, Italy and West Germany. Japan has experienced phenomenal growth, backed by an extraordinary rate of savings. But Canadian savings rates are not much behind those of any of the other countries.

There seem to be widespread fears of future trends toward reduced saving, particularly if government transfer payments grow and less is left of individuals' and corporations' investible surpluses. Both the Canadian and U.S. governments seem to be aware of the danger. In recent years the share of new financing going to corporations has held up well.

There is some evidence of a growing dependence by corporations on debt, rather than equity. But the balance between internal and external sources has not changed much in recent years. Once again there are fears, primarily related to government policies, that internal sources may be forced to play a reduced role in the future. But current changes in the tax laws at least favour equity financing.

Foreign capital is becoming increasingly important to the

18 *Id.* at 108.

Canadian economy, and the Eurobond market must be regarded as a significant supplement to the Canadian capital market. Keeping Canada attractive to foreign investors is therefore increasingly important.

Criticism has been directed at the functioning of the Canadian capital markets chiefly in terms of the way they serve small and medium-sized industrial corporations. The same criticism can be found in the U.S. and the U.K. There is a good deal of anecdotal evidence and widespread opinion, though little statistical evidence, to support this. One cannot dismiss complaints about malfunctioning and anticompetitive features of the market, even though they are unsupported by clear evidence.[19] But there is reason to believe that the difficulties in creating and maintaining a lively small business community within the economy are more closely related to management ability than to the availability of financing.

Chapter II
Efficiency of the Canadian Capital Markets

For those concerned with public policy, a critical question is: "How well are the capital markets working?" The answer from economists generally comes in the form of an assessment of "efficiency". But there are many kinds of efficiency as the term is applied to capital markets. Some of them are appropriate to the public policy question and some are not. Much that has been offered in testimony on the state of the capital and securities markets refers to "efficiency", without making clear what kind of efficiency is meant, and indeed the efficiency meant is often of a kind not particularly relevant to the public policy issue at hand.

A. THE MEANING OF EFFICIENCY

The term "efficient market" is used in at least three senses. The kind of efficiency that is most important in terms of the national economy is so-called "allocational" efficiency. A market that is efficient in this sense allocates capital to users (business, government and individuals) in such a way that those who can make the best use of capital are taken care of first and those who make the poorest use of capital are the last to receive it. This sort of efficiency ensures that savings are channeled into the most

19 The complaints reinforce some of the observations in another paper. *See Williamson, Financial Institutions*, ch. II.

productive uses, and maximum economic benefits accrue to the nation as a whole.

1. *Allocational Efficiency*

One has to be a little careful about the criteria used in judging allocational efficiency. To the economist, "most productive" usually means most profitable to the saver. So if two business opportunities exist, one in rural Nova Scotia offering a rate of return of 6% and one in urban Ontario offering a return of 10%, allocational efficiency is served if the Ontario opportunity is chosen first by those with savings, and the Nova Scotia opportunity attracts no funds until the more profitable venture is fully financed. Most economic analysis would go at least one step further, however, and add a risk dimension to the two opportunities. Risk here refers to the uncertainty surrounding the expected rates of return. If the 6% return is much safer than the 10% return, then the Nova Scotia opportunity may be as attractive to savers as the Ontario opportunity, perhaps even more attractive. There is a problem in defining and measuring the risk in an investment opportunity and we will look more closely at risk measures later.

A refined criterion for allocational efficiency, then, is the ability of one opportunity to attract the funds of savers before a second opportunity that offers a lower "risk adjusted" return or a poorer "risk-return combination".

One who is concerned with the public policy issue may object that what is most profitable to an individual (or corporate) saver is not necessarily what is best for the nation. Relative unemployment between rural Nova Scotia and urban Ontario may seem to call for more investment in the former location, even though it offers a lower return and a poorer risk-return combination. There are two answers to this. One is the Adam Smith argument that in a free economy the risk-return criterion is sufficient and if there are unemployed in rural Nova Scotia where investment is unprofitable they should move to urban Ontario. The second answer is that if a government wishes to channel investment into high unemployment areas it should shift the risk-return prospects by way of tax relief or subsidies or perhaps even tax penalties, so that the risk-return criterion allocates savings in a way that satisfies national interests by also satisfying individual interests.

It is easy to see both approaches at work in the Canadian mixed economy. Investment is allowed, by and large, to go its own way in seeking the most attractive opportunities. But taxes and subsidies of one sort or another are frequently applied so as to

make the activities most favoured by a government also those most attractive to an investor.

In this context, then, an economist's conclusion that efficient allocation has been achieved is gratifying to the public policy-maker. It says that savers are responding to the taxes and subsidies efficiently, that they are selecting the opportunities that (giving effect to taxes and subsidies) are most attractive in risk-return terms. But it does not confirm that the taxes and subsidies themselves are correct. They may or may not be encouraging what is good for the country and discouraging what is bad.

2. *Operational Efficiency*

A second kind of efficiency necessary to the first is so-called "operational" efficiency. A market that is efficient in the operational sense is one with low transaction costs. It is a market in which investors can easily transfer their investments from one user of capital to another as in selling shares of one corporation and buying those of another, or from one type of investment to another as in selling shares and buying bonds. The greater this operational efficiency, the greater the assurance that allocational efficiency will actually be achieved. Operational efficiency is sometimes thought of as being limited to brokers' commissions or dealers' spreads. But "transaction costs" really go beyond this to embrace the costs of obtaining information about investment opportunities and processing this information and indeed the costs of a regulatory "investor protection" system that may, in shielding investors from unsuitable ventures, make it difficult for them to find suitable ones.

3. *External Efficiency*

The kind of efficiency that is most often analyzed by economists, and on which the most substantial literature exists, is neither operational nor allocational. Indeed it generally carries no identifying adjective – a source of some confusion. One author has suggested that it be termed "external" efficiency because it has to do with the activities of "outsiders" – investors and savers who are not brokers or dealers or otherwise "inside" the market.[20] "Inside" efficiency on the other hand is what has been described above as operational efficiency.

External efficiency has to do with information and prices. A

20 West, *On the Difference between Internal and External Market Efficiency*, 31 FIN. ANALYSTS J. 30 (November-December 1975).

market in which prices fully reflect available information is externally efficient. The term "fully reflect" means that good and bad news about a company is incorporated in the price of the company's stock as soon as the information is disseminated. Publication of an unexpected item of good news brings about an immediate upward adjustment of the price. There is no advantage to be gained in buying the stock after the news is out. Such a market is sometimes referred to as "fair" in that an investor can be confident that the stock prices he faces fully reflect all that is publicly known about the companies and no investor can trade profitably through the use of public information.

Even though the prices in an externally efficient market fully reflect available information they are not necessarily "correct" in the sense of accurately representing the true value of a company. To some extent the future of a company is simply unknowable without clairvoyance and even in an efficient market the price of a stock is based on only what investors know. And to some extent what is known about a company is known only to insiders and is not publicly available. There is a version of external efficiency – so-called "strong form" efficiency – that describes a market as one in which prices fully reflect even inside information. But evidence of this extreme form of external efficiency is uncertain and there is plenty of evidence that possessors of inside information have been able to use it to advantage.

For a market to be externally efficient, information must be freely available. The cheaper the information and the more easily obtained, the greater the number of investors who will analyze it to reach a new price judgment, and the faster prices will adjust. But it may not take a great many knowledgeable investors to bring prices to levels that fully reflect the information they have. So external efficiency may be attainable with a far from perfect flow of information.

The important point is that the existence of external efficiency in a marketplace has often been passed off as proof that the marketplace is allocationally efficient. External efficiency is *necessary* to allocational efficiency but it is not synonymous with allocational efficiency. For the latter we need both external and operational efficiency. Unless this requirement is kept clearly in mind – and in many analyses it is not – we are apt either to overlook the matter of operational efficiency or to assume that because a market is externally efficient it must be operationally efficient.

B. REQUIREMENTS FOR ALLOCATIONAL EFFICIENCY

Allocational efficiency, the efficiency we really care about, demands both external efficiency and operational efficiency. Without external efficiency prices do not fully reflect available information. It is bad enough that the capital markets present us with surprises we cannot possibly anticipate. But if prices do not even reflect what we do know, then they clearly fail to reflect the most likely returns and risks in the companies whose securities are traded.

Operational efficiency is important to allocational efficiency for two reasons. First, a generally high level of transaction costs makes investment generally less profitable and hence discourages all investment although it does not necessarily distort prices of securities relative to one another. Second, uneven and substantial transaction costs will distort prices. If the commission cost of buying stocks is much greater than the cost of buying guaranteed savings certificates, then stocks are that much less attractive than certificates.

The allocational efficiency in which we are most interested is the efficiency in the primary capital market – the market in which individuals, businesses and governments raise funds to invest in real assets, like houses, machinery and roads. But primary capital markets are much smaller than secondary markets (as we saw in chapter I) and most of the efficiency that is tested and measured is the efficiency of secondary markets. How is this efficiency relevant to the allocation of resources to real assets? The answer lies chiefly in the pricing function of the secondary markets. The price of a company's stock on the Toronto Stock Exchange reflects what investors expect from the company in the way of earnings and dividends and the rate of return they expect on their investment in the stock. The rate of return expected will depend on the risk or uncertainty that investors perceive in the stock and it is this rate that constitutes the company's "cost of equity capital". This rate cannot be observed directly but it can be deduced, at least approximately, from the quoted stock price. The cost of equity capital is important because it serves as a criterion for investment decisions by the company itself. So long as the company can find investments in real assets that offer a rate of return above that cost, it will pay to issue more stock and invest the proceeds.

The device that allocates investment in real assets is cost of capital. Investments will – or at least should – be made only if the promised return is greater than the cost of the funds invested. And the cost is deduced from the price of stock (and other securi-

ties) in the securities market. If this market is allocationally efficient and prices fully reflect what is known of company prospects, then those prices are a good guide to each company's cost of capital and will lead to an efficient set of investments in real, productive assets.

This pricing function is the chief link between secondary markets and investment in real assets. But there is at least one other link. In a good secondary market cheap transactions and "fair" prices inspire confidence and make it easy for a saver to invest, alter his portfolio to suit changing needs and opportunities, and withdraw funds as needed for other purposes. Thus they will tend to bring down the cost of capital for all corporations, and encourage investment in real assets.

C. TESTS OF EXTERNAL EFFICIENCY

A substantial amount of research has been done on the efficiency of capital and securities markets. Most of it has to do with external efficiency – whether the market is a "fair game" for investors.

One area of research has been concerned with serial correlation of stock prices. If there are patterns over time in the movement of stock prices, then one might expect to be able to take advantage of these patterns to make money. It turns out that there are often such patterns but that the ordinary investor cannot take advantage of them because they involve very small price changes and commission costs more than wipe out the profits.[21] These results confirm external efficiency but offer no reassurance about internal efficiency. There is some evidence that patterns in price movement may in fact be *caused* by transaction costs, even though the costs prevent investors from taking advantage of the patterns.[22]

Another area of research concerns direct observation of the impact of news on stock prices. A well-known study on stock-splits[23] and a study of the effects of major world events[24] both concluded that the United States market was externally efficient.

A third focus of research, in both the United States and Canada, has been on the ability of professional managers to "beat

21 *See* R. BREALEY, AN INTRODUCTION TO RISK AND RETURN FROM COMMON STOCKS (1969).

22 *See* Smidt, *A New Look at the Random Walk Hypothesis*, 3 J. FIN. & QUANTITATIVE ANALYSIS 235 (September 1968).

23 Fama, Fisher, Jensen & Roll, *The Adjustment of Stock Prices to New Information*, 10 INT'L ECON. REV. 1 (February 1969).

24 Reilly & Drzycimcki, *Tests of Stock Market Efficiency Following Major Events*, 1 J. BUS. RESEARCH 57 (summer 1973).

the market" – to achieve risk-adjusted rates of return above those obtainable by simply "buying the market" or assembling portfolios by random selection.[25] Once again, the conclusions have generally been that markets are externally efficient, that professionals have not succeeded, after paying transaction costs, in outperforming the market itself.

Finally, a fourth series of tests has been directed to the risk-return character of the securities markets. According to the theory we have already seen, in an externally efficient market securities should be priced such that expected returns accompany high expected risks. And assuming investors hold diversified portfolios, expected returns should be proportional to expected market risk, as opposed to diversifiable risk, or total risk. (This point is discussed later. Briefly, since diversifiable risk can be eliminated by combining stocks in a diversified portfolio, there is no reason to demand, or expect, a compensatory rate of return.) The results of these tests have not been conclusive. By and large, it appears that in United States markets expected returns are proportional to expected risk but often to total risk rather than market risk.[26] This relationship casts some doubt on the external efficiency of these markets.

The research described above was almost all carried out using data from securities markets in the United States. There are a few research findings based on Canadian data.[27] Two studies were concerned with the impact of institutional trading – whether the transactions of institutions seem to distort stock prices. These studies are discussed elsewhere in the context of individual and institutional trading.[28] Briefly, one study found little or no "price pressure" effect,[29] while the other found that mutual fund transactions did have an impact.[30] This impact suggests some lack of external efficiency.

A third study is particularly interesting, because it examined separately two classes of stocks listed on the Toronto Stock Ex-

25 *E.g.* Jensen, *The Performance of Mutual Funds in the Period 1945–1964*, 23 J. FIN. 389 (May 1968); Williamson, *Performance of Canadian Mutual Funds, 1961–70*, 36 BUS. Q. 94 (autumn 1971).

26 A number of research findings on this point are described and discussed in STUDIES IN THE THEORY OF CAPITAL MARKETS, pt. II (M. Jensen ed. 1972).

27 A summary of the research can be found in Saint-Pierre, *L'efficience des marchés financiers secondaires au Canada*, 2 L'ACTUALITÉ ÉCONOMIQUE 232 (avril-juin 1976).

28 *See, Williamson, Financial Institutions*, ch. V.

29 Close, *Price Reaction to Large Transactions in the Canadian Equity Markets*, 31 FIN. ANALYSTS J. 50 (November-December 1975).

30 J. Evans, Mutual Fund Trading and the Efficiency of Canadian Equity Markets (Working Paper No. 214, Faculty of Commerce and Business Administration, University of British Columbia, 1975).

change: industrials, and mining and oil stocks.[31] Data for 450 industrials, 110 mining and 40 oil stocks over the period 1948–66 were used. For the total of all three groups, rate of return appeared to *decline* with increasing risk – an indication of external inefficiency. For the industrials alone (and for almost all classes of industrials examined separately) rate of return increased with risk – a sign of external efficiency. But for the mining and oil stocks, rate of return declined with increasing risk, and the market for those stocks was apparently inefficient.

The mining and oil stocks, then, present an interesting case. The author of the study suggested some explanations for the results.[32] Investors in mining and oil stocks may realize that on average these stocks do not offer a fair return for the risk taken but hope for extraordinary profits on a "long shot". That is, these investors may regard mining and oil stocks as equivalent to lottery tickets. A second possibility is that investors are simply much too optimistic – chronically optimistic – about mining and oil stocks. The study quoted evidence that many of these investors do regard mining and oil stock purchases as gambling, and tend to be poorly informed.[33] The mining and oil stock market may or may not be serving the preferences of those who buy these stocks, but in conventional terms the market appeared to be externally inefficient.

A fourth study, of eighty-seven stocks listed on the Toronto Stock Exchange, covered the 1959–71 period and reached a conclusion similar to the one reported above for all stocks – rates of return declined as risk increased and the market was apparently externally inefficient.[34] However, there was no separate testing of industrial and mining and oil stocks.

Overall, the Canadian listed market for industrials seems to be very similar to the United States market in terms of external efficiency, and the level of efficiency is high. There is some evidence that institutional trading in Canada introduces more distortion in prices than does institutional trading in the United States, but there is also evidence to the contrary. The market for mines and oils, however, appears to be different and operates at a low level of external efficiency.

31 J. Boeckh, Long-Run Stock Market Performance in Canada: Implications for Allocational Efficiency (1968) (Ph.D. dissertation, University of Pennsylvania).

32 *Id.* at 110-12.

33 *Id.* at 135-36.

34 Findley & Danan, *A Free Lunch on the Toronto Stock Exchange*, 6 J. BUS. ADMIN. 31 (spring 1975).

D. OPERATIONAL EFFICIENCY IN THE SECONDARY MARKET

Few investors will find it attractive to seek out directly purchasers of stocks they wish to sell or sellers of stocks they wish to buy. It will almost certainly be more practical to make use of the services of a broker or dealer. During the later years of fixed commissions on stock exchanges in the United States, the so-called "fourth market" evolved, a market in which institutions deal directly with one another, without the intervention of a broker or dealer. But even the fourth market relied and still does rely (despite unfixed commission rates some 300 to 400 institutions still use the fourth market) on agents, or information intermediaries, who provide a searching service. The best known is Instinet, an automated system linking subscriber institutions.

1. *Brokers and Dealers*

Payment of a commission to a broker secures the services of an agent who will search for the "other side" to a transaction. The commission is one part of the transaction cost. If the market is thin, with few buyers and sellers bringing in orders at any particular time, then even with the services of a broker it may be difficult to obtain a "fair" price. A buyer may pay more, or a seller receive less, than the "equilibrium price" which is the price that the most eager buyer will pay and the most eager seller will accept in a market with plenty of buyers and sellers. The deviation from the equilibrium price is another element of transaction cost.

There is an alternative to reliance on the presence of other public buyers and sellers in the market. One can turn to a dealer, a member of the securities industry who stands ready to buy or sell a stock. In this case the cost (perhaps in addition to a commission) is the dealer's bid-ask "spread".

2. *Auction and Negotiated Markets*

An auction is a kind of sale organized so that the seller receives the highest price any buyer attending the sale is willing to pay. A securities auction market adds a second feature: a buyer obtains the lowest price any seller is willing to accept. And a "continuous auction" market is one in which both characteristics are always present for all listed securities. The alternative to an auction market is a negotiated market, in which buyer and seller agree on a price independently of what other buyers and sellers may be willing to pay or accept.

3. *Exchange and Over-the-Counter Markets*

Both auction and negotiated markets are compatible with securities firms acting as either brokers or dealers. The stock exchanges in Canada and the United States maintain continuous auction markets. These markets have traditionally also been broker, rather than dealer, markets. Customers have brought their buy and sell orders to brokers, either "limit" orders calling for execution only at a price set by the customer, or "market" orders calling for the broker to use his best skill and judgment in completing the execution at a favourable price. In either case the broker serves as a commission agent, representing the customer but neither buying from the customer nor selling to him.

In the United States there is a very substantial over-the-counter market in stocks not listed on an exchange. This market is regulated to some extent by the National Association of Securities Dealers, a self-regulatory organization. In recent years the association has developed a quotation system, NASDAQ, for about 2,400 stocks, providing price quotes as do the stock exchange quotation systems.

Canada has virtually no over-the-counter market in stocks and the same has been true of the United Kingdom. But recently, a small over-the-counter market has been developing in the United Kingdom, apparently fostered by investment bankers arranging placements to institutions and then to the public. The financial editor of *The Times* reported in August 1977 that the London Stock Exchange was caught between a wish to make it easier for members to deal in unlisted companies and a concern for retaining the regulatory powers that go with a full listing. The editor's suggestion was the development of a new market with a modified form of listing agreement.[35]

The stock exchanges, particularly the Toronto Stock Exchange and the New York Stock Exchange, have for many years extolled the virtues of the broker-auction market. The auction market has clear advantages. But the attractions of a broker market are not as clear.

For the investor who is willing to trade only at a specific price, who is seeking to buy or sell a small number of shares and is in no hurry to complete a transaction, the pure broker market probably works well enough. A limit order can be left with a broker until another broker appears with a customer willing to buy or sell at the limit price. For the investor who is in a hurry, however – whether

35 The Times (London), August 2, 1977, at 14, col. 2.

because he needs cash or has cash to invest and will find a delay costly in terms of having to borrow or to hold idle cash, or whether because he expects the stock to rise or fall in value and wishes to act before the change – the broker market may not be satisfactory. There may simply be too long a delay before another customer appears to take the other side and complete the transaction. The larger the trade, the greater the likelihood that this will happen. One way to speed up the process, of course, is to reward the broker, to provide an incentive for him to seek out a customer on the other side. This is just what many institutions in the United States do today – they pay premium commissions to brokers who place large blocks. Another way to achieve a quick transaction is to place a "market" order, expressing a willingness to trade with whoever offers the best price, whatever that price may be. But even a generously paid broker may be unable to find a party to complete a limit order transaction and in a thin market – one with few willing buyers and sellers – a market order may be completed at a quite unsatisfactory price.

In a dealer market the investor buys from or sells to a dealer and the quality of the market depends on the readiness of dealers to quote bids and offers with a narrow spread between them. There are those who argue that an all-dealer market is best. It is interesting that in North America the first stock exchange – the forerunner to the New York Exchange – was organized for the trading of government bonds. But bond trading, except for very small transactions, long ago moved from the exchange to a dealer market. The same is true of foreign exchange trading in Europe. At least one commentator has predicted that an international market in equities will be a dealer market.[36] And many U.S. brokers are expressing a conviction that the future of the Wall Street brokers' institutional business lies in a dealer market.[37]

4. *The Third Market in the United States*

In the United States an exchange market and an over-the-counter market exist side by side for a substantial number of stocks. The so-called "third market" is an over-the-counter market in New York listed stocks. The market is an informal one with no particular structure, made up of firms that are not members of the New York exchange. Some are well capitalized – better capitalized than New York Stock Exchange specialists. In recent years

36 Yassukovich, *L'organisation et le développement du marché hors bourse des euro-obligations*, in L'AVENIR DES MARCHÉS DE VALEURS MOBILIÈRES, JOURNÉES D'ÉTUDES 1976 (Institut universitaire international, Luxembourg 1976).

37 *See e.g.* Securities Week (New York), January 31, 1977, at 2a.

the third market has succeeded in attracting about 7% of all trading in listed stocks and this share has persisted following the unfixing of exchange commission rates.

The New York exchange has done its best to arrange the demise of the third market. In 1974 the Securities Subcommittee of the Senate Committee on Banking, Housing, and Urban Affairs reported Bill S. 2579, abolishing fixed commission rates on the exchanges. The New York exchange, in the course of the hearings on this legislation, proposed a requirement that trading in listed stocks be permitted only on the exchanges – in other words, that the third market be legislated out of existence. This proposal found its way into Bill S. 3126 which would have authorized the SEC to impose such a requirement, and in the course of hearings on the bill in 1974, the role of the third market was discussed in detail.

The New York Stock Exchange position was that elimination of fixed commission rates would remove the primary incentive for firms to belong to the exchange. These firms would leave, taking their business to the third market and the central auction market would wither away to the great loss of the investing public. The answer put forward to this argument was that if the exchange is truly an efficient marketplace then it could survive competition with other markets.

T. Lawrence Jones, president of the American Insurance Association, testified before the Senate Securities Subcommittee on the function of the third market and its importance to members of the association. He said:

> "The continued ability of third market dealers to handle institutional orders with the same degree of efficiency and flexibility which they now possess is important to the members of our Association.
>
> "Third market firms are one of the few sources of competition with the specialist system on the New York Stock Exchange (NYSE) for making markets in common stock. Together with member firms which position blocks of stock, third market dealers enable institutions to trade in a manner least likely to disrupt the marketplace.
>
> "As financial institutions have grown, and as individuals have increasingly chosen to invest through professional managers, the specialist system for making orderly markets in common stock has not changed. Large dealer firms have developed the practice of negotiating trades off the exchange floor to meet this need. If the dealer regularly quotes a two-sided market in a security, he is called a market maker. Dealers which are members of the New York Stock Exchange, and which negotiate trades

'upstairs', or off the exchange floor, are required by exchange procedures to take a completed trade to the floor in order to 'cross' it for execution with the specialist which holds a monopoly to make markets for particular stocks on the floor.

"If the dealer not only negotiates the transaction off the floor, but also executes it without participation of an exchange specialist, he is said to operate on a 'third market' for listed stocks.

"Although the member dealer and the third market dealer operate in the same way, and compete for some of the same business, when the member dealer executes on the exchange floor, procedures require the exchange community to collect two commissions from customers on the transaction – one from the buyer and one from the seller. If the dealer finds both sides of the transaction it gets two commissions. If not, another firm receives the second commission. In addition to those commissions, the specialist may earn three separate fees when participating in the transaction. If the specialist supplies part of the passive side of a transaction in his capability as a dealer, he receives a dealer's commission to the extent of his participation.

"The specialist may also receive two types of floor brokerage apart from the dealer's fee. The first is paid if any limit orders on his book participate in the block transaction. The SEC's *Institutional Investor Study* found that limit orders usually receive the benefit of any block discount or premium. In some situations, the *Study* said they do not. The *Study* also observed that stop orders received disadvantageous executions at times. The second type of floor brokerage is paid to the specialist in a block transaction by a dealer even though the dealer is represented at the post on the floor. In some cases, the *Study* reported such 'writeouts' were earned by the specialist in return for his role as a 'finder' in the block transaction. In specific instances, however, the *Study* concluded these 'writeouts' raise regulatory questions, 'particularly with respect to the independence of at least some specialists' administration of the retail market'.

"I have outlined the commissions and floor brokerage required by exchange rules at some length because the fact they apply to member dealers and not to third market dealers is the basic distinction, and, perhaps the only qualitative distinction between these two types of firms,

both of which are so important to institutional investors. When we hear some spokesmen in the securities industry call for restrictions upon third market dealers, what we suspect they are really saying is that all dealers should be subject to the Exchange's requirements on fixed dealer commissions and floor brokerage fees.

"The suggestion that all trading in listed stocks should be required to take place on an exchange is usually based on the fear that including third market dealers in a composite quotation system will eliminate the auction market on at least one side of each trade. There is serious question, however, of the extent to which trades are presently 'auctioned' on the exchanges themselves. This subcommittee's study found the percentage of trading on the New York Stock Exchange where a firm acted as dealer on one side of the trade increased from 28.8% in 1945 to 45.1% in 1971. Inclusion of third market dealers with member firm dealers would not significantly affect this degree of dealer participation at present. Trading in the third market now equals approximately 7% of the total NYSE volume."[38]

On the matter of choice of markets, he said:

"The decision whether to take an order to a member firm dealer or to a third market dealer is necessarily a subjective one. Each trade has certain variables, and the dealer likely to offer best execution in a particular situation will receive the order.

"Third market firms during the past four years have annually received approximately 10% of the total common stock transactions from our members. Approximately the same amount has been executed through affiliated brokers on regional exchanges. Our members use on the average ten different third market firms.

"The traders in our companies say third market firms are quite competitive with member firms in executing institutional orders which do not require a dealer to take a very large position in the stock. Larger transactions may require the capital which a few member firms are capable of committing.

"During 1973 there has been a noticeable decline in trading by our companies in all markets due to the general

38 *SEC Authority over Third Market Trading: Hearings before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs,* 93d Cong., 2d Sess. 59 (1974).

economic conditions. Third market firms appear to have felt this as much, if not more, than member firms. One of our companies, for example, reports its percentage of trades in the third market has declined from 9.2% in 1970 to 4.7% in 1973. Trading through affiliated broker dealers appears to have decreased along the same lines."[39]

The subcommittee came to the conclusion that competition among markets and brokerage firms is beneficial and that a central market system should preserve the benefits of that competition. The Treasury was even more specific in urging strengthened competition among market-makers.[40]

5. *New York Stock Exchange Specialists*

In the third market, or any over-the-counter market, "market-making" consists of standing ready to buy from the public or sell to the public in reasonable quantity and at a reasonable spread between bid and offer prices. The New York Stock Exchange, despite its commitment to a broker market, found over 100 years ago that customers in an exclusively broker market could not always count on completing a transaction quickly at a satisfactory price. The answer was a market-maker on the floor of the exchange: the specialist. The specialist brings together buyers and sellers and receives a commission for this. But more important, he also acts as a dealer, buying for his own account from customers who wish to sell and selling to customers who wish to buy always at a price close to the "going" price. He is supposed to provide an assurance, then, that no customer will suffer the disadvantages of a "thin" market. For this activity the specialist is compensated by what he can make in the difference between the prices at which he buys and those at which he sells. The "spread" he quotes between his buying price and his selling price has a lot to do with the profitability of his dealing.

The specialist is something of an anomaly on the New York Stock Exchange, an exception to a broker auction market. He is a necessary exception, and one the exchange points to with pride. Yet the specialist's role has been subject to some highly critical reviews.

The SEC *Special Study* said of the specialist system in 1963 that "it appears to be an essential mechanism for maintaining continuous auction markets and, in broad terms, appears to be

39 *Id.* at 60-61.
40 *Id.* at 36.

serving its purposes satisfactorily".[41] But this conclusion was accompanied by a number of recommendations for changes in policies and procedures. Conflicts of interest were seen as a serious problem; there was evidence of excessive trading by specialists; some firms contributed more to the quality of the market than did others, and the quality varied from stock to stock, with most specialist activity taking place in stocks already enjoying a high volume rather than in those that were thinly traded. The New York Stock Exchange methods for evaluating quality of specialist trading were criticized; ability and willingness to position blocks varied among specialists and there seemed to be a need for greater specialist capital. Perhaps the most significant conclusion was that the capacity of specialists to provide price stability was quite limited at best, but that specialists should be able to provide depth, probably more than they were providing.

Some eight years later, the *Institutional Investor Report* once again found substantial differences in quality among specialists, and complained that the New York Stock Exchange did not provide the appropriate incentives.[42]

The specialist has a privileged position. He has until recently been given a monopoly to deal in a particular stock or group of stocks on the floor of the exchange. He alone has knowledge of the "book", the list of buy and sell "limit" orders that have been left with him. He carries a responsibility: to service market orders promptly at a "fair" price and so prevent an imbalance of buy and sell orders from distorting the price. And he suffers from one disadvantage: he is not permitted to solicit others, to look for buyers when he is confronted with many sell orders and must buy for his own account, and to look for sellers when he is confronted with buyers.

There are arguments that the monopoly is unnecessary, that competing specialists would serve the market better, that the "book" should be open for all to see, and that the specialist should be free to solicit others. These arguments are discussed elsewhere in connection with proposals for a new national market system, but what is more important in the present context is whether the specialist concept is appropriate – a dealer in the midst of a broker market. In the United States there seems to be little question. The specialist dealer function is needed.[43] Indeed, the specialist alone

41 SECURITIES AND EXCHANGE COMMISSION, 2 REPORT OF SPECIAL STUDY OF SECURITIES MARKETS 167 (1963).

42 4 INSTITUTIONAL INVESTOR REPORT at 1958–59.

43 In testimony before the SEC in August 1977 the chairman of the New York Stock Exchange said that public-to-public transactions – handled by brokers representing public customers, without the intervention of a dealer – accounted for 57% of 1976 reported volume on the New York Stock Exchange; *see* NYSE, Statement of

has proved inadequate to meet the needs of institutional traders with large blocks to buy and sell. For the most part, specialists are not well enough capitalized to deal in institution-size blocks. Probably more important, they do not deal directly with an institutional clientele, so they cannot arrange large placements. As a result the exchanges in the United States have had to go a further step, to permit members other than specialists to deal as principals in large blocks. Moves away from the traditional broker market, however, have met strenuous resistance from member firms.

6. *Competition, and Superiority of Agent or Dealer*

In a 1976 article,[44] Hamilton reported that empirical testing of spreads in New York listed stocks and over-the-counter stocks indicated that specialists do not enjoy economies of scale, and thus contradicted a principal argument in favour of reserving monopolies for specialists. He also concluded that wholesale spreads on listed stocks would have been greater if the stocks had been traded over-the-counter[45] and hence that the exchange need not fear competition from a dealer market.

In 1976 competition between specialists returned but the reasons for it have been the subject of a bitter dispute. In June 1976 the specialist firm Kingsley Boye & Southwood began wide promotion of a discount public brokerage business. In October a rival specialist firm, Robb Peck McCooey & Company, was established, some say in retaliation against Kingsley Boye. The rival firm succeeded in drawing away a large portion of Kingsley Boye's traditional limit-order business. The SEC has expressed its approval of this single example of specialist competition, but with some reservations because of the possibly anti-competitive purpose underlying the rivalry.[46]

In December 1976, Richard Zecher and Susan Phillips, of the SEC Directorate of Economic and Policy Research, proposed to the

the New York Stock Exchange, Inc., before the SEC Hearings on Off-Board Trading Rules 4 (August 2, 1977).

44 Hamilton, *Competition, Scale Economies and Transaction Cost in the Stock Market*, 11 J. Fin. & Quantitative Analysis 779 (December 1976).

45 *Id.* at 795. A Morgan Stanley & Co. study in mid-1977 confirmed these results.

46 SEC, Securities Exchange Act of 1934 Release No. 13662, June 23, 1977, CCH Fed. Sec. L. Rep. (extra edition No. 700). At one time specialists did compete. In 1933 there were 203 specialist units on the New York Stock Exchange and 466 stocks had competing specialists. Over the years the number of units had declined to 109 by 1967, and no stock issue had competing specialist units at that time, although specialists do compete on other exchanges; Securities Industry Study, Report of the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 93 Cong., 1st Sess. 126-27 (1973).

commission a study of auction and dealer markets as a preliminary to the development of a National Market System. The proposal pointed out that much of the debate concerning the development of this system had been based on the assumption that auction and dealer markets were inconsistent and that agency-auction markets are superior to dealer markets.[47] The SEC itself, in its statements, had generally repeated this assumption.

The proposal suggested that it would be appropriate to reconsider the superiority of agency-auction markets over dealer markets. Rather extensive reasons were given, reviewing the effects of competitive commission rates, the mechanization of the over-the-counter market, the growing institutionalization of the market, increased market-making competition, and improved electronic communication.

Figure 1 shows a spectrum from pure agency-auction market to pure dealer market. The coexistence of marketplaces ranging from pure agency-auction to pure dealer suggests that it is incorrect to assume that either kind of market is inherently superior to the other.

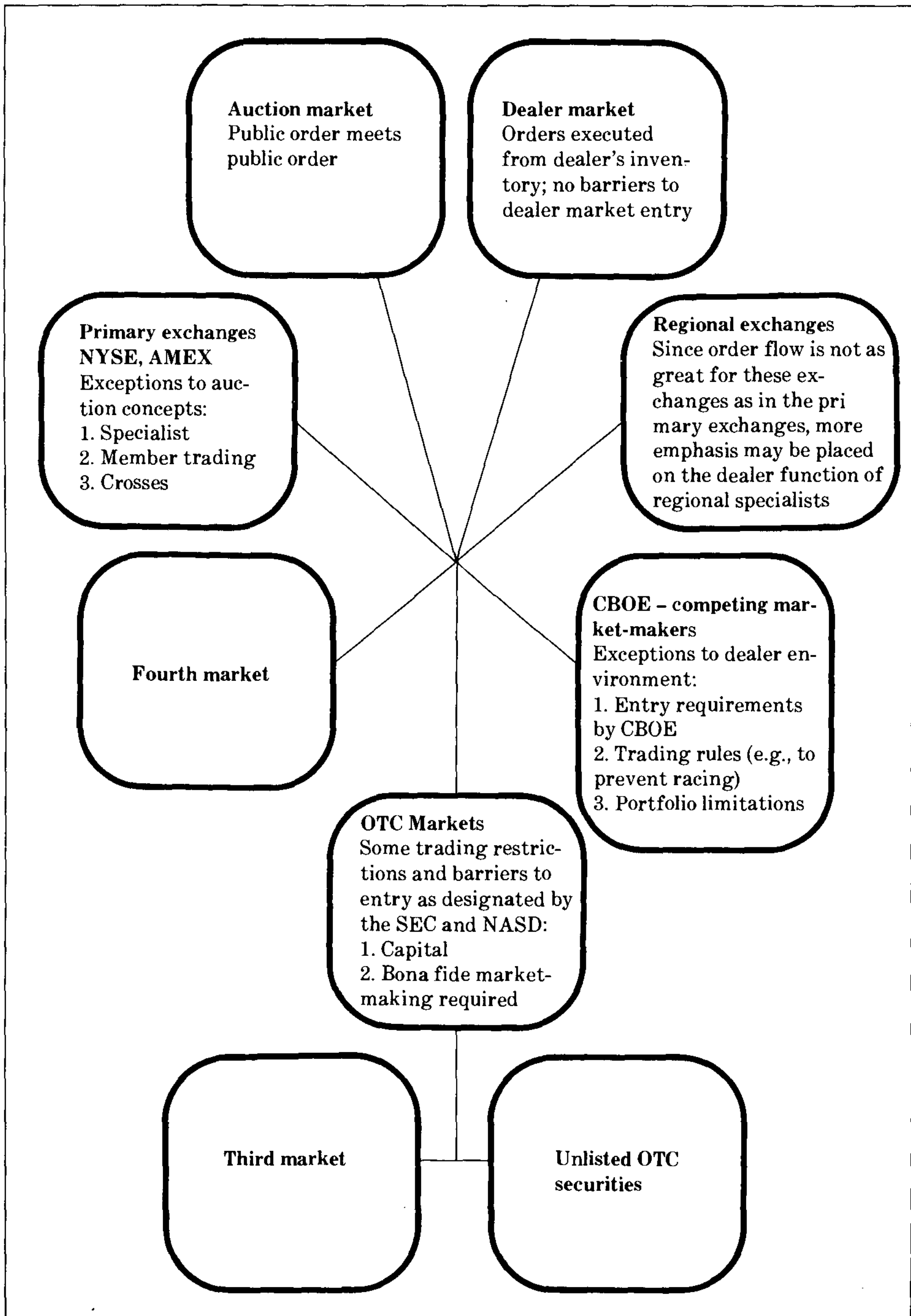
7. *The Toronto Stock Exchange and Liability Trading*

The Toronto Stock Exchange, like the New York exchange, has always defended the value of a broker market. Toronto has been much more resistant than New York to principal transactions by member firms, which are known variously as "principal transactions", "block trading", or "liability trading". In the course of the Ontario Securities Commission deliberations in 1976 on the matter of fixed commission rates in Ontario, a number of submissions expressed apprehension about preserving liquidity and meeting the demands of institutional traders. But none of the submissions to the commission showed any willingness to see liability trading provide the needed liquidity.[48] Virtually all indicated a profound distrust, and some saw liability trading as a probable but unfortunate consequence of abandoning fixed commission rates. The broker market was seen as clearly superior to a dealer market and at least one submission commented that the TSE registered trader system works better than the NYSE spe-

47 R. Zecher & S. Phillips, Information Memorandum to the [Securities and Exchange] Commission: Re Studies Related to the National Market System (December 15, 1976).

48 The same attitude on the part of the securities firms was reported in D. Shaw & R. Archibald, 7 The Management of Change in the Canadian Securities Industry 31-32 (1972) (The Securities Firm in the Canadian Capital Market). Part of the

Figure 1
Auction and Dealer Markets



Source: *See* note 47 *supra*.

cialist system. No reference was made to the work of West and Tinic,[49] who had found the agent-dominated TSE market to compare unfavourably with the specialist-dealer-dominated NYSE market.

West and Tinic distinguished three marketplaces in terms of broker and dealer functions. The dealer-specialist on the New York exchange, as described above, carries an *obligation* to participate as dealer in order to achieve depth and price continuity. In the over-the-counter market, which is negligible in Canada so far as stocks are concerned but substantial in the United States, there are as yet no obligations imposed on participants. Any broker-dealer can deal and make markets in OTC stocks without being held to standards of depth or price continuity (except that quotes must be real ones, backed up by a willingness to buy or sell).

On the Toronto Stock Exchange there are "registered traders" who have a role similar in some respects to that of the New York specialist, at least in principle. The registered trader position was created by the TSE in 1962 and was modified significantly in 1966. Prior to that time members were free to trade for their own accounts on the floor of the exchange, whether for "investment" purposes or simply to take advantage of short-term price swings, perhaps resulting from short-term imbalances between supply and demand. At the same time, members had no obligation to take positions.

To anyone familiar with the specialist system on the New York Stock Exchange, the principal disadvantage of the TSE system before 1966 might have appeared to be the absence of obligatory market-making. However, to some observers of the TSE, an even more significant shortcoming was the opportunity for floor traders to take advantage of public orders handled by other members. The TSE market was then, and still is, thin enough that a substantial order to buy or sell can have a price impact large enough to provide an incentive for a floor trader to make use of knowledge or suspicion of an impending order to buy or sell in anticipation of the order and then to fill the order himself.

In 1966 the TSE decided to formalize "professional" floor trading. Members were invited to apply for the status of "registered traders" for their floor representatives. In order to provide them with a privileged position, the previous freedom of all floor brokers to trade for their own accounts was reduced through

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reason for a distaste for liability trading may stem from a lack of necessary capital and a reluctance to furnish or obtain it; *id.* at 58, 61.

49 Tinic & West, *Marketability of Common Stocks in Canada and the USA: A Comparison of Agent Versus Dealer Dominated Markets*, 29 J. FIN. 729 (June 1974).

procedural formalities including time-stamping of orders that makes short-term trading highly inconvenient. Floor brokers were also prohibited from financial participation in a floor-managed account, while registered traders were left free of these formalities. And in return for the privileges, the registered traders were obligated to engage in a certain amount of market-making and to refrain from "destabilizing" transactions.

In 1973 the rules were modified and, at the end of 1978, the position of the registered trader was roughly as follows.[50] A registered trader must apply to the TSE for his position and he is assigned "stocks of responsibility". (There are about one hundred registered traders with from five to eighty stocks each and almost all the listed stocks have been assigned.) His privileges and obligations relate to those stocks. He is privileged through an exemption from a rule requiring that every order executed on the floor must be time-stamped in a member office before execution. He is also partially exempt from the short-sale up tick rule, to the extent necessary to meet his responsibilities. The registered trader carries a responsibility to maintain a market quotation (for at least one board lot) no wider than a specified spread (which is subject to negotiation with exchange officials for each stock) and to provide odd-lot bids and offers within stipulated premiums and discounts. He is also required to "trade in a stabilizing manner against the trend" and he has a general responsibility to see that "registered trader and other nonclient trades do not interfere with the reasonable execution" of a customer order, when he is aware of that order. This last condition responds to the charge of taking advantage of public orders, referred to above, in the pre-1966 system. The condition is seen by some as a crucial element in the registered trader position.

The stabilizing requirement is spelled out more specifically. The registered trader's transactions in his "stocks of responsibility" are to be "predominantly of a market stabilizing nature". Stabilizing trades are purchases below the last preceding trade at a different price (or sales above the last preceding at a different price). He is prohibited from destabilizing trades on other stocks while establishing or increasing a position. Destabilizing purchases are those at prices above the last preceding trade at a different price.

Clearly the responsibilities focus on price stability rather than on providing market depth. (The conclusions of the SEC *Special Study* in the United States, referred to above, were to the effect

50 *See* TSE by-laws, ss. 8.26-8.30, 11.15, 11.16 and 16.04, 3 CCH CAN. SEC. L. REP. ¶¶ 89-340 to 89-344, 89-405, 89-406 and 89-624.

that at least on the NYSE this same relative emphasis had been wrong.) Like the specialist, the registered trader is intended to serve customers with small orders, not institutions with a need to trade large blocks.

Some 10% to 12% of TSE dollar volume consists of trading by registered traders. A small part of this represents odd-lot business.

Members of the Toronto exchange other than registered traders are discouraged from dealing in listed stocks. The following description is taken from a Toronto Stock Exchange Notice to Members of late 1975.

"BACKGROUND REASONING

"The Canadian market in listed equities has developed primarily as an agency market. Dealer trading plays a less significant role in the Canadian listed market than in other markets. Both in the United States and the U.K. markets, the dealer function is represented on the floor, in the one case by floor specialists and in the other by jobbers. Neither of these roles are formally represented on the floors of Canadian stock exchanges. In addition, in the U.S. considerable dealer trading in the form of "block positioning" has developed both by exchange members and by third market dealers. In Canada, the bond market is basically a dealer market with the majority of trades being done on a positioning basis.

"The use of broker's capital can add liquidity to the marketplace. The use of such capital can assist both with *bridging the time factor* necessary to locate buyers or sellers on the other side and also with *smoothing out the supply and demand factor* to the benefit of clients. Thus, while Canadian exchanges prefer that the marketplace be primarily an agency market they feel dealer trading with customers should be facilitated where it can improve the agency market. The question the exchanges have faced in devising appropriate rules is the extent to which such trading should be permitted and under what terms and conditions.

"The rules regulating dealer trading with customers have varied from time to time. At one time such trades could be made *off* the floor in amounts as low as $25,000. In 1959 the level moved to $50,000 and in 1962 the figure was fixed at $100,000. A major change was made in the rules in 1968 when a rule package was adopted which raised the size of trades permissible for trading off-floor between members and their customers.

"The new package which was adopted by all Exchanges in 1968 included a new volume discount rate and the five-day accumulation period. Under the accumulation principle, an order executed over a period of five days got the benefit of the volume discount as if it had been completed in one day. The prime reason for the adoption of these provisions was to create more liquidity in the Canadian listed market. With these provisions it was decided that the size of trades which could be done on a dealer basis should be increased which would cause more trades to come to the floor to be filled in the auction market. The rules continued to provide, however, that very large trades could be made *off* the floor of the Exchange and therefore could bypass orders existing on the floor of the Exchange, which orders are frequently orders of individual investors.

"Provisions were made for two types of off-floor trades. One was termed an 'internal secondary distribution'. Such distributions were in the minimum amount of $500,000 and done by making distribution of shares internally to the members' own clients at a price related to the prevailing markets. No part of such trades had to involve other members or their clients.

"The second was termed an 'external secondary distribution'. They could be made in amounts of not less than $250,000. In these trades, a portion of the trade, normally 20%, had to be offered to other members for their clients at the same price at which the stock was being offered to the clients of the broker who had taken on the position. These offerings were made by opening a book on the floor of the Exchange one half-hour prior to the opening of trading.

"A third form of dealer trade, commonly referred to as the 'tag end rule' was adopted in 1971. Under it, a member was permitted to deal with his customer on the floor in order to take on the remainder of an order after the agency market had been exhausted. Such on-floor trades were permitted to clear up 'tag ends' of orders with an original value in excess of $400,000.

"This last provision, which had been made extremely restrictive, was adopted after much discussion and consideration. It was agreed that the rule was to be carefully monitored to test its effectiveness. Since its adoption only six on-floor tag end trades have taken place. It appears

that the rule is too complicated and it has not provided the additional liquidity which had been expected of it."[51]

This statement accompanied a new set of rules which retained $400,000 as the minimum order size for a principal transaction but established two forms for these transactions: on-floor and off-floor. An on-floor transaction would have to meet other orders on the floor; an off-floor transaction would normally involve the sale of a block by a member firm to at least twenty-five purchasers and once again orders on the floor would have to be met with stock supplied at the distribution price to all investors with buy orders on the floor at this or a higher price.

In early 1976 the Market Functions Committee of the Toronto Stock Exchange recommended a reduction in the $400,000 minimum. Specifically, the committee recommended that the minimum for each stock be 10% of the number of shares traded in the stock in the preceding calendar year and at least $50,000 in value. In all cases an order of $300,000 would qualify. The exchange did make some changes in the procedures for principal transactions but did not change the $400,000 minimum size.

The Notice to Members said:

"In considering the procedure for principal transactions on the floor it is necessary to bear in mind that the rules have been created to permit the use of dealer capital in the context of an agency-auction market. Those trying to make trades under these rules will find a number of provisions which will make block trading on a principal basis less simple than it would be if such rules to safeguard the agency-auction market were not included. However, as has often been said by the Exchange, for the benefit of all participants in the secondary trading markets, it is necessary to support and maintain an effective agency-auction market. These regulations will be more readily understood if this overriding consideration is kept in mind."[52]

It is quite clear from the paragraph above that there were still strong misgivings about the use of principal transactions and a persistent conviction that a broker-auction market is best.

Another serious concern had to do with the fixed minimum commission structure on the Toronto Stock Exchange, and a fear that member firms might circumvent the minimum rates for

51 TSE, Notice to Members No. 1264 (October 1975). The description quoted accompanied the statement of new rules governing off-floor principal transactions by members.

52 TSE, Notice to Members No. 1385 (October 21, 1976).

institutional trading through block positioning. Hence these comments in the same notice:

"(a) Commission Equivalent Requirements:

"In agreeing to take on a contra position to complete an order, a member must bear in mind that if, when the position is unwound, he has not obtained a trading profit equal to or greater than the commission equivalent requirement he may be criticized by the Exchange for overly aggressive pricing. In Take-On Trades this consideration will be important in deciding on both the actual net price at which the member is willing to deal and on the Recorded Price (see below).

"NOTE: the average spread or profit resulting from take-on and/or unwinding of positions involving principal transactions is to be not less than the amount which would have been earned by the member if the transaction(s) had been accomplished as agent. Note, however, that the average spread or profit can only be measured after the position is unwound – it cannot be measured in relation to the Recorded Price."[52a]

The Market Functions Committee of the Toronto Stock Exchange reported that in 1976 there were sixty-five principal transactions done on the exchange and that the aggregate "required commission equivalent" was $263,000.[53] But the aggregate profit actually obtained on profitable trades was $547,000 and the aggregate losses on the eleven trades where the member failed to obtain the requisite commission equivalent was $162,000. The net profit was then $385,000 or nearly 50% more than what the rules required. The committee said that 83% (fifty-four out of sixty-five) of the trades should be considered successful.

Of the 1.7 million shares involved in these principal transactions, $959,000 (56%) were unwound on the floor to other members, $619,000 (36%) were unwound by crosses on the floor and $128,000 (8%) were unwound on U.S. exchanges, or through other trading outside Canada, through redemptions or conversions. The committee concluded that principal transactions had not led to weakening of the minimum commission structure and believed that the number of shares unwound on the floor indicated that they materially contributed to floor liquidity.

In 1977 the pressure for increased liability trading was renewed. Early in the year the Market Functions Committee recom-

52a *Id.*

53 *Memo* from chairman, TSE Market Functions Committee (March 17, 1977), accompanying TSE, Notice to Members No. 1450 (March 23, 1977).

Table 13
Percentage of Agency Trading by TSE members in Interlisted Canadian Companies Executed on U.S. Markets

May 1975–October 1976

May 1975	November 1975	March 1976	June 1976	September 1976	October 1976
6.94%	10.77%	12.93%	12.87%	15.34%	13.63%

Source: Toronto Stock Exchange, Market Functions Committee.

mended lowering the minimum $400,000 to $100,000.[54] The reason had to do with an alarming shift of trading from Toronto to United States markets.

The committee's findings are summarized in table 13.

Further analysis of the division of trading by TSE members between Toronto and U.S. markets indicated that a substantial percentage of the larger orders were going to the United States. This shift was particularly true for orders in the $100,000 to $200,000 range. The committee suggested four reasons. Clients were in some cases insisting that they benefit from negotiable commission rates in the United States; anonymity is more easily guarded in the United States market; principal transactions are permitted in the United States regardless of order size; and as trading has shifted to the United States market that market has become more liquid and a "better" market than the Canadian market.

The committee urged strongly that unless the $400,000 minimum was lowered an increasing portion of large order business could be expected to move to U.S. markets. This would reflect both an increasing number of Canadian brokers carrying business to those markets and also Canadian institutions short-circuiting Canadian dealers and going directly to American dealers. The committee said that experience with the $400,000 minimum had indicated that principal transactions had been constructive and beneficial to the market. They had not resulted in commission cutting or "dealerization" of the market. The committee also noted that a reduction of the $400,000 minimum to $100,000 would not by itself halt the shift of trading to the United States but it would help.[55]

The change was approved by the TSE board of governors in March, and by the membership (voting fifty-seven to thirty-three) in April 1977. (The Montreal Stock Exchange decided to maintain the $400,000 level.) The Ontario Securities Commission completed the process by granting its approval in June in conjunction with its approval of a new commission rate structure.[56] Objections were made to the commission emphasizing the risk, particularly to firms with small capital, and arguing that increased liability trading would threaten the fixed commission rates and lead ultimately to negotiated rates. But perhaps the major reason for objecting was a fear on the part of small firms of increased competition from the heavily capitalized firms.

In its submission to the Ontario Securities Commission, the

54 *Id.*

55 *Id.*

56 *In re* Securities Act and by-law 153 of the Toronto Stock Exchange, [1977] OSC Bull. 171-75 (July).

TSE discussed, of course, the slippage of business to the United States. The statistics in table 13 were extended to show that the percentage of trading on U.S. markets was 12.47% in November and 16.40% in December 1976 and 13.70% in January 1977.[57] But generally improved liquidity was also held out as a major objective of the change. There was perhaps some basis for complaints that the exchange had seized on the slippage problem as an excuse for dealing with liquidity. Some members argued that slippage was due more to commission rates than to a lack of liability trading and one letter to the commission claimed that there had been no significant slippage in liability trading itself.[58]

The background memorandum furnished by the exchange to the commission provided a detailed history of principal trading in TSE stocks, with the minimum transaction raised in stages from $25,000 in 1958 to $500,000 in 1968. Until 1971, principal trades were all "off-floor" and reporting was delayed. The so-called "tag end rule" introduced in 1971 an on-floor combination of agency and dealer transaction with better disclosure.

The memorandum also drew the important distinction between an "auction" and an "agency" market, pointing out that an auction market need not be an agency or broker market.

The change from $400,000 to $100,000 as the minimum transaction for principal trading was a significant one. In September 1976, according to the exchange's *Revenue and Market Analysis Study*, nearly 60% of member agency business for institutions was in orders above $100,000 and nearly 40% was in orders between $100,000 and $400,000.[59]

8. *Analysis of Spreads - The Price of Marketability*

The West and Tinic study concluded that the "price of marketability services is higher in the TSE than in either the NYSE or OTC (U.S. over-the-counter) market".[60] Demsetz did the original work in this area. In his article in 1968 he used the bid-ask spread

57 TSE, Background Memorandum concerning Principal Transactions 31 (May 23, 1977).

58 Letter from Maison Placements Canada Inc. to the Ontario Securities Commission (June 10, 1977). The letter also made the point that there was substantial business done in the United States in transactions over $500,000, for which commissions were negotiable in Canada as well as in the United States. The exchange memorandum, however, argued that "the percentage of volume actually consummated by the member as principal masks the importance of the *availability* of the service.... What is generally known to institutional accounts is that a dealer going to a U.S. exchange can give the account a clean-up price on orders of any size"; TSE, Background Memorandum, *supra* note 57, at 31.

59 TSE, Background Memorandum, *supra* note 57, at 32.

60 Tinic & West, *supra* note 49, at 729.

as the "cost" to an investor of having his order handled without any delay. The investor is guaranteed that his transaction will be executed instantly at either the bid or ask quoted by the specialist. The lower the cost of immediate execution the better the market from the point of view of the investor. Demsetz found that this cost was proportional to the stock price and inversely proportional to the volume of trading, while it did not seem to matter in how many markets the stock was traded.[61]

West and Tinic used the Demsetz analysis as a starting point,[62] adding to Demsetz's relationship a measure of price volatility and one of trading continuity. For 200 stocks on the TSE over the period December 1–13, 1971, the continuity and the number of markets was not significant but, just as in Demsetz's case, the spread was proportional to price and inversely proportional to volume. It was also proportional to price volatility.[63]

The same regression analysis was performed for the NYSE and over-the-counter market and then a modified form of the

61 Demsetz, *The Cost of Transacting*, 82 Q. J. ECON. 33 (February 1968).

Demsetz ran regressions, explaining the bid-ask spread in dollars per share (S) by the number of recorded transactions in a stock per day on the New York Stock Exchange (T), the price per share (P), and the number of markets on which the stock was listed (M). Demsetz used data for 200 stocks chosen at random from those listed on the New York Stock Exchange. His observations were for two days (January 5 and February 28, 1965) and his data on spread, price and transaction frequency were calculated from the Fitch sheets. The equation that is of most interest is:

$$S = .2102 + .008996P - .003589T - .04712M.$$

Demsetz reported that the coefficient for M was not significant, so he was left with a conclusion that the spread was proportional to the stock price and inversely proportional to its volume of trading.

62 Another interesting analysis, contemporary with Demsetz' work, was performed by Arthur D. Little Inc. (ADL) for the American Stock Exchange, in October 1968. This study used as the measure of market quality the average change in price of a stock on successive trades. This change is essentially a measure of price continuity; the lower the change the greater the continuity and the higher the quality of the market. The extent to which the continuity changes with the size of an order measures the depth of the market and the ADL study examined the effect of going from one to five round lots.

ADL used a sample of transactions for 20 trading days, June 18 to July 23, 1968. A total of about 720,000 transactions involving about 1,000 issues on each day were represented in the data. The regression equation that was deduced is:

The average change in successive trades, expressed as a percent of the security price,

$$= 1.782 - .055P + .000655P^2 - .302 \log T + .00042N,$$

where P is the price of the stock in dollars per share, T is the volume in transactions per issue per day, and N is the number of shares of stock per transaction.

The equation indicates that doubling volume decreases the expected price change by about .07% to .09%. Increasing the size of transaction between 1 and 5 round lots increases the expected price change between trades by .04% per round lot.

63 The regression equation was:

$$\text{Spread} = 2.16 + .039P - .3457 \ln V + .41563 \Delta P$$

where P is price, V is average number of shares traded per day and ΔP is price volatility.

analysis was performed to identify differences among these markets. The TSE compared unfavourably with both the NYSE and the over-the-counter market. TSE spreads were higher than those on the other two markets for the same price level, the same volume, and the same volatility.

The overall conclusion was that:

> "the average bid-ask spread in the TSE is larger than its counterpart in the NYSE, even after adjustments are made for the differential effects of price per share, trading activity and price volatility. Put somewhat differently, this result indicates that the marketability of a TSE security, having the same price as a NYSE listed stock and experiencing a comparable level of trading activity, is inferior irrespective of its price volatility."[64]

The Toronto Stock Exchange has been caught between the inadequacy of a purely broker market to meet the liquidity needs of institutions and the fear of domination of the market by dealers or members who function as both brokers and dealers. But something might be *gained* by exploiting the role of members who act *solely* as dealers. If it is true that the quality of the marketplace is improved by a substantial flow of moderate-sized buy and sell orders, then a major contributor to market quality might be the individual member of a stock exchange who simply trades for his own account. At one time there were many such members of the New York Stock Exchange. But over the years the exchange discouraged this kind of membership. In late 1976, however, the Montreal Stock Exchange proposed to the Quebec Securities Commission a policy modification that would encourage individual members to trade for their own accounts.

One would expect the individual member trading for his own account to provide competition for official market-makers like the specialists on the New York Stock Exchange, and therefore to bring about an improvement in the specialists' performance. If the specialist undertakes to maintain a quarter point spread on a stock, then a member trading for himself may be able to exploit that spread to his own profit, thereby reducing the spread faced by the public customer, and perhaps forcing the specialist to narrow his spread. The member trading for himself is able to do what the public customer cannot effectively do because his commission charges are lower than the charges to the public customer. In a market where there are no specialists charged with a responsibility for maintaining bid and ask quotes, the individual member trading for his own account serves as a sort of unofficial specialist,

64 Tinic & West, *supra* note 49, at 742-43.

taking the "other side" of transactions with public customers. The Toronto Stock Exchange, however, would probably argue that this unofficial specialist is too likely to take advantage of the public.

The MSE proposed a reduction in the capital requirements for individual members trading only for their own accounts. Quebec Securities Commission Policy No. 21 requires $150,000 of capital for a registered broker and his net free capital must be at least $75,000. The commission raised some questions about the objectives of the exchange and the details of the activities of members trading for their own accounts. In early 1977 the exchange modified its proposal somewhat and in June 1977 the commission approved a system of individual market makers.[65]

The commission insisted that the exchange spell out the market-making obligation of these members. It also insisted that should the member have a non-member partner, the partner should be required to disclose the existence of all other accounts in which he directly or indirectly participates. The commission agreed that orders of market-makers would rank equally with orders originating from the public at the same price but would not consent to the market-maker member also acting as a trading representative on behalf of a broker.

9. *Studies of Market Fragmentation*

The issue of market fragmentation has been critical in the debate over commission structure and principal trading in Canada as well as in the proposals for a National Market System and in the arguments over off-board trading in the United States. The exchanges have argued strenuously that the quality of the market in listed stocks depends heavily on concentration of trading in that market.

The issue is an important one and both the SEC and the Ontario Securities Commission have expressed general approval of the idea of centralized markets and some fear of the effects of fragmentation, with trading in a stock taking place in several market centres. We have already seen that Demsetz found that the quality of trading (the spread, as he measured it) did not seem to be affected by fragmentation.[66]

In the spring of 1977 the SEC Directorate of Economic and Policy Research began some research on the extent of fragmentation in trading of NYSE listed stocks. A memorandum dated May 10, 1977, described statistical tests based on trading for the week

65 8 QSC Bull. No. 26 (Decision No. 5257, July 5, 1977).

66 *See* materials in note 61 *supra*.

March 21–25, 1977, in 854 stocks that were traded both on and off the floor of the New York Stock Exchange during the week.[67] The study was mainly concerned with the proportion of order flow directed to the New York Stock Exchange, that is, the extent to which the New York exchange was the central market for these stocks.

For all of the stocks the exchange accounted for 85% of dollar volume, share volume, and number of trades. But while the New York Stock Exchange accounted for at least 50% of the number of trades in every stock, it accounted for as little as 10% of dollar volume and share volume in at least one of the stocks. It appeared that large block transactions were a little more likely to occur on the regional exchanges, on NASDAQ, or on Instinet. The proportion of dollar volume and share volume occurring on the New York exchange was found to vary inversely with total dollar and share volume on all exchanges. In other words, the more heavily a stock is traded, the smaller the proportion of the trading that takes place on the New York exchange. But the effect was rather small. The proportion of the number of trades occurring on the New York exchange was inversely related to the total number of trades in all markets, but here the effect was much stronger. All of this seems to confirm that the principal marketplace attracts business, because it is the "best" market, until total volume reaches a level such that even the satellite markets are "good enough", and as volume continues to increase a smaller share goes to the central market.

A continuation of the study was reported in a memorandum dated June 17, 1977.[68] For this work the list of stocks studied was narrowed to sixty-five very active stocks. In this case trading on the New York exchange accounted for 78% of total dollar volume and share volume and 75% of the number of trades. The lower percentages of New York participation are consistent with the earlier finding that the more active a stock is, the smaller the proportion of trading on the New York exchange. It also appeared that for these actively traded stocks, there was no evidence that blocks were being traded away from New York.

E. EFFICIENCY IN PRIMARY MARKETS

Reference has already been made to the linkage between primary and secondary securities markets and to the theory that predicts efficient allocation of real investment as a consequence of

67 S. Phillips & P. Martin, Off-Board Trading Restrictions: app. A, memo to the [Securities and Exchange] Commission (May 10, 1977).

68 S. Phillips, Off-Board Trading Restrictions: Continuation of app. A, Memo to the Securities and Exchange Commission (June 17, 1977).

efficient securities markets. The theory, and some conclusions as to its validity, were described in 1965 in a classic study by William J. Baumol.[69] Baumol pointed out that the level of stock prices is an indicator of the cost of equity capital which is in turn an indicator of the rate of return a business should achieve on new investments. With respect to efficiency, he said:

> "The role of guardian of efficiency is one which it is natural to expect to be assigned to the stock markets. One would think that the firm which employs funds ineffectively would find itself denied easy access to them by an alert capital market, whereas the efficient user of resources should be able to obtain them cheaply and easily. Thus rewards and punishments would be meted out by the market and management's collective nose kept to the grindstone by anticipated future capital needs."[70]

As a practical matter, however, Baumol reached a discouraging conclusion. He observed that corporations in the United States simply avoided the equity market and many of them went for decades without a single issue of common stock.[71] While it was still possible that the stock market was exercising an indirect discipline on the use of capital by corporations, because managements are still concerned about the price of their corporation's common stock even if they are not issuing new stock, Baumol was sceptical even about this indirect influence. He quoted a British study that found no correlation between corporate growth in earnings and the rate of reinvestment by those corporations,[72] suggesting that there had not been efficient allocation of real investment in Britain, and he remarked that empirical analysis of the United States market was in process.

That analysis was reported in 1970 in the form of regression equations relating rate of return on new investment by U.S. corporations to the source of capital: debt, newly issued equity and reinvested earnings. For the period 1949–63 the rates of return were 4% to 14% on debt, 14% to 21% on new equity, and only 3% to 5% on retained earnings.[73] To the extent that corporations actually raised new equity capital in the market, the discipline of the marketplace appeared to be effective. But the indirect discipline seemed not to work. It may have made its contribution, but if so

69 W. Baumol, The Stock Market and Economic Efficiency (1965).

70 *Id.* at 66-67.

71 *Id.* at 67-69.

72 *Id.* at 76-77. The British study was the celebrated one by Little, *Higgledy Piggledy Growth*, 24 Bull. Oxford Inst. Statistics 24 (November 1962).

73 Baumol, Heim, Malkiel & Quandt, *Earnings Retention, New Capital and the Growth of the Firm*, 52 Rev. Econ. & Statistics 345 (November 1970).

that contribution was swamped by other factors such as tax rules and government regulation.

We are left, then, with reason to believe that corporations do allocate real investment so as to earn on investments financed by new equity a rate of return reasonably consistent with the probable cost of that equity in the marketplace.

1. *The Primary Market for Equity Securities*

With respect to unseasoned equity offerings, the kind that are of chief interest, at least three questions may be distinguished. First, do new firms have adequate access to equity markets and if so, at what cost? Second, do those who invest in unseasoned equities receive fair returns and do they generally have adequate information on which to base their decisions? Third, are there structural features of the investment industry that are undesirable (anticompetitive features, for example) and what would be the effects on that structure of any policy actions directed toward the first two questions?

a. *Issuer Costs*

The cost of raising equity capital has two components. The first is a new issue premium and the second is the direct cost of underwriting or the investment dealer's spread, the difference between the price at which the security is sold to the public and the amount received by the issuer.

Concerning the new issue premium, if an issuer offers stock to the public and its price rises immediately after the offering, the net receipts of the issuer are presumably lower than they would have been if the securities had been priced just right. The difference between the offering price and the immediate after-market price reflects the new issue premium or the amount of underpricing that was thought necessary to sell an unseasoned stock in a short time.

If, other things being equal, the prevailing degree of underpricing appears excessive, the equity-seeking firm may simply believe it has been priced out of the market. It may postpone or completely forego the new issue and as a result it may grow more slowly. One way of testing for this phenomenon is by examining the rate of return performance of new issues. If the primary securities market is efficient so that new issue premiums are not excessive, the returns to investors for a large sample of new issues bought on the day of the offering and held for some short or intermediate holding period should be comparable to the returns on previously outstanding securities of similar risk.

Within the last several years at least three analysts have studied the question of price performance of new issues in the United States during the 1960s and 1970s.[74] Each made great efforts to adjust for volatility and to assure that errors in measurement would not bias the results. Despite each researcher's choice of a distinctive methodology, the results were all very similar: after adjusting for market-wide movements in stock prices and the risk of the securities, *new issues were found to appreciate in price by about 20% between the time they were offered and the end of the month during which they were offered.* In addition, each researcher examined the price performance of new equity issues between the end of the month during which they were offered and some later date, generally seven months to one year. Again, each reached a similar conclusion: after the initial price surge, these securities integrated with the general market and investors were not able to achieve extraordinary returns by buying a few weeks after the offering. The general conclusion from these analyses is that if there is any inefficiency in the market for new equity issues it has to do with the initial price set by the investment banker in consultation with the issuer and not with the market mechanism itself.

A similar study was conducted for Canadian new offerings during the period 1956–63.[75] For seasoned issues (stock of the issuer was already outstanding in the hands of the public) the conclusions tended to contradict those described above for the United States. Underpricing did not occur. These conclusions could reflect differences in the time periods for the issues or (and this is discussed later) they may reflect differences in institutional arrangements between Canada and the United States, particularly those pertaining to underwriter compensation.

For unseasoned, relatively high-risk new issues, the Canadian study suggested overpricing: the new issues underperformed outstanding issues. But as the study points out, this apparent overpricing may simply reflect an investor attitude toward risk that differs as between high-risk, unseasoned issues and other issues. The possibility of a high-return "long shot" may attract investors to the unseasoned stocks.

74 *See* Logue, *Risk-Adjusted Performance of Unseasoned Common Stock Offerings*, 12 Q. Rev. Econ. & Bus. 67 (winter, 1972); R. Ibbotson, Price Performance of Common Stock New Issues (1974) (Ph.D. dissertation, University of Chicago); D. Downes, The Investment Performance of Unseasoned New Issues (1975) (Ph.D. dissertation, Cornell University).

75 Shaw, *Hot New Issues: How Do They Perform?*, 34 Bus. Q. 42 (Summer 1969); Shaw, *The Performance of Primary Common Stock Offerings: A Canadian Comparison*, 26 J. Fin. 1101 (December 1971); D. Shaw, The Market for New Equity Issues in Canada (1968) (Ph.D. dissertation, University of Pennsylvania).

The second component of the cost of new equity offerings is the underwriter spread. While little work has been done on this issue, there are some insights in the literature. Several studies have shown that the magnitude of the spread is inversely related to the degree of underpricing.[76] Moreover, an important but only partially substantiated conjecture suggests that initial underpricing exists largely because there are institutional limitations on the size of the underwriter's spread in the United States.[77]

Selling new equity issues is difficult and expensive. The underwriter can make its job easier by underpricing the issue, so as to attract investors, and charge a low spread. Alternatively the underwriter can try to sell the issue at a price close to the market and charge a high spread for the extra effort involved. Institutional limitations on the size of the underwriting spread may preclude the use of the second strategy, for the costs of the extra effort may exceed the limits set by a regulatory authority. From the point of view of the issuer, any limitations on the spread may simply switch his costs of raising equity from one form, direct underwriter compensation, to another, underpricing.

If the foregoing is correct, then one reason why underpricing of new equities may not be as common in Canada as in the United States is that there are fewer institutional limits on the magnitude of underwriter spreads. And, by induction, this contrast suggests that the preferred form of the capital-raising cost to the issuer may be through direct payment to underwriters rather than indirect payment to investors.[78]

One public policy conclusion that may be derived from this discussion is that no regulatory or statutory limitations should be placed on the magnitude of underwriters' spreads. So long as the market for underwriting services is competitive, the total cost of raising new equity capital will tend to be kept at a minimum by the private decisions of issuers and investors.

There is not much evidence available on underwriting spreads and commissions in Canada. In 1961, I concluded that the underwriting spread itself was lower in the United States but that the

76 Logue, *On the Pricing of Unseasoned Equity Issues: 1965–1969*, 8 J. FIN. & QUANTITATIVE ANALYSIS 91 (January 1973); and Logue & Lindvall, *The Behaviour of Investment Bankers: An Econometric Investigation*, 29 J. FIN. 203 (March 1974).

77 Logue, *Premia on Unseasoned Equity Issues*, 25 J. ECON. & BUS. 133 (spring-summer 1973).

78 A similar conclusion emerges from D. Logue & R. Jarrow, Rule 50 of the Public Utility Holding Company Act of 1935 (unpublished 1976), dealing with the question of whether the rule requiring competitive bidding for security issues of regulated utility holding companies was effective in reducing the cost of raising capital. It was shown not to be.

other expenses of an underwriting of debt were lower in Canada.[79]

A much more recent study by J. Peters concluded that for public debt offerings of $5 million and over, underwriting spreads were lower in the United States but other expenses were higher. For offerings between $1 million and $5 million, underwriting spreads and other expenses were lower in Canada, while for offerings under $1 million, underwriting spreads were lower in the United States but expenses were higher. Total costs of underwriting were lower in the United States for offerings of $5 million and over and higher for smaller offerings. For private placements the Canadian agent's fee was larger than the American fee for all sizes of placement.[80]

Peters drew the conclusion that private placement agency fees in Canada were higher than necessary, presumably because of lack of competition. And he suggested that Canadian spreads on public offerings were too high relative to U.S. spreads.[81] He described the Canadian underwriting business as not very competitive and he referred specifically to the high degree of concentration reported by the Royal Commission on Banking and Finance (the Porter Commission) in 1964. Bond underwriting in Canada is directed much more to individual (as opposed to institutional) investors than is underwriting in the United States, and this may help to account for higher spreads in Canada.

All of these comparisons relate to debt rather than equity offerings, of course, but they suggest a greater reliance on spreads and lesser reliance on underpricing in Canada.

b. *Adequacy of Information*

An interesting question is whether disclosure aspects of the regulation of securities markets and new offerings has had any effect on efficiency. We shall look at other aspects of regulation later in this chapter.[82]

Irwin Friend has been the principal spokesman for the contribution of disclosure regulation to efficiency and in 1976 he published a review of his own findings, as well as a review of the findings of George Stigler, who has consistently argued that the regulation has *not* improved efficiency.[83] Research has been aimed

79 J. Williamson, Effects of Securities Regulation on Canadian Corporate Financing 22-23 (1961) (unpublished D.B.A. dissertation, Harvard Business School).

80 J. Peters, Economics of the Canadian Corporate Bond Market 53-55 (1971).

81 *Id.* at 69.

82 *See* text accompanying note 108 *infra*.

83 Friend, *Economic Foundations of Stock Market Regulation*, 5 J. Contemp. Bus. 1 (summer 1976).

at identifying differences in the behaviour of (1) new issues subject to full disclosure and those exempt from full disclosure (small, regulation A issues), (2) new issues before the coming of the SEC and new issues since, and (3) new issues subject to full disclosure and outstanding issues not so subject. Friend concluded that on the whole the research indicates that regulation has increased efficiency and that the benefits have exceeded the costs of the regulation.

In a study in the mid-1960s, George Stigler[84] found that the average performance of new issues before establishment of the Securities and Exchange Commission and its financial disclosure requirements was about the same as after. The rules on the amount and quality of information that new equity issuers had to divulge had no effect on average performance. However, the *range* of performance of new equities was considerably greater (generally more than double) in the pre-SEC than in the post-SEC period. There were more big winners and big losers before the SEC than after.

One generalization that may be drawn from the Stigler result is that the enforcement of a set of accounting and reporting standards and required dissemination of this information through prospectuses led to better pricing of securities, or at least fewer extreme cases of malpricing. In the absence of required information, investors' decisions to purchase or not purchase new equities depend heavily on the information provided by the underwriter. Similarly, the issuer, having little specific financial knowledge on comparable firms, is largely dependent on the underwriter for guidance. The net result may be that the dispersion of return or price performance is greater than it would be if audited information on issuers and comparable firms were routinely available. With such information both issuer and investor decisions could be made on sounder bases than otherwise.

The thrust of this argument is that there may be considerable benefit to uniform disclosure and registration statement policies for firms offering new equity. Since information is costly and there are probably economies of scale in generating information, to require the production and dissemination of some minimally useful financial reports (prospectuses) will tend to economize on investors' information gathering costs and reduce risks to both investors in and issuers of new equities.

The requirement that a prospectus be accepted for filing before a new issue of securities is offered to the public is an obvious

84 Stigler, *Public Regulation of the Securities Markets*, 37 J. Bus. 117 (April 1964); comment, 37 J. Bus. 414 (October 1964). Friend, *supra* note 83, comments on Stigler's work.

hurdle for new financing. The disclosure required may be difficult, or simply unwelcome to the issuer. Preparation of the filing may be expensive. And the whole process may be time-consuming. Figures 2, 3 and 4 are based on an analysis of all prospectuses accepted for filing in Ontario, Québec and British Columbia for the years 1969–74. For industrial and mining company issues, clearance generally seems to require thirty to sixty days. There is no indication that the clearance process slowed over these years. For mutual funds, although sixty days is the most common time for clearance, a significant number were cleared in only fourteen days. There is some evidence of a lengthening of the average clearance time over the years.

Small businesses may be heavily burdened by modern disclosure requirements, and in the United States the SEC has tried to reach a compromise between a level of disclosure adequate to inform investors and one that does not stifle a small enterprise. In March 1978 the SEC announced that it would hold hearings on the effects of disclosure requirements on small businesses, and reviewed evidence that the current requirements went too far in favour of investor protection and were excessively burdensome on the businesses.[85] At the same time the commission proposed a simplified registration statement for offerings of securities not exceeding $3 million.[86]

c. *Structure of the Investment Dealer Industry*

For a long time there has been widespread suspicion that the investment banking industry in the United States has been a closely-knit club whose established members effectively exclude competitors.[87] In fact, there has been at least one major legal suit brought against investment banking firms by the U.S. Department of Justice.[88] Although the suit was dismissed, opinion persists that investment banking firms are collusive.

If the investment banking industry is cartelized or is characterized by imperfect competition, then appropriate antitrust remedies are available. However, there may be very good economic reasons why a small group of firms has gotten most of the investment banking business, particularly prior to the formation of the SEC, and these reasons give further support to the notion that

85 SEC, Securities Act of 1933 Release No. 5914, March 6, 1978, [1978–1979 Transfer Binder] CCH FED. SEC. L. REP. ¶ 81,530.

86 SEC, Securities Act of 1933 Release No. 5913, March 6, 1978, [1978–1979 Transfer Binder] CCH FED. SEC. L. REP. ¶ 81,532.

87 *See e.g.* West, *Bidding Competition for Municipal Bonds: The William Morris Episode*, 21 FIN. ANALYSTS J. 119 (July-August 1965).

88 United States v. Morgan Stanley & Co., 118 F. Supp. 621 (S.D.N.Y. 1953).

Figure 2
Prospectus Clearance Times: Industrial Issues
Ontario, Québec and British Columbia

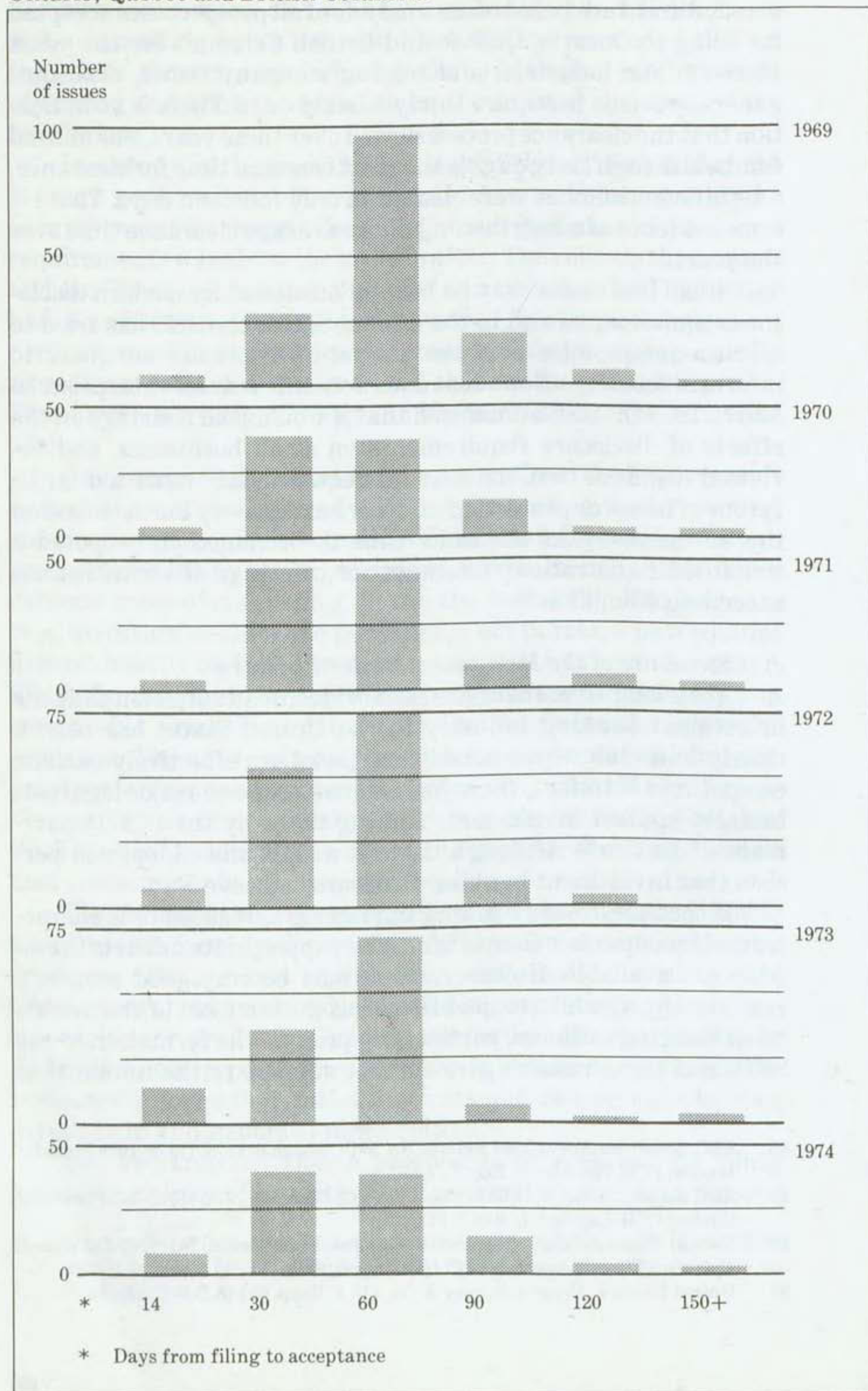


Figure 3
Prospectus Clearance Times: Mining Company Issues
Ontario, Québec and British Columbia

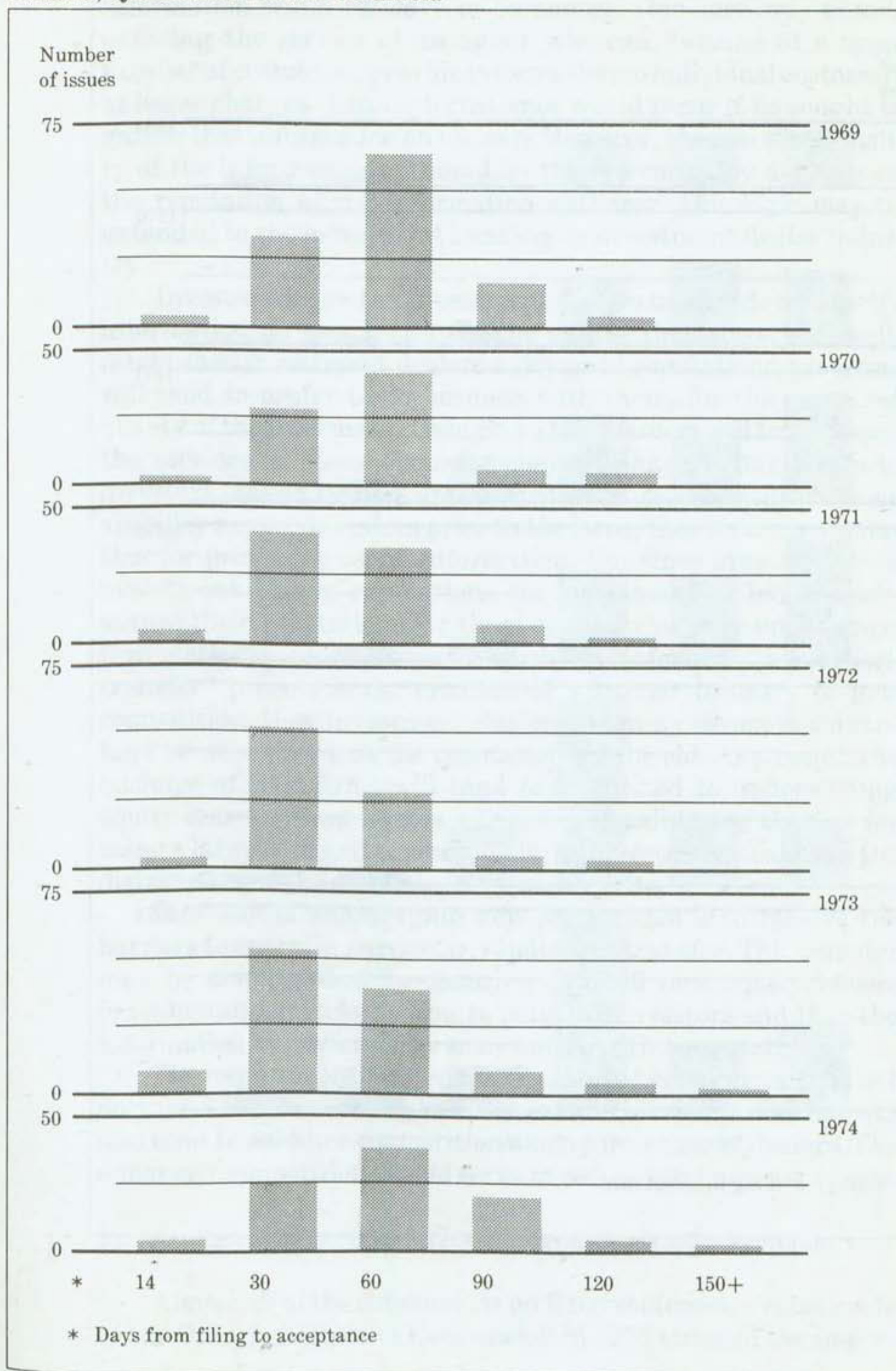
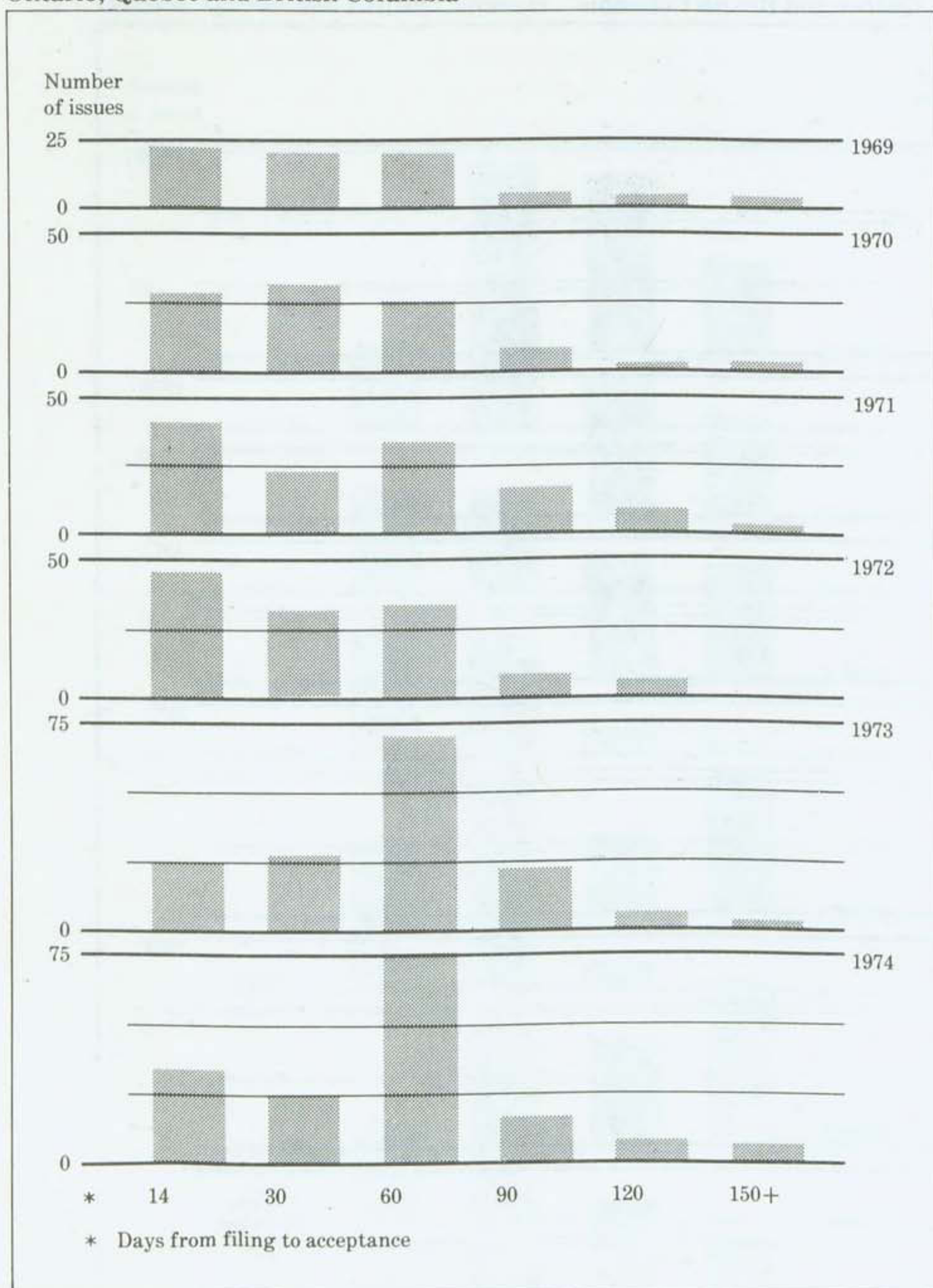


Figure 4
Prospectus Clearance Times: Mutual Funds
Ontario, Québec and British Columbia



enforced disclosure of financial information by equity issuers may be generally beneficial.

When information is costly to obtain, potential users of that information will seek ways to economize. One such way entails enlisting the service of an agent who can, because of a large number of customers, provide information to individual customers at lower charges than each customer would incur if he sought to gather that information on his own. However, the perceived quality of the information gathered by the intermediary depends on the reputation of the information gatherer. This logic may be extended to the investment banking or investment dealer industry.

Investors depend on investment dealers to provide and verify information on new issues. To the extent that large, old, well-established investment dealers enjoy good reputations, investors will tend to prefer to do business with them, for the perceived quality of the information is high. In turn, issuers will tend to seek the services of these firms for they will have better access to investors. Firms issuing unseasoned equities generally have no visibility among investors prior to the issue; they have no reputation for providing useful information. But since investors know investment dealers' reputations, the investment dealers can substitute their reputations for those of the firms they underwrite. One national consequence of such an informal "reputation-transfer" process is the creation of a barrier to entry to new competition. New investment dealers are at a distinct disadvantage because they lack the reputations of the old. As a result, the business of new firms will tend to be limited to underwriting equity issues by new issuers who are too small to pay the fees for using a large firm and to assisting large investment dealers in the distribution of the securities they underwrite.

One way of encouraging new competition is to remove the barriers to entry, in particular, reputation-transfer. This transfer may be accomplished by assuring that all new equity issuers provide uniform information to potential investors and that the information be reviewed by some entity with a reputation.

The requirement for firms to file audited prospectuses will not only tend to reduce the risks of issuers and investors alike but will also tend to enhance competition among investment dealers. The enhanced competition should serve to reduce total new issue costs.

F. BROKER RESEARCH AS A CONTRIBUTOR TO MARKET EFFICIENCY

Almost all of the submissions on fixed commission rates made to the Ontario Securities Commission in 1976 stressed the impor-

tance of an efficient securities market. And most of them expressed the belief that broker research is an important element in producing this efficiency. More specifically, some submissions stressed the need for research from many independent sources (especially firms not engaged in underwriting) to produce a variety of investment evaluations and therefore presumably a wide variety of purchase and sale decisions.[89] Other submissions stressed a particular need for research directed toward retail customers which is generally a byproduct of institutional research.[90] This direction was seen as necessary to maintain the trading of independent investors, said by many of the submissions to be critical to an efficient marketplace. Still other submissions stressed the need for research on small and medium-sized companies on the grounds that these are the companies that have the greatest difficulty undertaking primary financing and therefore the ones for which it is most important to develop a satisfactory secondary market.[91]

On the other hand, a number of institutions (chiefly trust companies and life insurance companies) expressed some reservations about the present flow of broker research. These institutions generally described the research they were getting as useful and of high quality but said there was too much of it.[92] Some said they could do with less repetition and some expressed the hope that quality would replace quantity. Others said that too much research is directed to institutions and retail customers are neglected.[93]

It is interesting that while many of the submissions supporting continued fixed commission rates expressed fear that institutions would drive unfixed commission rates down to the point where research would disappear, not a single institution in its submission gave any indication that *it* might do this. A number of institutions (again, chiefly trust companies and life insurance companies, which are the dominant trading institutions) were quite specific in stating that they were willing to pay for research through commissions.[94] It is true that some submissions raised a

89 *See e.g.* Sun Life Assurance, submission to OSC (June 1976); Great-West Life Assurance, submission to OSC (June 1976); Manufacturers Life Insurance, submission to OSC (June 1976); North American Life Assurance, submission to OSC (May 1976); Loewen Ondaatje McCutcheon, submission to OSC (July 1976).

90 *See* Montreal Stock Exchange, submission to OSC (June 1976); Toronto Stock Exchange, submission to OSC (June 1976).

91 *See* Moss Lawson, submission to OSC (April 1976); Bongard Leslie, submission to OSC (May 1976).

92 *See e.g.* Montreal Trust, submission to OSC (April 1976); Canada Permanent Trust, submission to OSC (June 1976); Great-West Life Assurance, submission to OSC (June 1976).

93 *See* International Trust, submission to OSC (April 1976).

94 *See e.g.* Montreal Trust, submission to OSC (April 1976); Confederation Life Insurance, submission to OSC (June 1976).

question whether the services, including research services, obtained by institutions from brokers benefitted the clients of the institutions or the institutions themselves.

A number of institutions expressed the opinion that there was simply no incentive to destroy sources of research.[95] The mutual funds took an especially strong position in favour of supporting research through commissions, admitting quite candidly that so long as the fees for managing a mutual fund are limited by the provincial securities regulators, it would be painful for the management companies to use their own money rather than fund commissions to pay for research.[96]

The submissions of a few trust and life insurance companies went into some detail on the importance of research in allocating brokerage commissions. Table 14 summarizes some of the statistics.

The trust companies and life insurance companies are in somewhat different positions, of course, on the value of broker research. The trust companies in their stock transactions are acting on behalf of clients and using client money to pay commissions which may in turn purchase research services. The life companies are working to a substantial extent with their own money when they pay commissions. Many, however, manage substantial amounts of client funds and there is therefore some opportunity to purchase research with client money. On balance, one might expect trust companies to be more cautious about reducing commission rates if this might mean a reduction in broker research.

Of twelve life insurance companies making submissions to the OSC, only three supported an immediate unfixing of commission rates, while two others advocated a gradual move to negotiated rates. Of seven trust companies making submissions, two advocated unfixing commission rates immediately, and two recommended gradual unfixing. It is interesting that the largest trust company, Royal Trust, recommended a gradual move to negotiated commissions, while the second largest, Montreal Trust, recommended maintainance of fixed commissions.

Competitive commission rates in the United States do not seem to have brought about a significant decline in broker research, although some duplication is gone. But there has been some change in sources of research. Greenwich Research Associates reported in 1977:

> "Every one of the brokers who gained market share in research in our study this year was an investment bank-

95 *See e.g.* Royal Trust, submission to OSC (March 1976).
96 *See* The Investment Funds Institute of Canada, submission to OSC (1976).

Table 14
Factors in Allocating Brokerage Commissions for Trust and Life Companies

1976

	Royal Trust[a]		Mutual Life	Confederation Life
Research	45%	54%	65%	60%
Economic research	10 }	13	10	
Coverage (salesman)	36 }		15	32
Execution	9	33	10	8

a. The first column excludes broker-originated trades, and the second column includes them.
Source: Submissions to the Ontario Securities Commission, 1976.

er. All of the brokers who lost market position in research were 'institutional' firms.

"For the investment banking firms, the institutional-research-agency business is not so much an end in itself as it is a means of achieving another purpose: distribution. Just as the production companies in the oil industry sought downstream distribution outlets, the major investment banking firms need access in size to the institutional market to protect and strengthen their major bracket status in corporate underwritings."[97]

A number of studies have been undertaken in the United States on the value of broker research. One of the most thorough was that of Logue and Tuttle,[98] which examined recommendations to retail clients of six major United States brokerages from July 1970 through June 1971 and compared the results of following these recommendations to the results of choosing stocks at random. The recommendations consisted of 277 buys, 27 qualified buys, 40 holds, 2 qualified sells and 18 sells. The authors concluded:

"This paper examined the investment performance of brokerage house investment recommendations and compared it with the performance of randomly selected securities. After analyzing the recommendations of a small group of brokerage firms, it concluded that an investor who routinely follows the advice of his brokerage firm would do, on balance, as well by randomly selecting securities.... There are many investors who would have absolutely no idea as to what to buy or sell without advice of some sort or another. To the extent that they would otherwise not invest, except for brokerage firm investment advice, and since it appears that such advice is not generally harmful, brokerage firm investment advice serves a valuable purpose. What is objectionable, however, is that the cost of these services is included in the fixed minimum commission schedule and that investors therefore pay for investment advice, whether they desire it or not."[99]

Some interesting views of retail customers themselves on the value of broker advice in the United States were reported by the New York Stock Exchange in 1974.[100] Interviews were conducted

97 Greenwich Research Associates, Fourth Annual Report on Institutional Brokerage Services at i (1977).

98 Logue & Tuttle, *Brokerage House Investment Advice*, [1973] Fin. Rev. 38.

99 *Id.* at 54.

100 New York Stock Exchange Research Department, Planning for Competitive

with individual investors to explore investor needs and attitudes. The summary of the report said:

> "Individual investors tend to psychologically cluster brokerage services into two types. Investors place primary importance on those services representing direct profit-making tools, such as research and timely investment advice....
>
> "Many investors feel that quality investment advice is available but difficult to obtain since registered representatives currently function as both investment counselors and salesmen. Investors view this dual role as incompatible with their best interests and would prefer a more equitable compensation system. They also complain that there is too much pressure on registered representatives to produce, too little advice when to sell or move to a cash position, outdated and poor quality research, and pretended competence by registered representatives in many areas in which they are actually naive or unknowledgeable.
>
> "Because of widespread disenchantment with investment advice received from brokerage firms in recent years, many investors have downgraded their expectations of the registered representative and try to rely on their own judgment and independent research....
>
> "[T]he view of the representative as a valued partner is far less common than the attitude that he is a force to be resisted rather than embraced in the investment-making process."[101]

On the specific issue of competitive commission rates, the report said:

> "Competitive commission rates are welcomed by most individual investors as a sign of industry recognition of the importance of the individual investor. Additional competition is viewed as an impetus for member firms to develop greater efficiencies which will result in improved services for the individual investor. The key appeal of competitive rates to the investor is the belief that he will be able to select and pay for only those services he really wants....
>
> "The idea of an execution-only concept is viewed favourably by investors. A definite demand for this service

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COMMISSION RATES: INVESTOR ATTITUDES TOWARDS BROKERAGE SERVICES (August 1974).

101 *Id.* at 2, 3.

> exists, particularly if a New York Stock Exchange member firm offers it."[102]

Even before commission rates in the United States became competitive in 1975, the use of commissions to buy research for managers of "other people's money" was suspect as a possible breach of fiduciary duty.[103] But at least the manager could argue that there was no way to reduce commissions paid through reduction or elimination of research received. Since commission rates have become competitive, however, a manager may be able to minimize the commission cost to customer accounts by purchasing only the necessary execution services. Mindful of what this might do to providers of research, Congress added section 28(e) to the Securities Exchange Act of 1934 in the course of the 1975 amendments. Section 28(e) provides explicitly that:

> "no person...in the exercise of investment discretion with respect to an account shall be deemed to have...breached a fiduciary duty under State or Federal law...solely by reason of his having caused the account to pay a member of an exchange, broker, or dealer, an amount of commission for effecting a securities transaction in excess of the amount of commission another member...would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such member...."

This subsection authorized what is known as "paying up" for research. There have been a good many denunciations of section 28(e)[104] and the SEC has proposed a set of disclosure requirements that would seriously restrict its usefulness to managers. Managers would have to disclose how they select brokers, what research and other services were purchased with commissions, and the commission paid.[105] The consequences of section 28(e) may be a "regulatory nightmare"[106] and the practical difficulties in using the section are horrendous.[107] But without it the use of commissions to

102 *Id.* at 5.

103 *See* Pozen, *Money Managers and Securities Research,* 51 N.Y.U.L. Rev. 923, 955-58 (1976).

104 *See id.* "Paying up" is further discussed in ch. V of *Williamson, Financial Institutions.*

105 SEC, Securities Act of 1933 Release No. 5772, Nov. 30, 1976, [1976-1977 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 80,815. The SEC has also had to issue a number of rulings on what services fall within the protection of s. 28(e) and from whom they may be purchased; *see* Pozen, *supra* note 103, at 959-64.

106 Pozen, *supra* note 103, at 964.

107 Stark, *Problems of Institutions under Competitive Rates: "Paying Up" for Research,*

purchase research would raise serious fiduciary problems for many managers. And some of these managers are simply unable to pay cash for research and charge the cash expenditures back to customers, or to raise the fees charged to customers.[108]

G. EFFECTS OF REGULATION ON EFFICIENCY

There has been substantial argument, and not much agreement in the United States in recent years, over the effects of federal regulation of securities markets. Has the coming of the SEC made these markets more efficient or at least more efficient than they would have been without an SEC? We have already considered the effects of disclosure requirements.[109] Here we are concerned with something different.

SEC regulation, at least of new offerings of securities, is essentially aimed at full disclosure. State "merit regulation" is aimed at screening out unsuitable securities and simply preventing their sale or setting conditions having to do with the method of underwriting and sometimes with the issuer's internal financial arrangements which must be met before an offering is allowed.

A book published in 1971[110] was critical of merit regulation, claiming its disadvantages outweighed its benefits. A 1976 article, on the other hand, compared the performance of securities registered in Wisconsin with that of securities denied registration there and concluded that the screening had been beneficial.[111] This article, however, has been criticized as being so badly done as to be useless in another article referring to a study that showed no significant difference between securities registered in North and South Carolina and those denied registration there.[112]

Two studies have examined the narrow issue of trading suspensions – a regulatory device used by both stock exchanges and securities commissions to halt trading in an issue. The New York Stock Exchange frequently (perhaps three times a day) orders temporary suspensions of trading, either because a specialist reports a serious imbalance of buy and sell orders, or because of the disclosure or pending disclosure of news likely to have a significant impact on a stock price.

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in PRACTISING LAW INSTITUTE, SEVENTH ANNUAL INSTITUTE ON SECURITIES REGULATION 355 (R. Mundheim, A. Fleisher, B. Vandegrift eds. 1976).

108 Pozen, *supra* note 103, at 973-77.

109 *See* text accompanying note 82 *supra*.

110 J. MOFSKY, BLUE SKY RESTRICTIONS ON NEW BUSINESS PROMOTIONS (1971).

111 Goodkind, *Blue Sky Law: Is There Merit in the Merit Requirements?* [1976] WIS. L. REV. 79.

112 Mofsky & Tollison, *Demerit in Merit Regulation*, 60 MARQUETTE L. REV. 367 (1977).

An analysis of over 900 temporary trading suspensions on the New York exchange during the bear market from late February to December 1974 and the bull market from December 1974 to June 1975 was reported in 1976.[113] There were generally large price adjustments between the last trade before suspension and the first after trading was restored and little or no adjustment after the restoration of trading. This suggests that the suspensions improved efficiency – that the prices when suspension took place did not adequately reflect information but that when trading was restored they did.

A study of 134 stock suspensions on four stock exchanges in Canada from 1967 through 1973 drew the same conclusions for cases when favourable information was disseminated during the suspension period. But where the news was unfavourable, there was still significant price adjustment after trading was restored.[114] Once again, regulatory interference appeared either to increase efficiency or to protect investors by delaying trading until new information had been absorbed and reflected in prices.

Neither study indicated what suspensions may cost investors in lost marketability, an element that detracts from the benefits.

H. SPECIALIZED SECURITIES MARKETS

The discussion so far in this chapter has concerned conventional markets in stocks and bonds. These are the markets that are best understood and that have been most analyzed. But new markets, sometimes for new instruments, are constantly emerging. The money market has become significant in both the United States and Canada just within the past twenty years. Provincial and municipal securities markets have been with us for many years but recent events in the United States suggest that some changes may be coming. Mortgage loans are a familiar investment vehicle but no one has yet succeeded in developing an entirely satisfactory secondary market for mortgages. (Some U.S. institutions, however, have made a good deal of progress.) Commodity futures are not new but the market in financial instrument futures is new and promising.[115]

These specialized markets are discussed here briefly. Listed

113 Hopewell & Schwartz, *Stock Price Movement Associated with Temporary Trading Suspensions: Bear Market Bull Market*, 11 J. FIN. & QUANTITATIVE ANALYSIS 577 (1976).

114 L. Kryzanowski, *Some Tests of the Efficacy of Security Regulation in Canadian Capital Markets* (1976) (Ph.D. dissertation, University of British Columbia).

115 In Ontario, Bill 8, 31st Leg., 2d Sess., 1978 (An Act to Regulate Trading in Commodi-

stock options are not yet five years old but they are a well established, if not perfectly understood, investment vehicle. They are a minor part of the Canadian securities market but they may also have much to offer. The market in American state and municipal bonds has undergone recent changes that may forecast some change in Canada. Finally, developments in the U.S. mortgage market may suggest opportunities for Canada.

1. *Listed Stock Options*

Put and call options on common stocks have been available as investment vehicles in the United States for many years. Until 1973, however, options were generally regarded as highly speculative and there was no well organized market for them. In that year, the Chicago Board Options Exchange was established, investors were presented with an auction market and visible prices, and dealings in options began to gain in respectability. In 1975 the American Stock Exchange and the Philadelphia Exchange initiated trading in call options. The Pacific Coast Exchange and the Midwest Exchange followed in 1976.

As of mid-1977 call options on about 209 stocks were being traded on the five exchanges. All of the stocks were listed, almost all of them on the New York Stock Exchange. The New York exchange itself was considering options trading but was held back because of questions about the propriety of trading both the stocks and the options on the same exchange.

Trading began in 1977 in put options on the five exchanges and puts were available for about sixteen issues in the fall of 1977.

When trading in listed options began in the United States, Canadian regulatory authorities had difficulty deciding whether to allow Canadian brokers to participate in this market. It was a new kind of market with unknown risks. At the same time, the Canadian securities industry would not benefit if Canadian participation in the United States market was all to be channeled through American brokers.

In late 1974 the Chicago Board Options Exchange (CBOE) applied to the Ontario Securities Commission for an order that would allow trading in Ontario of Chicago Board Options. The CBOE pointed out that technically an option is a security and the writing of an option is a trade in security that would appear to call for the issue of a prospectus. However, over-the-counter option writing had gone on in both the United States and Canada for

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ty Futures Contracts) was introduced in February 1978, and received third reading in June 1978).

many years without any demand that prospectuses be issued. It would, of course, be impractical to issue a prospectus each time an option is written. But the formal exchange market in listed options called for some formal disclosure. The answer that had been developed in the United States was for the Options Clearing Corporation, the entity that technically issued all listed options, to file a prospectus disclosing in detail the operation of the options market but no specific information on the underlying stocks which were already listed stocks. The CBOE proposed the same procedure for Ontario.

The Ontario Securities Commission granted the request,[116] subject to a condition that trading in Chicago Board Options would be restricted in Ontario to members of the Toronto Stock Exchange, which had undertaken to amend its by-laws, regulations and policies to assure protection for the public as well as its own members. In May 1975 the TSE issued to its members a "guideline" for the conduct of a public business in options issued by the Options Clearing Corporation which by that time was handling options on both the CBOE and the American Stock Exchange.

Both the Toronto and Montreal stock exchanges then began to develop option trading programs of their own. The two exchanges discussed the feasibility of a single options clearing corporation following the U.S. pattern. But the negotiations broke down and in September 1975 the Montreal Stock Exchange, through its Montreal Options Clearing Corporation, began trading options. The Toronto Stock Exchange was somewhat slower in developing its own options market and its own clearing corporation – the Canadian Clearing Corporation for Options Limited. It applied to the Ontario Securities Commission in February 1976 for an order permitting trading. The Montreal Stock Exchange and its clearing corporation applied at the same time for an order permitting trading in Ontario. The commission expressed some unhappiness at the inability of the two exchanges to establish a single clearing corporation but given assurances that the exchanges would endeavour to do this in the future, it gave the requested permission to both exchanges.[117]

In May 1977 the Montreal and Toronto stock exchanges finally reached agreement and the Montreal Options Clearing Corporation and the Canadian Clearing Corporation for Options Limited were replaced by Trans-Canada Options, Inc. (TCO), which provides a single clearing facility for all options traded in the Montre-

116 *In re* Chicago Board Options Exchange Clearing Corporation and Section 20 of the Securities Act, [1975] OSC Bull. 22 (January).

117 *In re* Montreal Options Clearing Corporation and the Canadian Clearing Corporation for Options Limited, and s. 20 of the Securities Act, [1976] OSC Bull. 93 (March).

al and Toronto exchanges. TCO is jointly owned by the two exchanges.

In August 1977, the Ontario commission issued a ruling permitting trading in Ontario in put option contracts traded on United States exchanges.[118]

The trading of call options on registered stock exchanges in the United States had become well established by late 1977. Volume was substantial; trading on the Chicago Board alone might amount to 100,000 contracts on a day on which the New York Stock Exchange traded 20 million shares. Each contract represents an option on 100 shares, so the shares underlying the contracts traded might amount to about half the New York Stock Exchange volume. Brokers have found option trading very profitable and the value of a membership on the CBOE has risen rapidly, while memberships on the New York exchange have declined in value.

Trading of options on the Toronto and Montreal stock exchanges was through 1977 much less active, although it rose late in the year. A day's trading might amount to 2,000 contracts (in twenty-six stock issues) compared to a volume of 2 million to 2.5 million shares on the two exchanges.

It is hard to assess the potential for the future. Canadian exchanges offer more opportunities for speculation in listed stocks than do American exchanges, so the speculator demand for options is likely to be less. On the other hand, as Canadian institutions discover the value of options in reducing volatility of stock portfolios, there may be a growing volume. Institutional activity in late 1977 was almost nonexistent.

2. *Provincial and Municipal Securities*

In both Canada and the United States provincial (or state) and municipal securities have traditionally been excluded from the scope of securities regulation. No prospectus has been required for new issues and no registration has been required to act as a broker or dealer in those securities. The exemptions have been based in part on an apparent absence of risk in these securities and in part on an unwillingness for one government to attempt to regulate another.

Canada seems to have escaped the difficulties experienced in the U.S. market for state and municipal securities. Whatever the quality of the securities themselves, there are opportunities for fraud and unethical practices in dealing in this market. There were enough examples of undesirable conduct to persuade Con-

118 [1977] OSC Bull. 198 (August).

gress to provide in the Securities Reform Act of 1975 for the registration of municipal dealers.[119] In addition, the financial difficulties of New York City and potential difficulties of other cities led to the establishment of the Municipal Securities Rulemaking Board to develop rules for the municipal securities market.[120]

A certain amount of enthusiasm for subjecting all municipal offerings to a full prospectus requirement has been shown, but it is also becoming apparent that the market itself demands, without legislative sanction, substantial disclosure from municipalities and states that borrow substantial amounts.[121]

3. *Mortgages*

Mortgage loans constitute one of the most important financing vehicles in North America. The efficiency with which savings can be channeled into mortgage loans is critical to housing and the construction industry. For many years both the United States and Canada relied largely on life insurance companies and savings institutions to provide residential mortgage funds, but in recent years attempts have been made to broaden the pool of savings that might go into these loans. However, mortgage loans differ from other investment instruments in several important respects. First, mortgage lending is a specialized activity that requires considerable skill. Only institutions with a substantial commitment to mortgage lending can afford to set up the necessary machinery. Second, mortgage loans come in substantial denominations. A single loan will represent several thousand dollars. So it is not practical for most individual investors to hold diversified portfolios of mortgage loans. Third, to most investors, particularly institutional investors, a mortgage loan is an odd kind of financial instrument. Investors accustomed to stocks and bonds and the dividend, interest and principal payment schedules associated with stocks and bonds have difficulty coping with the monthly amortization of mortgages. And finally, no satisfactory secondary market has been developed in mortgages to provide the marketability that is critical to many investors and that can be found in stocks and bonds.

One possible answer to the need for an efficient mortgage market is a mutual fund investing in mortgages. This can permit individuals to participate in a diversified portfolio and the fund

119 Securities Exchange Act of 1934, s. 15B.

120 *Id.*

121 Despite this, Senator Harrison Williams announced his intention, in the fall of 1977, to introduce the Municipal Securities Full Disclosure Act of 1977.

may either originate its own loans or work with other originating institutions. The absence of a secondary market presents a mortgage mutual fund with serious problems in the event that large redemptions require substantial liquidation. The lack of a secondary market also makes difficult the valuation of a portfolio and the pricing of fund shares. In Canada a few mutual funds do invest largely in mortgages. The managements of these funds are generally financial institutions with their own mortgage operation and this immediately suggests a potential for serious conflicts of interest when the manager-institution sells mortgages to the fund. The provincial securities commissions had great difficulty with the liquidity and conflict issues for some years. But in June 1977 the commissions finally approved National Policy No. 29 which deals with both matters. Minimum liquid asset holdings are specified, some quality standards are imposed on the mortgages acquired by a fund, and procedures are set out to prevent or at least minimize overreaching on non-arms length acquisitions of mortgages.[122]

In the United States there do not appear to be any significant mortgage mutual funds. But some important innovations have succeeded in channeling large amounts of institutional investment funds into mortgages. The Federal Home Loan Mortgage Corporation (FHLMC), owned by the twelve Federal Home Loan Banks, and the Government National Mortgage Corporation (GNMA), a federal government agency, both issue mortgage participation instruments. FHLMC buys mortgages and finances the purchases through two types of instruments. Guaranteed mortgage certificates represent undivided interests in conventional residential mortgages and are designed to meet the needs of investors who are most comfortable with a bond-like instrument. These certificates return principal once a year in guaranteed minimum amounts regardless of the status of the underlying mortgages and interest is paid semi-annually. A second instrument, the mortgage participation certificate, represents an undivided interest in a pool of conventional mortgages and in this case the purchaser of the certificate receives each month a pro rata share of the principal payments collected on the mortgages in the underlying pool, including prepayments, and interest on the outstanding balance. FHLMC guarantees the timely payment of interest at the certificate rate and the full return of principal regardless of the status of the underlying loans. These certificates are, of course, designed for the investor who is comfortable with the payment terms of a conventional mortgage.

GNMA issues participations in pools of conventional mort-

122 [1977] OSC Bull. 145, 145-52 (July).

gages in the form of so-called "GNMA pass-through" certificates. As in the case of the FHLMC mortgage participation certificates, the pass-through certificate gives the holder a share of the monthly principal and interest payment from a pool of mortgages. The pass-through certificates have been enormously successful. In 1976, $13.8 billion of these participations were sold to the public. A substantial secondary market exists with trading of about $3 billion a month.

To a substantial extent, these three agencies reflect overall policy in the United States to force savers (and taxpayers) to subsidize home mortgages. Government guarantees, at taxpayer expense, hold down the cost of mortgages. And the Federal Reserve Board's Regulation Q, limiting interest rates that deposit-taking institutions may pay, does the same at the depositors' expense. The scheme breaks down when interest rates rise dramatically and depositors simply move their funds. Canada has fortunately followed a different course, benefitting from the efficiency of a relatively free market in interest rates for mortgages. But the unattractive features of the U.S. handling of mortgage financing should not obscure the advances that have been made. Canada still suffers from the traditional limitations in the form of the mortgage repayment and the lack of a secondary market.

I. CONCLUSIONS AND POLICY IMPLICATIONS

What is of concern to the national well-being is allocational efficiency in capital markets, for this efficiency will ensure that savings are directed to their most productive use. Allocational efficiency demands operational efficiency – investors must be able to transfer their investments cheaply and easily. It also demands external efficiency – prices must rapidly adjust to reflect all available information and the market must be "fair".

Allocational efficiency in *primary* capital markets is what really matters, since it is this market that channels capital from savers to those who will use it to acquire real capital assets, assets that produce goods and services. Efficient *secondary* markets are important because they furnish a pricing function and establish costs of capital to users of capital. They are important, too, because they furnish the mechanism by which investors can transfer investments and are therefore encouraged to supply capital in the primary market.

Tests of external efficiency have indicated that the United States stock market is quite efficient and that the same is true of the Canadian stock market, except for mining and oil stocks. It is

not clear that any changes in the mining and oil stock market are called for, however.

Operational efficiency in the U.S. stock market has benefitted from competition – in the form of an over-the-counter market competing with the exchanges in the trading of listed stocks, and in commission rate competition on the exchanges since rates were unfixed in 1975. There is a difference of opinion as to which of dealer markets or agent markets is the better. Either form is compatible with a continuous auction market. The need for *some* dealer activity in listed stocks has been grudgingly admitted by stock exchanges in both Canada and the United States. The specialist on the New York Stock Exchange and the registered trader on the Toronto Stock Exchange deal for their own accounts and are necessary to provide price continuity and depth for the benefit of investors who trade modest quantities of stock.

Neither the specialist nor the registered trader is expected to provide market depth to institutions trading large blocks of stock. Yet institutions have become an important part of the market.[123] Block positioning, or liability trading, in large blocks has become well accepted in the United States as a necessary adjunct to agency trading. In Canada, there has been less willingness to permit this kind of accommodation to institutions and as a result there has been some loss of business to United States markets. Although the Toronto Stock Exchange has been relaxing its limitations on liability trading in recent years the Canadian securities industry still does not offer to institutions the facilities for buying and selling large blocks that can be found in the United States. This is the result of rules imposed by the industry, rules that are subject to regulatory oversight.

Rather little research has been carried out on the operational efficiency of Canadian secondary markets. What has been done suggests a lower level of efficiency than is found in the United States.

As far as the primary capital market is concerned, some U.S. research has cast doubt on allocational efficiency in that country. The difficulties seem to originate in underwriting arrangements, however, rather than in the mechanism of the market. The Canadian primary capital market seems about as efficient as the U.S. market. There is some evidence that the costs of new issues in Canada are more likely to be reflected in direct charges by underwriters while those in the U.S. are more likely to take the form of underpricing.

123 Their importance, relative to that of individuals, is dealt with in some detail in *Williamson, Financial Institutions*, especially ch. V.

Whether government-enforced disclosure requirements actually add to market efficiency has been debated in the United States. The benefits of the availability of information must be balanced against the costs and delays imposed on issuers. Canadian data indicate that at least for mining and industrial offerings to the public delays have not been increasing in recent years.

Information supplied through broker research is considered by many investors, including many Canadian institutions, as an important contributor to efficiency. Some institutions, however, have indicated that there is a good deal of low quality, redundant research being produced. Experience in the United States suggests that the unfixing of commission rates might reduce the duplication and raise the average quality of research. Empirical analysis of broker research, however, has suggested that it is generally not of much value.

The provision of broker research to institutions is bound up with commission arrangements and the United States experience suggests that a shift to competitive rates requires careful consideration of the arrangements that have developed and perhaps some legislation or rule-making to bring about a smooth transition to new arrangements.

Recent years have shown opportunities for the use of imagination and ingenuity in developing new instruments and new market mechanisms to improve capital markets or parts of them. A regulatory commission that has a concern for the economy will want to keep track of these innovations, take advantage of what analysis has been done of their operations and economic effects, undertake or encourage further analysis, and determine whether or how they are to be brought under the regulatory system. In recent years innovation has almost all come from abroad but there is no obvious reason why this should continue.

Chapter III
Rates of Return on Stocks and Bonds

One test of the quality of a capital market or securities market is the performance of that market in terms of rate of return achieved by investors. If the market has been extraordinarily profitable over an extended period of time, then there is probably some lack of efficiency, some failure in the marketplace to channel savings into investment and therefore an inadequate flow of capital to those who could use it productively. And if the market has been extraordinarily unprofitable to investors over a long period, then once again the market is functioning poorly, this time

to channel savings into unproductive uses and to prevent investors from finding productive uses.

A more refined test of market quality goes to differentials in rates of return, particularly the difference between investor experience in stocks and bonds. Bonds should, in the long run, be less profitable than stocks. And the difference should reflect the greater safety of bonds. It may reflect other factors as well, such as tax rules differentiating stock investment from bond investment.

Differences in investor rates of return between stocks and bonds is a measure of the difference in cost, to a business corporation, between equity and debt. And this difference in cost gives some insights into the corporation's choice between equity and debt financing. This choice is a subject that has given rise to considerable concern in North America, with business groups and representatives of the securities industry arguing for government interference to shift that choice in favour of equity financing.

Whether interference is called for or whether the cost differential as it exists is enough to bring about a reasonable balance is something that we can try to establish from a study of rates of return.

A. HISTORICAL COMPARISONS

There have been two major studies in the United States of long-run rates of return in the securities markets. The first, undertaken at the University of Chicago by Lawrence Fisher and James Lorie, examined rates of return on all stocks listed on the New York Stock Exchange from 1926 through 1965.[124] The most notable feature of that study was the compound average rate of return of 9.3% a year that an investor would have experienced holding all the stocks listed on the New York Stock Exchange over the 1926 to 1965 period and reinvesting all his dividends in those stocks. The Fisher and Lorie study was followed up in 1975 by a broader study, also conducted at the University of Chicago, by Roger Ibbotson and Rex Sinquefield. This study examined rates of return on common stocks, treasury bills, long-term United States government bonds and long-term corporate bonds for the period 1926 through 1974.[125] These series have subsequently been extended through 1976.[126]

124 Fisher & Lorie, *Rates of Return on Investments in Common Stock: The Year-By-Year Record, 1926-65*, 41 J. Bus. 291 (July 1968).

125 Ibbotson & Sinquefield, *Stocks, Bond, Bills and Inflation: Year-By-Year Historical Returns (1926-1974)*, 49 J. Bus. 11 (January 1976).

126 Stocks, Bonds, Bills and Inflation: The Past (1926-1976) and the Future (1977-2000) (Financial Analysts Research Foundation Monograph 1977).

The Ibbotson and Sinquefield study has made it possible to compare, for the United States securities markets, long-run rates of return on stocks, bonds and treasury bills. In addition to calculating rates of return on these different securities, Ibbotson and Sinquefield also calculated variability in the rates of return in the form of standard deviations of return. And they used the consumer price index to put all of the returns in "real", or deflated, terms. If we take the standard deviation in returns as a risk measure, which most of the theoretical literature now does, we can examine the Ibbotson and Sinquefield results to see whether the securities marketplace has been efficient – that is, whether the rates of return on the various securities have been proportional to the risk in those securities. Table 15 summarizes the 1926–76 results of the Ibbotson and Sinquefield study. The geometric or compound average rate of return is the best guide to the long-run performance of the instrument in question. But it is the arithmetic mean of the fifty-one rates of return that one might expect to be correlated with the standard deviation in an efficient market. Figure 5 shows a plot of the arithmetic average rate of return against standard deviation. The relationship is not perfect but it is fairly close. The same is true for "real" rates – that is, rates adjusted for inflation.

It is possible to approximate the Ibbotson and Sinquefield study for securities markets in Canada using the series published monthly by the Bank of Canada and Toronto Stock Exchange index data. Table 16 shows the year-end consumer price index and year-end wealth relatives for the Toronto Stock Exchange composite index, long Canadian government bonds, ten provincial bonds, ten municipal bonds, and ten industrial bonds (these three are tabulated by McLeod Young Weir), treasury bills and bankers' acceptances. The wealth relative is based on a value of 100 at the beginning of the first year for which a series is tabulated.[127] The investor who started with a $100 investment and reinvested all his dividends or interest would have at each year end the amounts shown in the columns in table 16. For example, $100 invested at the end of 1933 in the Toronto Stock Exchange index would have grown to $3,501.61 by the end of 1976. From these wealth relatives it is easy to calculate a compound average rate of return for any of the securities over any time period for which data are available.

Table 17 corresponds to table 16, with all the wealth relatives adjusted for inflation. For example, $100 invested at the end of 1933 in the Toronto Stock Exchange index would have grown, with the reinvestment of all dividends, to have the purchasing power at the end of 1976 of $784.25 in 1933 dollars.

127 Details of the calculations are described in the appendix to this paper.

Table 15
Nominal and Real Average Annual Rates of Return for U.S. Securities Markets

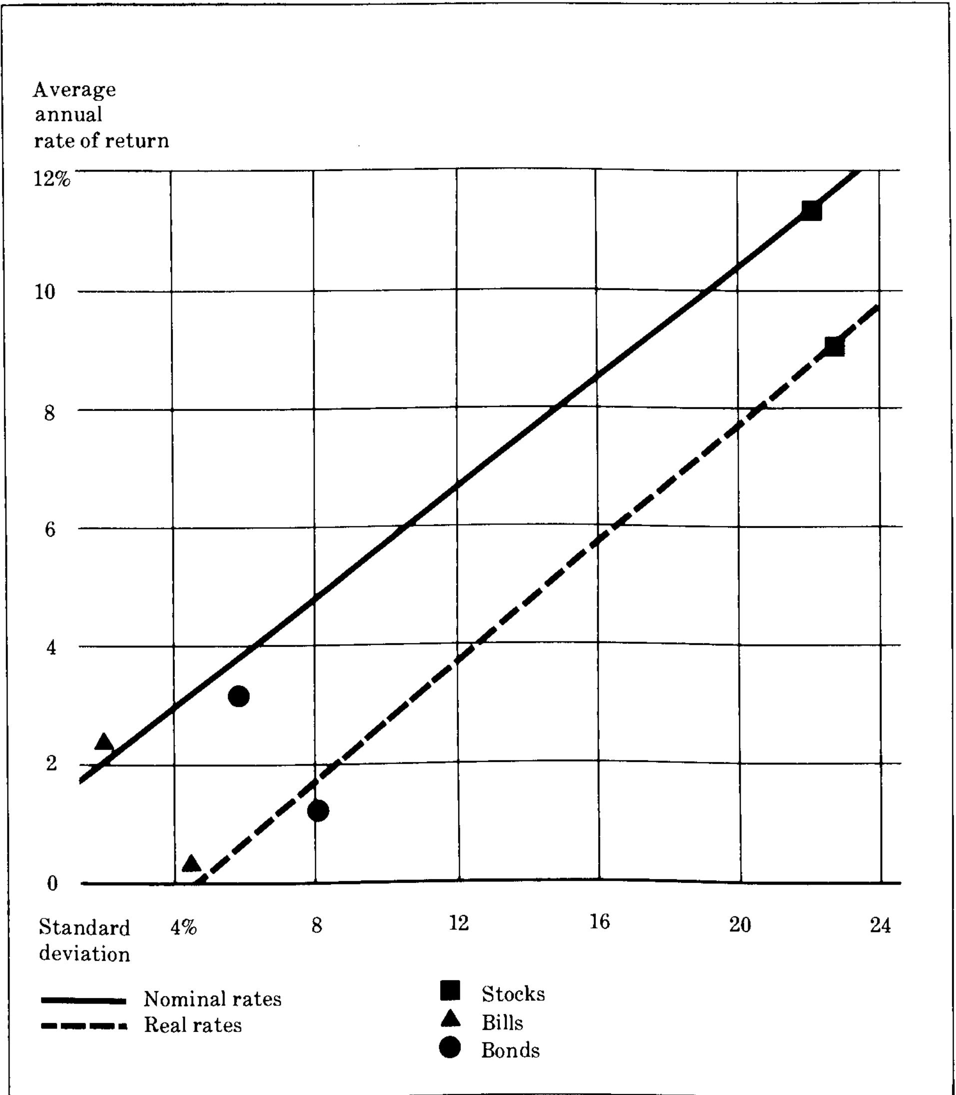
1926–76	Geometric average	Arithmetic average	Standard deviation
Nominal average annual rates			
Inflation	2.34%	2.44%	4.70%
Stocks	9.24	11.63	22.21
Government bonds	3.38	3.53	5.71
Treasury bills	2.37	2.40	2.12
Real average annual rates			
Stocks	6.74	9.19	22.42
Government bonds	1.02	1.33	7.99
Treasury bills	0.04	0.14	4.51

Table 16
Index of Canadian Wealth Relatives

1933–76

	Consumer price index	TSE stocks	Canadian Government bonds	Provincial bonds	Municipal bonds	Industrial bonds	Treasury bills	Bankers' acceptances
1933	34.20	100.00					100.00	
1934	34.60	94.16					101.05	
1935	35.30	118.85	100.00				102.11	
1936	35.80	154.78	103.24				103.06	
1937	37.10	117.51	102.62				103.80	
1938	36.50	126.63	108.44				104.44	
1939	37.50	133.05	104.80				105.15	
1940	39.00	108.52	114.09				105.93	
1941	41.80	102.63	118.46				106.55	
1942	43.00	112.55	122.12				107.13	
1943	43.50	137.44	126.86				107.67	
1944	43.10	159.16	130.87				108.09	
1945	43.70	222.56	137.77				108.48	
1946	46.30	230.25	146.06				108.90	
1947	53.00	226.33	150.70	100.00	100.00	100.00	109.34	
1948	57.70	246.94	147.18	101.77	99.54	101.92	109.79	
1949	58.30	291.47	154.43	107.17	103.65	106.99	110.30	
1950	61.90	419.87	154.04	106.97	107.12	109.75	110.89	
1951	68.50	509.38	149.00	97.99	95.40	102.23	111.71	
1952	67.20	495.44	151.92	102.83	101.70	106.78	112.83	
1953	67.20	494.60	157.59	108.22	107.79	110.95	114.65	
1954	67.60	673.50	173.39	123.16	123.12	122.68	116.45	
1955	67.90	850.62	172.36	119.56	123.07	125.22	118.05	
1956	69.90	976.09	165.75	107.27	108.67	115.12	121.30	
1957	71.50	774.41	176.78	118.56	119.10	123.86	125.92	
1958	73.30	1018.20	165.84	116.50	121.59	127.39	128.80	
1959	74.20	1063.27	157.89	110.26	112.81	121.44	134.70	
1960	75.20	1080.91	168.74	122.31	127.94	136.12	139.47	
1961	75.40	1432.55	185.36	133.83	142.12	148.31	143.48	
1962	76.60	1328.60	190.99	139.93	149.21	155.52	149.13	
1963	77.90	1535.24	199.62	146.10	156.19	163.78	154.52	100.00
1964	79.40	1923.61	213.06	156.41	167.03	171.34	160.36	103.75
1965	81.70	2049.29	214.87	156.42	167.97	169.87	166.61	108.12
1966	84.70	1903.65	218.15	153.86	166.14	166.70	174.92	114.13
1967	88.10	2246.14	212.53	153.59	163.73	165.61	182.84	120.40
1968	91.70	2748.17	210.58	155.58	166.86	169.17	194.38	128.62
1969	95.90	2721.73	204.85	150.44	158.75	166.75	208.09	138.72
1970	97.30	2623.58	251.85	178.79	188.91	189.92	221.94	149.17
1971	102.20	2835.02	281.61	202.59	222.18	217.37	230.38	155.88
1972	107.50	3609.28	285.34	216.02	233.66	237.76	238.48	163.68
1973	117.30	3611.64	290.19	217.81	239.08	243.17	250.60	175.47
1974	131.80	2666.00	286.21	212.15	228.59	228.22	270.24	194.14
1975	144.30	3156.55	293.16	226.75	244.30	246.61	289.88	209.66
1976	152.70	3501.61	350.87	274.57	304.80	301.48	316.41	229.74

Figure 5
Average Annual Rate of Return and Standard Deviation
U.S. Data 1926–76



The Canadian data do not go back to 1926 and indeed to push the Toronto Stock Exchange index back before 1956 it is necessary to splice the present index series to an old series.[128] Table 18 is based on the time period 1937–76 for which it is possible to use the Toronto Stock Exchange index and the Bank of Canada series for Canadian government bonds and treasury bills. For comparison purposes, United States statistics from the Ibbotson and Sinquefield study have been computed for the same 1937–76 period. The average rates of return and the standard deviations have also been computed in "real" terms, deflated by the appropriate consumer price index. The relationships between the arithmetic average rates of return and standard deviations in table 18 have been plotted on figure 6. As in figure 5, figure 6 shows an approximately linear relationship between rate of return and standard deviation. In terms of a risk-return tradeoff, it appears that stocks and treasury bills have done a little better than long government bonds over the forty-year period.

A comparison of tables 15 and 18 shows substantial consistency between fifty-one year and forty-year performances of stocks in the United States, with less consistency in the performances of government bonds and treasury bills. This provides some reassurance that the Canadian data for common stocks for forty years, in table 18, have some value as a guide to probable long-run performance.

B. EQUITY VERSUS DEBT FINANCING

Recent years have seen many appeals, in both Canada and the United States, for greater encouragement to industry to finance with equity as opposed to debt. It has been argued that the proportion of debt in corporate capital structures has been rising and is now dangerously high.[129] If this is the case, then it means that the cost of equity financing is excessive compared to the cost of debt so that corporations are induced to rely excessively on debt. The data we have just examined can be used to see whether this is the case.

One would expect prices of stocks, bonds and other investment opportunities to adjust in the marketplace until all appear to offer about the same risk-return tradeoff to investors. The high-risk investments will offer the expectation of high rates of return

128 The old and new indexes are described in the appendix to this paper.

129 *See e.g.* letter from the president of the Toronto Stock Exchange to the Minister of Finance (September 13, 1976); and accompanying it, TSE, STUDY AS TO THE CONTINUING SIGNIFICANCE OF EQUITIES IN THE CANADIAN CAPITAL MARKETS (1976).

Table I7
Index of Canadian Wealth Relatives Adjusted for Inflation

1933–76

	TSE stocks	Canadian government bonds	Provincial bonds	Municipal bonds	Industrial bonds	Treasury bills	Bankers' acceptances
1933	100.00					100.00	
1934	93.07					99.88	
1935	115.15	100.00				98.93	
1936	147.86	101.80				98.45	
1937	108.32	97.64				95.69	
1938	118.65	104.87				97.86	
1939	121.34	98.65				95.90	
1940	95.16	103.27				92.89	
1941	83.97	100.04				87.18	
1942	89.52	100.25				85.21	
1943	108.06	102.95				84.65	
1944	126.29	107.19				85.77	
1945	174.18	111.29				84.90	
1946	170.08	111.36				80.44	
1947	146.05	100.37	100.00	100.00	100.00	70.56	
1948	146.37	90.04	93.48	91.43	93.62	65.07	
1949	170.98	93.51	97.43	94.23	97.26	64.70	
1950	231.98	87.85	91.59	91.72	93.97	61.27	
1951	254.32	76.78	75.82	73.81	79.10	55.77	
1952	252.14	79.80	81.10	80.21	84.22	57.42	
1953	251.72	82.78	85.35	85.01	87.51	58.35	
1954	340.74	90.54	96.56	96.53	96.18	58.91	
1955	428.44	89.61	93.32	96.06	97.74	59.46	
1956	477.57	83.70	81.33	82.40	87.29	59.35	
1957	370.42	87.28	87.88	88.28	91.81	60.23	
1958	475.07	79.87	84.24	87.92	92.11	60.09	
1959	490.08	75.11	78.76	80.58	86.74	62.09	
1960	491.58	79.21	86.20	90.17	95.94	63.43	
1961	649.78	86.78	94.07	99.90	104.25	65.08	
1962	593.19	88.01	96.82	103.24	107.61	66.58	
1963	674.01	90.46	99.40	106.27	111.43	67.84	100.00
1964	828.56	94.72	104.40	111.49	114.37	69.07	101.79
1965	857.84	92.84	101.47	108.96	110.20	69.74	103.09
1966	768.65	90.92	96.28	103.96	104.31	70.63	104.97
1967	871.94	85.16	92.40	98.50	99.63	70.98	106.46
1968	1024.94	81.06	89.92	96.44	97.78	72.50	109.26
1969	970.63	75.40	83.14	87.73	92.16	74.21	112.68
1970	922.16	91.37	97.39	102.90	103.45	78.01	119.43

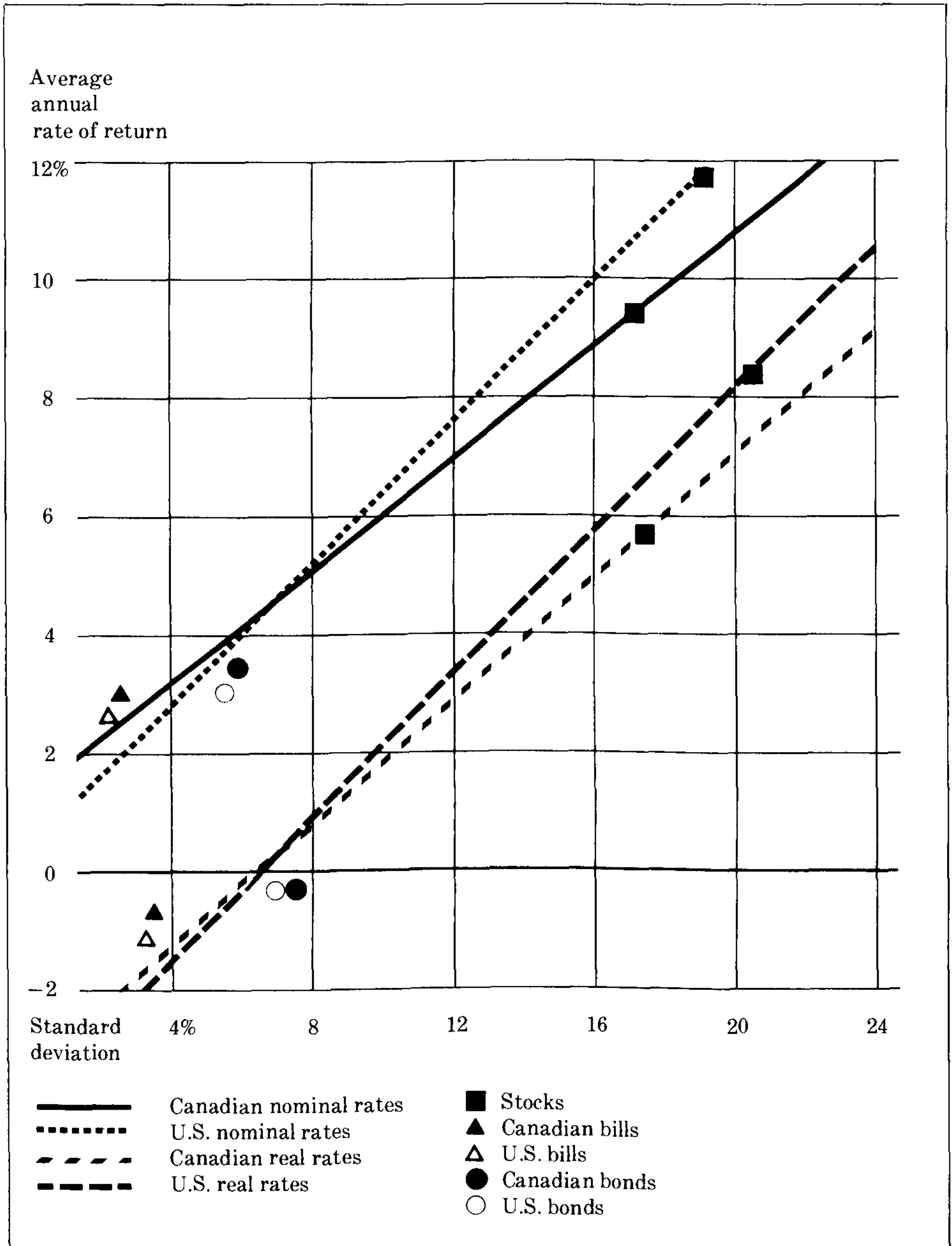
	TSE stocks	Canadian government bonds	Provincial bonds	Municipal bonds	Industrial bonds	Treasury bills	Bankers' acceptances
1971	948.71	97.27	105.06	115.22	112.73	77.09	118.82
1972	1148.25	93.70	106.50	115.20	117.22	75.87	118.61
1973	1053.01	87.33	98.41	108.02	109.87	73.06	116.53
1974	691.78	76.66	85.31	91.92	91.77	70.12	114.75
1975	748.12	71.72	83.28	89.73	90.58	68.70	113.18
1976	784.25	81.11	95.30	105.79	104.64	70.87	117.20

Table 18
Comparison of U.S. and Canadian Securities Markets Performance

1937–76

	Canada			U.S.		
	Geometric average	Arithmetic average	Standard deviation	Geometric average	Arithmetic average	Standard deviation
Nominal rates						
Inflation	3.69%	3.76%	3.68%	3.63%	3.70%	3.96%
Stocks	8.11	9.44	16.77	9.54	11.28	19.07
Government bonds	3.11	3.27	5.92	2.88	3.03	5.61
Treasury bills	2.84	2.87	2.45	2.54	2.56	2.21
Real rates						
Stocks	4.26	5.72	17.16	5.70	7.70	20.06
Government bonds	−0.57	−0.31	7.18	−0.72	−0.48	6.95
Treasury bills	−0.82	−0.75	3.66	−1.05	−0.98	3.61

Figure 6
Relationship between Return and Risk
1937–76



and the low-risk investments the expectation of a low rate of return.

The differential between expected returns on common stocks and expected returns on bonds will be a measure of the difference in risk that investors associate with the two. If the differential is high then investors are expressing great concern about the riskiness of common stocks and equity financing will be very expensive for industry compared to debt financing.

It is impossible to measure directly the rates of return investors *expect* from stocks, bonds and other investments, so we are forced to look at what they have actually obtained from these investments and to reason that over long periods of time, experience will mold expectations and therefore provide a fair representation of their expectations. And in fact, the Ibbotson and Sinquefield numbers described above *have* had a significant impact on the expectations of institutional investors in the United States.

Table 19 shows average rates of return achieved over ten-year periods on stocks, and on government bonds in Canada and the United States. The United States figures are computed from the Ibbotson and Sinquefield data and the Canadian figures from the Canadian data described above and represent average annual rates of return over the decades indicated, including both price appreciation and dividend or interest income.

Figure 7 shows the rate differentials from table 19. Until the stock market decline of 1973–74, the differential in the United States was generally higher than that in Canada – on the order of 1-1/2% to 2% higher. So apparently U. S. investors saw greater relative risk (relative to bonds) in U.S. common stocks than Canadian investors saw in Canadian stocks. And equity financing was therefore relatively cheaper in Canada. The choice facing an industrial corporation, of course, is not between stock and government bonds but between stock and corporate bonds, but the differentials between returns on stocks and on corporate bonds show relationships similar to those between stock and government bond returns. Table 20 is based on data for the McLeod Young Weir index of ten Canadian industrial bonds and the Ibbotson and Sinquefield data for long-term United States corporate bonds. Figure 8 shows the differentials from table 20.

For the decades ending in 1973 through 1975 the relationship reversed, but in 1976 it changed back again and Canadian companies once again appear to benefit from a lower differential between the cost of equity and cost of debt.

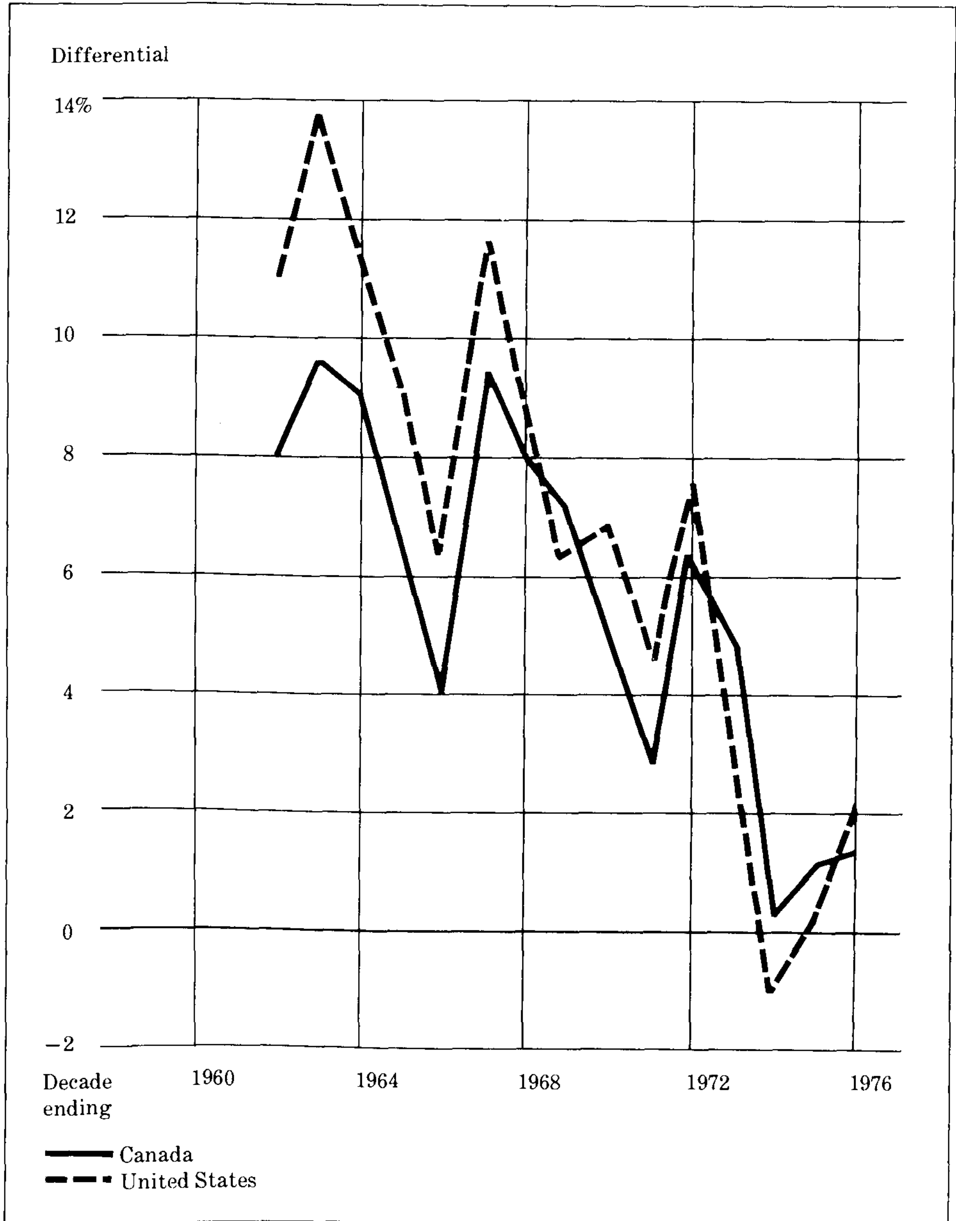
Figure 9 shows the rates of return on stocks and bonds from table 19. Canadian government bonds have fairly consistently produced higher rates of return than United States government

Table 19
Comparison of Average Annual Nominal Rates of Return of Common Stocks and Government Bonds between U.S. and Canada

Decades ending December 31, 1962–76

	Canada			U.S.		
	Common stocks	Government bonds	Differential	Common stocks	Government bonds	Differential
1962	10.37%	2.32%	8.05%	13.44%	2.29%	11.15%
1963	11.99	2.39	9.60	15.91	2.04	13.87
1964	11.07	2.08	8.98	12.82	1.69	11.13
1965	9.19	2.23	6.96	11.06	1.89	9.17
1966	6.91	2.79	4.12	9.20	2.85	6.35
1967	11.24	1.86	9.38	12.85	1.13	11.72
1968	10.44	2.42	8.02	10.00	1.74	8.26
1969	9.86	2.64	7.22	7.81	1.44	6.36
1970	9.27	4.09	5.19	8.18	1.30	6.88
1971	7.06	4.27	2.79	7.06	2.47	4.59
1972	10.51	4.10	6.41	9.93	2.35	7.59
1973	8.93	3.81	5.12	6.00	2.11	3.89
1974	3.32	3.00	0.32	1.24	2.19	−0.96
1975	4.41	3.16	1.26	3.27	3.02	0.25
1976	6.28	4.87	1.42	6.63	4.26	2.37
Average	8.72	3.07	5.66	9.03	2.19	6.84

Figure 7
Comparison between Canada and U.S.
Differentials between Average Annual Rates of Return on
Stocks and Government Bonds



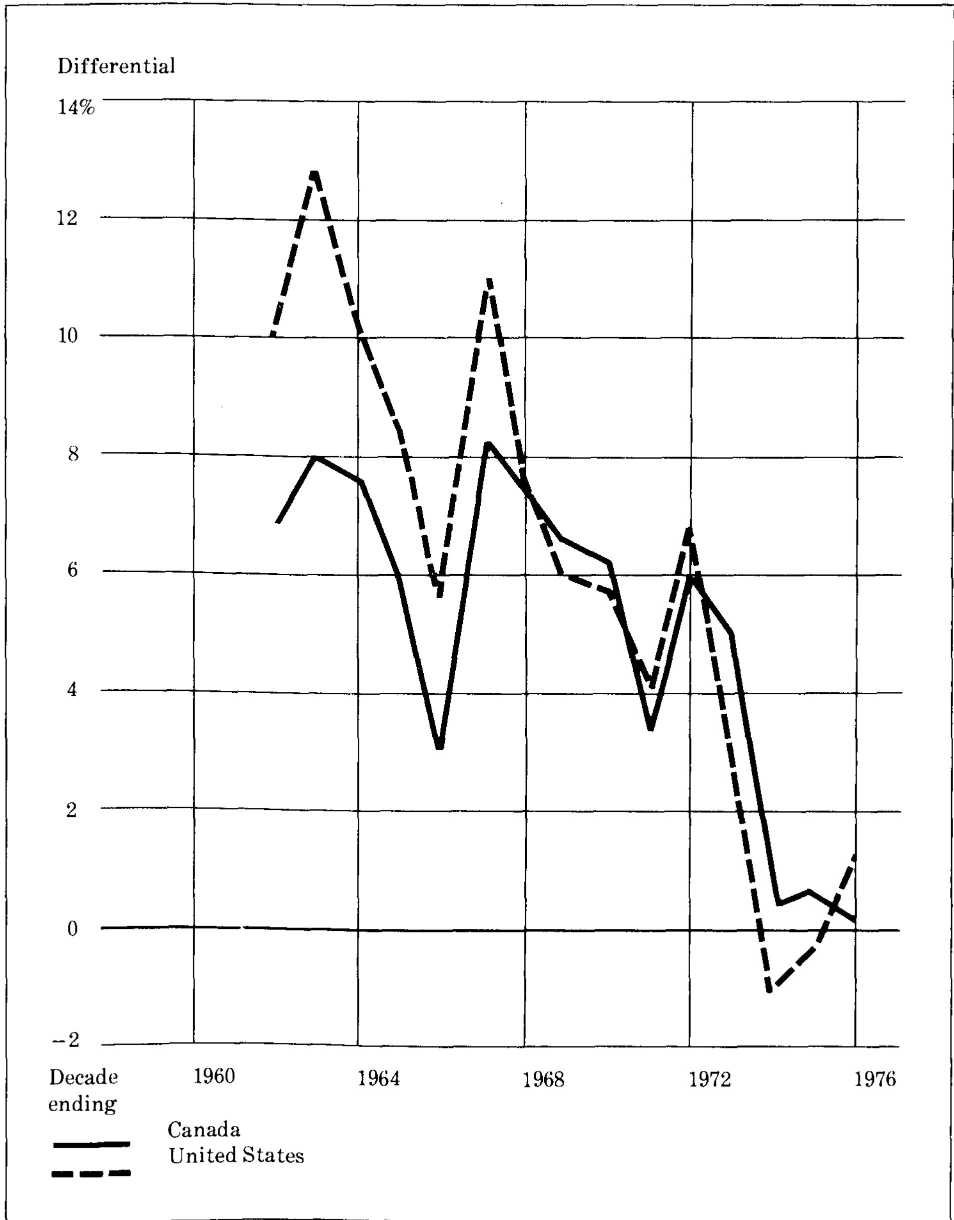
Source: Data in table 19.

Table 20
Comparison of Average Annual Nominal Rates of Return of Common Stocks and Corporate Bonds between U.S. and Canada

Decades ending December 31, 1962–76

	Canada			U.S.		
	Common stocks	Industrial bonds	Differ-ential	Common stocks	Corporate bonds	Differ-ential
1962	10.37%	3.83%	6.54%	13.44%	2.86%	10.58%
1963	11.99	3.97	8.02	15.91	2.74	13.17
1964	11.07	3.40	7.67	12.82	2.68	10.15
1965	9.19	3.10	6.09	11.06	2.58	8.48
1966	6.91	3.77	3.14	9.20	3.30	5.89
1967	11.24	2.95	8.29	12.85	1.95	10.90
1968	10.44	2.88	7.56	10.00	2.44	7.57
1969	9.86	3.22	6.63	7.81	1.68	6.13
1970	9.27	3.39	5.89	8.18	2.51	5.67
1971	7.06	3.90	3.17	7.06	3.10	3.95
1972	10.51	4.34	6.17	9.93	3.04	6.89
1973	8.93	4.03	4.90	6.00	2.93	3.07
1974	3.32	2.91	0.41	1.24	2.13	−0.90
1975	4.41	3.80	0.62	3.27	3.59	−0.31
1976	6.28	6.10	0.18	6.63	5.38	1.25
Average	8.72	3.71	5.02	9.03	2.86	6.17

Figure 8
Comparison between Canada and U.S.
Differentials between Average Annual Rates of Return on Stocks and Corporate Bonds



Source: Data in table 20.

bonds. Canadian stocks generally provided lower returns than U.S. stocks for the decades ending before 1968. Since then, until the decade ending in 1976, Canadian returns have been higher. It is possible that the experience since 1968 has been affected by a repatriation of foreign investments by Canadian pension funds. In 1969 the Canadian government first announced the 10% limitation on foreign investment by Canadian pension funds, a limitation that went into effect in 1971.

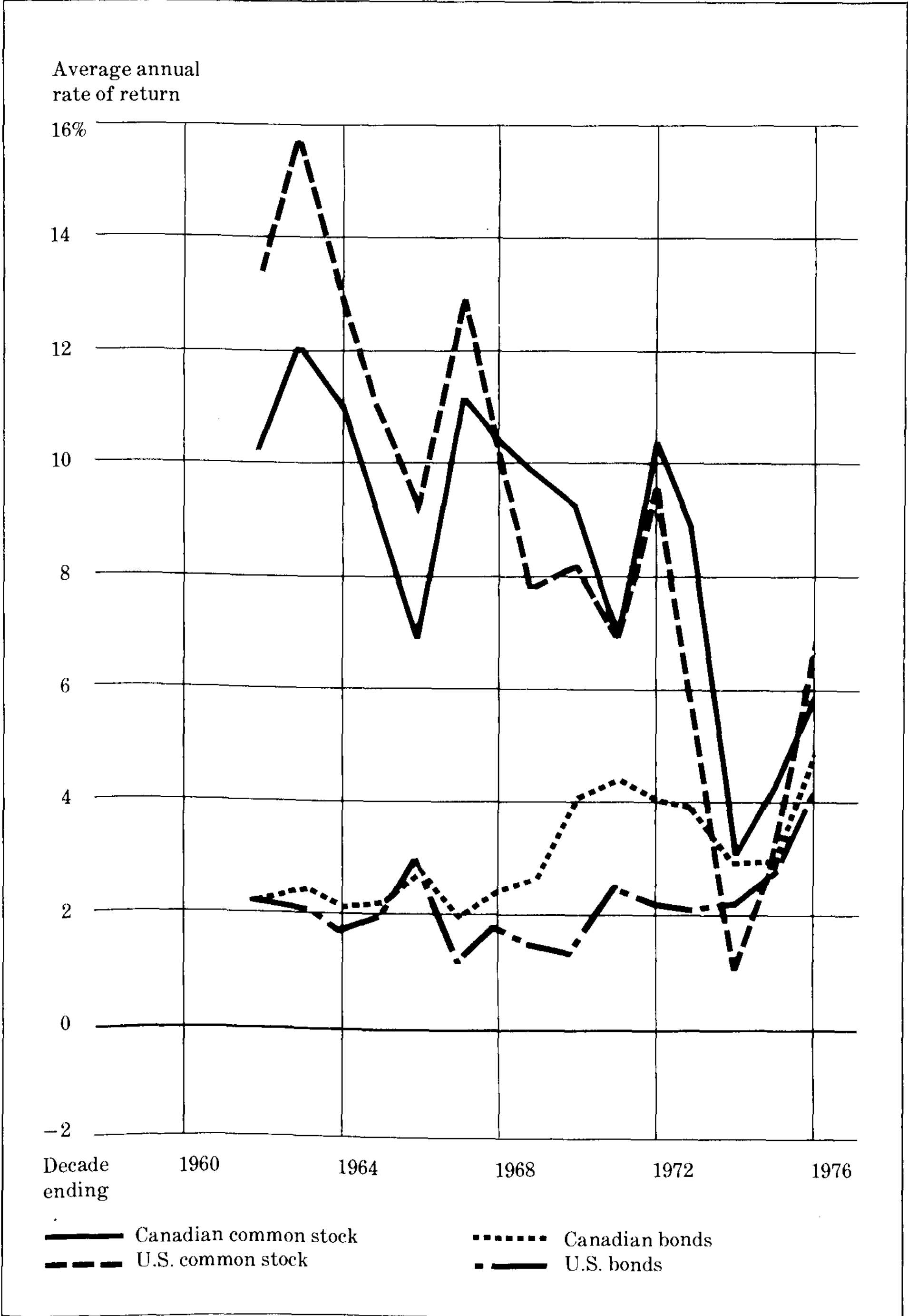
With the exception of the 1969–75 period, then, it appears that investors in Canadian stocks have been satisfied with lower rates of return than those achieved in U.S. stocks. This satisfaction could be because Canadian stocks appeared less risky. At least two studies have concluded that the history of stock performance in the United States and Canada, *after allowing* for risk, shows the former to have been the better one for investors.[130] In both cases the analyses were directed at identifying the benefits of international diversification – there is a good deal of evidence that a portfolio diversified across national boundaries offers better risk-return characteristics than one restricted to a single country. But it appeared that portfolios restricted to U.S. stocks offered better risk-return combinations than those combining Canadian and U.S. stocks. The second of the two studies was concerned chiefly with portfolios diversified across Canadian, Belgian, French, Italian, Japanese, South African, German and British stocks and found that Canadian stocks showed up in "efficiently" diversified portfolios only for conservative, that is, low-risk, low-return, portfolios.

So far, all of this discussion suggests that the Canadian equity market has been a rather poor one for investors (and an attractive one for issuers). But the comparisons have ignored taxes, and the Findlay and Smith study pointed out that the Canadian tax treatment of an individual's dividend receipts may make the Canadian stock market as attractive to Canadians as any other on an after-tax basis. (The analyses certainly indicated that a tax exempt investor was better off in non-Canadian equity markets.) We examined some of the tax factors in chapter I.

This reasoning in turn suggests that the Canadian equity market is segmented from the rest of the world and should depend very much on Canadian investors, without much expectation of attracting substantial foreign investment. United States government bonds, on the other hand, have been relatively more attrac-

130 Smith & Khoury, *Effective Diversification by Canadian and United States Mutual Funds*, 4 J. BUS. ADMIN. 43 (spring 1973); Findlay & Smith, *Some Canadian Implications of International Portfolio Diversification*, [1976] FIN. REV. 36.

Figure 9
Comparison between Canada and U.S.
Rates of Return on Common Stocks and Government Bonds



Source: Data in table 19.

Table 21
Comparison of Average Annual Real Rates of Return of Common Stocks and Government Bonds between U.S. and Canada, Deflated by Consumer Price Index

Decades ending December 31, 1962–76

	Canada			U.S.		
	Common stocks	Government bonds	Differential	Common stocks	Government bonds	Differential
1962	8.93%	0.98%	7.95%	11.99%	0.98%	11.01%
1963	10.35	0.89	9.46	14.31	0.63	13.68
1964	9.29	0.45	8.84	11.08	0.12	10.96
1965	7.19	0.35	6.83	9.18	0.16	9.01
1966	4.87	0.83	4.04	7.29	1.06	6.24
1967	8.94	−0.25	9.18	10.88	−0.63	11.51
1968	7.99	0.15	7.84	7.78	−0.32	8.10
1969	7.07	0.04	7.03	5.16	−1.05	6.21
1970	6.49	1.44	5.05	5.11	−1.58	6.69
1971	3.86	1.15	2.71	3.75	−0.70	4.45
1972	6.83	0.63	6.20	6.30	−1.03	7.34
1973	4.56	−0.35	4.91	1.81	−1.93	3.74
1974	−1.79	−2.09	0.31	−3.77	−2.86	−0.91
1975	−1.36	−2.55	1.19	−2.31	−2.54	0.23
1976	0.20	−1.13	1.34	0.72	−1.52	2.24
Average	5.56	0.04	5.53	5.95	−0.75	6.70

Figure 10
Comparison between Canada and U.S.
Rates of Return on Common Stocks and Government Bonds,
Deflated by Consumer Price Index

Source: Data from table 21.

tive to investors than have Canadian government bonds and the investors have been willing to accept lower interest rates. Very likely the explanation is a lower perceived risk in the United States, coupled with legal requirements making these bonds either more attractive or obligatory for many U.S. institutions. Figure 9 suggests that these Canada-U.S. differences may have declined in recent years, and there may be little difference in costs of financing between the two countries now.

Table 19 was limited to nominal rates of return, unadjusted for inflation. Differences between inflation rates in the two countries could explain some differences between rates of return. Table 21 and figure 10 show stock and bond rates of return adjusted to eliminate inflation. The differences between the two countries are smaller but the pattern remains the same. Table 22 corresponds to table 20, after adjustment to eliminate inflation.

C. CONCLUSIONS AND POLICY IMPLICATIONS

One measure of efficiency in securities markets is the relationship between risk and return for different kinds of securities. The historical evidence for Canada, as well as for the United States, suggests that stocks, bonds and treasury bills have been appropriately priced relative to each other. Compared to the United States securities market the Canadian market has been characterized by relatively low rates of return on equities and high rates of return on fixed income securities. Put another way, Canadian corporations have found the cost of equity to be lower, compared to the cost of debt, than have corporations in the United States.

All of this should be reassuring in view of concern that there should be more equity financing of Canadian corporations. It may be that the welfare of the economy calls for even further narrowing of the gap between the cost of equity and the cost of debt. And this could be accomplished through tax changes. But there is certainly no evidence that the markets are not working well.

If it is true that the Canadian stock market offers competitive rates of return (competitive with foreign markets) to tax-paying Canadian investors but noncompetitive rates to tax-exempt investors such as pension funds, then there may be difficulties ahead. A continuing shift of investment from direct individual holding of shares to intermediation through pension funds will weaken the appeal of Canadian equities, unless the tax-exempt funds are *forced* to buy them. As we have seen, they are prevented by law from buying foreign equities. A further step might be to limit their investment in Canadian fixed income securities. This kind of

Table 22
Comparison of Average Annual Real Rates of Return of Common Stocks and Corporate Bonds between U.S. and Canada, Deflated by Consumer Price Index

Decades ending December 31, 1962–76

	Canada			U.S.		
	Common stocks	Industrial bonds	Differential	Common stocks	Corporate bonds	Differential
1962	8.93%	2.48%	6.45%	11.99%	1.54%	10.45%
1963	10.35	2.45	7.90	14.31	1.32	12.99
1964	9.29	1.75	7.55	11.08	1.09	9.99
1965	7.19	1.21	5.98	9.18	0.84	8.34
1966	4.87	1.80	3.08	7.29	1.50	5.79
1967	8.94	0.82	8.12	10.88	0.18	10.71
1968	7.99	0.60	7.39	7.78	0.37	7.41
1969	7.07	0.61	6.47	5.16	−0.82	5.98
1970	6.49	0.76	5.74	5.11	−0.40	5.51
1971	3.86	0.78	3.07	3.75	−0.09	3.83
1972	6.83	0.86	5.97	6.30	−0.36	6.67
1973	4.56	−0.14	4.70	1.81	−1.14	2.95
1974	−1.79	−2.18	0.39	−3.77	−2.92	−0.85
1975	−1.36	−1.94	0.58	−2.31	−2.01	−0.30
1976	0.20	0.03	0.17	0.72	−0.46	1.18
Average	5.56	0.66	4.90	5.95	−0.09	6.04

regimentation is an almost automatic development when rates of return are manipulated, as through tax changes, by governments.

Chapter IV
A National Securities Market

In both the United States and Canada the concept of a single national market in securities, particularly in stocks, is very appealing. Computer facilities can clearly do much to make the operation of a marketplace more efficient and they offer the hope of a unification that has never been achieved in the past.

Operational efficiency, as it was described in chapter II, is an obvious goal of a national system. From a Canadian point of view, meeting the competitive threat of U.S. markets may be another goal. A significant portion of the trading in active Canadian stocks already takes place in the United States, most of it among Americans and other foreigners or in the form of dealer arbitraging. If the U.S. marketplace becomes a more attractive place to trade relative to Canadian markets, it is possible that it could also take over a significant portion of the business generated by Canadians.[131]

Creation of a national marketplace, particularly one in which computerized trading may play a significant part, is bound to meet with some opposition. In both Canada and the United States some elements of the securities industry are likely to suffer a loss of privileges or competitive advantage, although this is much more obvious and is likely to generate much more opposition in the United States than in Canada. In Canada a shift from what is now an unofficially national marketplace dominated by Toronto to a formal national market is likely to add some urgency to questions of federal and provincial jurisdiction. In the United States jurisdiction is not an issue but a serious policy question has emerged concerning a compromise between competition that fosters efficiency and innovation in a marketplace and the public utility kind of monopoly that often seems essential to an efficient, specialized service. This question is not as significant in Canada which does not have the variety of competing marketplaces that can be found in the United States, a variety that could vanish in a single national market. But some policy choices will have to be made, even if they are made by default, concerning access to a national market and the degree of competition within it.

131 This competition is discussed in *Williamson, Financial Institutions*, ch. III.

A. MOVEMENT TOWARDS A NATIONAL MARKET SYSTEM IN THE UNITED STATES

In the Securities Reform Act of 1975 Congress instructed the SEC "to use its authority under this title to facilitate the establishment of a National Market System for securities...to carry out the objectives set forth...". The objectives included economically efficient execution of securities transactions, fair competition among brokers and dealers and markets, availability to brokers, dealers and investors of quotation and transaction information, the practicability of executing orders in the best market, and an opportunity for investors' orders to be executed without the participation of a dealer. Congress was not very specific about how this National Market System was to be constructed but it did call for a National Market Advisory Board to make recommendations to the SEC. The board and the SEC appealed for suggestions.

1. *The Merrill Lynch Proposal of October 1975*

One of the first proposals was put forward by Merrill Lynch in October 1975. It was intended to promote the auction-agency market and was based on three principles: there would be price priority (*i.e.*, securities would be sold to the highest bidder and bought from the lowest offeror), investors would trade with one another without the intervention of a dealer whenever possible, and competition among securities firms including market-making firms would be encouraged. Merrill Lynch expected its model to increase competition, to provide broader access to the broker-dealer and market-making functions, and to attract more firms and more capital to the securities business.[132]

The Merrill Lynch proposals form a good starting point against which to judge subsequent proposals. Some features were relatively noncontroversial. Merrill Lynch assumed that commission rates would remain competitive and that all professional participants in the system would be subject to equal regulation. All would be registered under the Securities Exchange Act, including affiliates of institutions and foreign entities. All transactions of registered broker-dealers or "institutional investors" would have to take place within the National Market System, making them subject to composite tape reporting, a best execution rule, and limit order protection. There would be a single central system communicating quotes to participants in the market. Executions

132 MERRILL LYNCH, PIERCE, FENNER & SMITH, INC., PROPOSAL FOR A NATIONAL MARKET SYSTEM, annex A, at 2 (October 1975).

would be subject to price priority, time priority, and priority of the public over securities firms.

Limit order protection is an important element in any proposal for a National Market System. An offer to buy or sell a specified number of shares of a particular stock at a specified price is a limit order. Most limit orders sent to a stock exchange in the United States end up on the book of the specialist in the stock. The specialist matches orders to buy and sell at the same price and ensures that an order to buy or sell "at the market" is matched with the best limit order to sell or buy – the lowest priced sell order or highest priced buy order. All of this means that the investor who places an order to buy at a specified price can be assured that no one else will buy for less until his order is filled. And one who places an order to sell at a specified price can be assured that no one else will sell for more.

It is fairly easy to maintain limit order protection on the floor of an exchange. It is much more difficult to maintain it throughout a larger marketplace, one that includes several exchanges and an over-the-counter market.

The controversial aspects of the proposal were concerned with the market-making function and the quotation system. Merrill Lynch proposed that all bids and offers with accompanying price and size would have to be entered in the National Market System electronic "book" without identification of the source. The entire book would be available for viewing by any market-maker, and by any other member of the system with a "need to know" but not by the public. A broker with a "need to know" would be a broker wanting to make a transaction in a particular security and he would be allowed to see the book for that security.

All quotations in the book would be available to be "hit". Those with access to the book could then complete a transaction simply by signalling acceptance of a quotation.

There would be no limit on the number of market-makers in a stock. Exchanges would be free to impose limitations on market-making on their floors but they would not be able to limit off-board market-making. No market-maker would have any *obligation* to "make a market" but, to discourage in-and-out market-making, a market-maker would have to make a commitment for perhaps six months to provide two sides in given size for any stock in which he became a market-maker.

Market-makers would be free to deal directly with institutions. Limit orders would be fed directly into the quotation system by brokers and there would be no floor brokerage charges.

Merrill Lynch was not entirely clear about how stocks would be assigned to market-makers. There was an implication that any

member of the system could become a market-maker by giving a six-month undertaking as described above. There was also some implication that stocks would be assigned so that each stock had at least one market-maker. An exception to this would involve inactive stocks for which the book would carry any bids and offers available but for which there would be no securities firm acting as market-maker.

2. *The New York Stock Exchange Proposal of July 1976*

The New York Stock Exchange put forward two proposals as useful steps toward a National Market System.[133] The exchange conceded the advantages of a Consolidated Limit Order Book (CLOB) covering the entire national securities market, but it also foresaw substantial disadvantages. It was clear from the presentation that the exchange regarded the protection of its own marketplace and of the role of its specialists as a major objective.

The first proposal – an Electronic Order Indication System – would communicate pending block trades to all markets that had limit order books. These markets could then respond on the basis of the orders on their books and be given limit order protection so that they might participate in the block transaction. The effect of this proposal would be to ensure that all public limit orders were able to participate in block transactions. The exchange claimed that such a system could be implemented quickly and cheaply.

The second proposal was for Broker Representation of Limit Orders in Primary Markets. This system was aimed at bringing to the floor of the New York Stock Exchange any limit orders for New York listed stock placed in other markets.

The exchange's objections to a full CLOB were rather interesting. First, it believed that any specialists and market-makers having access to the CLOB would have to be prohibited from dealing directly with institutional investors and corporate insiders, following the New York Stock Exchange rule for specialists. The exchange also believed that commissions for limit order executions would have to be fixed so that brokers would know in advance what the charge would be regardless of the place of execution. And if the CLOB were extended to permit automatic execution, as Merrill Lynch had proposed, the exchange predicted the end of the auction market.[134]

The exchange did submit recommendations for the structure

133 THE NEW YORK STOCK EXCHANGE, INC., A NATIONAL MARKET SYSTEM: A REPORT BY THE NATIONAL MARKET SYSTEM COMMITTEE (July 1, 1976).

134 *Id.* at 17–18.

of a National Market System. Not surprisingly, these emphasized the preservation of separate exchange markets. Exchanges would trade only the stocks of their choice and would assign stocks to specialists or other market-makers. Specialists would be bound by the kinds of market-making obligations that the New York exchange now imposes. And other market-makers would be bound by similar rules. Competition would be permitted among exchanges, among specialists, and among specialists and market-makers. But the competition would be restricted to prevent market fragmentation. One restriction would come about, of course, by a prohibition against market-makers dealing directly with institutions. Indeed, this restriction alone might eliminate any third market competition with the exchange.

The exchange was quite frank about its concern for maintaining adequate incentives for specialists. The proposal said: "Introduction of a CLOB could lead to the diversion of the floor brokerage income that specialists now receive for executing orders in their limit order books."[135]

3. *Proposal from the American Society of Corporate Secretaries*

This proposal was prepared by Professors Sametz and Bloch of New York University, for the society. The authors aimed at a competitive auction market within a framework of regulated access.[136] But they seem always to have equated auction market with broker market. They were in general agreement with the New York Stock Exchange proposal for close control over the allocation of stocks to market-makers and would give substantial privileges to market-makers accompanied by the responsibility to maintain continuous two-sided quotes in depth. However, they argued for an early CLOB. Indeed, they identified the definition of a CLOB as the key and first decision to be made by the National Market Advisory Board.[137]

But Sametz and Bloch would free the specialist to deal with institutions and would not force specialists to make markets in stocks they did not want. The authors, however, were concerned about inactive stocks and were sympathetic to the idea of not relying on a free marketplace to provide specialist services for

135 *Id.* at 46.

136 National Market Study Committee, American Society of Corporate Secretaries, position paper submitted to the National Market Advisory Board and to the Securities and Exchange Commission 2 (July 29, 1976). The paper was reprinted as E. BLOCK & A. SAMETZ, A MODEST PROPOSAL FOR A NATIONAL SECURITIES MARKET SYSTEM AND ITS GOVERNANCE (1977).

137 *Id.* at 4-5.

those stocks. There was some uncertainty about the amount of regulatory interference that might be called for here.

The Sametz and Bloch proposals would then support an active third market competing with the exchange markets. But it would significantly limit access to the market-making function.

4. *National Market Advisory Board Report to Congress, December 1976*

This *Report* to Congress was on the possible need for modifications of the scheme of self-regulation to adapt it to a National Market System.[138] The board did not recommend any new self-regulatory organization but it did propose "one or more coordinating entities in which the self-regulatory organizations and the public are represented, but in which no one or two existing self-regulatory organizations have a dominant position".[139]

The board expressed some preliminary views on the form it believed a National Market System should take, reserving until later its final prescription. The *Report* reviewed the steps that had already been taken toward a National Market System. The first of these was the consolidated last sale reporting facility, generally referred to as the consolidated tape. There is a consolidated tape association consisting of the New York and American Stock Exchanges, and the Midwest, Pacific Coast and Philadelphia Stock Exchanges and the NASD as voting members, and three non-voting members: the Boston and Cincinnati Stock Exchanges and Institutional Networks Corporation (operators of the "Instinet service"). The association came about as the result of strong pressure from the SEC and produced by March 1976 the consolidated tape, which reported all transactions on all exchanges and in the over-the-counter markets for all issues listed on the New York and American exchanges as well as selected issues listed on other exchanges.

The board commented that the difficulties encountered in bringing about this degree of cooperation among self-regulatory organizations "suggests the inadvisability of including in the charter of a National Market System coordinating or governing entity any veto, or other measure, which would give one or two of the participating self-regulatory organizations the ability to dominate such entity".[140]

138 NATIONAL MARKET ADVISORY BOARD, REPORT TO CONGRESS: THE POSSIBLE NEED FOR MODIFICATIONS OF THE SCHEME OF SELF-REGULATION IN THE SECURITIES INDUSTRY SO AS TO ADAPT IT TO A NATIONAL MARKET SYSTEM (December 31, 1976).

139 *Id.* at 1-2 (Letter of Transmittal).

140 *Id.* at 16-17.

The second step that had been taken was the development of a composite quotation system. The board reported that there were available from two private services composite bid and ask quotations emanating from participating exchanges for securities listed on the New York Stock Exchange which are also traded on other exchanges. The board anticipated that there would soon be a third service which would include third market quotations for New York listed securities. The board commented that the private vendors were initially dissatisfied with the quality of the quotation information provided by the self-regulatory organizations. The SEC had proposed a rule to improve the quality of this information and the board was led to observe:

> "Efforts with respect to the development of a composite quotation system may show whether it is possible for a National Market System facility to be developed through the interplay of competitive forces, with Commission assistance when necessary, but without the creation of a new self-regulatory or coordinating body."[141]

The board strongly advised the commission to allow the industry the primary role in developing a CLOB system. But because of doubts about industry agreement within a reasonable time, the board recommended that the commission proceed with "its analysis and decision-making process". The end result is a rather ambiguous statement about the recommended roles of the industry and the SEC in the development of a CLOB. The board in fact seemed to throw up its hands in the face of strong and diverse feelings within the industry.[142] The board did recommend that the commission prescribe the characteristics of a CLOB and ask the industry to propose plans to meet them.

5. *Proposals for a Consolidated Limit Order Book*

In the course of explaining Rule 19c-1 (which has to do with off-board trading, and is discussed later) and dealing with the obviously attractive objective of protecting public limit orders, the SEC considered proposals for patching up the existing rules on the stock exchanges to extend protection from one floor to another but concluded:

> "It is clear, therefore, that the only fair, realistic and practicable way of mandating satisfaction of public limit orders, a goal the Commission shares with all those witnesses who have stressed the importance of public limit

141 *Id.* at 19.
142 *Id.* at 22-23.

> order precedence, is through the creation and development of a composite book and the imposition of a requirement that all transactions, wherever and by whomever effected, must clear that book."[143]

On the existing market structure, the commission said:

> "First, as discussed above, limit orders may be avoided, in whole or in part, by a number of techniques, including the execution of a transaction on a regional stock exchange. Second, dual members are not required to satisfy orders on the books of all the exchanges for which they are members before they execute a trade on any particular exchange, and existing technology would make such a requirement, if imposed, wholly impracticable. Finally, existing exchange rules regarding priority and precedence and renewal of the 'auction' after each transaction do not, in our view, provide an ideal framework for the protection of public orders (especially those of small size).
>
> "The Commission believes that the answer to the problem of providing adequate protection for public limit orders is not to maintain existing rules which perforce provide only imperfect protection and have certain undesirable anticompetitive effects, but rather to use the advanced technology now available to provide for a computerized central limit order repository, or composite book. A composite book would permit the effective integration of existing market-makers (both exchange and third market) by ensuring continuation and extension of the public's ability to obtain priority in competing for executions; in addition, such a book would provide brokers and dealers with an efficient and practical means by which all limit orders, regardless of origin, can be protected on a national basis. Once a composite book is in place, the Commission believes that all transactions, regardless of size, should be required to satisfy orders on that book at the same or at a better price either immediately before, simultaneously with or immediately after execution."[144]

One of the most interesting proposals directed specifically to the matter of a quotation system was that of Peake, Williams and Mendelson, submitted to the SEC in April 1976.[145] Their proposal was for a National Book System, with characteristics similar in many respects to those proposed by Merrill Lynch. A single quota-

143 SEC, Securities Exchange Act of 1934 Release No. 11942, December 19, 1975, at 44.

144 *Id.* at 49-50.

145 J. PEAKE, R. WILLIAMS & M. MENDELSON, THE NATIONAL BOOK SYSTEM: AN ELECTRONICALLY ASSISTED AUCTION MARKET (April 30, 1976).

tion system, in effect a single national market, would handle limit orders, execution of the orders, and reporting of transactions. The book would be open for all to see and any broker or dealer meeting SEC qualifications would be permitted to enter orders and to "hit" orders so as to execute transactions. Trading would be carried on in the stocks of companies meeting SEC criteria. The entire system would be run by a self-regulatory organization, the National Securities Board.

Like the system proposed by Merrill Lynch, this system would rely heavily on open competition. No market participant would be given any special privileges with respect to market-making and access to the system. And no securities firm would carry any obligation with respect to market-making. All of these features, of course, were directly opposed to what the New York Stock Exchange wanted. This proposal would give wider access to the book than would the Merrill Lynch proposal and would go somewhat further in erasing the identity of each stock exchange. Peake, Williams and Mendelson would leave to the stock exchanges all functions other than communications, execution and record keeping. But at best this would seem to relegate the exchanges to minor housekeeping and clerical activities. At the same time a new organization was proposed with the possibility that an existing organization, perhaps the New York Stock Exchange itself, might evolve into this new organization.

In January 1977 the National Market Advisory Board itself offered recommendations to the SEC on establishing a Composite Limit Order Book.[146] The board was very cautious with its suggestions and its communication to the SEC suggested that it would have preferred to wait until the industry had moved closer to agreement but felt compelled to offer some advice in view of action the SEC had already taken to increase competition among markets in reliance on an imminent National Quotation System.

The board had concluded that a composite book was called for, apparently dismissing the proposals of the New York Stock Exchange for a simpler substitute. The board also concluded that brokers and dealers should be able to enter limit orders directly into the system without having to go through specialists or other official market-makers. This conclusion, too, conflicted with the proposals of the New York Stock Exchange. Brokers would not be compelled to enter limit orders into the composite book, but would be required to ensure participation of orders in the book in any

146 Letter from National Market Advisory Board to the SEC commissioners, Re: Establishment of a Composite Limit Order Book (January 28, 1977).

transactions. In other words, orders in the book would have protection in any marketplace outside the book.

In what amounted to a concession to the arguments of the New York Stock Exchange, the board recommended that only specialists and qualified market-makers be allowed to actually execute an order in the book, but did not explain who would qualify as a non-specialist market-maker or what obligations would be imposed on specialists and other market-makers.

The board recommended complete visibility of the composite book, with its contents made available to vendors who would be free to sell the information in any format permitted by applicable regulations. Initially, only exchange traded common stocks would be included in the book and this proposal seemed to pave the way for the New York Stock Exchange to become the national market.

In the summer of 1977 in the course of SEC hearings on the abolition of the last of the rules restricting stock exchange members from taking orders off-board (this subject is discussed later), Merrill Lynch presented some specific proposals for a Consolidated Limit Order Book. The Merrill Lynch proposal was a follow-up of its earlier, more general proposal for a National Market System. It dealt with specific steps that could be taken in the near future to develop the National Quotation System so crucial to a National Market System. Merrill Lynch began by commenting that 45% of the daily flow of orders on the New York Stock Exchange were limit orders. On the books of New York Stock Exchange specialists there would be from 200,000 to 250,000 limit orders. The number may seem large but it has declined in recent years. Merrill Lynch argued that it is important to the quality of the stock market to restore the number of limit orders.

Specifically, Merrill Lynch proposed a CLOB consisting of a series of remote terminals linked by a communications network to a central storage and processing unit. Any broker-dealer eligible for membership in the National Market System would be entitled to lease a terminal and enter, cancel, and modify limit orders on behalf of customers or on its own behalf. This system would involve wider access than Merrill Lynch had suggested in its original proposal two years earlier. The contents of the CLOB would be visible to any member of the National Market System but not necessarily to the public.

Merrill Lynch proposed that orders on the CLOB would take priority over orders represented in the "crowd" of traders on the floor of a particular exchange. This of course would tend to make the CLOB market more attractive than the floors of the exchanges. The public would be given no priority over market-makers, however, since Merrill Lynch felt the latter should be encouraged and it

recognized that the CLOB would cut into the existing revenue of specialists. Specialists should also be freed from restrictive rules that prevent them from competing on an equal footing with other market-makers. Market-making would be open to all financially responsible broker-dealers with no affirmative obligations other than a commitment to make a specific two-sided market for a minimum time period.

Merrill Lynch urged strongly that a CLOB should be introduced quickly, before any further major changes were made in the market structure, including the removal of restrictions on off-board trading. Merrill Lynch could see serious dangers in fragmentation of markets but argued that a CLOB would obviate these dangers.

Within a month of the Merrill Lynch proposals, the New York Stock Exchange put forward a fresh set of proposals again in the context of the SEC hearings on off-board trading restrictions. As might be expected, the New York Stock Exchange did not favour a CLOB or anything that looked like a single national market. It urged instead improved linkages among existing exchange markets. Each market would control its own market-makers, with competition among market-makers and among markets. What was more significant about the exchange proposal was the endorsement of a Composite Quote System, available to all market centres so that investors would have access to the best quotes in all markets. Not all limit orders would be entered into the quotation system. Specialists on the New York Stock Exchange, for example, would apparently be able to continue to maintain their own books outside the system. However, and this proposal represented another very significant concession by the exchange, specialists would have to disclose the contents of their books on request to other participants in the system. So all qualified market-makers would have access, one way or another, to all books.

6. *Removal of Restrictions on Off-Board Transactions*

The first affirmative steps by the SEC toward the development of a National Market System involved the elimination of restrictions on off-board transactions. This elimination had the effect of bringing about, at least to some degree, an integration of the exchange and over-the-counter markets. The over-the-counter market referred to here, of course, is the so-called "third market" which is an over-the-counter market in stocks listed on stock exchanges. The market is essentially one for institutions and securities firms and is maintained by firms that do not belong to exchanges.

The SEC action in opening up competition between the exchange and third markets has no obvious direct effect on Canadian securities markets, since there is no third market in Canada. It must, however, have an indirect effect by extending competition in the United States in the trading of interlisted issues, which are Canadian stocks listed on exchanges in the United States as well as in Canada. They are important stocks to the Canadian markets since they account for something like 50% of all trading on Canadian exchanges and the competition of the U.S. marketplace for trading in these stocks is therefore important.[147]

All of the stock exchanges in the United States have rules limiting the ability of members to effect transactions in listed securities in the over-the-counter market either as principal or agent. In all cases, the principle of "displacement" must be respected, which means that before a member may take a transaction off the floor of the exchange, he must permit participation in that transaction by those with limit orders entered in a specialist's book, public bids or offers represented in the "crowd", and bids and offers by members, including specialists, for their own account. For example, if a specialist's book includes an order to purchase 100 shares of a stock at $40 a share, then before a member may take an order to sell at $40 or more off the floor of the exchange he must supply the 100 shares to meet the limit order at $40. The exchanges generally require more, however. Rule 394 of the New York Stock Exchange prescribed a number of steps the member was required to take to explore the market on the floor, obtain permission to go off the floor, and report the details of his transaction.

In December 1975 the SEC announced, after extensive hearings, the adoption of Rule 19c-1 to go into partial effect on March 31, 1976, and full effect on January 2, 1977.[148] The rule provided that after March 31, 1976, the rules of a stock exchange may not prevent a member of an exchange, acting as agent, from effecting transactions in listed securities on other exchanges or over-the-counter with a third market-maker or nonmember block positioner. Until January 2, 1977, it was to be permissible to require members effecting such transactions to satisfy limit orders left with a specialist or represented through any other limit order mechanism. But after January 2, 1977, even these requirements would have to cease. The rule did not affect restrictions on members acting as *principal* off the exchange floor – that subject was not to be tackled until 1977. Nor did it affect restrictions on

147 This competition is discussed in *Williamson, Financial Institutions*, ch. III.
148 SEC, Securities Exchange Act of 1934 Release No. 11942, *supra* note 143.

exchange members effecting transactions "in-house" as agent for both buyer and seller. Only transactions in which the member acted as agent and effected a transaction with a "third market-maker" or "nonmember block positioner" were covered by the rule. The SEC indicated, in announcing the rule, that it favoured the removal of restrictions on in-houses crosses but was deferring action.

The SEC was seriously concerned with the protection of limit orders. It set out quite clearly in its decision an expectation that the ultimate National Market System would provide for the protection of limit orders in all markets.[149] That is, a customer placing an order to buy 100 shares of a particular stock at $40 a share, whether the order was placed with an over-the-counter dealer or a stock exchange member and regardless of the exchange to which the member belonged, would be assured that nowhere within the national securities market would 100 shares be sold for less than $40 unless they were sold to him and that if 100 shares were sold at $40 they would be sold to him unless another order to buy at $40 had been entered before his order. In effect, then, all limit orders placed by all buyers and sellers of securities in the national securities market would be pooled and orders would be filled according to price and time priority. The SEC observed that this ideal had not yet been reached and that while each exchange provided limit order protection for transactions on its own floor, there was nothing to stop a member of two exchanges from taking an order to the floor of one of those exchanges and ignoring the limit orders on the other.[150] While it was sympathetic to a plea that exchanges should be able to limit off-board transactions to protect limit orders on the floor of the exchange, it concluded that this protection need not extend beyond January 2, 1977, with the expectation that complete protection would be coming with a National Market System.

The SEC concluded that the limitations imposed by the exchanges on members acting as principals effectively prevented these members from (i) making a *bona fide* continuous two-sided round-lot market over-the-counter, (ii) executing customers' orders as principal over-the-counter, (iii) "positioning" a portion of a large block (by acquiring stock for their own accounts) over-the-counter to facilitate a block trade, and (iv) acquiring or disposing of investment positions over-the-counter.[151] The agency restrictions effectively prevented a member acting as agent from (i)

149 *Id.* at 43-44, 49-50.

150 *Id.* at 44, 49.

151 *Id.* at 5-6.

effecting an over-the-counter transaction in a security listed or traded on the exchange for a customer directly with a third market-maker or broker or an institutional buyer or seller, (ii) crossing both sides of a large block transaction in-house, acting as agent for both, and (iii) crossing small retail orders in-house, acting as agent for both sides.[152] The principal effect of the limitations on off-board agency transactions, then, was to limit competition between specialists on the exchange and over-the-counter market-makers off it. And it was the restoration of this competition that was the principal aim of Rule 19c-1.

The commission said:

> "Of all the arguments advanced in favour of retaining some form of off-board trading rule requiring that an exchange be interrogated, and that at least certain orders on that exchange be satisfied by a member wishing to effect a third market agency transaction, the most persuasive concerned the desirability of continuing protection for public limit orders, to provide a means for those orders to participate in transactions which otherwise would occur at prices below those which the public is willing to pay or above those at which the public is willing to sell.
>
> "As explained below...the Commission believes that it is essential to create a central mechanism for the national protection of limited price orders. Testimony presented at the October hearings cogently argued that such protection is fundamental to the fairness of our securities markets. Existing exchange mechanisms designed to protect limit orders and provide for their participation in transactions occurring on particular exchanges, however, are inadequate for the future and can be circumvented under existing circumstances by members of 'primary' exchanges (who may transport an order to a regional exchange if avoiding the limit order book on the 'primary' exchange is an important factor in consummating a substantial trade) and by customers (who are not required to effect a transaction on an exchange at all)."[153]

The SEC comments on avoiding the limit order book were reinforced by the news in May 1977 that Pershing & Company planned to divert from the New York Stock Exchange to the Midwest Stock Exchange major portions of its correspondent order flow in forty-one stocks for which it had been a Midwest

152 *Id.* at 6.
153 *Id.* at 43.

specialist. Pershing had the second largest order flow at the New York exchange so that this diversion was of some significance. The chief reason for the diversion was that the Midwest exchange provided better executions on smaller orders.

A number of proposals were made to the SEC offering alternatives to the elimination of restrictions on off-board trading. All of these proposals included preservation of "displacement", or protection of limit orders, and all added further limitations. The commission concluded that all were as objectionable as the existing limitations. The organization and structure of all the exchanges was such that protection of limit orders required that a member physically check the market at a specialist's post and the commission concluded that the time, effort and expense involved in making that check constituted an unacceptable obstacle to the use of third market execution opportunities by member firms acting as agents.[154]

The commission also observed that the existing limitations placed retail customers at a disadvantage relative to institutional customers. First, institutional investors were generally equipped to deal directly with third market-makers whenever they believed it was advantageous to do so, while retail customers were more likely to stay with exchange member firms. Second, member firms were willing to explore all the opportunities for execution of an order of an institutional size and to take the trouble to deal with the many restrictions set up by the exchanges, trouble they would not take with the smaller retail orders. The commission said:

> "It would be anomalous, at best, for the Commission to question the right of an exchange member diligently to explore and use any and all competing markets and methods of achieving executions when individual customers would benefit financially thereby. Exchange restrictions which have the effect of preventing a member from offering professional coverage of competing markets for retail customers, similar to that coverage which members provide to institutional customers, cannot therefore be permitted to continue."[155]

The usual arguments were raised in opposition to Rule 19c-1, arguments that come up whenever efforts are made to increase competition within an exchange or between an exchange and another market. It was said that the rule would induce members of exchanges to abandon their memberships, give rise to a significant loss of orders from exchanges to the third market, result in

154 *Id.* at 31.
155 *Id.* at 45.

the bypassing of public orders entitled to priority, reduce the quality of market-making by specialists, lead to undue concentration in the securities industry, destroy the auction process and lead to dealer markets, annihilate investor confidence in the fairness of the markets, and make the capital raising process generally difficult.[156] There seems to be no evidence that any of these predictions have been fulfilled; at least no evidence has been put forward by those who in 1977 suggested the same consequences in arguing against an SEC proposal to eliminate restrictions on off-board principal transactions.

7. *Proposed Further Removal of Restrictions on Off-Board Trading*

In June 1977 the SEC followed up on Rule 19c-1 with proposals for a modification to that rule and for a new rule, 19c-2. Rule 19c-1 would continue to apply to agency transactions in listed securities but would be broadened to prohibit any limitations on transactions, not just with over-the-counter market-makers and block positioners but also "with another person". (It was, in fact, broadened to eliminate all restrictions except those relating to "in-house" agency crosses as of March 1, 1978.[157])

Rule 19c-2 would apply to "in-house" crosses, as well as to off-board principal transactions. The rule would prohibit any limitation on the ability of a member acting as agent for both buyer and seller to effect an off-board cross transaction. And it would prohibit any limitation on a member acting as principal to effect an off-board transaction with any person. But while Rule 19c-1 applies to transactions in "listed" securities, Rule 19c-2 would apply to transactions in "reported exchange securities". Reported exchange securities is a class within listed securities which includes those listed securities for which last sale prices from all reporting markets are published on the consolidated system. This class would include all the stocks listed on the New York and American Stock Exchanges, and would exclude only some of the stocks listed exclusively on the regional exchanges. Rule 19c-2 would in effect finish off Rule 390 of the New York Stock Exchange, a rule weakened by 19c-1, but still regarded by the exchange as critical to its survival.

The commission had concluded that the exchange off-board trading restrictions effectively prevented exchange members

156 *Id.* at 34.
157 SEC, Securities Exchange Act of 1934 Release No. 14325, December 30, 1977,

other than specialists from competing with specialists and with over-the-counter market-makers in the business of making two-sided, round-lot markets in exchange-listed securities. The restrictions also prevented exchange members from executing their customers' orders in-house from inventory accumulated as a result of market-making or otherwise and precluded members from executing orders periodically for their accounts off-board with third market-makers or with institutions, either for investment purposes or in connection with positioning a portion of a larger block transaction.[158]

In commenting on the experience that had been gained since March 31, 1976, under the limited form of Rule 19c-1, the commission said that the rule seemed to have made little impact on the selection of markets by exchange members acting as agents.[159] The commission observed that none of the exchanges had gone any further than they were required to under Rule 19c-1 in removing off-board principal or agency restrictions.[160] Although the commission was still concerned, as it had been in late 1975, with protection of public limit orders, it pointed out once again that there were deficiencies in the existing protection, both within exchanges and among exchanges and it reported that although the National Market Advisory Board had also expressed great concern over this issue, the securities industry had been unable to reach any agreement on the industry market linkages that would bring about protection of limit orders in all markets.[161]

The commission had resolved that there was no point in deferring its efforts to reduce limitations on off-board transactions in the hope that the industry might come up with improved limit order protection.[162] Rather, the strategy adopted by the SEC seemed to be to force increased competition on the exchange markets, accepting a small reduction in the quality of limit order protection and in the process putting increased pressure on the industry to reach agreement on a composite quotation system.

The SEC also considered the argument that an increase in off-board transactions involves a certain amount of market fragmentation. The exchanges had argued that such an increase would seriously impair the efficiency of the exchange auction market. It

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[1977-1978 Transfer Binder] CCH FED. SEC. L. REP. ¶ 81,397 (announcing the amendment of Rule 19c-1).

158 *Id.* at 17.

159 SEC, Securities Exchange Act of 1934 Release No. 13662, June 23, 1977, CCH FED. SEC. L. REP. 22 (extra edition No. 700) (June 23, 1977).

160 *Id.* at 17.

161 *Id.* at 30-32.

162 *Id.* at 23.

was argued that the ability to take in-house crosses off the floor of the exchange might induce the large retail firms to remove a substantial amount of their trading from the exchange floor, which could lead both to a lower quality market on the exchange floor and to inefficiencies and higher costs, as brokers found it more difficult to check on different markets and assure their customers the best price available. In addition, it was argued that the firms engaging in principal transactions with customers might not assure those customers the best price available.[163]

The commission was not persuaded that the danger was great enough to justify delay in removing restrictions. It observed that real-time disclosure of last sale information in the consolidated system should go far to preserve efficiency and fairness. And it noted that once the industry is able to agree on a composite quotation system, the assurance should be virtually complete.[164]

The commission did concede that some regulation might be necessary to prevent overreaching by member firms acting as principals. And it therefore proposed for discussion four versions of a possible Rule 15c5-1. The first version, the "person limit approach", would limit off-board principal transactions to those with other brokers or dealers and with institutions. The second version, the "price limit approach", would require that dealer prices be in line with the best prices appearing in a composite quotation system. The third version, the "disclosure approach", would require that the confirmation of a principal trade disclose the highest bid and lowest offer available in the marketplace. And the fourth version, the "fair dealing approach", would simply impose an obligation on those dealing as principals to offer prices to their customers as favourable as those available in agency trades.[165] (The New York Stock Exchange expressed a preference for a combination of the "price limit" and "fair dealing" approaches.)

As of early 1978 the SEC had not acted to implement proposed Rule 19c-2. Opposition to the rule was organized and widespread. The New York Stock Exchange could be expected to defend what remained of its Rule 390, limiting off-board transactions, but fears were expressed throughout the securities industry, and even within the academic community, and the SEC initiative appeared to be stalled.

163 *Id.* at 48-50.
164 *Id.* at 56.
165 *Id.* at 111-14.

8. *National Clearing and Transfer Facilities*

Among the provisions relating to a National Market System introduced by the Securities Reform Act of 1975 was new section 17A of the Securities Exchange Act of 1934. This section directs the SEC to facilitate the establishment of a national system for clearance and settlement of securities transactions, "having due regard for...maintenance of fair competition among brokers and dealers, clearing agencies, and transfer agents...". In December 1975 the SEC granted temporary registration to a number of existing clearing corporations and depositories and began to work out a set of rules for permanent registration. As it turned out the first rules were developed in the midst of the handling of an application by National Securities Clearing Corporation (NSCC) to take over clearing operations on the New York and American Stock Exchanges by way of a merger of three clearing corporations.[166] When in June 1977 the SEC proposed a set of standards to be used for the registration of all clearing agencies,[167] there had already been bitter complaints that the registration of NSCC was one step toward a monopoly on clearing operations based in New York. Protests came from the Midwest Stock Exchange, the American Bankers Association, the Stock Clearing Corporation of Philadelphia, and the New England Securities Depository Trust Company. In addition, there were complaints in Congress that the SEC was ignoring the statutory intent that competition be fostered. The difficulty seemed to be in trying to combine a substantial degree of competition in the furnishing of stock clearing facilities along with the efficiencies of a national regulated utility.

9. *The Situation in Early 1978*

In its June 1977 proposals for modifications to Rule 19c-1 and its proposed Rule 19c-2 the SEC dealt at some length with the elements of a National Market System.[168] It referred to the consolidated reporting system as fully operational on April 30, 1976; this system disseminates nationally on a current and continuous basis last sale prices from all reporting markets for equity securities listed on the NYSE and for equity and certain debt securities listed on the AMEX. With respect to a composite quotation system, however, the best the commission could say was that limited

166 SEC, Securities Exchange Act of 1934 Release No. 12954, November 3, 1976, [1976-1977 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,785.

167 SEC, Securities Exchange Act of 1934 Release No. 13583, June 1, 1977, [1977-1978 Transfer Binder] CCH FED. SEC. L. REP. ¶ 81,182.

168 SEC, Securities Exchange Act of 1934 Release No. 13662, *supra* note 159.

prototypes of such a system were available and in some use.[169] Although a third element of a national system, a national system for clearance and settlement, had not been achieved, the SEC believed that progress had been made; the National Securities Clearing Corporation had been registered as a clearing agency to take the place of the AMEX, NASD and NYSE clearing corporations. A fourth area, industry market linkage, appeared to have become bogged down. Although the National Market Association had sought industry support for a proposal to construct an electronic intermarket order routing facility, it had been unable to secure agreement among self-regulatory organizations on trading rules to be applicable to the system.[170]

As of early 1978 the elimination of barriers to competition within markets and among markets seemed inevitable. The SEC appeared to be pressing for this elimination, despite warnings that it might be premature, in the belief that it was the only spur likely to move the industry toward agreement on a National Market System. The New York Stock Exchange was trying very hard to preserve as much as possible the character of the exchange markets (and therefore its own supremacy among them) as at least somewhat independent entities within a national marketplace. The specialist's monopoly position seemed due to disappear and the exchange was prepared to sacrifice the secrecy of the specialist's book. Merrill Lynch and others were arguing for a Composite Limit Order Book with more or less unlimited broker-dealer access and in effect a single national marketplace, perhaps permitting the existence of other markets but with the expectation that they would be minor and probably restricted to inactive stocks. The best hope for the New York Stock Exchange, and therefore a likely compromise, seemed to be the evolution of the New York Stock Exchange, perhaps along with the American Stock Exchange, into a new national market. The New York Stock Exchange might at least be able to use its physical facilities to house a new national market and perhaps its clearing facilities as well. However, the NASD, which in NASDAQ already had a highly advanced quotation system, had given indications that it might be willing to develop a National Market System.

In its final report to the SEC in December 1977 the National

169 *Id.* at 24-25.

170 *Id.* at 31. Another difficulty has to do with exclusivity. A New York Stock Exchange subsidiary, Securities Industry Automation Corp., has a Common Message Switch (CMS) system which automatically routes orders to the New York or American exchanges. But the Midwest Stock Exchange complained in 1977 that the system should be able to direct orders to it and the broader question is whether any order

Market Advisory Board was quite divided in its views on what action the commission should take. Two members favoured the Merrill Lynch type of CLOB; four favoured a CLOB coexistent with other markets offering executions only to specialists and other "qualified" market-makers; three favoured market linkages, and two favoured commission action involving no more than the development of a composite quotation system. All believed that at least a composite quotation system should be in place when off-board trading restrictions were removed.

B. DEVELOPMENTS IN CANADA: CATS AND CANADA-WIDE

Planning toward a national securities market in Canada, the "Canada-wide securities market system", has been undertaken by a committee representing the Toronto, Montreal and Vancouver stock exchanges, and the Investment Dealers Association of Canada. The committee developed a conceptual model of the system in late 1975 which was put before the sponsors.[171] However, the ultimate form of the model and its method of implementation will depend very much on the development of a computer based trading system. The development is taking place in the form of the Computer-Assisted Trading System (CATS) research project at the Toronto Stock Exchange, which is described in some detail in Cleland, *Applications of Automation*, in this volume,[172] but a brief discussion may be helpful.

1. *CATS*

Work on CATS was begun in 1969 when the Toronto Stock Exchange concluded that some improvements in trading facilities were necessary to handle the rising volume of the exchange. It was decided to explore the possibility of a computer system that would enable trading to take place via terminals in members' offices rather than by traders meeting face-to-face in a trading room. If it was not possible to replace all face-to-face trading, then there was still the possibility of replacing some of it or at least making it more efficient through electronic communication.

In 1975 the first stage in the system development was

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routing system should automatically seek out the best execution regardless of market.

171 COMMITTEE FOR THE DEVELOPMENT OF A CANADA-WIDE SECURITIES MARKET, A CONCEPTUAL MODEL OF A CANADA-WIDE SECURITIES MARKET (June 23, 1975) (revised October 2, 1975).

172 *See, Cleland, Applications of Automation*; a technical description is given in *Jenkins, Computer Communications Systems.*

reached, in the form of CANDAT II, a market information system, providing quotations through terminals. CANDAT II was made available to TSE members and others and proved a successful product. What remained to be done was the inclusion of the entire "book" of limit orders and the addition of execution ability. By November 1977 the technical implementation was complete and tests were begun on CATS.

Initially, trading in six relatively inactive stocks was transferred to CATS. CATS operates through CANDAT II terminals which display on request to those with CATS access the "book" in these six stocks, showing prices and size of the bid and offer sides and codes identifying the source of each bid and offer. Members with access can complete an execution through their terminals.

In March 1978 the list was expanded to a total of eighty relatively inactive stocks, with thirty member firms entering orders from office terminals.

As of early 1978, it was not clear whether CATS could satisfactorily replace face-to-face trading on the floor of the exchange. United States experience was so far not helpful since the Consolidated Limit Order Book (CLOB) system had not yet been implemented anywhere to completely replace floor trading. Indeed, this was an aspect of trading about which U.S. markets might be able to learn from Canadian experience. However, putting the relatively inactive stocks on CATS is far from conclusive testing. The inactive stocks are traded at Posts 10 and 11 on the floor of the Toronto exchange. Members file their bids and offers in pigeonholes at these posts so that there is essentially a book of bids and offers in all of these stocks open for all members to see. Putting this book into a computer and substituting entries at a terminal for the physical filing of bids and offers at Posts 10 and 11 and the physical finding of members who entered these orders to complete a transaction does not suggest great difficulty. But for the active stocks the book of bids and offers consists of order slips carried by the floor attorneys for member firms. There is a strong inclination to keep these orders confidential and many believe that good executions can only take place among these attorneys meeting face-to-face in negotiation. Certainly those member firms that believe they possess a competitive edge in these negotiations have reason to resist the implementation of CATS.

The New York Stock Exchange has had good reason to be cautious about the development of a national system in the United States, but the CATS system in Canada is the product of a single exchange and the dominant exchange at that. It offers no immediate threat of sharing the market for Toronto listed stocks with outsiders and even if the system were to be extended to embrace

other stock exchanges in Canada, there is a sufficient overlap of memberships that the Toronto members have little to worry about. In the United States it is clear that the CLOB as proposed would integrate trading on the New York Stock Exchange with trading on the regional exchanges and in the third market. So specialists on the New York exchange can see in a CLOB a very serious threat to their business. Member firms in general see the likelihood of a move to dealer, rather than broker, markets. This move is distressing to some, but not all.

2. *The Canada-Wide Securities Market*

Just as the final development of a model for a Canada-wide system is waiting for confirmation of the feasibility of the CATS system, so the impetus for planning the system came from CATS. When the Toronto Stock Exchange undertook to develop CATS, the Montreal exchange was faced with a dilemma. There is a substantial overlap of membership and listed stocks between the Toronto and Montreal exchanges. Over 90% of the business on both exchanges is done by firms that belong to both. Probably two-thirds of the business on the Toronto exchange and 80% to 90% of the business on the Montreal exchange is in stocks listed on both. If the Toronto exchange were to implement a highly successful CATS, one demonstrating the superiority of computer based trading over face-to-face trading on an exchange floor, then the floors of both exchanges might disappear to be replaced by Toronto's trading system. This would probably be of little concern to the Montreal members who also trade on the Toronto exchange but would be a serious blow to the few firms that are members only of the Montreal exchange, and it might be painful, too, for the government of Québec.

The Montreal exchange, with resources considerably smaller than those of the Toronto exchange, could hardly attempt to develop an even better computer based trading system to capture the trading of the two exchanges. What it did was to propose the development of a Canada-wide system. The Toronto and Vancouver exchanges and the IDA took up the proposal and a project committee was formed. (The Alberta Stock Exchange was added to the committee in 1977.) Work began in 1973 on a conceptual model which was put before the sponsors in late 1975.

What the committee put forward was essentially a plan for a new securities market: the Canada-wide securities market. If the CATS trading system were successfully developed by the Toronto Stock Exchange, then the Canada-wide market would be built around that system. This was directly analogous to a United States

National Market System built around a CLOB. If CATS cannot be successfully developed, it is not clear just what form the Canada-wide market might take. But the committee's report suggested an attempt would be made to develop a floor trading system, one that sounds like a scheme for electronically linking the trading floors of three exchanges, perhaps in a manner similar to the linkages that have been evolving for stock exchanges in the United States.

The committee proposed a new entity to operate the Canada-wide system, which would be owned and controlled by the sponsors, and which would perform many of the functions of a self-regulatory organization including the disciplining of members. The committee did not discuss the question of responsibility of this new entity to a regulatory commission. But since the entity was proposed as an Ontario corporation, presumably it was contemplated that the Ontario Securities Commission, at least in the absence of any federal regulatory commission, might have jurisdiction over it.

The committee proposed that initially the Canada-wide system would include all stocks listed on the TSE plus stocks listed on the MSE and VSE meeting the current TSE listing requirements. All members of the three stock exchanges as of May 31, 1975, would have access to the Canada-wide system and new members of any of the three exchanges might be put forward by their exchanges as candidates for the Canada-wide system and might be accepted into it. This scheme could present some difficulties, if the Canada-wide system includes all of the TSE listed stocks and it becomes possible to gain trading access to all of these stocks without actually joining the TSE. The committee anticipated the possible depressing effects of the Canada-wide system on the value of a stock exchange membership and proposed that these effects be provided for in establishing membership fees for Canada-wide.

The conceptual model contemplated a highly centralized system and the industry was far from unanimously in favour of it. As of early 1978 it seems likely that the future of a Canada-wide system depends almost entirely on the future of CATS. Indeed the design of Canada-wide will become a matter of describing access to CATS.

Given a successful CATS, the Toronto Stock Exchange will presumably become the Canada-wide system for stocks listed on the TSE. So the TSE membership should be in a very strong position. Since these member firms, or some of them, dominate the trading on the Montreal and Vancouver exchanges, they have little reason to object to a cooperative Canada-wide system, at least so long as they are compensated for giving up some trading in

Toronto listed stocks to firms that are members only of the Montreal or Vancouver exchanges.

It is possible, of course, that a government or a regulatory agency confronted with a computerized marketplace, national in scope, might insist on the irrelevance of the TSE origin and create a new self-regulatory organization to operate the market. The likelihood of this happening, however, may depend on the TSE's willingness to accommodate the other exchanges in a Canada-wide entity.

C. TRANSFER BY BOOK ENTRY

A national securities market suggests, although it does not demand, a national clearing system. The Canadian securities industry can certainly cope with regional clearing – with a separate clearing organization for each stock exchange, for example. But a unified national system offers the prospect of economy and perhaps increased convenience. A national clearing system, in turn, suggests further economy in some method of securities transfer that does not involve the physical handling of certificates. The ideal seems to be a transfer system that consists entirely of book entries. The securities themselves are held by a central depository and the beneficial owners have their interests recorded on the books of the depository. A transfer of beneficial ownership requires no more than a debit and a credit entry on those books. Substantial progress has been made in both Canada and the United States toward this method of transfer. The details are discussed elsewhere[173] but a brief description is given here because transfer facilities are an important part of the securities market.

In the United States the Depository Trust Company was established in 1973 and is run by representatives of banks and a life insurance company, as well as representatives of broker-dealers and stock exchanges. Participation by banks is important, since this means that the banks are willing to accept stock held by the depository as collateral. A large number of institutions in the United States are now making use of Depository Trust Company, because transfers effected through its books can be both faster and cheaper than transfers that involve the movement of certificates.[174]

Just as the development of a national clearing system has confronted the SEC with a difficult choice between competition

173 *See, Cleland, Applications of Automation.*

174 The Municipal Securities Rulemaking Board has endorsed a proposal by Depository

and monopoly, so the same choice has emerged with respect to depositories. Indeed, since clearing, transfer and depository functions are all closely intertwined, all three call for some simultaneous resolution of the conflict.

In Canada work on the Canadian Depository for Securities Limited (CDS) began in 1968. In 1969 a staff was hired and a substantial financial commitment was made by organizations representing banks, life insurance companies, mutual funds, trust companies, and the securities industry. CDS developed a standard securities identification system and a securities settlement system (for institution and dealer settlement) that is now in operation. The clearing operations of both the Montreal and Toronto stock exchanges have been turned over to CDS.

As of early 1978 CDS had not yet become a depository. It serves as a convenient clearing agent to bring about exchanges of cash and securities among the dealers and institutions that are its members and it is able to reduce the flow of cash and securities by netting the obligations of all parties and calling for transfers to meet only the net obligations. It also has a linkage with the Depository Trust Company in the United States. But CDS has no inventory of securities (although it uses its own bank account in the process of transferring cash among its members). Depository status is waiting for a book entry transfer system.

There are many obstacles to full implementation of a book entry transfer system. Banks and trust companies in particular are concerned about the legal aspects of a transfer effected without a certificate. Closely related are concerns about detection of errors, prevention of fraudulent or improper transfers, protection of collateral, and all the safekeeping aspects of securities ownership. In addition, the book entry system represents a change from the traditional custodian and transfer functions of trust companies, and a number of trust companies are naturally suspicious that a change will do them an injury.

D. CONCLUSIONS AND POLICY IMPLICATIONS

Securities markets in the United States and Canada are competitors, and the competition became especially noticeable in 1976 and 1977. There was, as of early 1978, a growing conviction in the United States that the securities business will become still more competitive and that dealer markets will largely replace broker markets in stocks. As a result, the industry has been busy reorga-

Trust to handle municipal bonds through a book entry system; Securities Week (New York), August 15, 1977, at 6.

nizing itself through mergers, building strength across underwriting, trading and distribution and building the capital needed to carry dealer inventories. It may be helpful to Canadian markets to lead United States markets in the improvement of efficiency. But it may be crucial to at least avoid lagging the U.S. markets. If the United States attractions of lower commission rates and more liquid markets are supplemented by a vastly improved trading system, it may be very difficult for the Canadian exchanges to hold their share of trading in interlisted issues.

So far as automated trading is concerned, and substitution of terminals for face-to-face negotiation, Canadian systems testing may be ahead of American testing. CATS, on a limited basis, was doing in early 1978 what no system in the United States was yet doing. The delay in the United States is not one in technology. The computer-based trading systems are available. But the industry has not yet been able to organize itself to use the technology. It may well be that under congressional and SEC pressure there will be a great leap forward and the Canadian industry may have a chance to observe automated trading in some very active stocks. The risk to Canada lies in the possibility that the United States industry will be prodded or forced into a system that proves highly successful and attracts trading before the Canadian industry is able to agree on the full implementation of CATS.

The anticipated move in the United States toward greater dealer activity presents another competitive challenge. The Canadian industry is almost unanimous in viewing dealer activity with great suspicion. If, as seems likely, increased dealer market-making becomes part of the U.S. National Market System and provides greater depth and liquidity, that market will become even more attractive to Canadian as well as United States investors.

Competition or potential competition from U.S. markets, together with a wish to improve the efficiency of trading, are the principal motivation for developing CATS and a Canada-wide system. Unlike the United States industry, the Canadian industry is not being pressured by governments, regulatory agencies, or components of the industry itself. At the same time Canada is free of most if not all of the fears and resistance within the industry that have plagued development of a national system in the United States.

Appendix: Computation of Rates of Return

1. *Bankers' Acceptances*

The Bank of Canada tabulates annualized yields on 30-day bankers' acceptances. These rates, when divided by 12, give the monthly rates of return. The wealth relative was set at 100 as of the beginning of 1964, and compounded forward. For example:

$$\left\{\begin{array}{l}\text{wealth relative}\\ \text{end of}\\ \text{January 1964}\end{array}\right\} = \left\{\begin{array}{l}\text{wealth relative}\\ \text{beginning of}\\ \text{January 1964}\end{array}\right\} \times (1 + \text{January rate of return})$$
$$= 100 \times (1 + .0369/12)$$
$$= 100.31$$

$$\left\{\begin{array}{l}\text{wealth relative}\\ \text{end of}\\ \text{February 1964}\end{array}\right\} = \left\{\begin{array}{l}\text{wealth relative}\\ \text{beginning of}\\ \text{February 1964}\end{array}\right\} \times (1 + \text{February rate of return})$$
$$= 100.31 \times (1 + .0369/12)$$
$$= 100.62$$

The end of December wealth relatives are given in table 16.

Adjustment for inflation was handled as follows:

$$\left\{\begin{array}{l}\text{wealth relative}\\ \text{after inflation}\\ \text{adjustment for}\\ \text{end of month}\end{array}\right\} = \left\{\begin{array}{l}\text{wealth relative}\\ \text{before}\\ \text{adjustment}\end{array}\right\} \times \left\{\frac{\begin{array}{c}\text{consumer price index}\\ \text{end of 1963}\end{array}}{\begin{array}{c}\text{consumer price index}\\ \text{at end of month}\end{array}}\right\}$$

for December 1964 $= 103.75 \times 77.90/79.40$
$= 101.79$

The inflation-adjusted wealth relatives are shown in table 17.

2. *Treasury Bills*

The Bank of Canada tabulates yields on 3-month Government of Canada Treasury Bills. One-month rates of return were calculated on the assumption that a 3-month bill is purchased at the beginning of a month at a price given by:

$$\text{price beginning of month} = \frac{100}{\left(1 + \dfrac{\begin{array}{c}\text{quoted annual yield}\\ \text{at beginning of month}\end{array}}{2}\right)^{1/2}}$$

which is the present value of $100, discounted for one quarter at the quoted yield. It was assumed that the bill was sold at the end of a month at a yield that was the average of the 3-month yield quoted at that time and the yield one month before:

$$\text{price end of month} = \frac{100}{\left(1 + \dfrac{\text{yield at end of month} + \text{yield at beginning of month}}{4}\right)^{1/3}}$$

The average yield was used as an approximation of the yield on a two-month maturity and the expression above discounts $100 for two months at that rate.

The month's rate of return was calculated as:

$$\text{monthly rate of return} = \left(\frac{\text{price end of month}}{\text{price beginning of month}}\right) - 1$$

The wealth relatives were then calculated as in the case of bankers' acceptances with an initial value of 100 at the end of 1933 and adjusted for inflation in the same way.

3. *Government of Canada Long Bonds*

The Bank of Canada publishes yields to maturity for these bonds. It was assumed that a bond was purchased at par at the beginning of a month (the coupon was therefore assumed equal to the quoted yield to maturity at the time of purchase) and was sold at month end. It was also assumed that at purchase the bond's maturity was 18 years and therefore that at the sale date it was 17 years, 11 months. If the quoted yield is $2 \times C$ at the beginning of the month and $2 \times Y$ at the end of the month, the price at month end, plus accrued interest, is given by:

$$\text{Price plus accrued interest at month end} = C \times \left(\frac{\dfrac{1 - (1 + Y)^{-35}}{Y} + \dfrac{100}{(1 + Y)^{35}} + C}{(1 + Y)^{5/6}}\right)$$

The monthly rate of return was calculated as:

$$\text{monthly rate of return} = \left(\frac{\text{end of month price} + \text{accrued interest}}{100}\right) - 1$$

Wealth relatives were calculated just as for banker's acceptances, beginning with 100 at the end of 1934.

4. *Provincial, Municipal and Industrial Bonds*

The Bank of Canada publishes yields to maturity for these 3 classes of bond, obtained from McLeod Young Weir. Rates of return and wealth relatives were calculated as described above for government bonds. Wealth relatives were all initialized at 100 as of the end of 1947.

5. *Toronto Stock Exchange Index*

For the years since 1956, the Toronto Stock Exchange has tabulated its "300" Index which is published with the accompanying dividend. The monthly rate of return is given by:

$$\text{monthly rate of return} = \left(\frac{\text{month end index value} + \frac{\text{dividend}}{12}}{\text{beginning of month index}} \right) - 1$$

For earlier years, since 1933, an earlier index series was spliced to the new series. An adjustment factor of 0.181802 was used, reflecting the relationship between the two indexes over a year. The dividend yield was assumed to be 3% annually from the start of the series at the end of 1932 to the end of 1954. Yields computed by the exchange were used for succeeding months. Monthly rates of return were used to compute wealth relatives as for bankers' acceptances, with a value of 100 as of the end of 1932.

Constitutional Aspects of Federal Securities Legislation

Philip Anisman and Peter W. Hogg

September 1978

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"...the assertiveness of the federal legislature may exert pressure upon the court as to the view to be taken of the reach of constitutional power...the inflexibility of the Privy Council, for eighty years Canada's final court, appears to have diluted federal legislative courage."*

Chapter I
Introduction

The importance of the securities market has been emphasized in recent years by repeated statements of the vast amounts of investment capital required by Canadian industry during the next decade, especially for the development and exploitation of new sources of energy, for transportation and for the financing of small businesses.[1] Such statements at once highlight the primary function of the securities market and the need for it to perform that function effectively. Although securities markets are often defined in terms of the secondary markets, in Canada essentially the stock exchanges, economists generally agree that the allocation of funds from savers to users is the most important function

* B. LASKIN, THE INSTITUTIONAL CHARACTER OF THE JUDGE 18 (The Hebrew University of Jerusalem Lionel Cohen Lectures 1972), *reprinted in* 7 ISRAEL L. REV. 329, 342 (1972).

1 *See e.g.* REPORT OF THE ROYAL COMMISSION ON CORPORATE CONCENTRATION 259 (1978) ("between $460 and $520 billion"); A. Kniewasser, Address to the Association of Canadian Advertisers Incorporated, Toronto, May 1, 1978.

of the securities market; in other words, the primary function of a securities market is to facilitate the acquisition of capital from investors by industry.[2] The efficiency with which the market performs this allocational function affects the productivity of industry, employment and income and thus the overall growth of the economy.

However, if the primary market is to operate efficiently, it is necessary that the secondary market do so as well; the latter market not only enables investors to dispose of their investments, thus providing them with the security of liquidity, but also provides the basis for the pricing of new issues, that is, for the cost of capital. In short an efficient trading market enhances the allocational efficiency of the primary market by establishing an accurate pricing mechanism for new issues and by increasing investor confidence and concomitantly the readiness of investors to purchase such securities.[3] It is not surprising, therefore – indeed it is necessary – that the volume of trading in the secondary market far exceeds that in the primary.[4]

Investor confidence and an efficient securities market are complementary conditions, each contributing to the other. Securities legislation, therefore, has generally been intended to increase investor confidence by ensuring the fair operation of the market with the ultimate purpose of enhancing its efficiency.[5] And it has done so by a number of intermediate techniques such as the licensing of securities professionals in order to ensure their honesty, competence and financial stability, disclosure requirements so that investors may have equal access to information relevant to their investment decisions, and the prohibition of manipulative and other fraudulent methods of trading. More recently it has been used to regulate directly the self-regulatory bodies in order to encourage them to supervise their members, to deter anticompetitive conduct and even to regulate the cost of transactions established by them.

An efficient securities market may also aid in the achievement of other policy goals. Most obviously, it encourages savers to

2 *See generally, Williamson, Capital Markets,* ch. II; W. BAUMOL, THE STOCK MARKET AND ECONOMIC EFFICIENCY (1964); Friend, *The SEC and the Economic Performance of Securities Markets,* in ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES 185 (H. Manne, ed. 1969); *see also* Mendelson, *Economics and the Assessment of Disclosure Requirements,* 1 J. COMP. CORP. L. & SEC. REG. 49 (1978).

3 *See e.g. Williamson, Capital Markets,* ch. II.

4 *See id.* ch. I; *see also* ONTARIO SECURITIES COMMISSION DISCLOSURE REPORT at 27 n. 51 (new issues filed with OSC in 1968 less than 10% of value of trading on Toronto Stock Exchange in same year); *cf.* Wheat, *The Disclosure Policy Study of the SEC,* 24 BUS. LAW, 33, 34 (1968) (proportion of secondary to primary markets in the United States is 50 or 60 to one).

5 *See e.g.* KIMBER REPORT, pt. 1, and in particular ¶ 1.12.

employ their funds productively and enables both individuals and institutions to participate in the ownership and control of business enterprise. Moreover, by encouraging investment, in particular equity investment, it facilitates Canadian ownership of such enterprises and also enhances foreign portfolio investment as an alternative to foreign direct investment, thus providing at least a partial solution to foreign ownership of Canadian industry.[6]

That the functions performed by the securities market transcend provincial boundaries is undeniable and economists have long recognized that the financial market in Canada is national in scope.[7] Indeed this fact is demonstrated by the cooperative efforts of the provincial securities administrators, for example, in the adoption of "national policy statements" and in particular by the first such statement which establishes a cooperative system to avoid unnecessary delays in the clearance of prospectuses for national issues.[8] It is clear that provincial borders are irrelevant to buyers and sellers of securities unless artificial boundaries are erected by law and that the efficient functioning of the primary market in Canada, if nothing else, creates pressures compelling the adoption of national policies.

The national character of the securities market is emphasized by the operations of the Canadian securities exchanges and by the process through which they obtain approval of their commission rates. The exchanges invariably settle on a commission structure among themselves and then each exchange applies to the securities commission in its province for approval. If a commission denies approval, the exchanges renegotiate with each other in order to develop a new structure that satisfies it. The initial application is usually made before the Ontario Securities Commission by the Toronto Stock Exchange and once it receives that commission's approval other commissions may be forced to accept a compromise with which they may disagree.[9] Similarly a single clearing facility

6 *See e.g. Howard*, text accompanying n. 37 and following.

7 *See e.g.* PORTER REPORT; *cf.* REPORT OF THE COMMITTEE TO STUDY THE REQUIREMENTS AND SOURCES OF CAPITAL AND THE IMPLICATIONS OF NON-RESIDENT CAPITAL FOR THE CANADIAN SECURITIES INDUSTRY ¶ 4.4 (1970) [hereinafter MOORE REPORT]; and *see* CANADIAN MUTUAL FUND REPORT, especially ch. 19.

8 *See* National Policy Statements Nos. 1-29, 2 CCH CAN. SEC. L. REP. ¶¶ 54-838 - 54-867; National Policy No. 1 is entitled "Clearance of National Issues". *See also* Uniform Act Policy Statements Nos. 2-01 - 2-12, 2 CCH CAN. SEC. L. REP. ¶¶ 54-871 - 54-882, adopted by the "uniform act" provinces, Alberta, British Columbia, Manitoba, Ontario and Saskatchewan. *Cf.* REPORT OF THE STUDY COMMITTEE ON FINANCIAL INSTITUTIONS 131-35 (Québec 1969).

9 *See e.g.* QSC TASK FORCE, COMMISSION RATES IN THE SECURITIES INDUSTRY (June 1976); UPDATED REPORT ON COMMISSION RATES IN THE SECURITIES INDUSTRY (December 1976) (opposing fixed rates). The report is summarized in *Williamson, Financial Institutions*, ch. III.C.

for options traded on the Montreal and Toronto exchanges was developed primarily as a result of the Ontario Securities Commission which required the two exchanges to cooperate in its establishment.[10] And even the Ontario Commission has found itself in the unenviable position of either accepting a uniform set of rules for takeover bids made through the facilities of a stock exchange which had been approved by several other commissions for the exchanges in their provinces, but with which the Ontario Commission disagreed, or depriving Ontario investors of an opportunity to profit in a bid made subject to those rules in other provinces.[11]

Even more important, technological developments are underscoring the national character of the market with the increasing use of automation in the dissemination of trading information, the clearing and settlement of securities and even the trading of securities.[12] Information on transactions on each of the major stock exchanges in Canada is available on all three trading floors. The Canadian Depository for Securities handles the clearing and settlement of trades for the Toronto and Montreal Stock Exchanges and also has connections with the Depository Trust Company, its counterpart in New York; and the Vancouver Stock Exchange Service Corporation performs a similar function for that exchange and for the Alberta Stock Exchange. Most significant, the Computer-Assisted Trading System which is now being tested at the Toronto Stock Exchange enables stock to be traded by means of computer terminals in the offices of its member firms instead of on the exchange floor and appears likely to lead to an automated Canada-wide trading system which would replace the trading floors of all the Canadian exchanges.

Automation of the Canadian market will complement the already increasing internationalization of securities markets. Although Canadian developments have been alleged to be somewhat ahead of those in the United States, the U.S. securities market is headed in a similar direction. Forty-four years ago the United States Congress, recognizing that the stock exchanges in the United States were institutions with national economic impact, passed the Securities Exchange Act of 1934 to regulate their activities. In the early part of this decade Congress again considered the securities market and enacted the Securities Reform Act

10 *See In re* The Montreal Options Clearing Corporation, [1976] OSC Bull. 93, 99-101 (March).

11 *See In re* Bralorne Resources Limited, [1976] OSC Bull. 258 (September) ("stock exchange takeover bid" made by Cornat Industries Limited for shares of Bralorne Resources Limited through Vancouver and Montreal exchanges). *See also infra* text accompanying notes 15-16, 64-69.

12 *See generally, Cleland; Jenkins; Williamson, Capital Markets,* ch. IV.B, C; *see also infra* ch. III.C.

of 1975 which, *inter alia*, requires the Securities and Exchange Commission to direct and supervise the development of a "national market system for securities".[13] The proposals for that system have been premised on the use of computerized trading[14] and it is likely that when the system is developed some links with a parallel computerized trading system in Canada will also be established. Similar developments are occurring in the United Kingdom and computer connections with the securities market in Britain, and even Japan, now seem possible of achievement.

Even without such a system, however, it is clear that the securities markets are not only transprovincial but also transnational as was shown recently in the acquisition by Alberta Gas Trunk Line Company of over a third of the outstanding shares of Husky Oil Limited in order to defeat announced takeover bids by Petro-Canada Limited and Occidental Petroleum Corporation. As the shares of Husky Oil were listed on the American as well as the Toronto Stock Exchange, Alberta Gas was able to purchase the shares in the United States in a manner which is precluded by the by-laws of the Canadian exchange[15] and thus use to its own advantage the differences between the rules governing acquisitions in the two jurisdictions.[16]

Investors have thus always ignored national borders in relation to their investment decisions. Perpetrators of frauds have done likewise and have exploited the potential for evasion of securities laws by organizing fraudulent schemes on an international basis.[17] The obvious example is Investors Overseas Services Ltd., the activities of which caused some damage to Canada's international reputation.[18] There have been other examples as well; in recent years both the Quebec and British Columbia Securities Commissions have attempted to prevent local issuers from selling their securities abroad.[19]

All of the above factors indicate the inevitability of some form of federal involvement in the regulation of the Canadian securities market. Recent recommendations for amendment of the income tax laws to encourage investment in equity securities ensure this

13 Securities Exchange Act of 1934, s. 11A, added by Securities Reform Act of 1975, s. 7.

14 *See generally, Williamson, Capital Markets*, ch. IV.A.

15 *See* TSE BY-LAWS, pt. XXIII (maximum of 5% of shares may be purchased in 30-day period).

16 *See e.g.* Carruthers, *AGTL Raises Holding in Husky to 35%*, The Globe and Mail (Toronto), June 28, 1978, at Bl, col. 4.

17 On international enforcement problems generally, *see*, *Hebenton & Gibson*.

18 *See* 1 MUTUAL FUND PROPOSALS at 52.

19 *See e.g. In re* Rock Enterprises Limited, 8 QSC Bull., No. 39 (Decision 5357, Septem-

result[20] and reinforce the national economic implications of the functioning of the securities market. It is the responsibility of the federal government to consider the interest of the country as a whole.

Indeed, it is perhaps to be expected that the provincial commissions will tend to emphasize local policies and interests.[21] On occasion parochial interest has even become dominant to the detriment of the efficient functioning of the market. The prime example is the implementation of a policy in 1969 by the Quebec Securities Commission requiring orders received in Québec to be filled on the Montreal or Canadian Stock Exchange;[22] the application of the policy as a basis for disciplining a registrant for executing a Québec order on the Toronto Stock Exchange[23] resulted in a retaliatory amendment to the Toronto Exchange's by-laws precluding arbitrage transactions by its members with the Québec exchanges[24] and thus served to some extent to balkanize the Canadian market. Once enacted, the policy and the accompanying restrictions persisted; in fact, the policy was not repealed until within the last year[25] and the exchanges announced only within the last few months that agreement has been reached on repeal of the "anti-freighting" rules.[26]

The recent removal of the barriers to arbitrage emphasizes the movement toward a Canada-wide trading system.[27] In short

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ber 22, 1977); *see also In re* Dévelopement Morin Heights (Canada) Limitée, 9 QSC Bull., No. 26 (Decision 5593, June 14, 1978).

20 *See e.g.* REPORT OF THE ROYAL COMMISSION ON CORPORATE CONCENTRATION, ch. 11 (1978).

21 *See e.g. In re* The Montreal Options Clearing Corporation, [1976] OSC Bull. 93, 96-97 (March) (Commission hesitant to authorize options trading by Chicago Clearing Corporation as might "hinder the development of a similar options market in Ontario - a development the Commission wished to encourage").

22 *See* Policy Statement No. 4, 3 CCH CAN. SEC. L. REP. ¶ 66-015; *cf.* Notice re: Buy and Sell Orders of Securities Originating in British Columbia, B.C. Corporate and Financial Services Division Weekly Summary, September 12, 1975, at 8.

23 *See In re* Mills, Spence & Co. Limited, 1 QSC Weekly Summary, No. 4 at 2 and 4 (1970) (Decision Nos. 1107 and 1049 respectively).

24 *See, TSE Moves to Curb Block-Trade Outflow,* The Globe and Mail (Toronto), September 2, 1970, Bl, col. 4 at col. 5; Editorial, *One Act of Discrimination Provokes Another,* The Globe and Mail (Toronto), September 4, 1970, at 6, col. 1; Balfour, *MSE, CSE to Discuss Toronto Restriction,* The Globe and Mail (Toronto), September 5, 1970, at B2, col. 4; Sugar, *Arbitrage Now Could Become an Ugly Battle,* The Financial Post, September 19, 1970, at 22, col. 6.

25 *See* Notice: Abrogation of Policy Statement number 4, 8 QSC Bull., No. 35, September 6, 1977 (Decision No. 5316, August 31, 1977). The decision is especially interesting in that it recognizes the likely development of a nationally integrated trading market.

26 *See, Exchanges Agree on Rules,* The Globe and Mail (Toronto), June 14, 1978, at B8, col. 6.

27 *See supra* note 25.

there is already a substantial computer network that links the Canadian exchanges for limited purposes and it appears likely that in the not-too-distant future there will be one automated Canadian exchange through which both trading and settlement occur. This development makes federal involvement in the regulation of the market essential, both as a matter of policy and because the provinces lack jurisdiction to regulate an interprovincial undertaking.[28] In any event, even the present limitations on their authority may on occasion impede the ability of the provincial legislatures to deal effectively with fraudulent or other transactions that are interprovincial or international as was shown in the Husky Oil case mentioned above.[29]

It is clear that the federal government has an interest in the efficient functioning of the securities market in Canada. In fact, it is already involved in its regulation through the tax laws and the prohibitions against fraud contained in the Criminal Code[30] and this involvement is likely to increase with the developing role of financial institutions - for example, banks - in the market.[31] Moreover, the federal government has long engaged in international negotiations relating to the securities market in connection with treaties and to obtain beneficial treatment for Canadian corporations,[32] and in light of the developments in the Canadian and international markets outlined above, its involvement in this area too is likely to increase. It is, therefore, the purpose of this paper to outline the constitutional basis in Canada for securities legislation and, in particular, the jurisdiction available to the federal government to enact such legislation.

Chapter II
Provincial Jurisdiction over Securities

Although there is some federal legislation affecting the secur-

28 Interprovincial undertakings are discussed *infra* ch. III.C.

29 *See supra* text accompanying notes 15 and 16; *see also* Black v. Doherty McCuaig Ltd., [1974] 4 W.W.R. 342 (B.C.S.C.). The scope of provincial jurisdiction to regulate the securities market is discussed in ch. II.

30 *See e.g.* Criminal Code, ss. 338-42, 358.

31 *See* An Act to Revise the Bank Act, Bill C-57, 30th Parl., 3d Sess. (First reading May 18, 1978); *see generally, Williamson, Financial Institutions*, ch. IV. And *cf.* An Act Respecting Bankruptcy and Insolvency, Bill S-11, 30th Parl., 3d Sess., pt. VII (First reading March 21, 1978).

32 *See e.g.* FOREIGN DIRECT INVESTMENT IN CANADA 279-80 (Canada 1972), outlining the negotiations between the Government of Canada and the Securities and Exchange Commission in the mid 1960s in order to retain exemptions for Canadian corporations from the reporting requirements of the Securities Exchange Act of 1934. For a discussion of the treaty-making power, *see generally* P. HOGG, CONSTITUTIONAL LAW OF CANADA, ch. 10 (1977) [hereinafter cited as P. HOGG].

ities market,[33] only the provinces have enacted statutes that can properly be termed securities acts. Indeed, since their entry into the field almost sixty years ago provincial legislatures have consistently accorded much attention to the securities market as is demonstrated by the virtually continuous process of amendment to and revision of the provincial acts.[34] Not surprisingly, the legislation has also been the subject of consideration by the courts which have made clear that the provinces have extensive powers to regulate trading in securities.[35]

The provinces have enacted securities legislation under their authority to legislate in relation to "Property and Civil Rights in the Province" which has been interpreted to include contracts, dealings with property and the regulation of businesses, trades and professions.[36] Provincial power in relation to the securities market in particular has been generously interpreted by the courts. In 1932 the Privy Council upheld the Alberta Security Frauds Prevention Act, 1930,[37] as a valid exercise of provincial jurisdiction intended to protect local investors from fraudulent practices[38] and the case, now the leading decision in the field, has been broadly read so that in most instances in which a question concerning the validity of a securities act has arisen, the provincial legislation has been upheld.[39] Judicial sympathy for provincial securities legislation is reflected even more dramatically in a number of decisions which held that no conflict exists between federal legislation and overlapping provisions in the securities acts.[40]

33 *See e.g. supra* notes 30, 31 and accompanying text.

34 The first securities act enacted in Canada was the Sale of Shares Act, S.M. 1912, c. 75; *see also* R.S.M. 1913, c. 175. For the history of Canadian securities legislation until 1966, *see* J. WILLIAMSON, ch. 1; J. WILLIAMSON, SUPP., ch. 1. Since 1966 the amount of legislative attention paid to securities has, if anything, increased; *see e.g.* P. ANISMAN at 4-8. And *see* the recent efforts in Ontario to replace the present "uniform act" with a new one; Ontario Bill 154; Bill 75; Bill 98; Bill 20; Bill 30; and Bill 7. Bill 7 received third reading on June 23, 1978.

35 *See generally* P. HOGG, *supra* note 32, at 312-13; LASKIN'S CANADIAN CONSTITUTIONAL LAW 359-61 (4th ed. rev., A. Abel ed. 1975) [hereinafter cited as LASKIN]; J. WILLIAMSON, ch. 7; J. WILLIAMSON, SUPP., ch. 7; *see also* KIMBER REPORT, pt. IX.

36 British North America Act, 30 & 31 Vict., c. 3, s. 92(13) (1867) [hereinafter cited as BNA Act]. On the interpretation of the section, *see* P. HOGG, *supra* note 32, ch. 17.

37 S.A. 1930, c. 8. The act required persons trading in securities to obtain a licence as a broker or salesman and granted extensive powers of investigation.

38 Lymburn v. Mayland, [1932] A.C. 318 (P.C.).

39 *See e.g.* Re Thodas, 10 C.R.N.S. 290 (B.C.C.A. 1970); International Claim Brokers Ltd. v. Kinsey, 57 D.L.R. (2d) 357 (B.C.C.A. 1966); Woodson v. Russel, [1961] Qué. Q.B. 349 (C.A. 1959); Re Williams, 29 D.L.R. (2d) 107 (Ont. C.A. 1961).

40 *See* Duplain v. Cameron, [1961] S.C.R. 693 (requirement that issuer of promissory notes register not in conflict with Bills of Exchange Act); Smith v. R., [1960] S.C.R. 776 (offence for misrepresentation in prospectus not in conflict with false prospec-

The reluctance of the courts to strike down provincial securities legislation likely stems in part from the fact that there is no federal securities law so that a declaration of the invalidity of a provincial act or any of its provisions would create a potential gap in the existing regulatory scheme that might be exploited by the unscrupulous.[41] This unstated influence is manifest in the famous *McKenzie Securities* case in which a broker-dealer registered in Ontario was held to have violated the Manitoba Securities Act by trading in Manitoba without registration;[42] the trading consisted of solicitations made from Ontario to Manitoba residents by means of telephone calls and letters. As the activities in question were clearly interprovincial, the court felt constrained to demonstrate that the impact of the conduct was felt in Manitoba and was, therefore, within the Manitoba Act[43] and found it necessary to support this conclusion with the assertion that securities legislation is "not in the nature of marketing legislation";[44] as a result it was reasonable to conclude that it was not "designed in any way for the regulation of interprovincial trading" and had no extra-provincial effects.[45]

It is not surprising that the Supreme Court of Canada denied an application for leave to appeal the decision[46] for the Manitoba Court of Appeal in its refusal to analogize the Act to marketing legislation had relied expressly on a dictum of the Supreme Court in a decision made the year before involving the converse fact situation. In *Gregory & Company Inc. v. QSC* the Supreme Court of Canada upheld the application of the Quebec Securities Act to a broker-dealer in Québec who traded only with clients outside the province, in fact, outside the country.[47] As the constitutional issue

tus section of Criminal Code); Malczewski v. Sansai Securities Ltd., 49 D.L.R. (3d) 629 (B.C.S.C. 1974) (condition on registration requiring deposit in trust fund for benefit of clients in event of bankruptcy neither in relation to bankruptcy nor in conflict with Bankruptcy Act); Gregory Company Inc. v. Imperial Bank of Canada, [1960] Que. S.C. 204 ("freeze order" under Québec Securities Act applicable to registrant's account in bank). *But see* Multiple Access Ltd. v. McCutcheon, 16 O.R. (2d) 593 (Div'l Ct. 1977), *affirmed,* (Ont. C.A. June 14, 1978, unreported). The paramountcy doctrine is discussed *infra* ch. III.H.

41 *See e.g.* LASKIN, *supra* note 35, at 360; P. HOGG, *supra* note 32, at 313.

42 R. v. W. McKenzie Securities Ltd., 56 D.L.R. (2d) 56 (Man. C.A. 1966), *leave to appeal denied sub nom.* West v. R., [1966] S.C.R. ix.

43 *See id.* at 64. The key passage, which reflects a conflict of laws interest analysis more than a traditional constitutional analysis to determine whether the transaction is interprovincial or intraprovincial, is quoted and discussed in J. WILLIAMSON, SUPP. at 226-27.

44 56 D.L.R. (2d) at 61.

45 *Id.* at 62-63; *see also* R. v. Jaasma, [1974] 1 W.W.R. 245 (Alta. Prov. Ct. 1973). *Cf.* Moran v. Pyle National (Canada) Ltd., [1975] 1 S.C.R. 393 (1973).

46 *See* West v. R., [1966] S.C.R. ix.

47 Gregory & Company Inc. v. QSC, [1961] S.C.R. 584. For a discussion of the decision, *see* J. WILLIAMSON, SUPP. at 225-26.

was not properly raised, the matter was determined on the basis of the Act which expressly deemed such transactions to be made within the province.[48] Nevertheless, Mr. Justice Fauteux, writing for the majority, declared that securities legislation is not like marketing legislation, thus appearing to indicate that it is applicable to interprovincial transactions where some defined activity occurs in the province.[49] However, as has been indicated elsewhere, the statement is ambiguous and it is doubtful that he intended to say that a province can regulate interprovincial and international trading; more likely he meant that the Securities Act was directed only at conduct in the province whereas the marketing legislation necessarily involved consequences outside the province.[50]And it is clear that neither the Québec nor the Manitoba legislation precluded any person from trading in securities outside the province.

It is arguable on a conceptual basis that there is no difference between an interprovincial transaction in commodities and one in securities and that the *McKenzie* case is inconsistent with the principles espoused in the marketing decisions of the Supreme Court.[51] Moreover, it has been cogently argued that the decision would permit a province to close its borders to nonresident brokers and dealers, for if "Manitoba refuses to register nonresidents, then the province has shut off interprovincial trading across its borders".[52] Nevertheless, as long as no federal legislation exists to regulate interprovincial trading in securities, it is doubtful that the approach reflected in *Gregory* by Mr. Justice Fauteux and in

48 *See* Quebec Securities Act, s. 50.

49 [1961] S.C.R. at 590; *see also supra* text accompanying notes 44, 45.

50 *See* J. Williamson, Supp. at 226. The same point was made in R. v. W. McKenzie Securities Ltd., 56 D.L.R. (2d) at 62. And *cf.* Cowen v. A.G.B.C., [1941] S.C.R. 321. *See also* the concurring opinion of Cartwright, J., stressing that the *Gregory* case does not decide in any manner whatever the constitutional validity of the Québec act, even while indicating some doubt about it; [1961] S.C.R. at 591-92. The Quebec Securities Commission has relied on *Gregory* to justify the application of the Quebec Securities Act to an issuer with its head office in Québec selling securities through a subsidiary exclusively outside the province; *see In re* Développement Morin Heights (Canada) Limitée, 9 QSC Bull., No. 26 (Decision 5593, June 14, 1978).

51 *See e.g.* A.G. Man. v. Man. Egg and Poultry Assn., [1971] S.C.R. 689; Burns Foods Ltd. v. A.G. Man., [1975] 1 S.C.R. 494; Reference re Farm Products Marketing Act, [1957] S.C.R. 198; and *see* P. Hogg, *supra* note 32, at 313 n. 112. *See also* Interprovincial Co-operatives Ltd. v. R., [1975] 5 W.W.R. 382, 390 (S.C.C. 1975) (where contract affects interprovincial trade, is no longer within provincial jurisdiction). *But see e.g.* Shannon v. Lower Mainland Dairy Products Bd., [1938] A.C. 708 (P.C.); Home Oil Distributors Ltd. v. A.G.B.C., [1940] S.C.R. 444; Carnation Company Ltd. v. Qué. Agricultural Marketing Bd., [1968] S.C.R. 238.

52 J. Williamson, Supp. at 227. *See also e.g.* Manitoba Securities Act, s. 14 (residence requirement). In fact the validity of the Ontario provisions relating to nonresident ownership of registrants has recently been questioned; *see* Anderson, *Reynolds to Appeal OSC Ruling,* The Globe and Mail (Toronto), March 22, 1978, at B4, col. 1.

McKenzie Securities will be reconsidered in any significant manner.

However, as the Kimber Committee recognized, there remain substantial limitations on provincial legislative jurisdiction arising "in the main, from the territorial restriction on all provincial law-making power, and from the interprovincial and, indeed, international character of the securities industry".[53] In fact the head of power which authorizes the enactment of securities laws by the provinces is explicitly limited to "property and civil rights *in the province* "[54] and a body of case law has demonstrated that this territorial limitation may be an impediment to effective provincial regulation.[55] For example, during the depression the Western provinces were held incapable of relieving resident debtors of some of their obligations where the scheme adopted involved impairment of the rights of creditors outside the enacting province.[56] More recently the Supreme Court of Canada adopted a similar analysis as a basis for declaring invalid a scheme adopted in Manitoba which would have governed the terms of a contract for the purchase of hogs in Saskatchewan.[57] Manitoba has also been held incompetent to create a statutory right of action against persons who discharge pollutants into rivers flowing into the province because it would, in effect, have destroyed rights to discharge granted by the province in which the polluter carried on its activities, including the discharge.[58]

These decisions indicate that a province's jurisdiction is limited to persons, property or activities within its borders and that the existence of some element in the province will not necessarily be sufficient to support regulatory legislation that modifies rights outside the province or that creates extraterritorial duties. Thus, despite *McKenzie Securities*, provincial legislation may in some circumstances be incapable of dealing adequately with securities transactions that involve interprovincial or international elements, especially in relation to enforcement problems.[58a] There has long been doubt, for example, over the validity of the warrant

53 KIMBER REPORT ¶ 9.01.
54 BNA Act, s. 92(13) (emphasis added).
55 *See e.g.* P. HOGG, *supra* note 32, at 208 - 11.
56 *See* Credit Foncier Franco-Canadian v. Ross, [1937] 3 D.L.R. 365 (Alta. App. Div.); *see also* Royal Bank of Canada v. The King, [1913] A.C. 283 (P.C.); Ottawa Valley Power Co. v. Hydro Elec. Power Commn., [1937] O.R. 265 (Ont. C.A.); Beauharnois Light, Heat and Power Co. v. Hydro Elec. Power Commn., [1937] O.R. 796 (Ont. C.A.). The approach in these decisions has been questioned; *see* P. HOGG, *supra* note 32, at 209-10.
57 Burns Foods Ltd. v. A.G. Man., 40 D.L.R. (3d) 731, 736-37 (S.C.C. 1973).
58 Interprovincial Co-operatives Ltd. v. R., [1976] 1 S.C.R. 477, [1975] 5 W.W.R. 382.
58a *See e.g.* Baillie and Alboini, *The National Sea Decision - Exploring The Parameters of Administrative Discretion*, 2 CAN. BUS. L.J. 454 (1978).

backing provisions contained in all the provincial securities acts[59] because of a decision holding an analogous procedure an "attempt to give extra-provincial effect to proceedings under" a provincial statute.[60] A more recent decision held the effect of a cease trading order issued under the British Columbia Securities Act to be limited to the province so that it did not preclude transactions in Ontario for the account of a British Columbia registrant.[61] As a result a Vancouver registrant was not able to obtain securities to cover a short sale to an Ontario registrant which then purchased the securities at a price resulting in a substantial loss to the former registrant's client. Mr. Justice Anderson viewed the case as an example which

> "points up the drastic results which can flow from the lack of a federal regulatory agency or, alternatively, the lack of joint action by the provincial regulatory bodies. It seems obvious that one of the results of the prohibitory orders was to dry up the supply of shares (capable of delivery) in British Columbia and, thereby, force up the market in Ontario."[62]

The distortive effects of a cease trading order made in one province where trading in the securities that are subject to it continues in other provinces have also been felt in Ontario.[63]

The regulatory problems facing provincial legislatures as a result of the territorial limitations on their legislative authority are highlighted by recent events and legislation relating to takeover bids. The recent acquisition of shares in Husky Oil Limited by Alberta Gas Trunk Line Company has caused some stir in Canada.[64] Because the shares were purchased on the American Stock Exchange in a manner that would not be permitted under the rules of the Toronto Exchange,[65] on which the shares are also listed, and because the proposed Ontario legislation expressly legitimates the Canadian exchange's approach,[66] it has been suggested that Ontario investors were deprived of a fair opportunity to sell their shares in Husky Oil at the prices paid in the United States.[67] In fact the Ontario Securities Commission has stated that

59 *See e.g.* Ontario Securities Act, s. 149; *see also* J. Williamson at 208.

60 *Ex parte* Eli, [1920] 1 W.W.R. 661, 662 (Alta. S.C.).

61 Black v. Doherty McCuaig Ltd., [1974] 4 W.W.R. 342 (B.C.S.C.).

62 *Id.* at 344.

63 *See e.g. In re* Bralorne Resources Limited, [1976] OSC Bull. 258 (September), discussed *supra* text accompanying note 11.

64 *See supra* text accompanying notes 15, 16.

65 *See supra* note 15.

66 *See* Ontario Bill 7, s. 88(2)(a).

67 *See* Pritchard, *OSC Upset Small Holder Was Left Out*, The Globe and Mail (Toronto), June 30, 1978, at B1, col. 2. The apprehended unfairness appears to ignore the fact that Ontario investors had an opportunity to sell their shares on the American

it is considering whether the Ontario cabinet has authority to limit the exemption from the takeover bid requirements to exchanges which have "stock exchange takeover bid" rules like those of the Canadian exchanges.[68] It is, however, reasonably clear that Ontario lacks jurisdiction to impose its statutory scheme for takeover bids on a person who purchases on an exchange outside the country, even if the corporation the shares of which are sought is listed on the Toronto Exchange.[69]

One of the major innovations in Ontario Bill 7 demonstrates the difficulties inherent in any attempt to develop a national regulatory scheme through uniform provincial legislation. The proposed legislation will require a person who buys a control block of shares at a premium above the market price[70] to make an equivalent offer to purchase the shares of the remaining shareholders.[71] As such an offer would be ineffective if made only to shareholders in Ontario, the bill requires that the offer be made to all securityholders of the same class whose last registered address

Stock Exchange at the inflated prices resulting from the announced bids and that the prices on the Toronto Exchange were also affected by the announcements. Indeed, the president of Alberta Gas Trunk Line has stated that over 90% of the independent Husky shares were held by arbitrageurs in New York which indicates that many Ontario investors had likely taken advantage of the opportunity to sell on the market; *see* Lukasiewicz, *AGTL Chief Claims Concern Has No Basis*, The Globe and Mail (Toronto), July 4, 1978, at B3, col. 3. And it is likely that many of those who did not so sell held their shares in the expectation that either Petro-Canada or Occidental Petroleum would make a takeover bid at an even higher price; *see* Pritchard, *Husky Share Price Takes Sharp Drop As Trade Resumed*, The Globe and Mail (Toronto), July 1, 1978, B1, col. 1 at col. 2. In short, it is questionable whether Ontario investors were deprived of any opportunities other than as a result of the Toronto Stock Exchange rules which precluded open market purchases otherwise permissible under Canadian legislation. If any party suffered from the transaction it was Petro-Canada which conducted itself in an open manner and as a result was precluded by U.S. law from countering the market purchases of Alberta Gas, even though it would have been permitted to do so under the Canadian legislation; *see* Securities Exchange Act of 1934, Rule 10b-13; *cf.* Canada Business Corporations Act, ss. 190(e), (f).

68 *See* Pritchard, *OSC Upset Small Holder Was Left Out*, *supra* note 67.

69 *See supra* text following note 58 and authorities cited in notes 57, 61. In any event, Ontario Bill 7 does not clearly include such an offer as a "takeover bid" because it is not made to Ontario residents and because the other elements of the definition are presumably limited territorially so that only an acceptance of an offer to sell by a person in Ontario is covered; *see* Ontario Bill 7, s. 88(l)(k). In fact, the definition is arguably so confined expressly as an acceptance is deemed to be an offer to purchase and only offers made to Ontario residents are within the definition; *id.* ss. 88(l)(k)(i), (ii). Although it might be argued that an offer made on a U.S. stock exchange is made to Ontario investors, it is at best doubtful whether the argument would succeed.

70 *See* Ontario Bill 7, ss. 88(l)(e) and (k), defining "market price" and "takeover bid"; the latter definition is framed in terms of an acquisition of shares that brings an offeror's holdings in the issuer over 20%.

71 *Id.* s. 91(1).

"is in Ontario or in a uniform act province".[72] In order to facilitate this result neither the definition of "takeover bid" nor that of "offeror" is expressly limited to the province.[73] It is likely, however, that the section would be characterized as merely imposing a duty on a local offeror, especially if it is read as applicable only to acceptances in Ontario.[74] While such an interpretation may be necessary to the provision's validity,[74a] it would be inconsistent with the other part of the section dealing with normal takeover bids made to Ontario offerees by any offeror;[74b] and, more importantly, it would necessarily be ineffective because of its failure to cover non-Ontario offerors. Indeed, it might even act as a deterrent to Ontario offerors by creating an advantage for foreigners. In short, if the provision is read down to avoid any extraterritorial application, even uniform legislation will not be sufficient to catch all purchases of control.

It is clear, therefore, that the limitations on provincial jurisdiction not only cast doubt on the ability of the provincial commissions to enforce their own acts in connection with interprovincial and international transactions but also on the ability of the provinces, even acting cooperatively, to enact a scheme that will satisfactorily regulate the entire securities market. It goes without saying that similar restrictions do not apply to the federal government's ability to legislate;[75] indeed, it is clear that Parliament may enact legislation with extraterritorial impact.[76]

A further limitation on provincial power to regulate the secur-

72 *Id. See also* Ontario Bill 7, s. 129 (person who fails to make takeover bid liable to pay "to the securityholders entitled to receive the offer" the amount at which the bid required to be made). Given the policy implicit in the Bill, even the requirement that the offer be made to securityholders in a uniform act province is an unsatisfactory halfway measure for unless all of the other provinces adopt the Ontario Bill, the offeror may still exclude some of the minority shareholders; on a policy basis, therefore, it would have been preferable to have required the offer to be made at least to all shareholders resident in Canada.

73 Indeed, it is arguable that the effect of the Bill is to require that offers be made to securityholders outside the province and that the provision is, therefore, beyond provincial jurisdiction in that it necessitates interprovincial transactions; *see infra* ch. III.B.1; and *cf. supra* text accompanying notes 53-58; *but see supra* text accompanying notes 42-52 and following.

74 *See supra* note 69 and *infra* note 407 ("reading down"). If the presumed "offer to purchase" of Ontario Bill 7, s. 88(l)(k)(ii) is, as is suggested *supra* in note 69, limited to Ontario offerees under *id.* s. 88(l)(k)(i), then the provisions would exclude as well a purchase by an Ontario offeror from non-Ontario shareholders and would apply only to purchases from local offerees by local offerors.

74a *See supra* text accompanying notes 53-58.

74b *See* Ontario Bill 7, s. 88(l)(k)(i) ("takeover bid"); *see also* P. ANISMAN at 43.

75 *See e.g.* Interprovincial Co-operatives Ltd. v. R., [1975] 5 W.W.R. 382, 390 (S.C.C.) (basic principle that what is beyond provincial authority is within federal, *per* Pigeon, J.).

76 *See* Statute of Westminster, 1931 (Imp.), R.S.C. 1970, app. III, No. 26, s. 3; Croft v. Dunphy, [1933] A.C. 156 (P.C.); P. HOGG, *supra* note 32, at 206-07.

ities market results from the special status accorded federal corporations.[77] A long line of well-known decisions has consistently held that a province lacks jurisdiction to interfere with the status or capacity of a federally created entity, for example, by precluding it from carrying on business in the province.[78] Not surprisingly, the doctrine was early applied to provincial regulation of new issues of securities of federal corporations; in 1923 the Supreme Court of Canada declared the Saskatchewan Sale of Shares Act[79] *ultra vires* the province in so far as it affected federal companies[80] and its conclusion was in effect affirmed by the Privy Council six years later.[81] The basis of both decisions was that the raising of capital was so essential to the functioning of a corporation that any legislation precluding it from doing so impaired its status and capacity "in a substantial degree".[82] Although the legislation under consideration in both cases involved a "blue sky" discretion exercisable by a provincial official, the reasoning does not appear to turn on the discretionary power to refuse to accept a prospectus but rather on the fact that the statutes imposed a prerequisite failure to comply with which would result in a prohibition against the sale of its shares by a federal corporation.[82a]

77 *See e.g.* KIMBER REPORT ¶¶ 9.01, 9.07.

78 *See* John Deere Plow Co. Ltd. v. Wharton, [1915] A.C. 330 (P.C.); Great West Saddlery Co. Ltd. v. R., [1921] 2 A.C. 91 (P.C.). Although these are the leading cases on the subject, the doctrine originated in a dictum of Sir Montague Smith in Citizens Insurance Company of Canada v. Parsons, 7 A.C. 96, 113-14 (P.C. 1881). For the most recent statement of the doctrine, *see* Canadian Indemnity Co. v. A.G.B.C., 73 D.L.R. (3d) 111, 118-22 (S.C.C. 1976). *See also* Ziegel, *Constitutional Aspects of Canadian Companies*, in STUDIES IN CANADIAN COMPANY LAW 149 (J. Ziegel, ed. 1967).

79 R.S.S. 1920, c. 199.

80 Lukey v. Ruthenian Farmers Elevator Co., [1924] S.C.R. 56, [1924] 1 D.L.R. 706 (1923).

81 A.G. Man. v. A.G. Can., [1929] A.C. 260 (P.C. 1928) (Sale of Shares Act, S.M. 1924, c. 175; Municipal and Public Utility Board Act, S.M. 1926, c. 33, ss. 162-78). These decisions are discussed more fully in J. WILLIAMSON at 196-200; P. Anisman, The Person-Company Dichotomy in the Ontario Securities Act: The Problem of the Dominion Company, unpublished paper at the University of Toronto, on file at Corporate Research Branch, Consumer and Corporate Affairs Canada (1967).

82 *See* A.G. Man. v. A.G. Can., [1929] A.C. at 268; Lukey v. Ruthenian Farmers Elevator Co., [1924] 1 D.L.R. at 707 (*per* Davies, C.J.), 714-15 (*per* Duff, J.) and 718 (*per* Mignault, J.).

82a *See e.g.* A.G. Ont. v. Winner, [1954] A.C. 541, 578 (P.C.).

It may be possible to interpret the Privy Council's decision in terms of the discretionary powers of the administrators to refuse to accept a prospectus as some commentators have; *see e.g.* Leigh and Whyte, *Two Recent Cases Concerning the Validity of Commodity Marketing Legislation*, 24 U. TORONTO L.J. 411, 420 (1974); *cf.* Re Royalite Oil Co., [1931] 2 D.L.R. 418, 430 (Alta. C.A.) (unfettered discretion to require information enables imposition by provincial administrator of incapacitating condition, *per* Harvey, C.J.A.). Even Chief Justice Harvey, however, adopted a stronger position on the validity of prospectus requirements, *id.* at 432, which may reflect the inevitability of the exercise of discretion by an administrator with jurisdiction to review even the adequacy of disclosure in a prospectus. In any event, the distinction is not material for present purposes as all of the provincial securities

Nevertheless, even a strong reading of the decisions does not preclude all provincial regulation of primary distributions by federal corporations. It would at least be permissible for a province to require such an issuer to file information so long as its ability to sell shares is not conditional on the filing.[83] Moreover, a federal corporation may be precluded from raising capital through an underwriter who is not registered in the province so long as there are registered underwriters who might act for it.[84] However, it is worth reiterating that *Lymburn v. Mayland*, the leading decision upholding provincial securities legislation and the decision on which the preceding sentence is based, upheld a statute that did not contain prospectus provisions and that, in fact, imposed no duties on corporate issuers.[85] The prospectus provisions in the present provincial securities acts, all of which require that a prospectus be accepted by an administrator who is granted a "blue sky" discretion to refuse,[86] are of questionable validity with respect to federal corporations.[87] Indeed, the doubt concerning these provisions has been reinforced in recent decisions of the Supreme Court reaffirming the vitality of the *Manitoba* decision[88] and extends to other provisions of the provincial acts as well, for example, those dealing with proxy solicitations.[89]

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acts grant a residual blue sky discretion to the commissions; *see infra* notes 86, 87 and accompanying text.

83 In fact, Ontario early enacted legislation requiring that specified information be filed by every public company "upon the sale in Ontario of any of its securities", presumably as a result of the *Lukey* decision; *see* Companies Information Act, 1928, S.O. 1928, c. 33, s. 3(1)(b).

It is also arguable that a prospectus may be required of a federal corporation the business of which involves the issue and sale of hybrid securities such as interests in land or interests in silver coins which constitute investment contracts, *see e.g.* Pacific Coast Coin Exchange of Canada v. OSC, 80 D.L.R. (3d) 529 (S.C.C. 1977); *In re* Développement Morin Heights (Canada) Limitée, 9 QSC Bull., No. 26 (Decision 5593, June 14, 1978), as the sale of such securities is in reality the conduct of the issuer's business rather than the raising of capital necessary for it to function at all; the latter type of distribution alone was considered in the *Manitoba* and *Lukey* decisions.

84 *See e.g.* Lymburn v. Mayland, [1932] A.C. 318; *see also In re* Kleena Kleene Gold Mines Ltd., B.C. Corporate, Financial and Regulatory Services Weekly Summary, July 22, 1977, at 5 (Corp. and Financial Services Commn.). *Cf.* Hretchka v. A.G.B.C., [1972] S.C.R. 119 (1971) (provincial legislation applicable to secondary distribution of shares of federal corporation); and *see* KIMBER REPORT ¶ 9.07.

85 *See* P. Anisman, *supra* note 81, at 42-43.

86 *See e.g.* Ontario Securities Act, s. 61; Ontario Bill 7, s. 60.

87 *See* J. WILLIAMSON, SUPP. at 229-30; P. Anisman, *supra* note 81, at 43-47.

88 *See* Canadian Indemnity Co. v. A.G.B.C., 73 D.L.R. (3d) 111, 122 (S.C.C. 1976). Mr. Justice Martland, speaking for the Court, concurred in a dictum of the Chief Justice, quoted *id.* at 118, from Morgan v. A.G.P.E.I., [1976] 2 S.C.R. 349, 365, 55 D.L.R. (3d) 527, 539 (1975). It is reasonable, therefore, to conclude that Martland, J., no longer holds to his seemingly contrary dictum in Hretchka v. A.G.B.C., [1972] S.C.R. 119, 127 (1971).

89 *See e.g.* KIMBER REPORT ¶ 9.07; P. Anisman, *supra* note 81, at 48, arguing that such

In summary, it is fair to say that limitations on provincial legislative jurisdiction may create serious impediments to pervasive regulation of the Canadian securities market by the provinces. Despite their having filled an otherwise regulatory void, particularly by cooperative efforts which have been accelerated in recent years, it appears that some form of federal legislation to ensure a comprehensive scheme of securities regulation in Canada is warranted.[90]

Chapter III
Federal Jurisdiction over Securities

A. NATURE OF FEDERAL LEGISLATION

Any modern securities act must deal with a number of areas each of which is essential to a comprehensive scheme of securities regulation. One of the basic techniques for enhancing investor confidence, for example, is to ensure the disclosure by issuers of information adequate to enable rational investment decisions to be made both in connection with new issues of securities and in the secondary market.[91] Such disclosure has usually been imposed by means of a prospectus requirement for primary and secondary distributions[92] and, especially recently, by means of continuing disclosure requirements applicable to issuers the securities of which are actively traded as a result of having been distributed or listed on a stock exchange.[93] In most schemes regular reporting by issuers is supplemented by provisions requiring disclosure in connection with the solicitation of proxies[94] and with takeover

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provisions might be held to interfere with the constitution of a federal corporation and citing Citizens Insurance Company of Canada v. Parsons, 7 A.C. 96, 113-14 (P.C. 1881); Lukey v. Ruthenian Farmers Elevator Co., [1924] 1 D.L.R. 706, 712-13 (*per* Duff, J.); *see also* Ziegel, *supra* note 78, at 170-71; Multiple Access Ltd. v. McCutcheon, 78 D.L.R. (3d) 701, 708 (Ont. Div'l Ct. 1977), *affirmed*, (Ont. C.A. June 14, 1978, unreported).

90 *See e.g.* SPECIAL JOINT COMMITTEE OF THE SENATE AND OF THE HOUSE OF COMMONS ON THE CONSTITUTION OF CANADA, FINAL REPORT, ch. 34 (1972). In fact, the limitations on provincial authority alone indicate that jurisdiction to legislate in relation to the securities market is concurrent; *see supra* note 75. *See also supra* ch. I.

91 *See generally e.g.* KIMBER REPORT ¶¶ 4.01-4.06; REPORT OF THE ADVISORY COMMITTEE ON CORPORATE DISCLOSURE TO THE SEC; WHEAT REPORT; and *see*, *Grover & Baillie.*

92 *See e.g.* Ontario Securities Act, ss. 35-57; Securities Act of 1933; and *see* Ontario Bill 7, ss. 51-59, 61; ALI FEDERAL SECURITIES CODE, pt. 5.

93 *See e.g.* Ontario Securities Act, pt. XII; Securities Exchange Act of 1934, s. 12; and *see* Ontario Bill 7, pt. XVII; ALI FEDERAL SECURITIES CODE, s. 602.

94 *See e.g.* Ontario Securities Act, pt. X; Securities Exchange Act of 1934, s. 14(a); *see also* Ontario Bill 7, pt. XVIII; ALI FEDERAL SECURITIES CODE, s. 603.

bids[95] and reporting of transactions by insiders.[96] Any federal legislation to be effective must contain similar requirements and would likely contain as well substantive provisions and discretionary powers necessary to supplement them such as a discretion in an administrator to refuse a prospectus on the basis of the merits of the securities offered under it.[97]

The other basic technique of regulation associated with securities laws is the licensing of market actors such as brokers, dealers, advisers and underwriters, in order to ensure their integrity, competence and financial stability.[98] As most market actors are today members of a self-regulatory organization, whether it be a stock exchange or association of brokers or dealers, which itself supervises their conduct and capital position, the legislative schemes in essence provide a standard against which to evaluate the performance of the self-regulatory organizations and a spur to the effective performance of their supervisory functions over their members. The self-regulatory organizations not only supervise their members' activities but also themselves establish standards for entry into the market, the rates at which business is conducted by their members and even set standards for trading and supervise the market in order to ensure its fair operation.[99] As a result, securities regulators have been required increasingly to supervise the self-regulatory organizations themselves so that the self-regulators will not be overzealous in protecting their members from competition or even in protecting the public by action unfair to their members.[100] It is clear that any federal act must deal with the

95 *See e.g.* Ontario Securities Act, pt. IX; Securities Exchange Act of 1934, s. 14(d); Ontario Bill 7, pt. XIX; ALI FEDERAL SECURITIES CODE, ss. 606-607. On the regulation of takeover bids generally, *see* P. ANISMAN, which indicates the integrated nature of securities regulation even in connection with a subject as seemingly restricted as takeover bids.

96 *See e.g.* Ontario Securities Act, pt. XI; Securities Exchange Act of 1934, ss. 13(d), 16(a); and *see* Ontario Bill 7, pt. XX; ALI FEDERAL SECURITIES CODE, ss. 605, 607. *See also, Yontef*, ch. II; *Anisman* at 181-201.

97 *See e.g. Grover & Baillie*, chs. V.A, VI.C, VII.B. Such a discretion is important in a federal law as it would fill a gap at present beyond provincial jurisdiction; *see supra* text accompanying notes 78-82. For examples of substantive requirements relating to takeover bids, *see* Canada Business Corporations Act, ss. 188-90; and *see* P. ANISMAN, ch. IV.

98 *See generally, Connelly.* In fact the provincial legislation upheld in Lymburn v. Mayland, [1932] A.C. 318 (P.C.), was exclusively directed at the registration of brokers and dealers; *see supra* note 37. *See also e.g.* Ontario Bill 7, pt. X; ALI FEDERAL SECURITIES CODE, pt. VII.

99 *See generally, Dey & Makuch.*

100 *See id.; see also e.g.* P. Anisman, Antitrust and the New York Stock Exchange: A Challenge for Self-Regulation, unpublished paper at the University of California, Berkeley, on file at Corporate Research Branch, Consumer and Corporate Affairs Canada (October 19, 1968). And *see e.g.* Ontario Securities Act, ss. 30-31, 140-41; Ontario Bill 7, pts. VIII-IX; ALI FEDERAL SECURITIES CODE, pt. VIII.

self-regulatory bodies[101] and likely that it will in one way or another contain supervisory powers over other market actors too.[102]

The Criminal Code now prohibits several types of market manipulation and other fraudulent conduct in connection with securities transactions.[103] A federal act to regulate the securities market would likely incorporate the prohibitions now in the Criminal Code and add a number of other prohibitions directed at fraudulent and deceptive practices in securities[104] and might include as well a number of supplementary provisions relating to the conduct of market actors.[105] Violation of all such provisions would, of course, invoke criminal penalties; and as securities regulation is essentially remedial it would be surprising indeed if a federal act did not provide for civil liability to enable investors who suffer harm to obtain a remedy.[106]

All of these types of provisions necessitate some sort of body for their administration and enforcement. Any federal legislation will, therefore, undoubtedly authorize some sort of administrative body to administer its provisions and will grant it investigative and other enforcement powers to enable it to do so.[107] In light of the national character of the market, it may also be advisable to provide for delegation of the administration of a federal act to a provincial commission and to authorize the federal body to accept a similar delegation from a province, a device frequently used in the past to establish cooperative regulatory schemes.[108]

Although the ultimate goals of all securities laws are essentially the same and although all of the elements outlined above would form parts of a single, comprehensive scheme for the regula-

101 Especially as one of the major developments necessitating federal regulatory involvement is inextricably associated with the self-regulatory bodies; *see supra* text accompanying notes 9-12 and following. And *see infra* ch. III.C.

102 Federal regulation of market actors is discussed *infra* text accompanying notes 203-13.

103 *See* Criminal Code, ss. 338 (fraud affecting public market), 340 (wash trading), 341 (bucketing), 342 (broker gambling against client) and 358 (false prospectus); and *see generally*, *Leigh*, ch. II.A.

104 *See e.g.* Ontario Securities Act, ss. 100, 137; Ontario Bill 7, ss. 75, 118; ALI FEDERAL SECURITIES CODE, pt. XVI. And *see generally*, *Leigh*, ch. II.

105 The legislation might, for example, establish the duties owed by a securities firm to its clients; *see e.g.* Ontario Securities Act, pt. VIII; Ontario Bill 7, pt. XII; ALI FEDERAL SECURITIES CODE, ss. 910, 913-15.

106 *See e.g.* Ontario Securities Act, ss. 100a, 113, 142; Ontario Bill 7, pt. XXII; ALI FEDERAL SECURITIES CODE, pt. XVII; and *see generally*, *Leigh*.

107 *See e.g.* Ontario Securities Act, pts. I, III, IV, XIII, XIV; Ontario Bill 7, pts. I-VI, XXI; ALI FEDERAL SECURITIES CODE, pt. XVIII.

108 *See e.g.* P.E.I. Potato Marketing Bd. v. H.B. Willis Inc., [1952] 2 S.C.R. 392; Reference re Agricultural Products Marketing Act, 19 N.R. 361 (S.C.C. 1978). Interdelegation is discussed *infra* ch. III.I.

tion of the Canadian securities market, each of them may be treated separately in the legislation and each of them may, as a result, raise somewhat different constitutional questions. In fact it may be possible to base different aspects of the scheme on different heads of federal power and such considerations may influence the structure of the scheme itself. It is worth pointing out initially that there is no decision holding that Parliament lacks jurisdiction to enact legislation regulating the securities market.[108a] The remainder of this paper, therefore, will discuss the legislative authority of Parliament which may provide a basis for a federal securities act both generally and in relation to particular parts that are likely to be included in the act and that may give rise to specific constitutional issues.

B. THE TRADE AND COMMERCE POWER

In view of the nature and function of the securities market the most obvious head of federal jurisdiction is subsection 91(2) of the BNA Act which authorizes Parliament to make laws in relation to the "Regulation of Trade and Commerce".[109] The font of judicial consideration of this provision once again[109a] is the *Parsons* decision of the Privy Council which indicated somewhat tentatively the boundaries of federal power under it.[110] In upholding provincial legislation regulating the terms of fire insurance contracts the Judicial Committee considered the federal power and concluded that it was intended to deal with matters of general concern to the nation[111] and that it did not, therefore, "comprehend the power to regulate by legislation the contracts of a particular business or

108a The Supreme Court of Canada has held, however, that Parliament may regulate transactions in the securities of federal corporations; *see* Esso Standard (Inter-America) Inc. v. J.W. Enterprises Inc., [1963] 2 S.C.R. 144, 152; *cf.* Multiple Access Ltd. v. McCutcheon, 78 D.L.R. (3d) 701 (Ont. Div'l Ct. 1977), *affirmed* (Ont. C.A. June 14, 1978, unreported) (jurisdiction assumed, 78 D.L.R. (3d) at 703); and *cf.* Canada Business Corporations Act, pt. VI (securities transfers).

109 For a general discussion of the trade and commerce power, *see* P. HOGG, *supra* note 32, ch. 15; A. SMITH, THE COMMERCE POWER IN CANADA AND THE UNITED STATES (1963) [hereinafter cited as A. SMITH].

109a *See supra* note 78.

110 Citizens Insurance Company of Canada v. Parsons, 7 A.C. 96, 112-13 (P.C. 1881). Indeed even today decisions dealing with matters of trade and commerce usually begin analysis with this case; *see e.g.* A.G. Man. v. Man. Egg & Poultry Assn., [1971] S.C.R. 689, 701, 723; MacDonald v. Vapour Canada Ltd., 66 D.L.R. (3d) 1, 21-23 (S.C.C. 1976); R. v. Dominion Stores Ltd., 79 D.L.R. (3d) 627, 629 (Ont. H.C. 1977), *affirmed*, 83 D.L.R. (3d) 266 (Ont. C.A. 1978).

111 7 A.C. at 112 ("the collocation of No. 2 with classes of subjects of national and general concern affords an indication that regulations relating to general trade and commerce were in the mind of the legislature, when conferring this power on the dominion parliament").

trade, such as the business of fire insurance in a single province".[112] While expressly refraining from any attempt to define precisely the limits of federal authority, the committee stated that it included "regulation of trade *in matters of interprovincial concern* and...general regulation of trade affecting the whole dominion".[113]

1. *Interprovincial Trade and Commerce*

During the subsequent fifty years, however, the Privy Council, instead of attempting to strike a balance between the powers of Parliament and the provincial legislatures based on the flexible approach adopted in *Parsons*, consistently restricted the scope of federal legislative authority.[114] In brief, by 1926 subsection 91(2) had been effectively deprived of its status as an independent head of power and relegated to service as a mere aid to jurisdiction granted to Parliament by other heads or under its residual powers.[115] This restrictive approach was reflected in decisions precluding Parliament from regulating particular trades or businesses, whatever their scope or economic significance, by means of a licensing system[116] and generally from regulating transactions or works within a province that were part of such trades or businesses, even if over 80% of the commodity in question was destined for international trade.[117] Despite some resilement in subsequent opinions of the Committee from the excesses of principle embodied in these decisions,[118] their practical effects continued. Indeed, the courts continued to strike down federal schemes

112 *Id.* at 113.

113 *Id.* (emphasis added). The precise holding of the Privy Council is analyzed in A. SMITH, *supra* note 109, ch. 3; *see also* A.G. Man. v. Man. Egg & Poultry Assn., [1971] S.C.R. 689, 723 (*per* Pigeon, J.).

114 The contraction and subsequent expansion of federal jurisdiction is described more fully elsewhere; *see e.g.* A. SMITH, *supra* note 109; P. HOGG, *supra* note 32, ch. 15; *see also* W. MCCONNELL, COMMENTARY ON THE BRITISH NORTH AMERICA ACT 168-81 (1977); and *see* the pithy summary of Chief Justice Laskin in MacDonald v. Vapour Canada Ltd., 66 D.L.R. (3d) 1, 23-24 (1976).

115 *See In re* the Board of Commerce Act, 1919, [1922] 1 A.C. 191, 197-98 (P.C. 1921); Toronto Electric Commnrs. v. Snider, [1925] A.C. 396, 409-10 (P.C.).

116 *See e.g.* A.G. Can. v. A.G. Alta., [1916] 1 A.C. 588, 596 (P.C.) (licensing scheme for insurance companies).

117 *See* R. v. Eastern Terminal Elevator Co., [1925] S.C.R. 434, 444 (regulation of grain warehouses and elevators); *cf.* Canadian Industrial Gas & Oil Ltd. v. Sask., 80 D.L.R. (3d) 449, 456-57, 463 (S.C.C. 1977) (as 98% of oil produced in province destined for export, legislation establishing prices at well-head aimed at interprovincial trade and *ultra vires* the province).

118 *See e.g.* Proprietary Articles Trade Assn. v. A.G. Can., [1931] A.C. 310, 326 (P.C.). The Supreme Court of Canada too found the limitation created by Viscount Haldane unfounded; *see e.g.* Lawson v. Interior Tree Fruit & Vegetable Committee of Direction, [1931] S.C.R. 357, 367-70 (*per* Duff, J.).

of regulation that dealt primarily with interprovincial transactions if they included even incidentally transactions that were completed within a province.[119]

In the last thirty years, and particularly since the abolition in 1949 of appeals to the Privy Council,[120] Canadian courts have taken a more expansive view of what constitutes interprovincial and international trade and of the permissible scope of regulation dealing with it, without, however, denying or substantially modifying the essential practical limitations established in the earlier decisions.[121] This alteration of attitude has been manifested primarily in cases dealing with statutory schemes regulating trade in commodities. In the *Ontario Farm Products Marketing Reference*, the decision generally regarded as heralding a new approach, five judges of the Supreme Court indicated that federal jurisdiction would extend to transactions completed in a province which enter the flow of interprovincial trade.[122] Since then a number of decisions have reinforced the indications that a more realistic understanding of the implications of marketing schemes and the economics of interprovincial and international trade would be discernible in constitutional adjudication.[123] Nevertheless, the principled foundation of the decisions remains essentially the same as in those prior to 1939 and the holdings in many of the earlier cases would likely be the same today.[124]

It might be argued, therefore, that the Supreme Court's new approach to issues concerning trade and commerce is not as strikingly shown in its statements of principle as it is in decisions applying the principles to the elements of federal regulatory schemes which, although wholly within a province, must be cov-

119 *See e.g.* A.G.B.C. v. A.G. Can., [1937] A.C. 377 (P.C.).

120 *See* A.G. Ont. v. A.G. Can., [1947] A.C. 127 (P.C.) (Privy Council upheld power of Parliament to abolish appeals).

121 *See e.g.* Reference re Agricultural Products Marketing Act, 19 N.R. 361 (S.C.C. 1978); and *see e.g.* A. SMITH, *supra* note 109, at 157 ("fresh approach").

122 Reference re the Farm Products Marketing Act, [1957] S.C.R. 198, 204-05, 209, 211, 231, 247; *cf.* Lawson v. Interior Tree Fruit Vegetable Committee, [1931] S.C.R at 365-66.

123 *See e.g.* Murphy v. Canadian Pacific Ry. Co., [1958] S.C.R. 626; A.G. Man. v. Man. Egg & Poultry Assn., [1971] S.C.R. 689; Burns Foods Ltd. v. A.G. Man., 40 D.L.R. (3d) 731 (S.C.C. 1973); Canadian Industrial Gas & Oil Ltd. v. Sask., 80 D.L.R. (3d) 449 (S.C.C. 1977); Reference re Agricultural Products Marketing Act, 19 N.R. 361 (S.C.C. 1978). *Cf. e.g.* Carnation Company Ltd. v. Que. Agricultural Marketing Bd., [1968] S.C.R. 238; and *cf.* R. v. Sommerville, [1974] S.C.R. 387 (1972).

124 *See e.g.* Canadian Indemnity Co. v. A.G.B.C., 73 D.L.R. (3d) 111, 116-18 (S.C.C. 1976) (even though insurance business "interprovincial and, indeed, international in scope", legislation regulating insurance business within provincial jurisdiction); *cf.* MacDonald v. Vapour Canada Ltd., 66 D.L.R. (3d) 1, 22 (S.C.C. 1976) ("*Parsons* case itself, on its facts, may even now be taken to have been correctly decided").

ered if the scheme is to work effectively.[125] Recently, for example, the Court upheld federal regulation of the sale of imported oil within Ontario as incidental to an extraprovincial marketing scheme intended to protect the domestic oil industry in Western Canada from foreign competition and as "an integral part of the control of imports in the furtherance of an extraprovincial trade policy".[126] In doing so the Court confirmed an increasing readiness to facilitate the working of valid regulatory schemes by a sympathetic application of constitutional principles[127] which it had indicated a number of years earlier by its refusal to accept an appeal from a decision holding a federal statute regulating the wheat trade applicable to a purely local feedmill as necessary to prevent avoidance of the scheme.[128]

Despite the breadth of the words used in *Parsons* to describe the scope of federal jurisdiction over interprovincial trade[129] and the Supreme Court's recent tendency to read life into them, the traditional and still dominant analytic approach, including the "flow of commerce" rubric, rests on a transactional analysis of the legislation – that is, on whether tangible goods or commodities physically cross a provincial border as a result of a transaction respecting them.[130] Although securities are chosen in action rather than tangible commodities, there is no apparent reason to treat interprovincial and international securities transactions otherwise than similar commodities transactions;[131] indeed both involve equally a transfer of rights pursuant to a contract from a person on one side of a provincial border to another on the other side.[132] Thus on a traditional analysis Parliament has the authority

125 For discussion of the "ancillary" doctrine, *see* Laskin, *supra* note 35, at 10-11, 100-01; P. Hogg, *supra* note 32, at 82 n. 21; and *see* Papp v. Papp, 8 D.L.R. (3d) 389, 393-95 (Ont. C.A. 1969).

126 Caloil Inc. v. A.G. Can., [1971] S.C.R. 543, 551 (1970); *see also* Capital Cities Communications Inc. v. CRTC, 81 D.L.R. (3d) 609, 623-24, 634-35 (S.C.C. 1977).

127 *See supra* note 125.

128 *See* R. v. Klassen, 20 D.L.R. (2d) 406 (Man. C.A. 1969), *leave to appeal denied*, [1959] S.C.R. ix (Wheat Board Act); *see also* Montana Mustard Seed Co. Inc. v. Continental Grain Co. (Canada) Ltd., 49 D.L.R. (3d) 72, 76-77 (Sask. C.A. 1974), *affirmed on other grounds*, [1976] 2 W.W.R. 768 (S.C.C. 1975) (licensing of grain dealers necessarily incidental to effectiveness of Canada Grain Act); and *see* R. v. Dominion Stores Ltd., 79 D.L.R. (3d) 627 (Ont. H.C. 1977), *affirmed*, 83 D.L.R. (3d) 266 (Ont. C.A. 1978).

129 *See supra* text accompanying note 113 ("matters of interprovincial concern").

130 This result is not too surprising as most legislation considered in the cases has involved schemes for the regulation of commodities. *See supra* cases cited in notes 115-17, 119, 121-23, 126. The decisions cited in notes 126 and 128 appear to be closer to the words used in *Parsons*; *see supra* note 129.

131 Indeed the movement toward treating securities as negotiable instruments would reinforce this result; *see e.g.* Canada Business Corporations Act, pt. VI; *cf.* BNA Act, s. 91(18) (negotiable instruments).

132 *See e.g. supra* cases cited in note 123; *see also* W. Hohfeld, Fundamental Legal Conceptions as Applied in Judicial Reasoning 30-31 (W. Cook, ed. 1964).

to regulate interprovincial and international trading in securities and has with the provinces concurrent jurisdiction over trading like that in the *McKenzie* and *Gregory* cases.[133]

Any scheme of regulation based on this approach would, as with marketing legislation, require provincial cooperation; Parliament might enact legislation regulating only interprovincial and international trading and the provincial acts would govern transactions in each province.[134] A federal act could thus require clearance of and establish disclosure and other requirements for distributions of securities that are international or interprovincial and for those by federal corporations.[135] As corporate securities are created and issued in the province in which an issuer is incorporated, it is arguable that all transactions in which the securities issued do not come to rest in the hands of an ultimate purchaser in the province of incorporation are interprovincial. In all such cases the securities cross a provincial border and involve at some point in the distribution an interprovincial transaction whether it be a trade with an underwriter or member of the underwriting group or a sale to an investor.[135a] By directing its legislation at such transactions Parliament can regulate all interprovincial and national new issues whether or not the province of incorporation or origin chooses to regulate the local trades made in the distribution, for the federal requirements would likely suffice to protect local investors as well. But provincial legislation would still be necessary to impose prospectus delivery requirements and civil liability for intraprovincial transactions - that is, for transactions completed in the originating province.[136]

Interprovincial trading, however, will not alone provide a sufficient basis for comprehensive federal legislation like that outlined above. While it may suffice for primary distributions and the imposition of continuing disclosure requirements on issuers who make them, it is less likely to prove adequate for secondary distributions which would tend more frequently to be intraprovincial. More important, the vast majority of secondary trading both on the exchanges and in the over-the-counter market likely con-

133 *See supra* text accompanying notes 42-48.

134 *See e.g.* Reference re Agricultural Products Marketing Act, 19 N.R. 361 (S.C.C. 1978).

135 *See supra* text accompanying notes 79-82.

135a Where the issuer is not incorporated the intraprovincial trading would occur in the province in which the securities are created, presumably the one in which the issuer resides.

136 A province may, of course, wish to delegate the administration of its securities act to a federal body, at least for intraprovincial transactions in an interprovincial distribution; *see infra* ch. III.I. It need hardly be said that all transactions in securities distributed by a foreign issuer would be within Parliament's jurisdiction.

sists of intraprovincial transactions and would thus be beyond the coverage of the legislation. And it is at best doubtful whether even interprovincial trading by a securities firm would provide a sufficient foundation for a federal licensing requirement.[137] As a result, if Parliament were to rely on interprovincial and international trade for the regulation of distributions, it would be necessary to use another jurisdictional basis for the remainder of the scheme – that is, regulation of the trading market, the self-regulatory organizations and other securities market actors. That basis may be found in Parliament's authority over undertakings extending beyond a province and over works declared to be for the general advantage of Canada.[138] Interprovincial trade, in conjunction with these heads of power, may provide an adequate foundation for federal legislation.[139]

2. *General Trade and Commerce*

It may be possible, however, to rely exclusively on Parliament's jurisdiction over trade and commerce to justify a comprehensive federal regulatory scheme. Although the Privy Council in the *Parsons* case merely attempted to indicate generally the types of matters which might be of sufficient national concern to justify federal regulation of trade,[140] subsequent treatment of the dictum resulted in the ossification of the two strands contained in it into two distinct categories, "interprovincial and international trade and commerce" and "general trade and commerce", the former, as is indicated above, limited to transactions involving the shipment of commodities across a provincial border and the latter connoting trade or commerce affecting the nation as a whole in a nontransactional manner sufficient to warrant federal regulation.[141]

During the period of eclipse of the federal trade and commerce power both categories fell into disuse.[142] Indeed, even though one of the few cases in which Parliament's jurisdiction over general trade and commerce constituted part of the holding was decided during this period,[143] that decision became the vehicle for

137 *Cf.* A.G. Can. v. A.G. Alta., [1916] 1 A.C. 588 (P.C.); Canadian Indemnity Co. v. A.G.B.C., 73 D.L.R. (3d) 111 (S.C.C. 1976).

138 *See* BNA Act, s. 92(10).

139 Federal jurisdiction over works and undertakings is discussed *infra* ch. III.C.

140 *See supra* text accompanying notes 111-13. Even the wording of the dictum itself, quoted *supra* text accompanying note 113, makes this fact clear.

141 *See e.g.* A. SMITH, *supra* note 109, chs. 3, 4; P. HOGG, *supra* note 32, ch. 15.

142 *See supra* notes 114-17 and accompanying text.

143 *See* John Deere Plow Co. Ltd. v. Wharton, [1915] A.C. 330, 340 (P.C. 1914) (once Parliament can create companies under residual power, "it becomes a question of general interest throughout the Dominion in what fashion they should be permit-

the strongest statement of limitation of federal powers;[144] and the Privy Council held invalid federal legislation directed at economic activities with clear national implications such as insurance,[145] combines, prices and profits,[146] labour relations and standards[147] and unemployment insurance.[148] Thus, despite the fact that the Privy Council softened its position[149] by upholding as a matter of general trade and commerce federal legislation creating a "national" trade mark,[150] it is not surprising that the concept was largely ignored.[151]

Recently, however, the Supreme Court of Canada resurrected the notion of general trade and commerce in a long dictum apparently intended to breathe new life into it and thus provide scope for Parliament to regulate economic matters of national concern. The case, *MacDonald v. Vapour Canada Ltd.*,[152] concerned a provision of the Trade Marks Act[153] that prohibited acts and business practices "contrary to honest industrial or commercial usage in Canada"[154] but that was unrelated to trade marks. Because the act created civil remedies in damages or injunctive relief for its breach,[155] the Chief Justice, writing for the majority, characterized the section as an attempt to create a civil cause of action

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ted to trade"). This use of the commerce power has been criticized; *see e.g.* P. HOGG, *supra* note 32, at 273 n. 40.

144 *See supra* cases cited in note 115.

145 *See e.g.* A.G. Can. v. A.G. Alta., [1916] 1 A.C. 588 (P.C.). This position has not been revised; *see* Canadian Indemnity Co. v. A.G.B.C., 73 D.L.R. (3d) 111, 116-18 (S.C.C. 1976).

146 *See In re* Board of Commerce Act, 1919, [1922] 1 A.C. 191 (P.C.). Legislation dealing with combines was subsequently sustained as criminal law under BNA Act, s. 91(27); *see* Proprietary Trade Articles Assn. v. A.G. Can., [1931] A.C. 310 (P.C.); and prices, profits and wages may be federally regulated in a time of emergency; *see* Reference re Anti-Inflation Act, [1976] 2 S.C.R. 373.

147 *See* Toronto Electric Commnrs. v. Snider, [1925] A.C. 396 (P.C.); *see also* A.G. Can. v. A.G. Ont., [1937] A.C. 326 (P.C.). Federal labour laws applicable to industries within federal legislative competence have been upheld; *see* Reference re Validity of Industrial Relations and Disputes Investigation Act, [1955] S.C.R. 529; and *see generally* P. HOGG, *supra* note 32, at 304-08.

148 *See* A.G. Can. v. A.G. Ont., [1937] A.C. 355 (P.C.).

149 *Cf. supra* note 118 and accompanying text.

150 *See* A.G. Ont. v. A.G. Can., [1937] A.C. 405, 417-18 (P.C.); *see also* R. v. Dominion Stores Ltd., 79 D.L.R. (3d) 627 (Ont. H.C. 1977), *affirmed*, 83 D.L.R. (3d) 266 (Ont. C.A. 1978).

151 Although it was not applied in any decisions, its theoretical existence continued to receive perfunctory recognition; *see e.g.* Reference re Farm Products Marketing Act, [1957] S.C.R. 198, 209, 228. And *see* Reference re Alberta Statutes, [1938] S.C.R. 100, 117-22 (*per* Duff, C.J.) (legislation altering the credit system beyond provincial jurisdiction as within s. 91(2) even though operates only within provincial boundaries).

152 66 D.L.R. (3d) 1 (S.C.C. 1976); *see also* Hogg, Comment, 54 CAN. B. REV. 361 (1976).

153 R.S.C. 1970, c. T-10.

154 *Id.* s. 7(e).

155 *Id.* s. 53.

unrelated to the rest of the act that was essentially the same as common and civil law remedies available in tort and delict and thus constituted an impermissible attempt by Parliament to "overlay or extend known civil causes of action" which were within provincial jurisdiction.[156] The Federal Court of Appeal had upheld the section under the general trade and commerce rubric as "a law laying down a set of general rules as to the conduct of businessmen in their competitive activities in Canada";[157] Chief Justice Laskin, therefore, was careful in declaring it invalid to point out that it "is not a sufficient peg on which to support the legislation that it applies throughout Canada when there is nothing more to give it validity".[158]

In concluding that the provision under consideration could not be supported under subsection 91(2), the Chief Justice briefly outlined the judicial interpretation of Parliament's general power to regulate trade[159] and suggested a number of factors relevant to a determination of its applicability to particular legislative initiatives. The majority opinion is implicitly premised on an acceptance of the thrust of the *Parsons* dictum,[160] that legislation within subsection 91(2) must be "concerned with trade as a whole"[161] or at least deal with a matter of general concern to the country.[162] The requisite generality may be indicated by the interprovincial nature of an enactment, that is, by a traditional transactional analysis,[163] or by its "transprovincial scope".[164] While it might ordinarily be unwise to attempt to determine the import of a decision from the use of a single term, it is less so when the opinion concerns constitutional law and is written by Chief Justice

156 66 D.L.R. (3d) at 11-19, 25.

157 Vapour Canada Ltd. v. MacDonald, 33 D.L.R. (3d) 434, 449 (Fed. C.A. 1972); *see also id.* at 444. (The difference in the spelling of the corporation's name reflects the styles of cause in the law reports at the various levels.) *Cf.* A.G. Ont. v. A.G. Can., [1937] A.C. 405, 417 (P.C.) ("There could hardly be a more appropriate form of the exercise of this power than the creation and regulation of a uniform law of trademarks").

158 66 D.L.R. (3d) at 19; *see also id.* at 21, 25-26.

159 *Id.* at 22-24.

160 *See supra* note 113 and accompanying text.

161 66 D.L.R. (3d) at 25.

162 *See id.* at 12, 20-27.

163 *See id.* at 12, 24. It is rather surprising in light of the diverse treatment of the two aspects of the trade and commerce head of power that the Chief Justice incorporates the interprovincial element into his analysis, even while distinguishing the marketing decisions; *see supra* text accompanying note 141. The fact that he does so may suggest an attempt to return to the integrated approach in the *Parsons* decision; *see supra* text accompanying notes 111-13, 140; *see also* P. Hogg, *supra* note 32, at 274 n. 59.

164 66 D.L.R. (3d) at 12.

Laskin[165] and when the word is one with obvious implications for the interpretation of the section which has not previously been used in any judicial decision interpreting it. The new term indicates that Parliament may legislate under the authority in subsection 91(2) in relation to matters that, although not involving interprovincial transactions, are of greater than provincial concern and seems intended to provide a broader basis for identification of such matters.[166] Its potential breadth is supported by a reference to credit legislation which is within the federal commerce power[167] if it involves "a public regulation thereof applicable to the conduct of trading and commercial activities throughout Canada".[168]

Indeed public regulation may help to support the generality of a regulatory scheme. The fact that paragraph 7(e) of the Trade Marks Act was enforceable exclusively in private actions was instrumental in defeating the argument in support of the legislation, in that it gave the provision a "local cast because it is as applicable in its terms to local or intraprovincial competitors as it is to competitors in interprovincial trade".[169] The Chief Justice stressed that the structure of a legislative scheme may in this manner influence its characterization and repeatedly indicated that the result would have been influenced had there been a regulatory scheme for the provision's enforcement administered by a government agency.[170] An administrative agency with a mandate to ensure the even-handed application of a scheme would at least provide evidence of Parliament's belief that the application of a national policy to a national problem is required and thus give some support to its "generality".[171] And if the legislation is valid on this basis, it may justify as well a civil remedy.[172]

Nevertheless, it is clear that the creation of a public authority will not alone support a scheme directed at intraprovincial trans-

165 The Chief Justice's profound knowledge of this subject is well known. His long attention to it is less so; *see e.g.* Laskin, *Taxation and Situs: Company Shares*, 19 CAN. B. REV. 617 (1941); B.L., Comment, 19 CAN. B. REV. 379 (1941); B.L., Comment, 19 CAN. B. REV. 750 (1941); Laskin, *A Note on Canadian Constitutional Interpretation*, 5 U. TORONTO L.J. 171 (1943); B.L., Comment, 21 CAN. B. REV. 237 (1943); B.L., Comment, 21 CAN. B. REV. 597 (1943).

166 Nevertheless, the similarity of the concept to that expressed in *Parsons* is worth noting; *see supra* text accompanying note 113. *See also supra* cases cited in note 150.

167 *See* LASKIN, *supra* note 35, at 347.

168 66 D.L.R. (3d) at 24, citing Duff, C.J.'s statements in Reference re Alberta Statutes, *supra* note 151.

169 66 D.L.R. (3d) at 26.

170 *Id.* at 12, 19-20, 25-27.

171 *See id.* at 25-26 ("would at least lend some colour to the alleged national or Canada-wide sweep"). *Cf.* Reference re Anti-Inflation Act, [1976] 2 S.C.R. 373, 422, 438.

172 66 D.L.R. (3d) at 21.

actions. This caveat is made manifest both in the significance attributed to the marketing decisions[173] and in the explanation of the holding of the Supreme Court thirty years earlier that Parliament lacked jurisdiction to establish a scheme requiring government "approval of agreements between persons engaged in a specific industry for controlling and regulating prices".[174] In fact the earlier Privy Council decisions holding invalid federal regulatory schemes administered by an administrative tribunal may be distinguished on the same basis;[175] all of them were directed at local transactions or agreements.[176]

In short, the apparent aim of the dicta in the majority opinion in *Vapour Canada* is to give some content to the concept of general trade and commerce. A regulatory scheme that is transprovincial in scope and administered by a public authority so that its enforcement is not dependent on redress of private grievances now appears to be within Parliament's jurisdiction to establish.[177] And the Supreme Court has indicated its willingness, where necessary, to overrule decisions of the Privy Council[178] as well as its own earlier decisions.[179]

Such extreme action should not be necessary to uphold federal legislation designed to regulate the Canadian securities market; indeed the dicta in the *Vapour Canada* decision provide, if anything, substantial support for a regulatory scheme like that outlined above.[180] A federal securities act would be directed not at a particular business or trade in the provinces but rather at the capital-raising function by issuers throughout Canada and would be designed to facilitate the allocational efficiency of the primary market, the capital-raising mechanism, by increasing investor

173 *Id.* at 24.

174 *Id.* at 77, citing Reference re Dominion Trade and Industry Commission Act, 1935, [1936] S.C.R. 379, 382; *cf. In re* the Board of Commerce Act, 1919, [1922] 1 A.C. 191 (P.C.).

175 *See e.g. supra* cases cited in notes 115-17; *see also* P. Hogg, *supra* note 32, at 274.

176 And Chief Justice Duff distinguished them on exactly this basis; *see* Reference re Alberta Statutes, [1938] S.C.R. 100, 119.

177 *Cf.* Reference re Anti-Inflation Act, [1976] 2 S.C.R. 373, 426-27 (*per* Laskin, C.J.). The Chief Justice in a dictum stated that the general trade and commerce concept provided Parliament with a "foothold" and that at least parts of the Act might have been upheld under s. 91(2). *But see id.* at 437 (authority to pass anti-inflation legislation does not stem "from any of the enumerated classes of subjects referred to in s. 91", dictum *per* Ritchie, J.).

178 *See e.g.* Reference re Agricultural Products Marketing Act, 19 N.R. 361, 367, 401-04, 423 (S.C.C. 1978) (overruling Lower Mainland Dairy Products Sales Adjustment Committee v. Crystal Dairy, Ltd., [1933] A.C. 168 (P.C. 1932)).

179 *See e.g.* Binus v. R., [1968] 1 C.C.C. 227, 229 (S.C.C.); McNamara Construction (Western) Ltd. v. R., 75 D.L.R. (3d) 273, 278-79 (S.C.C. 1977).

180 *See supra* ch. III.A.

confidence in the securities market generally.[181] Although this function necessarily involves transactions in securities, the aim of the legislation would be at distributions and issuers throughout Canada as a whole and not at specific transactions. Such legislation would clearly be "transprovincial in scope"[182] and the transactional element should not preclude its being characterized as a "general regulation of trade affecting the whole dominion".[183] This characterization would be reinforced by the fact that a regulatory authority of some sort would be required to administer and to enforce the provisions of the act.[184]

Parliament can therefore enact legislation requiring the filing and distribution of a prospectus containing specified information for all primary distributions of securities[185] and can require all issuers who distribute securities to continue to publicly disclose information relevant to investor decision-making on a regular and timely basis.[186] Continuing disclosure by issuers is also necessary for the secondary market to perform its role in providing support for the efficient functioning of the primary market.[187] To effectuate that role it may be advisable to extend the continuing disclosure requirements to all issuers the securities of which are actively traded.[188] Such a requirement would be directed at issuers rather

181 *See supra* ch. I.

182 66 D.L.R. (3d) at 12.

183 Citizens Insurance Company of Canada v. Parsons, 7 A.C. 96, 113 (P.C. 1881). It is clear, for example, that the Alberta credit legislation struck down by the Supreme Court in 1938 would have involved transactions in the province; *see* Reference re Alberta Statutes, [1938] S.C.R. 100, 122. And the federal anti-inflation legislation too applied to particular agreements; *see* Reference re Anti-Inflation Act, [1976] S.C.R. 373, 426 (dictum *per* Laskin, C.J.).

184 *See supra* text accompanying notes 169-71.

185 That the primary market involves matters of interprovincial concern is demonstrated by the percentage of new issues that are made in more than one province; approximately two thirds of the distributions of securities by industrial issuers in Canada from 1971 to 1974 were interprovincial. (In 1971, 74 of 112 distributions were interprovincial; in 1972, 100 of 150; in 1973, 79 of 133; and in 1974, 68 of 111. The figures for clearance of mutual funds for the same years are 67 of 114 in 1971, 66 of 120 in 1972, 71 of 154 in 1973 and 89 of 162 in 1974; over one half were interprovincial.) These figures are derived from tables of new issues prepared in the Corporate Research Branch, Consumer and Corporate Affairs Canada, for the years 1969 to 1974; the tables were based on the data concerning new issues contained in the weekly summaries published by the British Columbia, Québec and Ontario Commissions; the figures for 1971 and 1972, therefore, include only Québec and Ontario, while those for the succeeding two years include all three provinces. It is not clear how the figures would be altered if the other seven provinces were added.

186 *See supra* text accompanying note 93. This authority would also include supplementary disclosure, for example, by insiders and offerors; *see supra* text accompanying notes 94-96.

187 *See supra* text following note 2.

188 *See e.g. Grover & Baillie*, ch. VI.B (recommending continuing disclosure by issuers with over three hundred public holders of equity securities and discretion in a

than transactions or a business and would also come within the guidelines in *Vapour Canada* even if not tied to a prior distribution.[189]

As the trading market – that is, the stock exchanges and the over-the-counter market – consists of a large number of individual transactions most of which occur within a province, justification of federal legislation regulating its activities may at first appear more difficult. However, the economic function of the secondary market provides some support for such legislation in that it indicates the complementary nature of the trading and primary markets and thus the necessity for the former to function efficiently if the capital-raising mechanism is to do so.[189a] The transprovincial character of the Canadian secondary market is not demonstrated by economic theory alone but is also made manifest by the working of the Canadian stock exchanges on which, when compared with the over-the-counter market, the vast majority of secondary trading in equity securities occurs. The fact that each of the exchanges now provides reports of trades on the trading floors of the others, as well as those on its own,[189b] the joint mechanisms developed for clearing trades in securities and in put and call options and the current movement toward a computerized Canada-wide trading system,[189c] as well as the substantial number of interlisted securities and the procedures followed by the exchanges in obtaining approval for their by-laws and commission rates,[190] show conclusively that the secondary market as a whole transcends provincial authority and is a matter of national concern, that is, of general trade and commerce. This conclusion is bolstered by the related matter of continuing disclosure by issuers whose securities are actively traded.[191]

Parliament can therefore enact legislation to regulate the stock exchanges so long as it is directed at the regulation of the trading market rather than at individual transactions. A federal act might, for example, establish standards and procedures for supervision of the exchanges in the performance of their self-regulatory functions, possibly by imposing a registration require-

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commission to require filing by issuers with over that number of holders of other securities).

189 The criteria selected may, however, be relevant to the characterization; it is likely that the standards specified *id.* would be sufficient to indicate the transprovincial scope of the requirement. *Cf. e.g.* Ontario Securities Act, ss. 101(a), 118(1)(b) (issuers that have made a distribution or whose shares are listed on a stock exchange); Ontario Bill 7, s. 1(1)38 ("reporting issuer"); ALI FEDERAL SECURITIES CODE, s. 402.

189a *See supra* text accompanying note 3.

189b *See infra* note 221 and accompanying text.

189c *See supra* text accompanying note 12 and following.

190 *See supra* text accompanying notes 9-11.

191 *See supra* text accompanying notes 186-89.

ment.[192] In this manner a federal regulatory body might supervise the establishment of the rules governing secondary trading, without having to deal directly with individual trades between investors.[193] The statute might also require all securities for which an active market exists to be listed on an exchange in order to facilitate the working of the secondary market and its supervision by the self-regulatory bodies[194] and might require or permit registration of other self-regulatory bodies exercising supervisory functions over the trading markets of interprovincial scope.[195] Such a scheme could readily be characterized as regulating commerce generally.

As the securities market underlies commercial activities throughout the country, the interprovincial or transprovincial impact of the primary and secondary markets is theoretically and practically clear. Federal legislation creating a scheme for their regulation to be administered by a public authority would come within the most recent explication by the Supreme Court of Canada of the general trade and commerce concept first espoused almost one hundred years ago to indicate Parliament's legislative jurisdiction. This characterization, if adopted, would likely be sufficient to justify a comprehensive system for regulation of all aspects of the market. However, several matters which may influence the characterization or which raise peculiarly difficult constitutional issues require further discussion.

In the *Vapour Canada* decision Chief Justice Laskin was careful to exclude from Parliament's jurisdiction matters of merely local significance even if carried out throughout Canada.[196] Although it is arguable that intraprovincial distributions of securities are an integral part of the primary market in Canada, it may be advisable to exclude them from the coverage of a federal act in order to emphasize its interprovincial thrust. Intraprovincial is-

192 *See e.g.* ALI FEDERAL SECURITIES CODE, pt. VIII. The provincial securities acts require that an exchange be "recognized" before it may carry on business in the province, *see e.g.* Ontario Securities Act, s. 140(1). Another basis for federal jurisdiction over the secondary market is discussed *infra* ch. III.C.

193 *See supra* text accompanying note 169.

194 *See, Grover & Baillie*, text accompanying notes 313, 314. *Cf.* R. v. Klassen, 20 D.L.R. (2d) 406 (Man. C.A. 1969).

195 The most obvious example of such an organization is the Investment Dealers Association of Canada which supervises trading by its members in government bonds and money market instruments. The Investment Dealers Association should be treated like the exchanges in connection with its self-regulatory activities; however, the fact that the securities with which it is concerned are traded over-the-counter brings them closer to an intraprovincial characterization. As a result, a federal act could permit voluntary registration after which the organization would be subject to the specified standards; *see e.g.* R. v. Dominion Stores Ltd., 79 D.L.R. (3d) 627 (Ont. H.C. 1977), *affirmed*, 83 D.L.R. (3d) 266 (Ont. C.A. 1978).

196 *See supra* text accompanying notes 155-58, 169, 173-74.

sues are usually small offerings by local issuers seeking to obtain financing for a local venture in which federal interest is minimal;[197] and the regulatory policies governing them, which are frequently related to the exploitation of natural resources,[198] should be left to the provinces in any event.[199] In short, intraprovincial distributions provide a clear example of a problem in which substantive and constitutional considerations lead to the same result.

Secondary distributions and the over-the-counter market raise similar difficulties. A distribution by a person other than the issuer of the securities is unrelated to the raising of capital that provides a basis for the application of the general trade and commerce concept; and the over-the-counter market in Canada is small, at least in connection with equity securities, and appears to be essentially intraprovincial and unconnected with the national marketplace developing on the exchanges. Nevertheless, it is arguable that coverage of both is necessary to ensure the effective implementation of any legislation that is enacted.

At least some secondary distributions must be included in order to preclude evasion of the requirements applicable to a primary issue by means of a two-step distribution; such attempts would be treated as primary distributions in any event. True secondary sales, for example, by a controlling person, must also be covered if the legislation is to accomplish its purpose of instilling confidence in the market so that it operates as an efficient allocational mechanism. Investors must be in a position to select between securities on the basis of full information; the selling pressure that usually accompanies a distribution, without corresponding disclosure, might divert funds from enterprises seeking them and thus result in misallocation of resources.[200] As a result, a provision of a federal act applying the same requirements to

197 The intrastate exemption in the Securities Act of 1933, s. 3(a)(11), was intended to deal with similar distributions; *see e.g.* SEC, 1 REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS 570-71 (1963).

198 For example, of 93 prospectuses for junior mines filed in Ontario and Québec in 1971, only two were filed in both provinces and only five of the 89 prospectuses filed in 1972 were filed in both. In 1973 there were 128 prospectuses for mining companies filed in British Columbia, Ontario and Québec of which three were filed in more than one province and in 1974 only two of the 94 prospectuses filed were interprovincial. These figures are derived from the tables described *supra* in note 185.

199 For the experience in the United States with the intrastate exemption, *see e.g.* SEC, *supra* note 197, at 571-74; 1 L. Loss at 591-605; 4 L. Loss at 2600-06; ALI FEDERAL SECURITIES CODE, Tent. Draft No. 3, s. 513 and s. 1603, Comment (16); and *see*, *Howard*, text accompanying notes 178-79.

200 All securities legislation applies equally to primary and secondary offerings; *see e.g.* Ontario Securities Act, s. 1(1)6a ("distribution").

secondary as to primary issues of securities would likely be upheld as necessary to the statutory scheme.[201]

A similar analysis would result in regulation of the over-the-counter market being held ancillary to that of the exchanges to ensure that the legislative scheme cannot be avoided, for example, by an issuer not obtaining a listing for its securities. The small volume of equity trading on the over-the-counter market when compared with that on the exchanges might serve to reinforce this position. In any event, it would be possible to accomplish the same result by making listing mandatory for all issuers with a class of securities held by a sufficient number of persons to create a public market in them.[202]

Perhaps the most difficult element of a securities law to justify federally is the licensing of brokers, dealers and other market actors and the concomitant establishment of standards of competence and integrity and capital requirements.[203] Any licensing scheme by the federal government directed at a specific business is especially dubious in light of the long line of insurance cases precluding Parliament from regulating "a particular trade in which Canadians would otherwise be free to engage in the provinces".[204] The authority of these decisions continues not only in respect of the insurance business[205] but also in respect of all trades conducted in the provinces, that is, in Canada.[206] As a result it is clear that Parliament could not enact a scheme requiring the licensing of securities firms even if they carry on business in several provinces.[207]

It is less than clear, however, whether Parliament could impose a licensing requirement on securities firms as part of a broader statute that is otherwise within its power. Indeed it is arguable that Parliament can impose such a requirement where it is necessarily incidental to a valid regulatory scheme,[208] and this type of

201 *See supra* notes 125, 126, 128.

202 *See supra* note 194 and accompanying text.

203 *See supra* text accompanying note 98. It might be argued that Parliament can impose capital requirements on securities firms under BNA Act, s. 91(21) in order to prevent insolvency; *cf.* Bankruptcy Act, 1978, Bill S-11, 30th Parl., 3d Sess., pt. VII (First reading March 21, 1978) (bankruptcy of securities firms). But the success of the argument is doubtful; *see* P. Hogg, *supra* note 32, at 302.

204 A.G. Can. v. A.G. Alta., [1916] 1 A.C. 588, 596 (P.C.); *see also* A.G. Ont. v. Reciprocal Insurers, [1924] A.C. 328 (P.C.); on the insurance cases generally, *see* P. Hogg, *supra* note 32, at 299-303.

205 *See* Canadian Indemnity Co. v. A.G.B.C., 73 D.L.R. (3d) 111 (S.C.C. 1976).

206 *See e.g.* R. v. Eastern Terminal Elevator Co., [1925] S.C.R. 434; and *see* P. Hogg, *supra* note 32, at 302-03.

207 *See e.g.* P. Hogg, *supra* note 32, at 300.

208 *See e.g.* A. Smith, *supra* note 109, at 127.

argument has been upheld in at least one recent decision.[209] Thus if a comprehensive scheme for the regulation of the Canadian market is valid as described above, it is possible that a licensing requirement would be upheld as necessary to ensure the integrity of the securities market,[210] as there can be little doubt that a "rational, functional connection" between the two exists.[211] Nevertheless, a licensing requirement of this nature might influence the characterization of the legislation itself.[212] As a federal agency would be able to establish standards of conduct for securities firms through its supervisory powers over the self-regulatory organizations of which they are members, it may be advisable not to impose a licensing requirement on securities firms in the statute or at least to draft the legislation so that the part dealing with the requirement is severable.[213]

In result, Parliament's jurisdiction over trade and commerce generally is alone sufficient to uphold federal legislation that comprehensively regulates all aspects of the market that are of more than provincial significance. Even if it were unavailable, Parliament has authority to regulate interprovincial distributions and other trading in the same manner as it does commodities and to deal with the secondary market and the self-regulatory organizations under a head of power in subsection 92(10); this alternative approach would also permit the enactment of a comprehensive scheme of regulation.[214]

C. WORKS AND UNDERTAKINGS

Although subsection 92(10) of the BNA Act gives the provincial legislatures jurisdiction over "local works and undertakings", its major effect lies in the exceptions from it.[215] The subsection excepts

> "(a) Lines of Steam or other Ships, Railways, Canals, Telegraphs, and other Works and Undertakings connecting the Province with any other or others of the

209 *See* Montana Mustard Seed Co. Inc. v. Continental Grain Co. (Canada) Ltd., 49 D.L.R. (3d) 72, 75-77 (Sask. C.A. 1974), *affirmed on other grounds*, [1976] 2 W.W.R. 768 (S.C.C. 1975).

210 *Cf. id.* at 76.

211 Papp v. Papp, 8 D.L.R. (3d) 389, 393-94 (Ont. C.A. 1969).

212 *See e.g.* LASKIN, *supra* note 35, at 98-100; P. HOGG, *supra* note 32, at 80-82.

213 Severability is discussed *infra* ch. III.G.

214 *See supra* text accompanying notes 138, 139.

215 In fact, it is likely that the subsection was included primarily in order to make clear that the matters excepted from it are within federal jurisdiction as is indicated by the fact that local works and undertakings come within BNA Act, ss. 92(13) and (16) in any event; *cf. e.g.* McNairn, *Transportation, Communication and the Constitution: The Scope of Federal Jurisdiction*, 47 CAN. B. REV. 355, 356 (1969).

> Provinces, or extending beyond the Limits of the Province...[and]
> "(c) Such Works as, although wholly situate within the Province, are before or after their Execution declared by the Parliament of Canada to be for the general Advantage of Canada or for the Advantage of Two or more of the Provinces."

And the exceptions are, rather redundantly, expressly included in subsection 91(29) as federal heads of power.[216]

A Canada-wide automated trading system which replaces the trading floors of the stock exchanges and permits execution and clearing of trades in securities by means of computers located throughout the country will constitute an interprovincial undertaking within federal jurisdiction under paragraph 92(10)(a).[217] Although the purpose of such a system is trading in securities, the means used to accomplish it necessarily involve a communications network extending beyond a single province[218] and are analogous to an interprovincial telephone system which has been held to come within the exception.[219] Thus the development of a national automated trading system will, like the telephone, augment federal regulatory power.

Parliament's jurisdiction under this head of power is, however, not contingent upon the development of an automated trading system that replaces the existing exchange floors; the manner in which the exchanges now carry on business and the connections necessary to facilitate it may alone be sufficient to make their undertakings interprovincial. In fact of the three elements essential to an exchange, namely, trading, clearing and the quotation of securities prices, the latter two are handled in Canada on an interprovincial basis. As was mentioned above, the clearing and settlement of securities traded on the Montreal and Toronto Exchanges are handled by the Canadian Depository for Securities by means of a computerized facility and the same functions are performed for the Alberta and Vancouver Exchanges by the Vancouver Stock Exchange Service Corporation.[220] More important, perhaps, is the fact that the Montreal, Toronto and Vancouver Exchanges have installed automated systems so that the details of transactions on any of the three exchanges are available

216 *See e.g.* Toronto v. Bell Telephone Co. of Canada, [1905] A.C. 52, 57 (P.C. 1904); Commission du salaire minimum v. Bell Telephone Co. of Canada, [1966] S.C.R. 767, 771.

217 The movement toward such a system is described *supra* text following note 12; *see also, Cleland; Jenkins; Williamson, Financial Institutions*, ch. IV.B, C.

218 *See e.g.* Canadian Pacific Railway Co. v. A.G.B.C., [1950] A.C. 122, 142 (P.C. 1949).

219 *See supra* cases cited in note 216.

220 *See supra* note 217.

simultaneously on all three floors. In other words the three exchanges have, in effect, a common quotation system linked by computer or telephone lines that extend beyond the limits of the provinces in which they are located.[221]

The question that presents itself is whether these elements are sufficient to bring the exchanges within the initial exception in subsection 92(10) as interprovincial undertakings. Even if, as has been suggested, the exception is limited to works and undertakings involving transportation or communications,[222] the clearing and quotation systems qualify; both involve the transmission of information and both are integral to the functioning of the exchanges.[223] The relationship of the clearing function to trading

221 The quotation systems of the three exchanges are, however, independently operated. The Toronto Stock Exchange has developed the CANDAT II system which contains information on transactions occurring on the floors of all three exchanges as well as for Canadian and other securities on several American exchanges and on NASDAQ, *see, Cleland,* ch. VI.B.7, and CANDAT II terminals are maintained on the trading floors of the Vancouver and Montreal Exchanges. The CANDAT II system is clearly an interprovincial undertaking operated by the Toronto Stock Exchange which may alone be sufficient to bring that Exchange within federal jurisdiction.

Both the Montreal and Vancouver exchanges also participate in CANDAT II to the extent that they supply information concerning trading on their floors and obtain royalties for its use by lessees of the system; but it is questionable whether such participation is alone sufficient to bring them within federal jurisdiction on the same basis as the Toronto Exchange which owns, manages and operates the system. Both exchanges, however, disseminate information on their trading by other means as well, for example, by supplying trading information to the Combined Market Quotations system, which provides data on trading in interlisted securities on the Montreal, Toronto, Vancouver and New York exchanges, again on a royalty basis. The Vancouver Stock Exchange transmits the information by means of a computerized "Market and Reference Service" (MARS), *see, Cleland,* app. B, and the Montreal Stock Exchange too does so by means of its computer. Moreover, the Montreal Exchange has recently permitted the Canadian Press to establish a direct connection with its computer for purposes of disseminating trading information on its ticker, yet again on a royalty basis. Finally, the Montreal Exchange has on its floor a number of screens which show the trading information transmitted on the ticker from the Toronto, New York and American Stock Exchanges.

While these arrangements, other than the CANDAT II system, may if viewed severally be treated as local undertakings, when taken together they in effect provide an integrated mechanism for the transmission of trading information between the floors of the three exchanges.

222 *See e.g.* P. HOGG, *supra* note 32, at 324. On occasion, however, it is necessary to stretch the cases in order to bring within these two categories all of the works and undertakings held to be within the exception; *see* McNairn, *supra* note 215, at 359-60 ("energy" is "transported" through electrical wires).

223 *Cf. e.g.* Commission du salaire minimum v. Bell Telephone Co. of Canada, [1966] S.C.R. 767, 772 (matters which are "a vital part" of interprovincial undertaking within federal jurisdiction). Although the criterion enunciated by the Supreme Court relates to jurisdiction over elements associated with an undertaking that has already been determined to be interprovincial, similar considerations are relevant to the determination of whether the interprovincial elements of an undertaking are sufficiently related to its operation to make the whole undertaking interprovincial; *see e.g.* Canadian Pacific Railway Co. v. A.G.B.C., [1950] A.C. 122, 142-45

is obvious; it involves the matching of the number of securities purchased and sold so that the members of the exchanges may conclude their transactions. The quotation system also facilitates trading not only by enabling arbitrage transactions between the different exchanges so that a national price may be reflected for an interlisted security[224] but also by enabling brokers to find the best price possible for their client.[225] The importance of the integrated quotation systems is emphasized by the fact that over one half of the securities listed on the Toronto Stock Exchange are listed on one of the other Canadian exchanges as well.[226]

While it might be argued that the major function of the exchanges is trading which is for the most part intraprovincial, it is undeniable that the clearing and quotation systems are integral parts of the exchanges' undertakings and are essential supports for the trading conducted on their floors. As a result, the undertakings as a whole extend beyond the provinces in which the exchanges are located and come within paragraph 92(10)(a).[227] Nevertheless, the courts are likely to be reluctant to accept this conclusion so long as no federal legislation regulating the exchanges has been enacted,[228] as once a matter falls within an

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(P.C. 1949) (holding Empress Hotel a separate business and not a part of appellant's railway undertaking); *see also* Re Public Service Bd., 83 D.L.R. (3d) 178, 181 (S.C.C. 1977) ("The fundamental question is...what the service consists of...the inquiry must be as to the service that is provided and not simply as to the means through which it is carried on. Divided constitutional control of what is functionally an interrelated system...not only invites confusion but is alien to the principle of exclusiveness of legislative authority").

224 *See supra* text accompanying notes 21-26. *Cf.* G. WYSER-PRATTE, RISK ARBITRAGE 7-9 (1971); and *see e.g.* MSE General Rules, ss. 6351-56, 3 CCH CAN. SEC. L. REP. ¶¶ 86-209 - 86-214.

225 *See e.g.* Notice re: Buy and Sell Orders of Securities Originating in British Columbia, B.C. Corporate and Financial Services Division Weekly Summary, September 12, 1978, at 8 (broker's duty to obtain best execution for client). This duty emphasizes as well the transprovincial nature of the securities market.

226 *See*, *Cleland*. Moreover, approximately 80 of the securities listed on the Toronto Stock Exchange are listed on an American exchange or are included in the NASDAQ system and a number of American issuers have listings on the Toronto Stock Exchange.

227 *See e.g.* A.G. Ont. v. Winner, [1954] A.C. 541 (P.C.); Capital Cities Communications Inc. v. CRTC, 81 D.L.R. (3d) 609, 621-23 (S.C.C. 1977); *see also* McNairn, *supra* note 215, at 374. Nor does the fact that the majority of trading in Canada (approximately 70%) occurs through the Toronto Stock Exchange detract from this conclusion. Indeed the courts have held that a substantially smaller percentage than 30% is sufficient to constitute an undertaking interprovincial; *see* P. HOGG, *supra* note 32, at 326-27. Thus even if the percentage of interlisted trading is only a small proportion of the total trading, it is likely to be sufficient. And *see id.* at 329.

228 *See supra* note 41 and accompanying text. *Cf.* McNairn, *supra* note 215, at 386 (never suggested that facilities for interprovincial telephone calls provided by intraprovincial systems "enough to bring these systems under federal control").

exception to subsection 92(10) it is no longer subject to provincial regulation.[229]

Parliament may also obtain jurisdiction over the exchanges through the exercise of the power conferred by paragraph 92(10)(c) to declare a work "to be for the general advantage of Canada".[230] Such a declaration would preclude provincial regulation of the exchanges and would make them subject to exclusive federal jurisdiction.[231] In fact, after the Supreme Court's decision in the *Eastern Terminal Elevator* case holding the regulation of the grain trade by means of a licensing system directed at grain elevators and warehouses to be beyond Parliament's jurisdiction,[232] Parliament enacted a new statute to accomplish the same purpose which included a declaration that all grain elevators and warehouses were works for the general advantage of Canada.[233] And the declaration has been upheld as a sufficient basis for comprehensive regulation of the delivery, receipt, storage and processing of grain.[234] In short, a parliamentary declaration confers full regulatory power not only over the work itself but also over the activities carried on in it.[235]

As the stock exchanges consist of trading floors and other physical facilities, it is clear that they are "works"[236] and a parliamentary judgment that they are for Canada's general advantage is a matter of policy which will not be questioned by the

229 *See e.g.* A.G. Ont. v. Winner, [1954] A.C. 541, 579-80 (P.C.); Commission du salaire minimum v. Bell Telephone Co. of Canada, [1966] S.C.R. 767, 774; *but cf.* A.G. Que. v. Kellogg's Company of Canada, 19 N.R. 271 (S.C.C. 1978) (provincial legislation dealing with local trade may "affect" such undertakings).

230 *See supra* text accompanying note 216.

231 *See id.;* Madden v. Nelson and Fort Sheppard Ry. Co., [1899] A.C. 626, 628 (P.C.). For a general discussion of this exception, *see* A. LAJOIE, LE POUVOIR DÉCLARATOIRE DU PARLEMENT (1969); P. HOGG, *supra* note 32, at 329-32; LASKIN, *supra* note 35, at 478-82.

The declaratory power has been used at least 470 times, most frequently in relation to local railways but also for a variety of other types of works such as canals, bridges, dams, tunnels, harbours, wharves, telegraphs, telephones, mines, mills, hotels, restaurants, theatres, oil refineries, factories and grain elevators; *see* A. LAJOIE, *supra* at 54, 123-51; P. HOGG, *supra* at 330.

232 *See* R. v. Eastern Terminal Elevator Co., [1925] S.C.R. 434; *see also supra* text accompanying note 117.

233 *See* Canada Grain Act, S.C. 1925, c. 33, s. 234; the history of the provision is outlined in Jorgenson v. A.G. Can., [1971] S.C.R. 725, 730.

234 *See* Jorgenson v. A.G. Can., [1971] S.C.R. 725.

235 *See id.;* Chamney v. R., [1975] 2 S.C.R. 151 (1973); *see also* Montana Mustard Seed Co. Inc. v. Continental Grain Co. (Canada) Ltd., 49 D.L.R. (3d) 72 (Sask. C.A. 1974), *affirmed*, [1976] 2 W.W.R. 768 (S.C.C. 1975).

236 *See e.g.* Montréal v. Montreal Street Ry., [1912] A.C. 333, 342 (P.C. 1911) ("works are physical things, not services"); *see also* Jorgenson v. A.G. Can., [1971] S.C.R. at 729 (court must be satisfied declaration refers to a "work"). A national computerized trading system would necessarily also be housed in a "work".

courts.[237] In the present political climate, however, it is doubtful that Parliament would exercise its declaratory power without prior negotiations with and presumably agreement by the provinces.[238]

Parliament has, therefore, jurisdiction under both of the quoted exceptions from subsection 92(10)[239] to enact legislation regulating the securities exchanges and any trading conducted through their facilities. Indeed, as its jurisdiction would be plenary,[240] Parliament might require all transactions in securities to be made through an exchange in order to regulate the trading markets effectively.[241] It could also set standards for and supervise the exchanges' self-regulatory activities,[242] establish continuing disclosure requirements for issuers whose securities are traded on an exchange (effectively all issuers whose securities are publicly traded),[243] and even over brokers and dealers who might be required to become exchange members.[244] In this manner Parliament's jurisdiction under subsections 92(10) and 91(29) may complement its powers to regulate interprovincial trade so that the two heads of power may be used as the basis for a comprehensive scheme for regulation of the Canadian securities market.[245]

However, as the outcome of constitutional adjudication cannot be predicted with certainty, a number of other bases of federal jurisdiction which may serve to support such legislation are considered as well.

237 *See e.g.* P. HOGG, *supra* note 32, at 331; A. LAJOIE, *supra* note 231, at 69-70; LASKIN, *supra* note 35, at 479.

238 *See e.g.* P. TRUDEAU, A TIME FOR ACTION: TOWARD THE RENEWAL OF THE CANADIAN FEDERATION 11, 15-17 (1978); McNairn, *supra* note 215, at 392 ("declaratory power cannot now be practically exploited by the Dominion to any great extent"); P. HOGG, *supra* note 32, at 331-32 (Parliament "now inclined to use the power only sparingly").

239 *See supra* text following note 215.

240 *See supra* notes 216, 231.

241 *See supra* text following note 201 and accompanying notes.

242 *See also supra* text accompanying notes 188-95. Other self-regulatory bodies might be treated similarly if it is necessary to do so in order to achieve an effective regulatory scheme.

243 *See also supra* text accompanying notes 186-89.

244 *See supra* text accompanying notes 203-13. As jurisdiction over members would effectively permit the establishment of standards for brokers and dealers, it is arguable that a licensing scheme to regulate such persons, rather than indicating an attempt to regulate business activities in a province, is merely an alternative technique of accomplishing a result that is necessary to the integrity of the regulatory scheme; *see e.g.* Montana Mustard Seed Co. Inc. v. Continental Grain Co. (Canada) Ltd., *supra* note 235.

245 *See supra* text accompanying notes 137-39 and text following note 213.

D. THE PEACE, ORDER AND GOOD GOVERNMENT OF CANADA

Although Parliament's legislative jurisdiction over trade and commerce and over works and undertakings provides a sufficient basis for a federal securities law, its general power "to make Laws for the Peace, Order, and good Government of Canada, in relation to all Matters not coming within the Classes of Subjects...assigned exclusively to the Legislatures of the Provinces"[246] may also serve to support such legislation and must, therefore, be considered. The scope of this general power has been defined in judicial decisions and, like "general trade and commerce", its parameters are still unclear.[247]

In fact the judicial approach to the two powers has tended until recently to develop along parallel lines. The Privy Council initially adopted a broad interpretation of the peace, order and good government clause, holding that a desire to deal uniformly with a nationwide problem on a nationwide basis was sufficient to take a matter beyond the class of subjects "assigned exclusively to the Legislatures of the provinces" in section 92.[248] Again,[249] during the succeeding half century the Privy Council consistently restricted the potential scope of Parliament's general power until by 1926 it was limited to situations in which a national emergency existed which was incapable of being adequately dealt with by the

246 BNA Act, s. 91.

247 *See supra* text following note 139.

248 *See* Russell v. R., 7 A.C. 829, 841-42 (P.C. 1882); *cf.* Citizens Insurance Co. of Canada v. Parsons, 7 A.C. 96 (P.C. 1881), discussed *supra* text accompanying notes 110-13. Both decisions were written by Sir Montague Smith and it is worth noting that in *Russell* he indicated that the legislation under consideration, the Canada Temperance Act, 1878, would likely have been justifiable as well under s. 91(2) of the BNA Act as a "general regulation of the traffic in intoxicating liquors throughout the Dominion"; 7 A.C. at 842. It is now clear that a desire for uniform legislation governing an activity carried on throughout Canada is not alone sufficient to bring a matter within either the general power or s. 91(2); *see e.g.* Reference re Anti-Inflation Act, [1976] 2 S.C.R. 373, 400 ("mere desire for uniformity cannot be a support for an exercise of the federal general power" *per* Laskin, C.J.); *cf.* MacDonald v. Vapour Canada Ltd., 66 D.L.R. (3d) 1, 19 (S.C.C. 1976), quoted *supra* text accompanying note 158. For a more restrictive reading of *Russell*, *see* Gibson, *Measuring "National Dimensions"*, 7 MAN. L.J. 15, 18-20 (1976); *see also* Reference re Anti-Inflation Act, *supra* at 396-98, 400 (*per* Laskin, C.J.: *Russell* not founded on uniformity alone).

249 *See supra* text accompanying notes 114-19. The process of truncation beginning with A.G. Ont. v. A.G. Can., [1896] A.C. 348 (P.C. 1895), and the subsequent "expansive" interpretations are described more fully elsewhere; *see e.g.* Laskin, *"Peace, Order and Good Government" Re-examined*, 25 CAN. B. REV. 1054, 1067-83 (1947); P. HOGG, *supra* note 32, ch. 14; W. MCCONNELL, *supra* note 114, at 137-59; and *see* Reference re Anti-Inflation Act, [1976] 2 S.C.R. at 396-417 (*per* Laskin, C.J.).

provinces[250] and to cases which by necessary inference from the words of section 92 were not within provincial powers.[251] It is not surprising that the limitations on trade and commerce and "peace, order, and good government" were developed in tandem during this period for both were the obvious bases upon which to attempt to justify a broad range of federal economic regulation including the licensing of insurance companies[252] and the control of profiteering[253] and labour unrest.[254]

Although a few decisions during the succeeding decade indicated a potential scope for the general power beyond emergencies and beyond mere literary exegesis,[255] the rationale enunciated in them was almost immediately undermined[256] and the continued application of the Privy Council's earlier decisions in a series of cases holding, in effect, that the depression did not constitute an emergency sufficient to justify the Bennett "new deal" legislation reinforced the restrictive interpretation of Parliament's general power.[257] Even a direct assault by the Privy Council itself was

250 *See* Toronto Electric Commnrs. v. Snider, [1925] A.C. 396, 410-16 (P.C.); *In re* Board of Commerce Act, 1919, [1922] 1 A.C. 191, 197-98, 200 (P.C. 1921). The two "great wars" and their aftermaths have been held to be "emergencies" meeting the necessary prerequisites; *see e.g.* Fort Frances Pulp and Power Co., Ltd. v. Manitoba Free Press Co., Ltd., [1923] A.C. 695 (P.C.) (wartime price controls); Co-operative Committee on Japanese Canadians v. A.G. Can., [1947] A.C. 87 (P.C. 1946) (deportation of Japanese Canadians after war); Reference re Wartime Leasehold Regulations, [1950] S.C.R. 124 (rents).

251 *See e.g.* John Deere Plow Co., Ltd. v. Wharton, [1915] A.C. 330, 339-40 (P.C. 1914). This approach to the interpretation of federal powers has been called the "gap theory"; *see* Abel, *The Anti-Inflation Judgment: Right Answer to the Wrong Question?* 26 U. TORONTO L.J. 409, 439 (1976); P. HOGG, *supra* note 32, at 245-46. It has been suggested that all of the decisions in this period reflect a contemporary social orientation in favour of business activities; *see e.g.* Abel, *supra* at 441 n. 186.

252 *See* A.G. Can. v. A.G. Alta., [1916] 1 A.C. 588, 596-97 (P.C.) (insurance business).

253 *See In re* Board of Commerce Act, 1919, *supra* note 250.

254 *See* Toronto Electric Commnrs. v. Snider, *supra* note 250; *see also* A.G. Can. v. A.G. Ont., [1937] A.C. 326 (P.C.).

255 *See In re* Regulation and Control of Aeronautics, [1932] A.C. 54, 77 (P.C. 1931) (dictum); *In re* Regulation and Control of Radio Communication, [1932] A.C. 304, 312 (P.C.). The dictum in the former case and the holding in the latter were to the effect that matters involving international agreements were within Parliament's general legislative jurisdiction as s. 132 of the BNA Act was no longer applicable and such matters had not otherwise been expressly provided for; the cases seemed to indicate, therefore, that the general power encompassed subject matters not expressly included in ss. 91 and 92. *But see infra* note 256 and accompanying text. *Cf. supra* text accompanying notes 118, 119.

256 *See* A.G. Can. v. A.G. Ont., [1937] A.C. 326, 350-51 (P.C.) (*Aeronautics* case decided under s. 132 and *Radio* case held radio necessarily involved undertakings like telegraphs within paragraph 92(10)(a)).

257 *See e.g.* A.G. Can. v. A.G. Ont., [1937] A.C. 355 (P.C.) (unemployment insurance); A.G.B.C. v. A.G. Can., [1937] A.C. 377 (P.C.) (natural products marketing); *see also* Canadian Federation of Agriculture v. A.G. Que., [1951] A.C. 179, 197-98 (P.C. 1950); on the "new deal" generally, *see e.g.* P. HOGG, *supra* note 32, at 250 n. 54;

unable to dislodge the so-called emergency doctrine as the primary basis for the application of the general power of Parliament. In the *Canada Temperance Federation* case Viscount Simon, attempting to reconcile all of the Privy Council's decisions on the meaning of "the peace, order, and good government of Canada", enunciated the "true test" for determining the validity of legislation under the provision;[258] a matter that "must from its inherent nature be of concern to the Dominion as a whole" and, therefore, exceeds "local or provincial concern or interests" falls within Parliament's general power even though it might from another aspect also be within provincial legislative competence.[259] The "national concern test" thus enabled the Privy Council to uphold the continued vitality of the *Russell* decision[260] and to treat a national emergency as only one example of the type of circumstances that might take a matter beyond provincial concern; in fact the Judicial Committee equated the emergency cases with the fields of aeronautics and radio as being merely different applications of the same approach.[261] Even though the seemingly new test did no more than restate Lord Watson's earlier description of the function of the general power,[262] the Privy Council chose to ignore it and to apply the emergency doctrine in a case decided later in the same year[263] and subsequently appeared to disaffirm it.[264] However, as all of the decisions stood and as none were expressly overruled, the "correct" approach to the interpretation of the general power was in 1951 far from certain.[265]

Laskin, *supra* note 249, at 1080 (Privy Council's decisions "surely a monument to judicial rigidity").

258 A.G. Ont. v. Canada Temperance Federation, [1946] A.C. 193, 205 (P.C.).

259 *Id.*

260 *Id.* at 204-08. In declaring, accurately, that *Russell* had not been decided on the basis of an emergency, the Privy Council expressly disaffirmed Viscount Haldane's explanation of the case, *id.* at 206, thus implicitly accepting Chief Justice Anglin's earlier indignant repudiation; *see* R. v. Eastern Terminal Elevator Co., [1925] S.C.R. 434, 438.

261 [1946] A.C. at 205-06.

262 *See* A.G. Ont. v. A.G. Can., [1896] A.C. 348, 360-61 (P.C.) ("some matters, in their origin local and provincial, might attain such dimensions as to affect the body politic of the Dominion...and...become matter[s] of national concern").

263 *See* Co-operative Committee on Japanese Canadians v. A.G. Can., [1947] A.C. 87 (P.C. 1946).

264 *See* Canadian Federation of Agriculture v. A.G. Que., [1951] A.C. 179, 197-98 (P.C. 1950); *but see* Reference re Anti-Inflation Act, [1976] 2 S.C.R. 373, 417 (*per* Laskin, C.J.).

265 The uncertainty was heightened by the fact that the Privy Council in 1949, while rejecting an argument based upon the general power, adopted Lord Watson's statement of its role; *see* C.P.R. v. A.G.B.C., [1950] A.C. 122, 138-41 (P.C. 1949); *see also* Laskin, *supra* note 249, at 1083; W. McConnell, *supra* note 114, at 153. *Cf.* Reference re Anti-Inflation Act, [1976] 2 S.C.R. 373, 396 (*per* Laskin, C.J.) (reconciling *Canada Temperance Federation* and *Japanese Canadians* cases on basis that

After the abolition of appeals to the Privy Council the Supreme Court of Canada adopted and consistently applied the "national concern" test enunciated by Viscount Simon to uphold federal jurisdiction over aeronautics[266] and offshore mineral rights[267] as well as Parliament's authority to establish a national capital region[268] and a language policy for its agencies.[269] And the lower courts followed suit.[270] Recently, however, the Supreme Court altered the pattern that appeared to be developing and resurrected the emergency doctrine.[271] Despite the fact that the Anti-Inflation Act reflected in its preamble the recent Canadian decisions outlined above[272] and that the counsel for the federal government relied primarily on the "national concern" test, [273] the Supreme Court upheld the Act on one ground only, that inflation in Canada at the time of its enactment was reasonably apprehended by Parliament as an emergency.[274] And although the analysis of the Chief Justice in the plurality opinion indicated some sympathy for the national concern test in the *Canada Temperance Federation* case,[275] the majority of the Court, while differ-

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"particular legislation with which the Court had to deal and the circumstances in which that legislation came under scrutiny" were "the commanding considerations").

266 *See* Johannesson v. West St. Paul, [1952] 1 S.C.R. 292 (1951). Four of the five justices relied on the dictum in *Canada Temperance Federation* while Chief Justice Rinfret held that the issue was concluded by the *Aeronautics Reference, supra* note 255.

267 *See* Reference re Offshore Mineral Rights of B.C., [1967] S.C.R. 792.

268 *See* Munro v. National Capital Commn., [1966] S.C.R. 663.

269 *See* Jones v. A.G.N.B., [1975] 2 S.C.R. 182, 189 (1974).

270 *See* Pronto Uranium Mines Ltd. v. Ont. Labour Relations Bd., [1956] O.R. 862 (H.C.); Denison Mines Ltd. v. A.G. Can., [1973] 1 O.R. 797 (H.C. 1972) (atomic energy); Re C.F.R.B., [1973] 3 O.R. 819 (C.A.), *leave to appeal refused,* [1973] S.C.R. ix. *See also* P. Hogg, *supra* note 32, at 258 (every case since 1949, except *Anti-Inflation Reference,* decided by Canadian courts "on the basis of the Canada Temperance test"); *cf. supra* text accompanying notes 120-28.

271 *See* Reference re Anti-Inflation Act, [1976] 2 S.C.R. 373. As a result, the decision represents the first time that the general approach to the general power has differed substantially from that to the interpretation of "trade and commerce"; while the *Vapour Canada* decision indicates a continuation of the expansive approach to the latter head of power, *see supra* text accompanying notes 152-77, the Court's *Anti-Inflation* decision represents a more restrictive approach to the former power; *see infra* text accompanying notes 272-90; *but see* W. McConnell, *supra* note 114, at 157. This fact may bring into question the potential impact of the *dicta* in *Vapour Canada; see e.g.* [1976] 2 S.C.R. at 437, 458; *but cf.* Laskin, *supra* note 249, at 1078 ("inclined to agree in this result [in the *Snider* case, *supra* note 250] but only because adequate power to regulate industrial relations...ought to be found in the 'trade and commerce' power").

272 *See* S.C. 1974-75-76, c. 75 ("Whereas the Parliament of Canada recognizes that...the containment and reduction of inflation has become a matter of serious national concern").

273 *See* A.G. Can., Factum, May 10, 1978 ¶¶ 6, 8.

274 *See supra* note 271.

275 *See* [1976] 2 S.C.R. at 394-419; as the legislation was justifiable on the basis of a

ing in result,[276] agreed that the legislation could not be sustained otherwise than on an emergency basis and articulated a restrictive doctrine for the availability of Parliament's general power in ordinary circumstances.[277] It is, therefore, reasonable to treat the analysis of the general power in Mr. Justice Beetz's dissenting opinion as the majority view.[278]

The majority in the *Anti-Inflation Reference* does not revert to the earlier view of the Privy Council which effectively limited the use of the "peace, order and good government" clause to situations involving a national emergency.[279] Rather, in attempting to reconcile the decisions of the Privy Council and the Supreme Court of Canada,[280] it propounds a dual approach to the interpretation of Parliament's general power. Federal legislation is justifiable under the general clause either on the basis of an apprehended emergency, including a peacetime crisis,[281] or on the ground that it deals with a matter of national concern.[282] The latter justification, however, is unavailable for legislation concerning broad economic or other areas which are readily divisible for regulatory purposes into categories that have traditionally been included within the provincial heads of jurisdiction in section 92 of the BNA Act.[283] These matters, for example, inflation, labour relations, environmental regulation and economic growth,[284] are subject to

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"crisis", it was unnecessary to consider whether it could also have been supported as a matter of national concern, *id.* at 419, but it is worth noting the Chief Justice's agreement with Lord Watson's advice concerning the exercise of caution in the application of the broader doctrine; *see id.* at 412. Judson, Spence and Dickson, JJ. concurred in the Chief Justice's opinion. *See also* Abel, *supra* note 251, at 432 ("national concern" test the "one with which the plurality flirts and which it would clearly like to adopt").

276 *See* [1976] 2 S.C.R. at 437-39 (*per* Ritchie, J., Martland and Pigeon, JJ., concurring, holding that sufficient evidence that Parliament "motivated by a sense of urgent necessity created by highly exceptional circumstances", *id.* at 439), 459-72 (*per* Beetz, J., de Grandpré, J. concurring, holding that emergency not clearly indicated by Parliament as intended basis of Act).

277 *See id.* at 440-59, *per* Beetz, J.; *see infra* text accompanying notes 283-90.

278 *See id.* at 437, *per* Ritchie, J., indicating agreement with the explication of the scope of Parliament's general power in the dissenting opinion; *but see* Abel, *supra* note 251, at 420-21.

279 *See supra* note 250 and accompanying text.

280 *See supra* text accompanying notes 249-70.

281 *See* [1976] 2 S.C.R. at 412 (*per* Laskin, C.J.), 436 (*per* Ritchie, J.) and 459 (*per* Beetz, J.).

282 *See id.* at 442-59.

283 *See id.* especially at 452-53 (inflation not a self-sufficient category but contains elements of monetary and tax policy and Anti-Inflation Act directed at control of prices, profit margins, dividends and wages aspects of all of which relate "to the regulation of local trade, to contract and to property and civil rights in the provinces"); *see also* P. Hogg, *supra* note 32, at 264-65.

284 The examples derive from the opinion of Mr. Justice Beetz, [1976] 2 S.C.R. at 445 (economic growth, environmental protection, labour relations and business of

the divided jurisdiction of Parliament and the provincial legislatures and their various aspects must be treated within that legislative framework unless an "emergency" exists which temporarily[285] necessitates federal regulation.[286] Matters of national concern in normal circumstances are thus confined to new regulatory areas which do not fall within the traditional classifications and which are "not an aggregate but [have]...a degree of unity that... [makes them] indivisible, an identity which...[makes them] distinct from provincial matters and a sufficient consistence to retain the bounds of form".[287] The impetus underlying this narrow definition of the second branch of the general power is a fear that any other approach would permit Parliament to usurp too easily a jurisdiction that more appropriately belongs to the provincial legislatures,[288] especially as matters of national concern become in effect new heads of federal power.[289] The courts must therefore exercise caution to avoid the addition of "hitherto unnamed powers of a diffuse nature to the list of federal powers".[290]

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insurance), 453 (inflation); *see also* LeDain, *Sir Lyman Duff and the Constitution*, 12 Osgoode Hall L.J. 261, 293 (1974) ("inflation, environmental protection, and preservation of the national identity or independence"); Lederman, *Unity and Diversity in Canadian Federalism: Ideals and Methods of Modernization*, 53 Can. B. Rev. 598, 605, 610-11 (1975) (labour relations, pollution, economic growth and language requirements). Mr. Justice Beetz cited both articles, [1976] 2 S.C.R. at 451-52, and adopted the approach to the general power advocated in the latter at 604-16.

285 All of the opinions stressed the temporary nature of the Anti-Inflation Act and the majority viewed it as an essential quality of legislation enacted to deal with an "emergency"; *see* [1976] 2 S.C.R. at 427 (*per* Laskin, C.J.), 436-37 (*per* Ritchie, J.), 461 (*per* Beetz, J.); *cf.* A.G. Can. v. Dupond, 19 N.R. 478, 495 (S.C.C. 1978) (*per* Beetz, J.).

286 *See* [1976] 2 S.C.R. at 452-53, 458.

287 *Id.* at 458; *see also* LeDain, *supra* note 284; Lederman, *supra* note 284. Examples of matters said to satisfy the test adopted in the decision are the incorporation of companies for other than provincial objects, *see supra* note 251 and accompanying text, the regulation of aeronautics and radio, *see supra* notes 255, 266 and accompanying text, and improvement of the National Capital Region, *see supra* note 268 and accompanying text; [1976] 2 S.C.R. at 457; *see also* Lederman, *supra* note 284, at 605-06 (aviation primary example). *See generally* P. Hogg, *supra* note 32, at 262-65.

288 *See* [1976] 2 S.C.R. at 443-45, 460-64.

289 *See id.* at 461.

290 *Id.* at 458. It is worth noting that the plurality decision too advocated caution in the application of the "national concern" test; *see supra* note 275. As a result, it is not clear whether the plurality and dissenting justices would differ in the application of the test to specific legislation; nevertheless, the differences in tone and approach between the two opinions indicate that differences of application may occur. The fact that only five of the nine justices adopted the dissenting opinion's approach and that the composition of the court has since changed and will continue to change compounds the uncertainty. (In September 1977, Estey and Pratte, JJ. replaced Judson and de Grandpré, JJ.; Spence, Pigeon and Martland, JJ. are due to retire in 1979, 1980 and 1982, respectively.)

Although the dissenting opinion of Mr. Justice Beetz represents the most concrete judicial attempt yet to give content to the concept of "national concern",[291] the criteria indicated by him, perhaps inevitably, provide little more guidance than the more general formulation of the doctrine in the plurality opinion and the earlier cases.[292] Nevertheless, as it is highly unlikely that a federal securities law would be enacted in response to an emergency and as such a law would in any event not be a temporary measure,[293] the "national concern" doctrine is the only basis on which federal regulation of the securities market by Parliament pursuant to its general power may be sustained.

The view adopted by the majority of the Supreme Court requires the application of two criteria, first, whether the matter in question is of sufficient magnitude[294] to exceed provincial regulatory capabilities[295] and thus require regulation on a national basis[296] and, if so, second, whether it is sufficiently specific or distinct to permit such regulation without "destroy[ing] the equilibrium of the Constitution".[297] Although the contours of the

291 *See e.g.* P. HOGG, *supra* note 32, at 263 ("first, and so far the only, attempt by a Canadian judge to reconcile the emergency cases with the national concern cases"); Abel, *supra* note 251, at 430 ("certainly better than anyone else has done").

292 *See* the trenchant criticism in Abel, *supra* note 251, at 426, 429-30, pointing out that the specificity and unity of a particular matter necessarily involves questions of judgment and degree as all matters may be treated as aggregates of submatters and concluding that the "national concern" concept as explicated is "unworkable". This analysis becomes especially telling in light of the fact that aeronautics, now considered by all courts and commentators to be an obvious example of a specific and indivisible matter which must be regulated in a unified manner, *see supra* note 287, was originally treated by the Supreme Court as an aggregate, the intraprovincial elements of which were beyond federal legislative competence; *see* Reference re Regulation and Control of Aeronautics, [1930] S.C.R. 663, *reversed*, [1932] A.C. 54 (P.C. 1931).

293 *See supra* text accompanying notes 285, 286. As Parliament may legislate to prevent an emergency from occurring, as well as to deal with an existing one, *see e.g.* [1976] 2 S.C.R. at 459-60, the impermanence of legislation too is only a matter of degree; *see* P. HOGG, *supra* note 32, at 256.

294 *Cf.* Gibson, *supra* note 248, at 31-32, arguing that the "importance" of a matter is an inappropriate consideration and that the geographic scope, "the *extent* of the area affected" should be determinative; *see also* P. HOGG, *supra* note 32, at 259.

295 *See e.g.* Abel, *supra* note 251, at 434-36; Gibson, *supra* note 248, at 33-36; P. HOGG, *supra* note 32, at 260-61.

296 As the major consideration in the Anti-Inflation Reference was the question of the unity of the subject matter rather than the degree of its "national concern", the factors necessary to indicate when a matter takes on national dimensions received no elaboration; nevertheless, that this standard must be met is implicit in Mr. Justice Beetz's opinion, *see* [1976] 2 S.C.R. at 453-54, 457, and is expressed in the article which was effectively adopted as the basis of the opinion; *see* Lederman, *supra* note 284, at 606 ("something that necessarily requires country-wide regulation at the national level").

297 [1976] 2 S.C.R. at 458; *see also* Lederman, *supra* note 284, at 606.

former standard remain vague,[298] the regulation of the securities market arguably meets all of the criteria likely relevant to its application. As was outlined above,[299] the securities market is not only national but international in scope.[300] It thus transcends provincial boundaries both geographically[301] and in its regulatory needs as the provinces lack the ability to enact, even cooperatively, a comprehensive regulatory scheme.[302] And the increasing use of automation in the market exacerbates all of these factors.[303] It is but a small step to infer from these facts that the regulation of the Canadian securities market is a matter of national concern. Nevertheless, even though there is an "interrelated" and "overarching pattern of activities" in the market, it is difficult to demonstrate that "harmonious provincial action cannot provide a frame of control",[304] especially as the provinces have regulated the securities market for at least a third of a century in a manner that is generally considered reasonably effective.[305] As a result, despite the regulatory gaps in provincial powers, it may be difficult to convince the Court that a comprehensive federal regulatory scheme rather than legislation of an interstitial character is neces-

298 *See supra* note 296.

299 *See supra* ch. I.

300 *See supra* text accompanying notes 7-19. International obligations on the part of Canada have exerted a significant influence on the characterization of legislation as being directed at a matter of national concern; *see e.g.* Gibson, *supra* note 248, at 29-30, 32-33; similar arguments can be applied to the securities market; *see e.g.* Denison Mines Ltd. v. A.G. Can., [1973] 1 O.R. 797, 808-09 (H.C.); *see also supra* text accompanying notes 15-19; and *see generally, Hebenton and Gibson.*

301 *See supra* note 294.

302 *See supra* text accompanying notes 53-90; *see also supra* note 295 and accompanying text.

303 *See supra* text accompanying note 12 and following; *see also supra* ch. III.C.

304 Abel, *supra* note 251, at 436. It has long been accepted that a desire for a uniform solution to a nationwide problem is not alone sufficient to constitute a matter one of national concern; *see e.g.* Abel, *supra* note 251, at 434; Gibson, *supra* note 248, at 32; P. HOGG, *supra* note 32, at 259-60; *see also supra* note 248. Indeed, although the *Russell* decision was upheld by the Privy Council because of its longevity, *see* A.G. Ont. v. Canada Temperance Federation, [1946] A.C. 193, 206 (P.C.), recent commentators have universally concluded that it was wrongly decided; *see e.g.* Abel, *supra* at 422-23; Gibson, *supra* note 248, at 32; P. HOGG, *supra* note 32, at 265.

305 Although the first provincial securities legislation was enacted almost 70 years ago, *see supra* note 34, the provincial acts from 1928 to 1945 merely required brokers and dealers to obtain a licence before trading in securities; 33 years ago, in 1945, provisions requiring the filing and acceptance of a prospectus in connection with a distribution of securities were added to the Ontario Securities Act; *see* Security Frauds Prevention Act, S.O. 1928, c. 34; Securities Act, 1945, S.O. 1945 (2d Sess.), c. 22. The development of the Ontario legislation from 1928 to 1966 is described in P. Anisman, *supra* note 81, at 25-42; *see also* J. WILLIAMSON at 20-28, 30-34; J. WILLIAMSON, SUPP. at 2-6.

sary, especially in light of the restrictive inclinations evinced in the *Anti-Inflation Reference*.[306]

Similar difficulties are likely to be encountered in connection with the distinctiveness of the securities market as a subject matter of federal legislation.[307] Although the securities market, especially when contrasted with "economic growth",[308] may be viewed as a unified entity with an identity sufficiently distinct to avoid potential smothering of provincial powers,[309] it is far from clear that the Court would not view it as an "aggregate" of matters traditionally within provincial jurisdiction.[310] Despite the fact that the securities market as a legislative subject matter is substantially more "specific" and less "pervasive" than inflation,[311] the likelihood of its characterization as an "aggregate" is increased by the existence of provincial legislation which has been held to come within subsection 92(13) of the BNA Act by both the Supreme Court and the Privy Council.[312] In other words, the previous decisions upholding provincial securities legislation gravitate against characterization of the securities market as a "new subject matter" not encompassed by section 92.[313]

In short, while there are sound arguments in favour of characterizing the securities market as a matter of national concern within Parliament's legislative jurisdiction, countervailing arguments exist as well and certainty in predicting which would prevail is impossible. Indeed in light of the substantial doubt over the potential success of the former line of argument and of the Supreme Court's expressed antipathy toward an expansive interpretation of the general power, it would be advisable not to rely exclusively, if at all, on "the peace, order, and good government of

306 *See supra* text accompanying notes 276-90. This conclusion differs from that of one of the present authors in respect of the regulation of mutual funds by Parliament; *see* Hogg, *Appendix: The Constitutionality of Federal Regulation of Mutual Funds*, in 1 MUTUAL FUND PROPOSALS 75, 81. However, that opinion was written in 1974 before the Supreme Court restricted the scope of the "national concern" test.

307 *See supra* text accompanying note 287.

308 *See supra* note 284 and accompanying text.

309 *See* [1976] 2 S.C.R. at 458; *see also supra* note 287.

310 *See* [1976] 2 S.C.R. at 458.

311 *See id.* (inflation "is an aggregate of several subjects some of which form a substantial part of provincial jurisdiction. It is totally lacking in specificity. It is so pervasive that it knows no bounds. Its recognition as a federal head of power would render most provincial powers nugatory"). *See also supra* text accompanying note 308.

312 *See supra* notes 34-50 and accompanying text. The fact that the provincial legislation is directed at transactions in securities in the province may exert an independent influence on the characterization; *see also supra* text accompanying notes 134-37, 181-213.

313 *See supra* text accompanying note 289; *see also* [1976] 2 S.C.R. at 450-53, 458. This

Canada" as a basis for federal securities legislation. As is indicated above, the better support is the power to regulate trade and commerce, possibly in conjunction with that over interprovincial works and undertakings.[314]

E. THE CRIMINAL LAW POWER

A federal securities law will undoubtedly contain prohibitions against market manipulation and other types of fraud in connection with securities trading as well as a general prohibition against any other violation of its requirements.[315] Indeed, it is likely that it would incorporate the provisions of the Criminal Code dealing specifically with fraudulent conduct relating to securities transactions, which would simultaneously be deleted from the Code, and would also add a number of provisions to preclude other deceptive practices and improper market conduct.[316] It is, therefore, worth considering Parliament's power to legislate in relation to criminal law as a further basis upon which a federal securities act might be supported.[317]

Despite the difficulty of defining the outer reaches of the "criminal law",[318] the courts have generally declared that Parliament's power to legislate extends to "the criminal law in its widest sense"[319] and there is no doubt that it enables the prohibition of "undesirable commercial practices", as well as of violence, immo-

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type of argument could not have been made in connection with aeronautics, radio or a national capital region; *see supra* notes 255, 266, 268.

314 *See supra* ch. III.B, C. While securities legislation that comes within the general power would necessarily also meet the requirements for "general trade and commerce", the converse is not true; *compare supra* text accompanying notes 140-79 with that accompanying notes 266-90. Therefore, reliance on the power to regulate trade and commerce is also preferable as a tactical matter.

315 *See generally*, *Leigh*, ch. II.

316 *See id.*; and *see supra* text accompanying notes 103-05.

317 *See* BNA Act, s. 91(27) ("The Criminal Law, except the Constitution of Courts of Criminal Jurisdiction, but including the Procedure in Criminal Matters").

318 *See e.g.* P. HOGG, *supra* note 32, at 278-81. Recent decisions of the Supreme Court indicate that the matter of definition is far from resolution; *see e.g.* N.S. Bd. of Censors v. McNeil, 19 N.R. 570 (S.C.C. 1978); A.G. Can. v. Dupond, 19 N.R. 478 (S.C.C. 1978).

319 A.G. Ont. v. Hamilton Street Ry., [1903] A.C. 524, 529 (P.C.). The initial broad reading of subsection 91(27) was, like other federal heads of power, contracted by the Privy Council during the 1920s, *see In re* Board of Commerce Act, 1919, [1922] 1 A.C. 191, 198-99 (P.C. 1921), and readopted in the 1930s; *see* Proprietary Articles Trade Assn. v. A.G. Can., [1931] A.C. 310, 323-25 (P.C.). For more detailed discussion of the power's judicial history, *see e.g.* LASKIN, *supra* note 35, at 822-24; P. HOGG, *supra* note 32, ch. 16. It is now clear that the criminal law power provides a flexible concept capable of adaptation to changing circumstances; *see e.g.* R. v. Zelensky, 2 C.R. (3d) 107, 115-16 (S.C.C. 1978).

rality and other forms of vice.[320] In fact, the primary constitutional support for Canadian antitrust legislation has been the criminal law power;[321] not only have the prohibition of combines[322] and amendments prohibiting price discrimination[323] and resale price maintenance[324] been upheld under this head, but it has also been interpreted as sufficiently broad to support injunctive remedies against the prohibited practices.[325]

It is therefore clear that Parliament has plenary jurisdiction to prohibit and penalize manipulative conduct and to proscribe as well any other activities in the securities market that it considers undesirable. If there were any doubt concerning this authority, it was put to rest when the Supreme Court in 1960 unanimously upheld the Criminal Code's prohibition against making, circulating or publishing a false prospectus.[326] The transplanted provisions of the Criminal Code and other offences in a federal securities act would thus constitute a valid exercise of the criminal law power.[327]

A more difficult question is whether the same head of power would also provide support for the parts of a federal law that do not directly create offences. As was said above,[328] the purpose of securities legislation is not only to prevent fraud but also to ensure that investors have confidence in the fair operation of the securities market by means of disclosure of information and regulation of market actors. Any modern securities act must therefore include disclosure requirements both in connection with distributions of securities and by issuers on a continuing basis,[329] a scheme for supervising the conduct of market actors by licensing, self-regulation or both,[330] and an administrative mechanism to interpret and enforce its provisions.[331] Such provisions will invariably

320 LASKIN, *supra* note 35, at 824.

321 *See e.g.* P. HOGG, *supra* note 32, at 281-85; *see also* McDonald, *Constitutional Aspects of Canadian Anti-Combines Law Enforcement*, 47 CAN. B. REV. 161, 166-84 (1969); Hogg & Grover, *The Constitutionality of the Competition Bill*, 1 CAN. BUS. L.J. 197, 202-05 (1976); S. GRANGE, THE CONSTITUTIONALITY OF FEDERAL INTERVENTION IN THE MARKETPLACE - THE COMPETITION CASE 20-22 (undated).

322 *See* Proprietary Articles Trade Assn. v. A.G. Can., [1931] A.C. 310 (P.C.).

323 *See* A.G.B.C. v. A.G. Can., [1937] A.C. 368 (P.C.).

324 *See* R. v. Campbell, 58 D.L.R. (2d) 673 (S.C.C. 1965).

325 *See* Goodyear Tire & Rubber Co. of Canada Ltd. v. R., [1956] S.C.R. 303. It appears that a "consent decree" procedure may be developing in connection with the injunctive remedy; *see* R. v. Canada Safeway Ltd., [1974] 1 W.W.R. 210 (Alta. S.C. 1973).

326 *See* Smith v. R., [1960] S.C.R. 776; *see also* Criminal Code, s. 358.

327 *Cf. e.g.* ALI FEDERAL SECURITIES CODE, pt. XVI; and *see id.* ss. 909-16.

328 *See supra* ch. III.A.

329 *See e.g. Grover & Baillie.*

330 *See e.g. Connelly; Dey & Makuch.*

331 *See e.g. Howard; Leigh.*

involve the imposition of positive duties on issuers, brokers, dealers, self-regulatory organizations and other persons trading in securities and will likely involve as well extensive rule-making powers enabling an administrator to refine the general standards in the legislation and to specify the content of documents required to be filed and circulated.[332] And to be effective a securities act must also include a comprehensive system of civil liability so that persons who are harmed by a violation of or failure to comply with the act's requirements may be compensated.[333]

In short, criminal prohibitions would form only one part of a comprehensive scheme for the regulation of the securities market and not necessarily the dominant part. The disclosure and other regulatory provisions of a securities act go far beyond the boundaries usually assigned to the criminal law.[334] The courts have consistently held that the criminal law is not a sufficient peg upon which to support a regulatory structure[335] and have looked through form to the substance of legislation in order to determine its true character.[336] In doing so they have declared invalid, as "colourable" attempts to exceed Parliament's legislative jurisdiction,[337] apparently criminal provisions creating an offence for a person to act on behalf of an insurance company without a federal licence[338] or to offer, sell or possess butter substitutes such as margarine.[339] And the laws which have been upheld under subsection 91(27) have confined the enforcement powers of the agency to investigating, reporting, recommending and prosecuting, all matters that are clearly related to criminal law.[340] As a result it is

332 *See e.g.* Ontario Securities Act, pts. II, VII; Canada Business Corporations Act, s. 254(l)(c).

333 *See generally, Leigh*, ch. II.B; *see also e.g.* ALI FEDERAL SECURITIES CODE, pt. XVII. Constitutional considerations relating to civil remedies are discussed *infra* ch. III.F.

334 *See generally* P. HOGG, *supra* note 32, at 289-91.

335 *See e.g. In re* Board of Commerce Act, 1919, [1922] 1 A.C. 191, 198-99 (P.C. 1921); Reference re Dominion Trade and Industry Commission Act, 1935, [1936] S.C.R. 379, 381, *affirmed*, [1937] A.C. 405, 416 (P.C.) (approval of agreements in specific industry in which competition wasteful not ancillary to criminal law). Although no arguments were directed to the provision in question before the Judicial Committee, the opinion expressly states its agreement with the Supreme Court's holding.

336 On the characterization of the nature of legislation, *see generally* LASKIN, *supra* note 35, at 98-121; P. HOGG, *supra* note 32, at 80-88.

337 On "colourability" *see e.g.* LASKIN, *supra* note 35, at 101-02; P. HOGG, *supra* note 32, at 86-87.

338 *See* A.G. Ont. v. Reciprocal Insurers, [1924] A.C. 328 (P.C.); on the history of the insurance decisions of the Privy Council, *see* P. HOGG, *supra* note 32, at 299-301.

339 *See* Canadian Federation of Agriculture v. A.G. Que., [1951] A.C. 179, 195-97 (P.C. 1950) (purpose of provision to regulate trade; not criminal law).

340 *See e.g.* Proprietary Articles Trade Assn. v. A.G. Can., [1931] A.C. 310 (P.C.); and *see supra* note 335. Recent amendments to the Combines Investigation Act have extended its provisions to include civil remedies and give adjudicative powers to the Restrictive Trade Practices Commission; *see* S.C. 1974-75-76, c. 76. On the constitu-

unlikely that the criminal provisions outlined above, or for that matter a general provision creating an offence and prescribing penalties for a violation of any provision of the act,[341] would be sufficient to give a criminal law cast to a federal securities law.

Thus while Parliament's power to legislate in relation to criminal law would support the part of a securities law proscribing and providing penalties for fraudulent and other improper conduct,[342] the justification for the remaining parts of the law would have to be sought elsewhere.[343]

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tionality of these amendments, *see* S. GRANGE, *supra* note 321; Hogg & Grover, *supra* note 321.

Some doubt may be cast on the ability of a federal agency to engage in enforcement activities by Re Hauser, 80 D.L.R. (3d) 161 (Alta. App. Div. 1977), which held the prosecutorial function beyond Parliament's jurisdiction under the BNA Act, s. 91(27) on the basis that it is a matter of the administration of justice and thus within exclusive provincial jurisdiction under s. 92(14). The decision would preclude the prosecution for violations of the criminal provisions of a federal securities act by a federal agency and thus would limit the agency's ability to determine its own enforcement policies. There are, however, contrary holdings in other courts of equivalent jurisdiction, *see e.g.* R. v. Pelletier, 4 O.R. (2d) 677 (C.A. 1974), *leave to appeal refused*, [1974] 2 S.C.R. x, and the Supreme Court of Canada granted leave to appeal the *Hauser* decision on January 26, 1978, and heard argument on it on May 29-31, 1978.

The decision in *Hauser* is inconsistent with previous decisions which have held investigatory functions ancillary to the criminal law power, *see e.g.* A.G. Ont. v. A.G. Can., [1937] A.C. 405, 416 (P.C.); Proprietary Articles Trade Assn. v. A.G. Can., *supra*, for no rational distinction can be drawn between investigative and prosecutorial functions; both are equally a part of the administration of justice and equally relate to the effectiveness of criminal laws enacted by Parliament; *see e.g.* Di Iorio v. Warden of the Common Jail of Montréal, 73 D.L.R. (3d)491 (S.C.C. 1976); *cf.* Toronto v. R., [1932] A.C. 98, 103-04 (P.C. 1931) (power to direct recipient of fines ancillary to criminal law as may go to efficacy of legislation). Similarly the majority of the Alberta Court drew an arbitrary distinction between the enforcement of criminal law and the enforcement of laws enacted by Parliament pursuant to other heads of power; *see* Re Hauser, *supra*, at 173, 188; *cf.* Di Iorio v. Warden, *supra*, at 497-98 (*per* Laskin, C.J., dissenting), 529 (*per* Dickson, J. for majority). However, injunctive and other remedial proceedings by a government agency responsible for the administration and enforcement of a regulatory statute may be as much a part of the "administration of justice" as the enforcement of the criminal law; and as provincial jurisdiction over the administration of justice is broader under s. 92(14) in relation to civil than to criminal justice, the implications of *Hauser* may be far reaching indeed. In short, it appears that the *Hauser* Court gave insufficient weight to the implications of its decision, as well as to the implications of the exception in s. 91(27).

It is, therefore, unlikely that the Supreme Court will affirm the Appellate Division's decision. Rather, it is likely to conclude that the validity of legislation governing the prosecutorial, as well as other enforcement, functions depends upon the aspect from which it was enacted and that jurisdiction over them is concurrent; *see* Di Iorio v. Warden, *supra*, at 529 (*per* Dickson, J.), 542-43 (*per* Beetz, J.); and *see generally* P. HOGG, *supra* note 32, at 84-85.

341 *See e.g.* Canadian Federation of Agriculture v. A.G. Que., *supra* note 339; *cf.* MacDonald v. Vapour Canada Ltd., 66 D.L.R. (3d) 1, 10-11 (S.C.C. 1976).

342 In light of the difficulties of accurately predicting constitutional validity, it might be advisable to include the criminal prohibitions as a separate, and severable, part

F. CIVIL REMEDIES

The criminal law provides a technique for the enforcement of a regulatory statute that is necessarily limited both in incidence and in deterrent capability.[344] Criminal penalties by definition may be imposed only after an offence has been detected and proved. The deterrent effect of a fine or even imprisonment, especially in the case of economic crimes where the potential risks of a violation are likelier to be evaluated rationally,[345] will be diluted by the likelihood that the violation will go undetected, a factor which is influenced by the enforcement budget of the authority administering the legislation, and further by the fact that a criminal offence, even if discovered, imposes a heavy burden of proof on the prosecution,[346] and particularly so in connection with offences involving complex technical or financial activities.[347] Modern securities laws, therefore, place substantial reliance on other remedial devices which may be initiated by an administrative authority or by private litigants. Injunctive and other civil enforcement actions by a government agency permit preventative measures involving a lesser burden of proof than a criminal prosecution[348] and the availability of civil actions for damages by persons who suffer harm as a result of a violation both enhances the deterrent effect of the legislation and enables compensation to the plaintiff for his injury.[349] Indeed, the public benefits of private actions derive largely from the economic interest of the plaintiff in obtaining compensation for the effects of the violation.[350]

A federal securities act will, therefore, undoubtedly contain provisions creating civil liability for a false prospectus[351] and for false statements in other required documents such as takeover bid

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of a federal act, especially if the equivalent provisions in the Criminal Code are to be repealed when federal securities legislation is enacted. Severability is discussed *infra* ch. III.G.

343 *See supra* ch. III.B, C.

344 *See generally, Leigh*, ch. II.

345 *See e.g. id.* text accompanying notes 26-28.

346 *See e.g.* McDonald, *supra* note 321, at 163-65; P. ANISMAN at 306-07.

347 *See e.g.* R. v. Lampard, [1968] 2 O.R. 470 (C.A.), *reversed*, [1969] S.C.R. 373.

348 *See generally, Leigh*, ch. II.C-E; *see also e.g.* ALI FEDERAL SECURITIES CODE, s. 1819 and Notes. Constitutional questions relating to enforcement activities are discussed *supra* note 340; *see also* McDonald, *supra* note 321, at 210-25.

349 *See e.g. Leigh*, text accompanying notes 71-73; P. ANISMAN at 307.

350 *Cf. e.g.* J.I. Case Co. v. Borak, 377 U.S. 426 (1964).

351 *See e.g.* Ontario Securities Act, ss. 65, 142; Ontario Bill 7, s. 126; ALI FEDERAL SECURITIES CODE, s. 1704; and *see generally, Leigh*, text at note 88 and following.

and proxy circulars[352] and perhaps even annual reports.[353] And it would be surprising if it does not include as well civil remedies for fraudulent and other prohibited conduct such as insider trading[354] and manipulation of the market price of a security.[355] Such actions must form an essential part of any regulatory scheme and will also serve to bolster confidence in the fair operation of the securities market.[356]

If federal legislation is, as suggested above, based on Parliament's power to regulate trade and commerce or interprovincial works and undertakings,[357] the provision of civil actions for damages and other remedies will create no constitutional difficulties, regardless of whether they are premised on a violation of the criminal and other prohibitions in the act or are individually specified in a separate part;[358] their connection with the purpose and implementation of the legislation as a whole is clearly both rational and functional.[359] In other words, a system of civil remedies to reinforce the requirements of a securities act[360] is necessar-

352 *See e.g.* Ontario Securities Act, ss. 100(a), 144(a); Ontario Bill 7, s. 127; Canada Business Corporations Act, ss. 148, 198(3), 234; ALI FEDERAL SECURITIES CODE, s. 1713. The provisions of the Ontario Act relating to prospectuses and takeover bid circulars are criticized in P. ANISMAN at 320-27; *see also* D. JOHNSTON at 180-86, 341-42.

353 *See e.g.* ALI FEDERAL SECURITIES CODE, s. 1704; *see also id.* s. 1705 (false filings).

354 *See e.g.* Canada Business Corporations Act, s. 125; Ontario Securities Act, ss. 113-14; Ontario Bill 7, ss. 131-32; ALI FEDERAL SECURITIES CODE, s. 1703. The provision in the Ontario Bill was substantially modified in committee; *see* Third reading, June 23, 1978. On insider trading generally, *see, Yontef; Anisman; Leigh,* text accompanying notes 90-94.

355 *See e.g.* ALI FEDERAL SECURITIES CODE, s. 1710; *see generally, Leigh,* text following note 94. The ALI CODE provides a remedy for open market transactions involving fraud and manipulation, including insider trading; as a result, it does not require a contractual relationship to exist between a plaintiff and defendant as the Ontario legislation does; *see* Ontario Bill 7, *supra* note 354. It is arguable that Bill 7 is in this regard more limited than the present Ontario legislation; *see, Anisman* at 234-43.

356 *See supra* chs. I, III.A.

357 *See supra* ch. III.B, C.

358 *Cf.* MacDonald v. Vapour Canada Ltd., 66 D.L.R. (3d) 1 (S.C.C. 1976) in which the Supreme Court held invalid a provision creating civil liability for essentially tortious conduct which was wholly unrelated to the scheme of the act in which it was contained; *see id.* at 10-11, 25; *see also supra* text accompanying notes 152-58. And *cf.* Weider v. Beco Industries Ltd., 29 C.P.R. (2d) 175 (F.C.T.D. 1976) (following *Vapour Canada* in respect of application of Trade Marks Act, R.S.C. 1970, c. T-10, s. 7(b) to patents). The fact that all of the provisions creating civil liability are segregated from the other provisions on which the liability is based, that is, are included in a single part of the act, would not alone lead to the conclusion that they are unrelated to the rest of the act in the sense used in the *Vapour Canada* decision for the analysis in the case emphasized substance over form, *see* 66 D.L.R. (3d) at 8, 26-27, and clearly indicated that civil remedies that "round out regulatory schemes...in relation to patents, copyrights and trade marks" would be valid; *id.* at 31.

359 *See* Papp v. Papp, 8 D.L.R. (3d) 389, 393-94 (Ont. C.A. 1969).

360 *See supra* text accompanying notes 348-50.

ily incidental to the achievement of its objects.[361] Judicial decisions concerning a number of disparate matters such as federal elections,[362] railways,[363] federal corporations[364] and even divorce[365] have upheld Parliament's jurisdiction to provide civil relief in order to effectuate its legislative policies.[366]

Apprehension over the validity of such provisions, however integral to the regulatory scheme, need arise only if the basis of the statute is the criminal law power.[367] Because criminal law involves the prohibition of conduct that is considered undesirable and the specification of penalties for a violation,[368] it is arguable that any attempt to ascribe civil consequences to such conduct is beyond Parliament's jurisdiction under subsection 91(27) and necessarily constitutes an invasion of the exclusive provincial preserve labelled "property and civil rights".[369] While this conceptual approach has been adopted by some judges,[370] the Supreme Court

361 On the ancillary doctrine generally, *see supra* citations in note 125.

362 *See* Doyle v. Bell, 11 O.A.R. 326 (C.A. 1884).

363 *See* Curran v. Grand Trunk Ry. Co. of Canada, 25 O.A.R. 407 (C.A. 1898) (right of action for breach of Railway Act); Grand Trunk Ry. Co. of Canada v. A.G. Can., [1907] A.C. 65 (P.C. 1906) (regulation of employer-employee relationship); Greer v. Canadian Pacific Ry. Co., 51 S.C.R. 338 (1915); Canadian Northern Ry. Co. v. Pszenicnzy, 54 S.C.R. 36 (1916); Williams v. Canadian National Ry. Co., 75 D.L.R. (3d) 87, 89-91 (N.S.C.A. 1976) (limitation period). *See now e.g.* Railway Act, R.S.C. 1970, c. R-2, ss. 86 (contracts respecting rolling stock), 185 (wages), 294 (contracts limiting liability), 336 (breach of duty under Act creates cause of action for damages) and 397 (vicarious liability).

364 *See* Esso Standard (Inter-America) Inc. v. J.W. Enterprises Inc., [1963] 2 S.C.R. 144, 152-53 (dictum); *cf.* Multiple Access Ltd. v. McCutcheon, 78 D.L.R. (3d) 701 (Ont. Div'l Ct. 1977), *affirmed* (Ont. C.A. June 14, 1978, unreported) (jurisdiction assumed, 78 D.L.R. (3d) at 703).

365 *See* the recent series of decisions upholding the corollary relief provisions of the Divorce Act of 1968, S.C. 1967-68, c. 24, now R.S.C. 1970, c. D-8; Papp v. Papp, 8 D.L.R. (3d) 389 (Ont. C.A. 1969) (custody); Jackson v. Jackson, [1973] S.C.R. 205 (1972); Zacks v. Zacks, [1973] S.C.R. 891 (maintenance); on divorce and ancillary matters generally, *see* P. HOGG, *supra* note 32, at 371-76.

366 *See also* Nykorak v. A.G. Can., [1962] S.C.R. 331 (Parliament may impose liability to federal Crown on person who injures member of armed forces); on tort liability of the federal Crown under federal legislation, *see* P. HOGG, *supra* note 32, at 169-71. *See also* Combines Investigation Act, R.S.C. 1970, c. C-23, s. 31.1, added by S.C. 1974-75-76, c. 76, s. 12, creating an action for damages for specified breaches of the Act. There has been some difference of opinion over the validity of the new remedy, *see* S. GRANGE, *supra* note 321, at 35-37 (invalid); Hogg & Grover, *supra* note 321, at 207-09, but the issue has not yet received judicial consideration; *cf.* Eli Lilly & Co. v. Marzone Chemicals Ltd., 29 C.P.R. (2d) 255 (F.C.A. 1976) (refusal to hear argument on issue when not raised in lower court).

367 *See supra* ch. III.E.

368 *See e.g.* Proprietary Articles Trade Assn. v. A.G. Can., [1931] A.C. 310, 324 (P.C.); *cf.* H. PACKER, THE LIMITS OF THE CRIMINAL SANCTION 17-19 (1968).

369 BNA Act, s. 92(13); on property and civil rights generally, *see* P. HOGG, *supra* note 32, ch. 17.

370 *See e.g.* R. v. Zelensky, 2 C.R. (3d) 107, 140-47 (S.C.C. 1978) (*per* Pigeon, J. dissenting); *see also* Ross v. Registrar of Motor Vehicles, [1975] 1 S.C.R. 5, 13 (1973) (civil

has not been so restrictive. Rather it has directed its attention to the primary characteristics of the legislation under consideration[371] and where the statute was within Parliament's criminal law power, the Court has considered the functional relationship between the act as a whole and the provision establishing the civil consequences flowing from its violation.[372] Thus provisions authorizing injunctive and compensatory orders after a criminal conviction have been upheld as furthering the purpose of the offence with which they are connected.[373] And although the former type of order was treated as a supplementary sanction[374] and the latter as part of the sentencing process,[375] the approach adopted by the Supreme Court in both cases provides a basis for the creation by Parliament of civil remedies as an enforcement technique to supplement the more traditional criminal sanction.[376] The availability of such remedial methods of enhancing the effectiveness of criminal prohibitions is reinforced by the Supreme Court's declaration that there is no constitutional impediment to the implication of a civil cause of action on behalf of a person who suffers harm from

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consequences of criminal act not "punishment"); and *see* Pollock v. Lipkowitz, 17 D.L.R. (3d) 766, 767 (Man. Q.B. 1970) (dictum that Parliament lacks authority to abolish tort action for damages against juvenile delinquent); *cf.* LASKIN, *supra* note 35, at 835.

371 *See supra* notes 336-38 and accompanying text; MacDonald v. Vapour Canada Ltd., 66 D.L.R. (3d) 1 (S.C.C. 1976); and *see supra* note 358.

372 *See supra* notes 361-65 and accompanying text.

373 *See* Goodyear Tire & Rubber Co. of Canada Ltd. v. R., [1956] S.C.R. 303 (prohibition of continuation or repetition of offence); R. v. Zelensky, 2 C.R. (3d) 107 (S.C.C. 1978) (compensation for loss or damage suffered as result of indictable offence).

374 *See* [1956] S.C.R. at 308 (prohibitory order authorized "in addition to any other penalty").

375 *See* 2 C.R. (3d) at 119-25. In fact, in order to emphasize the relationship between an order for compensation and sentencing the Chief Justice created an unnecessary and rather questionable standard by suggesting that a court should have regard to the motives of the applicant in determining whether to make an order even accepting that an order "should only be made with restraint and caution". Whether a particular applicant wishes to "emphasize the sanctions against the offender", *id.* at 125, or merely to recover the value of what he lost is irrelevant to the effect of the provision enacted by Parliament and also to whether an order should be granted; a compensation order could not have been intended to benefit only those who seek retribution; *cf. id.* at 121, quoting from Re Torek, 44 D.L.R. (3d) 416, 419 (Ont. H.C. 1974) (valid object "to prevent convicted criminal from profiting from his crime"); and *cf.* Affiliated Ute Citizens of Utah v. U.S., 406 U.S. 128, 155 (1972) (if defendant's profit greater than plaintiff seller's loss, damages are amount of profit).

376 The majority opinion in the *Goodyear* case contained a broad statement of principle to justify the prohibitory order; *see* [1956] S.C.R. at 308 ("The power to legislate in relation to criminal law is not restricted...to defining offences and providing penalties for their commission. The power of Parliament extends to legislation designed for the prevention of crime as well as to punishing crime"). And although the tone of the majority in *Zelensky* is at best cautious, the decision rests on a straightforward application of the ancillary doctrine; *see* 2 C.R. (3d) at 119-20, citing Papp v. Papp, *supra* note 365.

the violation of a criminal statute;[377] for if a remedy may be implied by the courts, it may be expressly created by Parliament.[378]

The issue may be illustrated by the example of insider trading in the securities of non-public corporations.[379] As securities legislation is directed at public trading in securities, it is concerned almost exclusively with corporations that sell securities to the public and tends to exempt or ignore other issuers.[380] As a result, the provisions of the securities acts proscribing and creating civil liability for insider trading apply only to public corporations[381] even though the vast majority of corporations are private[382] and

377 *See* Direct Lumber Co. Ltd. v. Western Plywood Co. Ltd., [1962] S.C.R. 646, 649-50; *cf.* Joyal v. Air Canada, [1976] C.S. 1211 (injunction against continued breach of Official Languages Act, R.S.C. 1970, c. O-2); Magee v. Channel Seventynine Ltd., 75 D.L.R. (3d) 201 (Ont. H.C.) (dismissing action for breach of contract made in violation of Lord's Day Act, R.S.C. 1970, c. L-13).

378 The dictum in *Direct Lumber* might be explained as indicating that an implied cause of action is not a statutorily created right but a matter of common law; *see e.g.* London Passenger Transport Bd. v. Upson, [1949] 1 A.C. 155, 168 (H.L. 1948), cited with approval in Sterling Trusts Corp. v. Postma, [1965] S.C.R. 324, 329; *see also* Finkelman, *Comment: Industrial Law - Combines Legislation - Conspiracy - Right of Injured Party to Sue for Damages for Breach of Criminal Statute,* 13 CAN. B. REV. 517, 521-22 (1935); P. ANISMAN at 316-17. But the majority of the courts have tended to treat the implication of a civil remedy as a matter of legislative intent; *see e.g.* J. FLEMING, THE LAW OF TORTS 123-24 (5th ed. 1977). However, neither interpretation of the decision detracts from the conclusion in the text for even if the common law of tort be treated as within provincial jurisdiction under s. 92(13) of the BNA Act, *see e.g.* B. LASKIN, THE BRITISH TRADITION IN CANADIAN LAW 127 (1969); Finkelman, *supra; Leigh,* text accompanying note 115, the implication of a civil remedy in tort in accordance with common law principles necessarily involves a conclusion that the remedy is ancillary to the legislation; *see generally* J. FLEMING, *supra* at 122-33; P. ANISMAN at 314-18; *Leigh,* text accompanying notes 110, 119-30. As a result, if a matter of common law, it is federal; *see e.g.* LASKIN, *supra* note 35, at 793 ("is federal common law...and provincial common law...according to the matters respectively distributed to each legislature"); B. LASKIN, *supra,* at 129-30; Hogg, *Comment: Constitutional Law - Limits of Federal Court Jurisdiction - Is There a Federal Common Law,* 55 CAN. B. REV. 550 (1977).

379 On insider trading generally *see, Yontef; Anisman.* For purposes of the present discussion "insider trading" is intended to connote transactions in securities by a person who is in possession of material undisclosed information relating either to the issuer or the securities themselves; *see e.g. Anisman* at 154-55.

380 *See e.g.* Ontario Securities Act, ss. 19(1)9a, 19(2)9, 81(a)(iii), 101(a), 109(1)(b), 118(1)(b) (all exempting or excluding transactions in and reporting by private companies); Ontario Bill 7, ss. 1(1)38 ("reporting issuer"), 34(2)10, 72(1)(a), 74, 88(2)(b).

381 *See e.g.* British Columbia Securities Act, ss. 106(1)(b), 111; Ontario Securities Act, ss. 109(1)(b), 113; Ontario Bill 7, ss. 75, 131. *But see* Canada Business Corporations Act, s. 125; Companies Act, S.B.C. 1973, c. 18, s. 152 (all corporations). Rule 10b-5 under the Securities Exchange Act of 1934 also applies to transactions in securities of closely held corporations; *see e.g.* Arber v. Essex Wire Corp., 490 F.2d 414 (6th Cir. 1974), *cert. denied,* 419 U.S. 830 (1974).

382 *See e.g. Anisman* at 209 n. 359 (generally over 90% in all jurisdictions). "Private" corporations are here treated as synonymous with closely held corporations; *cf. e.g.*

even though most of the reported instances of insider trading have involved closely held corporations.[383] A federal securities act too is likely to be concerned primarily with public issuers not only for substantive reasons but also because justification for regulating closely held corporations the securities of which are almost invariably traded exclusively intraprovincially in face-to-face transactions is substantially more difficult under the BNA Act.[384]

Nevertheless, insider trading in the securities of any issuer arguably should be prohibited; although the market impact may differ, the "vice" is the same whether or not the issuer is a public corporation.[385] And it would be surprising indeed if a federal act prohibiting insider trading did not create civil liability for a violation of its provisions.[386] The legislation might, therefore, include a civil remedy for insider trading in the securities of both public and private corporations.[387] However, while liability in respect of the former type of corporation would further the market purpose of the act,[388] the remedy for persons trading in securities of closely held corporations would not do so; rather it would flow exclusively from the criminal prohibition and would have to be sustained on that basis.

As insider trading in the securities of a private corporation would have no market impact, it would not be the subject of an administrative agency's normal surveillance procedures. Such violations would come to the attention of the enforcement agency only when a complaint is filed by an aggrieved person and the initiation of proceedings in such cases would not only be costly but, more important, would divert the agency from its primary duty, the regulation of the public market.[389] A provision creating civil

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Ontario Securities Act, s. 1(1)14; Ontario Bill 7, s. 1(1)31 ("private company" one the constitution of which limits number of shareholders, restricts right to transfer its shares and prohibits public offering of securities).

383 *See e.g. Anisman* at 209-10 nn. 360, 361; P. ANISMAN at 118 n. 292.

384 *See supra* ch. III.B.

385 *See e.g. Anisman* at 209-10. In fact, it might be thought that the direct dealing involved in trading in the securities of private corporations makes insider trading in such transactions more culpable from a moral perspective than trading in an organized market where the harm is less tangible; *see e.g. Anisman* at 235-36; *but see id.* at 236-38. In any event, the distinction seems to be reflected in the case law; *see id.* at 155 n. 17, 167; Goodwin v. Agassiz, 186 N.E. 659 (Mass. S.C. 1933); *cf.* R. v. Littler, 13 C.C.C. (2d) 530 (Que. Sess. of Peace 1972), *affirmed*, 65 D.L.R. (3d) 443 (Que. C.A. 1974) (on merits).

386 *See supra* text accompanying notes 344-56.

387 *Cf.* Canada Business Corporations Act, s. 125; Companies Act, S.B.C. 1973, c. 18, s. 152; ALI FEDERAL SECURITIES CODE, ss. 1603, 1703.

388 *See supra* text accompanying and following notes 3-5, 188-91.

389 Moreover, as the number of such cases would be difficult to predict, an agency could not accurately budget for them and the inevitable limitations on enforcement

liability by enabling the person who suffers harm from a violation, that is, the person with the greatest incentive, to pursue his own remedy would serve a number of useful purposes; it would provide an effective deterrent to the prohibited conduct by increasing the likelihood of both detection and the initiation of legal proceedings[390] and at the same time would deprive the offender of the fruits of his violation by enabling his victim to obtain compensation.[391] Civil liability would thus further both the deterrent and punitive purposes of the prohibition. In short, there is undeniably "a rational, functional connection between what is admittedly good and what is [likely to be] challenged"[392] and there is no principled reason to preclude Parliament from enacting such remedies where it considers them necessary to effectuate its criminal laws.[393]

Despite the clarity of the connection, however, it is far from certain that the Supreme Court would sustain such a remedial provision. Although the statements in the *Goodyear* decision and the reasons underlying *Zelensky* support it,[394] the tone of the Court's recent decisions has been restrictive albeit not technically preclusive.[395] In any event, the issue is unlikely to arise except in

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resources would necessitate selection for prosecution only of cases involving significant issues of principle; *see supra* text accompanying notes 345-46.

390 A private action would not be subject to the constraints outlined *supra* in note 389.

391 *Cf.* Re Torek, 44 D.L.R. (3d) 416, 419 (Ont. H.C. 1974), quoted in R. v. Zelensky, 2 C.R. (3d) at 121; and *see supra* note 375. The punitive aspects of a compensatory action would be reinforced by the very fact of being taken to court and by any adverse publicity that accompanies it.

392 Papp v. Papp, 8 D.L.R. (3d) 389, 394 (Ont. C.A. 1969); *but see* S. GRANGE, *supra* note 321, at 37 (no such connection unless civil action preceded by criminal proceedings).

393 This conclusion is reinforced by the fact that the courts can and do perform their "very delicate role in maintaining the integrity of the constitutional limits imposed by the B.N.A. Act", R. v. Zelensky, 2 C.R. (3d) at 116, by determining the true character of the legislation in question; if it represents a "colourable attempt" to exceed federal jurisdiction through the creation of a criminal offence, the whole scheme will be invalid; *see supra* text accompanying notes 334-39.

Most of the commentators who have considered the question have concluded that there is no constitutional obstacle to the creation of civil remedies in aid of a valid criminal prohibition; *see e.g.* McDonald, *supra* note 321, at 225-29; *Leigh*, text accompanying notes 111-15; Hogg & Grover, *supra* note 321, at 207-09; P. ANISMAN at 316 n. 83; P. HOGG, *supra* note 32, at 287-88; *see also* Henderson, *Recent Development in Competition Law: The Limits of the Federal Criminal Law Power*, in LAW SOCIETY OF UPPER CANADA, SPECIAL LECTURES: THE CONSTITUTION AND THE FUTURE OF CANADA 109, 130-34 (1978) (seemingly, but not clearly, of the same view); *but see e.g.* S. GRANGE, *supra* note 321, at 37; Finkelman, *supra* note 378, at 521-22; Alexander, *The Fate of Sterling Trusts Corp. v. Postma*, 2 OTTAWA L. REV. 441, 445 (1968).

394 *See supra* notes 373-76 and accompanying text.

395 *See e.g.* R. v. Zelensky, 2 C.R. (3d) 107, 124-25, discussed *supra* in notes 375 and 376; *see also* Ross v. Registrar of Motor Vehicles, [1975] 1 S.C.R. 5, 13 (1973). In the latter case Mr. Justice Pigeon declared in the majority opinion that "civil consequences of a criminal act are not to be considered as 'punishment' so as to bring the matter

relation to isolated non-market matters like the example just discussed, as the act as a whole is within Parliament's regulatory authority over trade and commerce and interprovincial undertakings.[396] In light of this constitutional basis and of the widespread encouragement of the commentators,[397] it would be unduly timid to omit from a federal securities law civil remedies that on a policy basis are thought necessary to the effective operation of the scheme even if they can be justified only as ancillary to criminal prohibitions. It might be advisable, however, to include them in a manner that permits them to be severed from the rest of the act in the event of an adverse decision concerning their validity.[398]

G. SEVERANCE

Although a securities law may be supported under several heads of federal power,[399] any determination of its validity will invariably depend on the manner in which it is drafted;[400] and even in the best of circumstances the outcome of constitutional adjudication is rarely susceptible of assured prediction.[401] In light of the possibility that some provisions of any act embodying a comprehensive scheme of securities regulation enacted by Parliament may be found to extend beyond its legislative powers, it is advisable to consider methods which may minimize the chances of

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within the exclusive jurisdiction of Parliament"; *id.* In the context the statement has nothing to do with Parliament's jurisdiction to enact civil remedies as an incident of criminal legislation; rather it means only that Parliament's jurisdiction to do so is not exclusive and that a provincial legislature may also do so provided a provincial aspect exists. In other words, the statement involves no more than an assertion that where legislative authority is concurrent, a provincial legislature may prescribe complementary civil consequences. That Mr. Justice Pigeon meant no more is indicated by his citation of authority; *see id.* at 13-14, *quoting* Lymburn v. Mayland, [1932] A.C. 318, 323-24 (P.C.). (Although the correct citation is included, [1975] 1 S.C.R. at 13 n. 6, the page reference in the body of the opinion is to the case as reproduced in 3 DECISIONS OF THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL RELATING TO THE BRITISH NORTH AMERICA ACT, 1867 AND THE CANADIAN CONSTITUTION: 1867-1954 31, 36 (R. Olmsted, ed. 1954).) However *see* R. v. Zelensky, 2 C.R. (3d) at 142 (*per* Pigeon, J., dissenting).

396 *See supra* ch. III.B, C; and *see supra* text accompanying notes 357-66.

397 *See supra* note 393.

398 Severability is discussed *infra* ch. III.G.

399 *See supra* ch. III.B, C, E.

400 The drafting and structure of a statute may influence its characterization and the severability of its parts; *see e.g.* A.G. Alta. v. A.G. Can., [1947] A.C. 503 (P.C.); A.G.B.C. v. A.G. Can., [1937] A.C. 377 (P.C.).

401 *See e.g.* N.S. Bd. of Censors v. McNeil, 19 N.R. 570 (S.C.C. 1978) (majority of five with four dissenting justices); Reference re Anti-Inflation Act, [1976] 2 S.C.R. 373, discussed *supra* notes 274-78 and accompanying text; and *see supra* note 290; *cf.* Laskin, *Judicial Integrity and the Supreme Court of Canada*, 12 L. SOC'Y GAZETTE 116, 118 (1978) ("if a case gets to the Supreme Court, it is by that fact alone very likely a case that may go either way").

the complete scheme being declared invalid. The most obvious technique is the inclusion in the legislation of a declaration that all of its provisions and parts are severable.

The courts have frequently dealt with the effect of an invalid provision on the remaining elements of a statute.[402] On occasion they have assumed without discussion the severability of the unconstitutional part;[403] but such cases usually illustrate a silent application of the approach articulated in the decisions that expressly consider the question of severance. When the valid provisions of a statute are not "so inextricably bound up with the part declared invalid that...[they] cannot independently survive",[404] they may be declared severable so that only the latter part of the legislation ceases to have effect.[405] A determination of severability thus necessarily involves an assessment of the scheme of the act and of the relative importance of the unauthorized and remaining provisions to the effectuation of its purpose; in other words the intellectual process, like other exercises in statute interpretation,[406] requires a determination of whether the remaining part of the legislation standing alone is sufficiently close to the intent of the act as a whole to have been enacted by Parliament in its excised form.[407] The cases in which the issue has been raised reflect an application of these principles.[408] In fact, it appears that the courts

402 *See e.g.* Lymburn v. Mayland, [1932] A.C. 318, 326-27 (P.C.); Goodyear Tire & Rubber Co. of Canada Ltd. v. R., [1956] S.C.R. 303, 310.

403 *See e.g.* Reference re Agricultural Products Marketing Act, 19 N.R. 361, 368, 423-24 (S.C.C. 1978).

404 A.G. Alta. v. A.G. Can., [1947] A.C. 503, 518 (P.C.).

405 *See generally* P. HOGG, *supra* note 32, at 88-90; LASKIN, *supra* note 35, at 101.

406 *See e.g.* Interpretation Act, s. 11 ("Every enactment shall be...given such...construction and interpretation as best ensures the attainment of its objects"); *cf. Anisman* at 240-43.

407 *See e.g.* A.G. Alta. v. A.G. Can., [1947] A.C. 503, 518 (P.C.) ("whether on a fair review of the whole matter it can be assumed that the legislature would have enacted what survives without enacting the part that is *ultra vires* at all"); Reference re Section 5(a) of the Dairy Industry Act, [1949] S.C.R. 1, 45, 53-54, 67, 80-81 (1948). As with other interpretative questions, the intent of the legislation and the intention of Parliament are constructs; *cf. e.g.* Hand, *How Far is a Judge Free in Rendering a Decision?* in L. HAND, THE SPIRIT OF LIBERTY 79, 82 (I. Dilliard, ed. 1959); *see also* C. HOWARD, AUSTRALIAN FEDERAL CONSTITUTIONAL LAW 20-21 (2d ed. 1972). As a result, the process is analogous to the interpretative presumption of constitutionality; *see e.g.* B. LASKIN, CANADIAN CONSTITUTIONAL LAW 145-46 (rev. 3d ed. 1969); P. HOGG, *supra* note 32, at 88, 90-92 ("reading down"); and *see* Reference re Agricultural Products Marketing Act, 19 N.R. 361, 369, 429, 437 (S.C.C. 1978) (application of principle of interpretation by "reading down" scope of provisions); Di Iorio v. Warden of the Common Jail of Montréal, 73 D.L.R. (3d) 491, 524 (S.C.C. 1976) (*per* Dickson, J.); Laskin, *supra* note 401, at 119 ("in many cases, provincial legislation is not invalidated as such, but is simply limited in its application so as not to encroach upon a federal area of jurisdiction").

408 *See e.g.* Toronto v. York, [1938] A.C. 415, 427-28 (P.C.); Roy v. Plourde, [1943] S.C.R. 262, 264; Reference re Section 5(a) of the Dairy Industry Act, [1949] S.C.R. 1 (1948),

may be becoming increasingly receptive to the doctrine of severability.[409]

The inclusion in an act of a provision proclaiming the independence of the various parts and provisions of the statute and that the invalidity of any of them does not affect the continued viability of the others will not alter the analytical approach espoused in past judicial decisions as is apparent from the one case under the BNA Act in which an express clause was considered. In the *Natural Products Marketing Reference* the Privy Council, despite such a severance provision, applied the traditional test for severability, concluded that "the whole texture of the Act...[was] inextricably interwoven" so that none of the provisions could "exist independently"[410] and declared the whole act *ultra vires* Parliament. A section declaring the severability of the various parts of the act, therefore, by expressly indicating Parliament's intention, will merely create a presumption of severability, thus encouraging the courts to favour severance if they conclude that it is possible.[411] Indeed, this result has followed in the United States where the use of severance provisions is common[412] and in Australia where a similar declaration is included in the interpretation act of every jurisdiction.[413]

If a severance provision is included, it would also be advisable to draft the legislation in a manner that facilitates severability as far as possible without detracting from the substantive structure

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affirmed without consideration of this issue, [1951] A.C. 179 (P.C. 1950); N.S. Bd. of Censors v. McNeil, 19 N.R. 570, 605 (S.C.C. 1978) (severable); *In re* The Initiative and Referendum Act, [1919] A.C. 935, 944-46 (P.C.); A.G. Can. v. A.G. Ont., [1937] A.C. 355, 367 (P.C.); A.G.B.C. v. A.G. Can., [1937] A.C. 377, 388-89 (P.C.); A.G. Alta. v. A.G. Can., [1947] A.C. 503, 518-19 (P.C.) (not severable).

409 *See e.g.* N.S. Bd. of Censors v. McNeil, 19 N.R. 570 (S.C.C. 1978); Reference re Agricultural Products Marketing Act, 19 N.R. 361 (S.C.C. 1978).

410 A.G.B.C. v. A.G. Can., [1937] A.C. 377, 388-89 (P.C.). The Judicial Committee concluded that the provisions were incapable of standing alone in any event because they were ancillary to the invalid ones; *id.* at 389. The Committee stated its conclusions without detailed consideration of the severance clause, ostensibly because the lower courts had failed to discuss the issue; *id.* at 388-89. Nevertheless, the decision may be treated as one in which the structure of the statute was sufficiently integrated to preclude the operation of the section mandating severance; *see infra* text accompanying note 411.

411 The presumption is thus in effect similar to that in favour of constitutional validity; *see supra* note 407.

412 *See e.g.* Carter v. Carter Coal Co., 298 U.S. 238, 312-13, 321-22 (1936); Stern, *Separability and Separability Clauses in the Supreme Court,* 51 HARV. L. REV. 76 (1937); *see also* ALI FEDERAL SECURITIES CODE, s. 2009 (severability); and *see generally* 16 AM. JUR. 2D, *Constitutional Law,* sections 181-88 (1964).

413 *See e.g.* Bank of N.S.W. v. Commonwealth, 76 C.L.R. 1, 368-72 (1948); and *see generally* C. HOWARD, *supra* note 407, at 21-27; P. LANE, THE AUSTRALIAN FEDERAL SYSTEM WITH UNITED STATES ANALOGUES 899-910 (1972); W. WYNES, LEGISLATIVE, EXECUTIVE AND JUDICIAL POWERS IN AUSTRALIA 48-53 (4th ed. 1970).

or clarity of the act.[414] This design might be accomplished by treating the various elements of the statute in separate parts. In fact, without a constitutional motivation the proposed codification of the U.S. securities laws adopted a similar organizational approach on a functional basis.[415] A comprehensive securities act would, without some such structural principles, be unworkably complex.[416] Thus, a federal securities law might include its disclosure requirements in a single or several related parts,[417] while other parts could specify definitions and exemptions[418] and requirements applicable to self-regulatory organizations[419] and securities professionals.[420] The criminal prohibitions[421] and civil liability[422] might also be prescribed in separate parts and, of course, a part dealing with the administration and enforcement of the act itself would be required.[423]

Two of these subjects, the licensing of brokers and dealers and the antifraud provisions, demonstrate the utility of such an approach. While the former straddles the limits of Parliament's legislative authority,[424] the latter is clearly within it.[425] In the event that the licensing provisions were declared invalid, their severability would be essential to avoid their dragging the rest of the legislation with them. Conversely, as the antifraud sections are likely to replace the securities offences now in the Criminal Code,[426] they must continue in force even if the rest of the act were found to be in excess of Parliament's jurisdiction. The same considerations should apply to impermissible intraprovincial elements

414 It should not, however, be necessary to duplicate provisions in order to accomplish this purpose, for to do so would likely hinder both substance and clarity; *cf.* C. HOWARD, *supra* note 407, at 26 ("tendency for statutes to be drafted in minute detail and with much repetition in order to facilitate severance").

415 *See* ALI FEDERAL SECURITIES CODE at xxiii (Code divided into 20 parts).

416 *See also e.g.* Ontario Bill 7 (23 parts, plus the initial interpretation part which is unnumbered).

417 *See e.g.* Ontario Bill 7, pts. XIII-XX; ALI FEDERAL SECURITIES CODE, pts. IV-VI; *see generally, Grover & Baillie.*

418 *See e.g.* Ontario Bill 7, s. 1 and pts. XI, XVI; ALI FEDERAL SECURITIES CODE, pts. II-III and s. 512; *see generally, Iacobucci.*

419 *See e.g.* Ontario Bill 7, pts. VIII-IX; ALI FEDERAL SECURITIES CODE, pts. VIII-X; *see generally, Dey & Makuch.*

420 *See e.g.* Ontario Bill 7, pt. X; ALI FEDERAL SECURITIES CODE, pt. VII; *see generally, Connelly.*

421 *See e.g.* Ontario Bill 7, ss. 118-20; ALI FEDERAL SECURITIES CODE, pt. XVI; and *see generally, Leigh,* ch. II.A.

422 *See e.g.* Ontario Bill 7, pt. XXII; ALI FEDERAL SECURITIES CODE, pt. XVII; and *see generally, Leigh,* ch. II.B.

423 *See e.g.* Ontario Bill 7, pts. I-VII and ss. 121-24; ALI FEDERAL SECURITIES CODE, pt. XVIII; and *see generally, Howard; Leigh.*

424 *See supra* text accompanying notes 137, 203-13.

425 *See supra* ch. III.E.

426 *See supra* text accompanying note 316.

swept into the legislative scheme either in the ultimately mistaken view that they are ancillary to the valid parts or as a result of overbroad drafting.[427] In short, a severance provision and the separation of a federal law into functional divisions, while not sufficient to validate legislation beyond Parliament's jurisdiction, are useful precautionary measures for a legislative scheme that is otherwise justifiable.[428]

H. PARAMOUNTCY

A federal securities act is likely to contain provisions which overlap or are inconsistent with those in the provincial laws, especially as the statutes in all of the provinces are applicable to trades in securities any constituent element of which occurs in the enacting province[429] and as any federal legislation would likely apply to all but intraprovincial transactions.[430] Integration of the various statutory schemes may be attempted through federal-provincial negotiations directed at the enactment of complementary legislation as has generally been done in other areas of divided jurisdiction such as marketing of natural products and regulation of trucking.[431] Alternatively, Parliament may adopt its policies independently and leave the reconciliation of competing provisions to the courts as has more frequently been done in areas allocated exclusively to one or the other level of government depending upon the aspect from which they are approached,[432] for example, criminal law and regulation of the use of the highways.[433] A federal securites act would involve the application of both types of federal power[434] Although it is inconceivable that Parliament would in the present political climate enact such legislation without prior and full consultation with the provinces,[435] any such discussions will undoubtedly be influenced by past judicial treatment of federal and provincial legislation affecting the

427 *See supra* note 407 and text accompanying note 400.

428 *See supra* text accompanying note 399.

429 *See supra* text accompanying notes 41-50; and *see e.g.* Ontario Securities Act, s. 1(1)24 ("trade").

430 *See supra* ch. III.B.

431 *See e.g.* Reference re Agricultural Products Marketing Act, 19 N.R. 361 (S.C.C. 1978); Coughlin v. Ont. Highway Transport Bd., [1968] S.C.R. 569.

432 For discussion of the "aspect doctrine", *see generally* LASKIN, *supra* note 35, at 115-16; P. HOGG, *supra* note 32, at 84-85.

433 *See e.g.* O'Grady v. Sparling, [1960] S.C.R. 804; Mann v. R., [1966] S.C.R. 238.

434 *See supra* ch. III.B, C, E.

435 *See e.g.* P. TRUDEAU, *supra* note 238, at 15-17. In fact, it is understood that the proposals resulting from the Securities Market Study for which this paper is being written will serve as a basis for such discussions. *See also*, *Howard*, chs. VI, VII, discussing methods of federal-provincial regulatory coordination.

same subject matter. It is therefore necessary to consider the potential interaction between a comprehensive federal scheme for the regulation of the securities market and existing provincial laws in light of the doctrine of federal paramountcy.

Although the division of powers in the BNA Act seems to indicate the exclusivity of the classes of subjects allocated to the federal and provincial governments,[436] the courts soon recognized that the generality of the specified categories permits either level of government to deal with the same matter so long as it does so from its own constitutional perspective.[437] It was, therefore, inevitable that both Parliament and the provincial legislatures would sooner or later perceive and attempt to remedy the same problem and that the courts would be called upon to determine which of the two valid enactments should stand.[438] Despite the silence of the BNA Act on the point,[439] the courts held without hesitation that federal legislation is paramount and renders conflicting provincial laws inoperative to the extent of any collision.[440] Not surprisingly, however, the formulae devised to describe the doctrine's application, whether framed in terms of provincial "interference" with federal laws,[441] "repugnancy" between the provisions of two statutes,[442] the "meeting" of two pieces of otherwise valid legislation,[443] or simply of a "conflict" between them,[444] were far from precise[445] and provided little guidance in determining when the

436 *See* BNA Act, s. 91; the preamble to the section limits Parliament's general power to "Matters not...within the Classes of Subjects...assigned exclusively to the...Provinces" and the concluding paragraph contains an irrebuttable presumption that any matter within a head of power specified in the section is not subject to provincial legislative jurisdiction.

437 *See e.g.* Hodge v. R., 9 A.C. 117 (P.C. 1883); A.G. Ont. v. A.G. Can., [1894] A.C. 189 (P.C.); *see also supra* note 432.

438 The problem was foreseen in the *Voluntary Assignments Reference; see* A.G. Ont. v. A.G. Can., [1894] A.C. at 200-01.

439 *See e.g.* Huson v. South Norwich, 24 S.C.R. 145, 149 (1895) (*per* Strong, C.J.); *see also* LASKIN, *supra* note 35, at 24; P. HOGG, *supra* note 32, at 102 n. 6 (derives from initial and concluding clauses of BNA Act, s. 91); and *see supra* note 436.

440 *See e.g.* A.G. Ont. v. A.G. Can., [1896] A.C. 348, 368-69 (P.C.) (dictum); *see generally* Laskin, *Occupying the Field: Paramountcy in Penal Legislation*, 41 CAN. B. REV. 234 (1963); Lederman, *The Concurrent Operation of Federal and Provincial Laws in Canada*, in THE COURTS AND THE CANADIAN CONSTITUTION 200 (W. Lederman, ed. 1964); P. HOGG, *supra* note 32, ch. 6.

441 A.G. Ont. v. A.G. Can., [1894] A.C. 189, 200-01 (P.C.).

442 A.G. Ont. v. A.G. Can., [1896] A.C. 348, 366 (P.C.); *cf.* BNA Act, s. 95, which embodies the concept of "repugnancy".

443 Grand Trunk Ry. of Canada v. A.G. Can., [1907] A.C. 65, 68 (P.C. 1906); A.G. Can. v. A.G.B.C., [1930] A.C. 111, 118 (P.C. 1929).

444 *E.g.* A.G. Ont. v. A.G. Can., [1896] A.C. at 369; Montréal v. Montreal Street Ry., [1912] A.C. 333, 343 (P.C.).

445 *See also* Huson v. South Norwich, 24 S.C.R. 145, 149 (the principle of paramountcy "is necessarily implied in our constitutional act, and is to be applied whenever ...the federal and provincial legislatures adopt the same means to carry into effect

articulated standards were met.[446] Indeed, as such determinations necessarily affect both the nature of Canadian federalism and the regulation of the substantive field that is the subject of the legislation,[447] it may be, as was suggested by Chief Justice Duff, that a clear test applicable to all cases in which paramountcy is in issue cannot be devised.[448]

Nevertheless, some indication of the current concept of "conflict" may be derived from recent judicial decisions. During the last twenty years the Supreme Court has adopted an approach to questions of paramountcy analogous to the presumption of constitutionality.[449] In a series of cases involving penal legislation[450] relating for the most part to the use of the roads,[451] the Supreme Court of Canada emphasized the differences in the aspects from which the statutes in question were adopted[452] as well as the differences in their coverage[453] and in doing so evinced an inclina-

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distinct powers." *per* Strong, C.J.). Even the seeming clarity of this description fails to enhance the predictability of the outcome in specific instances.

446 *See e.g.* Multiple Access Ltd. v. McCutcheon, 78 D.L.R. (3d) 701, 704 (Ont. Div'l Ct. 1977), *affirmed* (Ont. C.A. June 14, 1978, unreported) ("The verbal formulae, of themselves, are too uninformative to solve paramountcy problems"); *see generally* Laskin, *supra* note 440, at 237-40.

447 *See e.g.* Laskin, *supra* note 440, at 236-37.

448 *See* Prov. Secr. P.E.I. v. Egan, [1941] S.C.R. 396, 401-02 ("I doubt if any test can be stated with accuracy in general terms for the resolution of such questions. ... It would be most unwise ... to attempt to lay down any rules for determining repugnancy").

449 *See supra* note 407; and *see e.g.* N.S. Bd. of Censors v. McNeil, 19 N.R. 570, 594 (S.C.C. 1978).

450 *See generally* Leigh, *The Criminal Law Power: A Move Towards Functional Concurrency?* 5 ALTA. L. REV. 237, 247-53 (1967); and *see supra* note 440.

451 *See* O'Grady v. Sparling, [1960] S.C.R. 804 ("reckless" and "careless" driving); Stephens v. R., [1960] S.C.R. 823 (leaving the scene of an accident); Mann v. R., [1966] S.C.R. 238 ("dangerous" and "careless" driving); Ross v. Registrar of Motor Vehicles, [1975] 1 S.C.R. 5 (1973) (suspension of driver's licence); Bell v. A.G.P.E.I., [1975] 1 S.C.R. 25 (1973) (suspension of driver's licence); *see also* Prov. Secr. P.E.I. v. Egan, [1941] S.C.R. 396 (suspension of driver's licence); and *see* Reference re Validity of Section 92(4) of the Vehicles Act, 1957 (Sask.), [1958] S.C.R. 608 (breathalyzer).

Paramountcy issues have not, however, been so limited; *see e.g.* Johnson v. A.G. Alta., [1954] S.C.R. 127, 135-39 (*per* Rand, J.) (slot machines); Smith v. R., [1960] S.C.R. 776 (false prospectus); Robinson v. Countrywide Factors Ltd., 72 D.L.R. (3d) 500 (S.C.C. 1977) (bankruptcy and insolvency: fraudulent preferences); N.S. Bd. of Censors v. McNeil, 19 N.R. 570 (S.C.C. 1978) (obscenity); *see also* Multiple Access Ltd. v. McCutcheon, 78 D.L.R. (3d) 701 (Ont. Div'l Ct. 1977), *affirmed* (Ont. C.A. June 14, 1978, unreported) (insider trading).

452 *See e.g.* Smith v. R., [1960] S.C.R. at 781; and *see* Prov. Secr. P.E.I. v. Egan, [1941] S.C.R. at 402-03, *quoted with approval* in Ross v. Registrar of Motor Vehicles, [1975] 1 S.C.R. at 10.

453 *See e.g.* O'Grady v. Sparling, [1960] S.C.R. at 808-11; Stephens v. R., [1960] S.C.R. at 826-27; Mann v. R., [1966] S.C.R. at 246, 251-54; Robinson v. Countrywide Factors Ltd., 72 D.L.R. (3d) at 528, 539.

tion to uphold provincial legislation where possible.[454] Moreover, in one of the early cases involving, significantly, a prosecution under a provincial securities act for issuing a false prospectus, Mr. Justice Martland enunciated an extremely narrow definition of "conflict"[455] which has since been adopted by a majority of the Court,[456] namely, that two provisions may "operate concurrently" so long as "compliance with one [does not] involve...breach of the other".[457] The fact that the provincial and federal provisions considered in the *Smith* case were virtually identical in substance[458] led at least one commentator to conclude in effect that Mr. Justice Martland's weak test of paramountcy was the exclusive one[459] and this conclusion was reinforced by subsequent decisions of the Court.[460]

The narrow standard is not, however, the only one that has been adopted nor did any of the decisions indicate that it should be.[461] In fact, in its recent decisions the Court has been careful to interpret the provisions under consideration in a manner that avoided duplication, the standard of repugnancy adopted in its earlier decisions,[462] and has pointedly asserted that the provincial statute precluded conduct not covered by the federal prohibition.[463] Even in *Smith* the majority, albeit confusing the question of validity with standards of paramountcy,[464] stressed

454 *See supra* note 449 and accompanying text.

455 *See* Smith v. R., [1960] S.C.R. at 800.

456 *See* N.S. Bd. of Censors v. McNeil, 19 N.R. at 601. A statement by Mr. Justice Judson, writing for the majority, in O'Grady v. Sparling, [1960] S.C.R. at 811 ("Both provisions can live together and operate concurrently") may be interpreted to have the same effect; but *see infra* text accompanying notes 462-63; and *see* Multiple Access Ltd. v. McCutcheon, 78 D.L.R. (3d) at 704-05.

457 Smith v. R., [1960] S.C.R. at 800.

458 *See id.* at 784-86, 795, 801-04 (*per* Locke, Cartwright and Ritchie, JJ., respectively, dissenting).

459 *See* Laskin, *supra* note 440, at 257 (concluding *Smith* overruled Home Ins. Co. v. Lindal, [1934] 1 D.L.R. 497 (S.C.C. 1933); *see also infra* text accompanying note 462.

460 *See e.g.* Ross v. Registrar of Motor Vehicles, [1975] 1 S.C.R. 5 (1973), holding provincial legislation suspending a driver's licence not in conflict with a judicial order made pursuant to the Criminal Code, s. 238(1) that permitted the accused to drive during working hours even though the provincial statute nullified the order's effect; *see also e.g.* P. HOGG, *supra* note 32, at 106-09.

461 *See e.g.* Multiple Access Ltd. v. McCutcheon, 78 D.L.R. (3d) at 707 (statement by Martland, J. only one test and not intended "as a universal principle").

462 *See e.g.* Home Ins. Co. v. Lindal, [1934] 1 D.L.R. 497 (S.C.C. 1933) (duplicative provincial prohibition against drunk driving inoperative); *see also* Johnson v. A.G. Alta., [1954] S.C.R. 127, 135-39 (*per* Rand, J.); N.S. Bd. of Censors v. McNeil, *supra* note 451.

463 *See supra* note 453. In other words, the provincial provisions were stricter than the federal.

464 *See* Smith v. R., [1960] S.C.R. at 781 (*per* Kerwin, C.J.). Despite his assertion that "it is not the same conduct being dealt with by the two legislative bodies", *id.*, it appears that a different aspect alone was sufficient in Chief Justice Kerwin's view

the different aspects from which the two provisions were enacted, thus implying the existence of a difference between them.[465] And in the *McNeil* case in which a majority of the Court expressly adopted Mr. Justice Martland's formulation of the meaning of "conflict",[466] it applied the duplication standard and declared inoperative a Nova Scotia regulation because it was in effect identical with a provision of the Criminal Code,[467] even though the regulation could not have been brought within the narrow definition as undermining the federal law.[468] In short, it is reasonable to conclude that provincial legislation which merely duplicates existing federal prohibitions as well as legislation that is inconsistent with a federal enactment in the sense described by Mr. Justice Martland in *Smith* are subject to federal paramountcy and inoperative.[469]

Thus, although Parliament may not repeal a validly enacted provincial statute, it may displace it by passing legislation that is identical or inconsistent.[470] The possibility of federal occupation of an entire field, that is, of preemption, by this means highlights the importance of Parliament's intention, and concomitantly of the

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to permit the concurrent operation of the identical provisions; *see supra* text accompanying note 458. *See also* P. Hogg, *supra* note 32, at 111.

465 *See* [1960] S.C.R. at 781.

466 *See supra* note 456 and accompanying text.

467 *See* N.S. Bd. of Censors v. McNeil, 19 N.R. at 604. In fact, Mr. Justice Ritchie, who wrote the majority opinion in *McNeil*, has consistently adhered to the same position, namely, that duplication renders provincial legislation inoperative; *see e.g.* Smith v. R., [1960] S.C.R. at 801-04 (dissenting); O'Grady v. Sparling, [1960] S.C.R. at 822 (concurring on basis that "there is a fundamental difference between the subject-matter dealt with" in the two enactments); Stephens v. R., [1960] S.C.R. at 829 (provisions "substantially different"); Mann v. R., [1966] S.C.R. 238, 251 (everyone who violates prohibition in Criminal Code also violates provincial act "but...the converse is [not] necessarily the case"; therefore, two sections "deal with different subject matters").

468 *Cf. e.g.* Multiple Access Ltd. v. McCutcheon, 78 D.L.R. (3d) at 704 (as provisions identical, application of provincial section nullifies federal in that no liability remaining); *see also* Laskin, *supra* note 440, at 258-59 (operational inconsistency where identical schemes of distribution).

Potential double penal liability does not create a conflict between two provisions; *see e.g.* P. Hogg, *supra* note 32, at 112; and *see generally* Friedland, *Double Jeopardy and the Division of Legislative Authority in Canada*, 17 U. Toronto L.J. 66 (1967), *reprinted in* M. Friedland, Double Jeopardy 405 (1969).

469 *See e.g.* Lederman, *supra* note 440, at 213-19; Leigh, *supra* note 450, at 249; and *see* Laskin, *supra* note 440, at 262.

This conclusion is not shared by the authors, one of whom adheres to the view already expressed by him that duplication is probably not a test of inconsistency; *see* P. Hogg, *supra* note 32, at 110-11. On this view a federal securities act would have little effect on the operation of provincial securities statutes as only federal provisions which "expressly contradict" provincial provisions would give rise to questions of paramountcy and such provisions are not likely to be common; *see also infra* note 502.

470 *See e.g.* A.G. Ont. v. A.G. Can., [1896] A.C. 348, 366 (P.C.).

interpretative element, to questions of paramountcy[471] as was made abundantly clear in a number of dissenting opinions in the Supreme Court. In both *O'Grady v. Sparling*[472] and *Stephens*[473] Mr. Justice Cartwright inferred from the prohibitions in the Criminal Code, a parliamentary intention to occupy the field by establishing minimum standards for the offences in question. In other words, he held that the adoption of a particular standard of conduct, whether recklessness or a specific intent, indicated "by necessary implication" that conduct falling short of it shall not be punishable and he would on that basis have declared the parallel provincial provisions inoperative.[474] And in a more recent decision Chief Justice Laskin drew a similar inference from the fact that the federal legislation under consideration was intended to constitute "a code on the subject of bankruptcy and insolvency".[475]

Although a majority of the Court has never applied a test of paramountcy based upon negative implication to hold provincial legislation inoperative, it has also not precluded such a finding

471 *See id.* ("if the existence of such repugnancy should become matter of dispute, the controversy cannot be settled by the action either of the Dominion or of the provincial legislature, but must be submitted to the judicial tribunals of the country"); *see also supra* notes 406, 407.

472 [1960] S.C.R. 804, 812-23.

473 [1960] S.C.R. 823, 827-29.

474 *See* O'Grady v. Sparling, [1960] S.C.R. at 820-21 ("when Parliament has expressed in an Act its decision that a certain kind or degree of negligence in the operation of a motor vehicle shall be punishable as a crime...it follows that it has decided that no less culpable kind or degree of negligence in such operation shall be so punishable. By necessary implication the Act says not only what kinds or degrees of negligence shall be punishable but also what kinds or degrees shall not. ...[T]he exclusive legislative authority in relation to the criminal law...must include the power to decide what conduct shall not be punishable as a crime...as well as...what conduct shall be so punishable"); Stephens v. R., [1960] S.C.R. at 828-29 ("The whole subject-matter of the charge against the appellant has...been drawn by Parliament within the ambit of the criminal law with the effect of suspending the provincial legislative authority in relation to that subject-matter"). The former decision involved a federal provision prohibiting reckless driving and a provincial one proscribing careless and inconsiderate driving while the latter involved offences for leaving the scene of an accident, the federal one requiring a specific intent to avoid liability and the provincial one imposing an absolute duty to remain. The essential weakness in the dissenting position was that it would have resulted in a situation in which the provinces could not enact higher standards of conduct for purposes of highway safety than those in the Criminal Code so that only activities that were so dangerous as to be considered "criminal" by Parliament could be prohibited. There can be little doubt that such a solution would be unsatisfactory; *see e.g.* Laskin, *supra* note 440, at 246; and *see supra* text accompanying notes 447, 448; *cf.* the rather conceptual approach in Lederman, *supra* note 440, at 217.

475 Robinson v. Countrywide Factors Ltd., 72 D.L.R. (3d) 500, 508-14 (S.C.C. 1977); *see also* Lederman, *supra* note 440, at 208-09 ("normal to find this [negative] implication in a federal statute that could properly be construed as a complete code for the concurrent subject...[such as the] federal code of priorities" in a bankruptcy); *cf.* Laskin, *supra* note 440, at 258-59 (priority of creditor's claims necessarily involves conflict).

where Parliament's intention to occupy a legislative field is expressly asserted.[476] In fact dicta in recent majority opinions raise the possibility of such a holding even where no operational inconsistency between two legislative schemes is otherwise found to exist.[477] An express statement in a federal securities act of an intention to exhaust the field may, therefore, be sufficient to make the parallel provincial laws repugnant.[478] However, in light of the Supreme Court's manifest apprehension over the possibility of federal absorption of provincial powers as a result of a broad interpretation of the categories in section 91 of the BNA Act[479] and of its inclination to uphold provincial legislation,[480] it is questionable whether the Court would readily implement such a provision. Rather, to avoid a conflict it might attempt an interpretation that, depending on the manner in which the jurisdictional assertion is drafted, would limit the scope of the federal law's application either by defining the "exhausted" field in terms of the substantive provisions of the act or by reading the preemptive provision as a restatement of the limitations of the act's

476 *See e.g.* Reference re Validity of Section 92(4) of the Vehicles Act, 1957 (Sask.), [1958] S.C.R. 608, 613 (no intent manifested by Parliament to limit provincial power to require sample; *per* Fauteux, J.); *cf.* Laskin, *supra* note 440, at 263 ("It may be the better part of wisdom, in the interests of a flexible federalism, to require the federal Parliament to speak clearly if it seeks, as it constitutionally can demand, paramountcy for its policies").

477 *See* Ross v. Registrar of Motor Vehicles, [1975] 1 S.C.R. 5, 15-16 (1973) (*per* Pigeon, J. for majority); Robinson v. Countrywide Factors Ltd., 72 D.L.R. (3d) at 539 (*per* Beetz, J.). Both justices advert to the Australian position, namely, that the intention of the paramount legislature governs; *see generally* C. HOWARD, *supra* note 407, at 36-45. The American position is similar, at least within areas of exclusive federal jurisdiction; *see generally* 16 AM. JUR. 2D, *Constitutional Law*, s. 207 (1964); E. CORWIN, THE CONSTITUTION AND WHAT IT MEANS TODAY 224-25 (13th ed. rev. by H. Chase and C. Ducat 1973).

478 Parliament has attempted to create repugnancy in a number of ways; *see e.g.* Bankruptcy Act, 1978, Bill S-11, 30th Parl., 3d Sess., s. 167 (First reading March 21, 1978) (making procedure in Bill exclusive and thus reversing result in *Robinson v. Countrywide Factors Ltd.*); *see also* CONSUMER AND CORPORATE AFFAIRS CANADA, BACKGROUND PAPERS FOR THE BANKRUPTCY AND INSOLVENCY BILL (1978) 18 (undated 1978). The Indian Act expressly adopts both the repugnancy and the duplication standards and, possibly, attempts as well to occupy the complete field covered by the Act; *see* R.S.C. 1970, c. I-6, s. 88 (provincial laws of general application applicable to Indians "except to the extent that such laws make provision for any matter for which provision is made by or under this Act"); for discussion of the section *see* P. HOGG, *supra* note 32, at 388-89.

479 *See e.g.* Mann v. R., [1966] S.C.R. 238, 250 (*per* Fauteux, J.); *see also supra* text accompanying notes 288-90.

480 *See supra* text accompanying notes 450-54. It is perhaps significant that the recent statements of the presumption of constitutionality refer only to provincial legislation; *see supra* notes 407, 449. *See also* A.G. Que. v. Kellogg's Company of Canada, 19 N.R. 271, 288 (S.C.C. 1978) (unexercised power to make regulations does not raise issue of conflict).

coverage.[481] Nevertheless, uncertainty about Parliament's ability so to occupy a legislative field does not substantially impede the enactment of securities legislation, especially as wholly intra-provincial transactions will likely not be included in any event,[482] and it may strengthen a federal negotiating position in relation to the development of a cooperative regulatory scheme.[483]

The impact of a comprehensive federal scheme of securities regulation will vary with the subject matter of each part of the scheme and even within parts. For example, the interaction of the takeover bid provisions of a federal law with those in the provincial securities acts may differ between provinces[484] and may also lead to different results than a comparison of the insider reporting requirements.[485] And the conclusions concerning operational compatibility in both areas may differ from that for accountability of an insider to his issuer for profits obtained as a result of improper trading in securities.[486] Not even these statements can be made with assurance, however, for an analysis of paramountcy must be based on the drafting of the federal act.[487] Without specific legislation for comparison a discussion of the compatibility of federal and provincial regulatory legislation runs the double risk of becoming mired in a mass of hypothetical detail or of being little more than a series of vague generalizations. Nevertheless, it may be possible to avoid both dangers by focusing on the major elements common to all modern securities acts.[488]

As was said above, an essential component of a law for the regulation of the securities market is a requirement that issuers disclose information relating to the value of their securities both at the time of issue and, where a secondary market exists, on a

481 *Cf. e.g.* Laskin, *supra* note 440, at 260 (provision stating that inadvertent negligence not an offence would not have altered result in *O'Grady v. Sparling* as it "would go no farther than to determine the actual reach of the offence in the particular case"). The most direct method of preemption would be a statutory declaration that specified provincial laws are not applicable but such a provision might be treated as a colourable attempt to repeal provincial legislation; *see supra* notes 335-39 and accompanying text.

482 *See e.g. supra* text accompanying notes 196-99.

483 *See supra* note 435 and accompanying and following text; *see also* Lederman, *supra* note 440, at 219 n. 39 ("the bargaining position of federal and provincial governments is defined by the judicial decisions about concurrency and the doctrine of Dominion paramountcy").

484 For a discussion of paramountcy issues between federal and provincial takeover bid legislation, *see* P. ANISMAN at 63-65 n. 14.

485 *Cf.* Multiple Access Ltd. v. McCutcheon, 78 D.L.R. (3d) 701, 707-08 (Ont. Div'l Ct. 1977), *affirmed* (Ont. C.A. June 14, 1978, unreported) (unnecessary to decide whether provincial reporting provisions inoperative but indicates that they may be).

486 *See id.*

487 *See supra* text accompanying notes 449-53.

488 These elements are described *supra* ch. III.A.

continuing basis.[489] Disclosure in connection with a distribution is made in a prospectus and the informational prescriptions are usually supplemented by a discretion in an administrator to refuse to permit the sale of the securities if specified standards are not met.[490] Continuous disclosure is made in documents such as annual and quarterly reports, proxy statements, insider reports and press releases.[491] The most common approach is to impose broad basic requirements and to create statutory and administrative exemptions[492] for situations in which the protection ordinarily afforded by the legislation is unnecessary[493] and, of course, to authorize the administrator to deny the exemptions where they are abused.[494] The majority of the provincial securities acts follow this pattern and it is indisputable that they have been validly enacted to protect local investors.[495] A federal act would undoubtedly deal with the same subject matter[496] and would likely adopt a similar approach; and it too, depending on the manner in which it is drafted, would be valid.[497]

In such circumstances the continued effectiveness of the provincial requirements would be subject to question. The issue is most difficult if the same information is required to be disclosed contemporaneously under both acts[498] for it might be argued that

489 *See supra* text accompanying notes 91-97.

490 *See supra* notes 92, 97 and accompanying text.

491 *See supra* notes 93-96 and accompanying text. Press releases are commonly used to disclose material developments; Ontario Bill 7, s. 74, would require the filing of such releases with the Commission. Although disclosure is also required in connection with takeover bids, a takeover bid circular is not part of a continuous disclosure system because it is required only in extraordinary circumstances; *see e.g.* ONTARIO SECURITIES COMMISSION DISCLOSURE REPORT ¶ 2.08; P. ANISMAN at 206 n. 299.

492 The coverage of a broad general provision may also be limited by creating exceptions from the definitions; *see e.g.* L. LOSS AND E. COWETT, BLUE SKY LAW 352 (1958).

493 *See e.g.* Ontario Securities Act, ss. 35, 58; Ontario Bill 7, pts. XIV-XVI; and *see*, *Grover & Baillie*, chs. V.C., VI.D, VIII.C.

494 *See e.g.* Ontario Bill 7, s. 124; *cf.* Ontario Securities Act, s. 19(5). Not surprisingly, there are minor variations between the acts of different provinces; *see e.g.* P. ANISMAN at 184-96.

495 *See* Lymburn v. Mayland, [1938] A.C. 318 (P.C.); *see also supra* text accompanying notes 36-40. The pattern outlined in the text has been adopted in all of the provinces in connection with distributions and in Alberta, British Columbia, Manitoba, Ontario, Québec and Saskatchewan with respect to continuing disclosure as well.

496 A federal act would probably not be applicable to intraprovincial transactions but both it and the provincial laws would apply to interprovincial transactions as well as to the same issuers; *see supra* text accompanying notes 41-49 and ch. III.B.

497 *See supra* ch. III.B.

498 The provincial acts authorize an exemption from the proxy provisions for issuers complying with similar requirements in their home jurisdictions; *see e.g.* Ontario Securities Act, s. 104; and a similar method of coordination is available for insider reports; *e.g. id.* s. 116. Under the Ontario Bill exemptions in such circumstances are automatic; *see* Ontario Bill 7, ss. 87 (proxy circulars), 117 (insider reports if filed with the Ontario Commission). It is questionable whether this technique of avoiding

identical disclosure requirements constitute the ultimate coordination in that compliance with both sets must occur simultaneously.[499] Indeed, no operational incompatibility exists even in the sense that enforcement of one set of provisions undercuts the effectiveness of the other, for enforcement of either ensures compliance with both.[500] As a matter of policy, therefore, this type of duplication may not warrant a declaration that the provincial law is inoperative,[501] especially as the primary effect of such a holding would be a reduction of the resources available to enforce the disclosure requirements. Nevertheless, the judicial decisions seem to require it.[502]

Although the result may be the same where the discretionary standards for a refusal to accept a prospectus are identical, the policy considerations differ.[503] It may be questionable whether a province should be able to preclude a sale of securities that has been approved by a federal agency where the criteria for the provincial refusal to permit the issuer to conduct a distribution are the same as those under the federal legislation. Such a denial would undermine the federal law while not furthering any additional provincial policies, for the provincial administrator would, in effect, merely be reviewing the federal application of the identical standard.[504]

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unnecessary duplication would avert the application of the paramountcy doctrine; *but see infra* note 508.

499 *See* Lederman, *supra* note 440, at 213 ("the ultimate in harmony"); P. HOGG, *supra* note 32, at 110; *see also supra* note 498.

500 Except for the filing requirements but doubtless filing at both levels would follow an order to comply with either. *Cf.* Laskin, *supra* note 440, at 245-46 ("practical result...from the standpoint of law enforcement") (order reversed).

501 *See id.* at 262 (in cases of duplication "policy as much as, or perhaps rather than, logic must give the answer"). It is thus arguable that the different filing requirements would alone suffice to distinguish the statutes for paramountcy purposes.

502 *See e.g.* N.S. Bd. of Censors v. McNeil, 19 N.R. 570 (S.C.C. 1978); Home Ins. Co. v. Lindal, [1934] 1 D.L.R. 497 (S.C.C. 1933); *see also supra* text accompanying notes 462-68; and *cf.* Multiple Access Ltd. v. McCutcheon, 78 D.L.R. (3d) 701 (Ont. Div'l Ct. 1977), *affirmed* (Ont. C.A. June 14, 1978, unreported) (no need "to decide any paramountcy issue" concerning reporting provisions, at 707-08).

As is indicated *supra* in note 469, the authors do not share this conclusion; in Professor Hogg's view duplication alone does not render provincial law inoperative. Even if it did, trivial differences in the two laws might lead the courts to deny the existence of duplication; *see* P. HOGG, *supra* note 32, at 111; and *see e.g. supra* note 501. Thus federal and provincial disclosure requirements are unlikely to be held duplicative as they would involve different filing obligations, one presumably in Ottawa and the other in the city in which the provincial commission is located; and licensing requirements would probably be treated similarly as they would involve applications to different administrators; *see infra* text accompanying notes 509-12.

503 This issue would not arise in respect of federal corporations; *see supra* text accompanying notes 79-82a.

504 It is unlikely, however, that the standards would be identical. Even if they were, it

The problem may, however, be easily avoided in both instances. While the courts have consistently held duplicate provincial laws inoperative,[505] they have also upheld provincial laws that extended beyond parallel federal requirements.[506] Overlapping local provisions that impose additional requirements or create stricter standards have been treated as sufficiently different to prevent a conflict even where most of the cases likely to arise were covered by both the federal and provincial statutes.[507] Thus provincial disclosure provisions that "supplement" a federal act by requiring additional items of information, by limiting the exemptions granted under the latter act or by imposing stricter standards for acceptance of a prospectus or denial of exemptions would be constitutionally unaffected.[508] In sum, it is doubtful that the disclosure requirements of a federal securities law would displace those in the provincial acts unless the provinces so desired.

The application of the paramountcy doctrine to the licensing of market actors is similar.[509] Assuming the validity of both federal and provincial legislation,[510] duplicative provincial provisions would likely be inoperative[511] but the provinces could supplement the federal requirements by imposing stricter standards for the granting, suspension or denial of registration or an exemption or by narrowing the exemptions available under the federal act.[512] The stock exchanges are not, however, susceptible to the same treatment as other market actors; if Parliament has authority over them by virtue of their being interprovincial undertakings or works for Canada's general advantage, then the provinces have none.[513] Thus while the provinces might retain jurisdiction over

might be argued that different policy goals resulting from different aspects must lead to diverse applications of a broad public interest standard; in fact, the applications themselves establish the standard in such cases; *see e.g.* K. Davis, Discretionary Justice: A Preliminary Inquiry 15-17, 38-42 (1969); Anisman, Book Review, 47 Can. B. Rev. 670, 680 (1969).

505 The obvious exception is Smith v. R., [1960] S.C.R. 776; *but see supra* text accompanying notes 464-65.

506 *See supra* notes 453, 463 and accompanying text.

507 *See e.g. supra* note 467; *cf.* P. Hogg, *supra* note 32, at 111.

508 *See e.g.* Lederman, *supra* note 440, at 210-12, 215-16. It may also be permissible for a province to require that all documents filed under the federal act also be filed with the provincial commission; *cf. e.g. supra* note 83; and *see supra* notes 501, 502.

509 *See supra* text accompanying notes 98-102.

510 There is no question about the validity of such provincial legislation concerning brokers, dealers, advisers and underwriters, *see supra* notes 37-39 and accompanying text, but federal jurisdiction is less certain; *see supra* text accompanying notes 203-13.

511 *See supra* note 502 and accompanying text.

512 *See supra* text accompanying notes 505-08.

513 This result flows from the BNA Act, s. 92(10) itself; *see supra* note 229 and accompanying text. But the conclusion would not automatically follow if Parliament's jurisdiction over the exchanges derives from subsection 91(2) of the BNA Act; *see*

exchange members, provincial regulation of the exchanges themselves would be displaced.

Conversely, it is doubtful in view of the *Smith* case that any offence created by a provincial securities act would be found repugnant to a criminal prohibition in federal legislation;[514] the false prospectus offence in the Ontario Securities Act was sustained even though there was no substantive difference between it and the Criminal Code.[515] Indeed it is fair to say that the Supreme Court accepted a conceptual difference which was no more than a reassertion of the aspects on which the validity of the provisions rested as sufficient to distinguish them.[516] It is therefore reasonable to conclude that the Court might do so again even with identical provisions. But this result too cannot be predicted with certainty.[517]

The interaction of provisions creating civil liability is still less clear. Although the *Multiple Access* decision applies only to accountability for benefits received or receivable by an insider as a result of improper trading,[518] its rationale extends to all liability for which privity is a prerequisite.[519] The basis of the Ontario court's decision was the fact that both the federal and provincial remedies dealt with the same benefit in that each created account-

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supra text accompanying notes 192-94; exchanges would then be in the same position as other market actors.

514 *See* Smith v. R., [1960] S.C.R. 776; *see also supra* text accompanying notes 103-06 and ch. III.E.

515 *See id.*; and *see supra* text accompanying note 458; *see also now* Ontario Securities Act, s. 137; Criminal Code, s. 358; *compare* Ontario Securities Act, R.S.O. 1950, c. 351, s. 63. The present Ontario Act presents a stronger case for concurrent operation as it embodies a stricter standard; the express requirement that a false statement be made "knowingly" has been deleted and a defence of lack of knowledge and an inability to discover the true facts in the exercise of reasonable diligence has been added; *see* Ontario Securities Act, s. 137(3).

516 *See supra* text accompanying notes 464, 465.

517 *See e.g.* N.S. Bd. of Censors v. McNeil, 19 N.R. 570 (S.C.C. 1978). The *Smith* decision, like all paramountcy cases, is easily limited to the legislation that was before the Court, especially as the provincial provision did not expressly require an intention "to induce persons...to become shareholders" as the Code did; the intention had to be inferred from the fact that a prospectus was required only when an issuer wished to sell securities to the public. But the context was pointedly described in the dissenting opinions, *see supra* note 458, and the majority did not expressly rely on this difference in drafting. Nevertheless, it is far from clear that the Court would uphold an identical provision; *see supra* text accompanying notes 462-68.

518 Multiple Access Ltd. v. McCutcheon, 78 D.L.R. (3d) 701 (Ont. Div'l Ct. 1977), *affirmed* (Ont. C.A. June 14, 1978, unreported).

519 Most commentators interpret the insider liability provisions in Canada as creating a cause of action only for a person who trades with the insider but this conclusion has been doubted; *see, Anisman* at 234-43; and *see e.g.* Ontario Securities Act, s. 113. Ontario Bill 7, s. 131, attempts to impose a clear privity requirement.

ability to the corporation in the same measure;[520] an action under the Ontario Act would have stripped away the insider's benefits and would have thus nullified the effect of the federal provision.[521] This reasoning applies equally to an action for damages against the insider, or any other defendant, if privity is a necessary element. In such circumstances only the person who traded with the insider has a cause of action and the amount of his loss would form a single fund. A successful action under the provincial act would thus destroy the federal remedy, even though furthering the latter's policy goals, and would be subject to federal paramountcy.[522]

The result would likely be the same even if the measure of damages under the provincial statute were greater. While it might be argued that an extended measure of damages supplements the federal remedy, it is doubtful that merely increasing the amount of the award would bring the provision within the cases upholding supplementary provincial legislation for all of the Supreme Court's decisions sustaining overlapping provisions do so on the basis of a stricter provincial standard of liability.[523] In other words the statutes all applied to conduct that was not covered by the federal legislation. The extension suggested above would not; rather it would only supplement the amount of damages prescribed by Parliament and might for that reason alone be in conflict with the federal section.[524] A negative implication would similarly arise if the federal act, like the *ALI Code*, creates a remedy available to the class of persons affected by improper market conduct, for example, to all persons who trade on the opposite side to an insider trading through the facilities of a stock exchange during the period of his violation whether or not in privity with him, and imposes a ceiling on the offender's potential damages.[525] In such circumstances a provincial remedy based on

520 *Compare* Ontario Securities Act, s. 113; Canada Corporations Act, s. 100.4. The coverage of the latter provision is, in fact, broader as the definition of "insider" is wider and the liability provision applies as well to employees and persons retained by the corporation; *see e.g. Anisman* at 182-84, 190-91, 207, 269-70; on accountability, *see id.* at 255-60.

521 *See* 78 D.L.R. (3d) at 704 ("For all practical purposes if a plaintiff resorts to one set of provisions to recover the loss, or benefit or advantage, then the factual subject-matter is completely and exclusively covered and there is no scope whatsoever for the other to have any operational effect").

522 *See id.* Significantly, Mr. Justice Morden included a loss by a person who trades with an insider in his discussion of constitutional principle.

523 *See supra* note 453.

524 *Cf.* Johnson v. A.G. Alta., [1954] S.C.R. 127, 138 (*per* Rand, J.). If anything may occupy a legislative field by implication, it is the measure of damages specified for the same conduct.

525 *See e.g.* ALI Federal Securities Code, ss. 1703(b), 1708(b); *see also*, *Anisman* at 236-43, 250-52.

privity would undercut both the amount available under the federal legislation and any prorationing requirements that follow from the specification of a maximum liability.[526] And a provincial market remedy without a similar limitation, even though, again, it might arguably "supplement" the federal scheme, would be inconsistent because it would subvert Parliament's clearly expressed intention to limit damages.[527]

The judicial reconciliation of a comprehensive federal securities law with the provincial securities acts pursuant to principles of paramountcy could thus involve a wide number of provisions and would necessitate litigation with little likelihood of satisfactory resolution.[527a] An integrated national scheme for the regulation of the securities market may, therefore, best be developed through federal-provincial negotiations utilizing the techniques of cooperative federalism devised to deal with similar regulatory issues.[528]

I. FEDERAL-PROVINCIAL INTERDELEGATION

One method of federal-provincial cooperation merits special attention. If a federal act does not apply to intraprovincial distributions,[529] the provinces will wish to retain some mechanism to ensure that local investors receive protection in such transactions like that under the present provincial securities acts or under the federal legislation. However, the maintenance of an agency to supervise intraprovincial distributions may be unduly expensive in provinces in which few are made; such provinces may prefer that the federal or another provincial body vet local prospectuses either in accordance with the standards that it usually applies or with locally established ones.[530] Conversely, the provinces with the

526 *See e.g.* ALI FEDERAL SECURITIES CODE, s. 1711.

527 *But cf.* Reference re Validity of Section 92(4) of the Vehicles Act, 1957 (Sask.), [1958] S.C.R. 608; and *see supra* text accompanying note 481.

It is also questionable whether a province could create a market remedy involving a prorationing scheme and a ceiling on liability where Parliament's remedies require privity, for the provincial scheme might then preclude a plaintiff from obtaining his full measure of damages under the federal law.

527a However, in the view of the authors the effect of a federal securities act on existing provincial legislation would be minimal; *see supra* notes 469, 502; *see also supra* text accompanying notes 507-17. Indeed it is possible that the Supreme Court's decision in *Multiple Access* will go far to resolve many of the issues raised in the text; *see supra* text accompanying notes 518-24.

528 *See supra* note 431 and accompanying text; and *see generally* P. HOGG, *supra* note 32, at 54-57.

529 *See supra* ch. III.B.

530 Prior to 1971 the smaller provincial commissions tended to rely on clearance by the larger ones of prospectuses in national issues; since April 1971 when National Policy No. 1, 2 CCH CAN. SEC. L. REP. ¶ 54-838 ("Clearance of National Issues"), became effective, this procedure has been formalized. On prospectus clearance for national issues, *see generally* Lockwood, *Procedures in Cross-Country Prospectus Clearance*

larger, more efficient commissions may wish them to continue to supervise all securities trading subject to provincial jurisdiction and the federal government may find it useful to harness the expertise existing in such commissions by establishing them as local offices for the administration of its legislation as well.[531] Cooperative regulation of the securities market may, therefore, involve not only the enactment of complementary federal and provincial legislation but also the appointment of common bodies to administer it; the latter end may be accomplished by the now common device of interdelegation.[532]

Although legislative jurisdiction cannot be delegated between Parliament and the provincial legislatures so as to extend the powers allocated to either under the BNA Act,[533] any of them may delegate authority to administer a statute validly enacted by it to an agency established by another level of government with the capacity to accept the delegation.[534] Parliament and the provincial legislatures may, therefore, delegate complementary administrative powers to the same body so that it may devise and apply consistent policies to both local and interprovincial aspects of the securities market.[535] Alternatively, either government may enact its own comprehensive scheme and delegate its administration to the one agency.[536] The delegate then acts in any specific instance on behalf of the legislature within whose jurisdiction the matter being regulated falls.

While a blanket delegation may be effective in some cases, in others it may not provide the most efficient method of regulation. A federal agency created to regulate the securities market will not displace the provincial commissions.[537] As coordination of regulatory activities may in some circumstances be accomplished better by supervision of specific elements of the market, rather than of the market as a whole, at the national or local level, it may be desirable to provide for delegation of specific parts of the various

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and Regulation by Policy Statement, in LAW SOCIETY OF UPPER CANADA, SPECIAL LECTURES 1972: CORPORATE AND SECURITIES LAW 111 (1972).

531 *See generally, Howard*, chs. VI, VII.

532 *See generally* P. HOGG, *supra* note 32, at 223-37.

533 *See* A.G.N.S. v. A.G. Can., [1951] S.C.R. 31 (1950); *see also* LASKIN, *supra* note 35, at 3. The decision is criticized in P. HOGG, *supra* note 32, at 224-25.

534 *See e.g.* P.E.I. Potato Marketing Bd. v. H.B. Willis Inc., [1952] 2 S.C.R. 392 (federal delegation to provincial board); Reference re Agricultural Products Marketing Act, 19 N.R. 361, 368-69, 425 (S.C.C. 1978) (provincial delegation to federal board; *per* Laskin, C.J., Pigeon, J., concurring on this issue).

535 *Cf. e.g.* Coughlin v. Ont. Highway Transport Bd., [1968] S.C.R. 569.

536 *See e.g.* Reference re Agricultural Products Marketing Act, 19 N.R. 361 (S.C.C. 1978); *see also, Howard*, ch. VI.

537 *See supra* ch. III.H; *see also, Howard*, ch. VII.

acts, and even of specific provisions, perhaps on an ad hoc basis. Nor need such partial delegation occur in the legislature or the cabinet. Any Canadian legislature, provincial or federal, may authorize its own agency to subdelegate the administration of various parts or provisions of its act to another equivalent body that has the capacity to accept it in order to permit flexibility of administration and enforcement.[538]

On the other hand, some provinces may wish to accept the standards of a federal act without replicating the complete statute, especially as it may be difficult to devise complementary legislation that is clearly within the authority of each legislative body.[539] The difficulties of drafting and enacting a detailed statute may be avoided by the use of both interdelegation and incorporation by reference of the law of the other jurisdiction as amended from time to time so that the delegate can apply the provisions of its own statute to all transactions in both jurisdictions.[540] This combination of techniques has been used in connection with the regulation of highway transport; after the Privy Council declared that the provinces lack jurisdiction to regulate interprovincial transportation undertakings[541] Parliament delegated its regulatory powers to the provincial boards established to supervise local transport by means of a statute that simply authorized the provincial agencies to grant licences to undertakings within federal jurisdiction "upon the like terms and conditions and in the like manner as if the extraprovincial undertaking operated in the province were a local undertaking".[542]

It is therefore open to Parliament to facilitate the maximum amount of federal-provincial cooperation. It may establish a body to administer a federal securities act that applies to matters within its jurisdiction and may at the same time either itself delegate the administration of the act or parts of it within a particular province to the securities commission administering the local act or authorize the federal agency to make the delegation as it becomes necessary or advisable. It may also empower its own agency to accept a delegation from a provincial legislature whether made directly or indirectly. In short, the availability of interdelegation

538 *See e.g.* Reference re Agricultural Products Marketing Act, 19 N.R. at 369, 439-40 (*per* Laskin, C.J., Pigeon, J., concurring).

539 *See e.g. id.*

540 Incorporation by reference has been consistently approved by the Supreme Court; *see* A.G. Ont. v. Scott, [1956] S.C.R. 137 (1955); Coughlin v. Ont. Highway Transport Bd., [1968] S.C.R. 569; R. v. Smith, [1972] S.C.R. 359 (1971); *see generally* P. HOGG, *supra* note 32, at 228-32.

541 *See* A.G. Ont. v. Winner, [1954] A.C. 541 (P.C.).

542 Motor Vehicle Transport Act, S.C. 1953-54, c. 59, s. 3(2); *see now* R.S.C. 1970, c. M-14, s. 3(2).

enhances Parliament's legislative, and therefore its negotiating, flexibility.

Chapter IV
Conclusion

The securities market performs an essential function in facilitating the transfer of funds from savers to those who may use them productively. Its efficiency as an allocative mechanism has wide ramifications; it affects industrial productivity, employment and income and thus influences the overall growth of the economy. The national character of the market's role is demonstrated not only by the demand for investment capital but also by the manner in which the securities market operates. The provincial commissions have found it necessary, for example, to cooperate in devising, implementing and enforcing policies under their acts, and the stock exchanges act jointly in devising and seeking approval of their commission rate structure and frequently do so as well with other by-laws that have a national impact. More important, the exchanges and the Investment Dealers Association of Canada are now in the process of developing a Canada-wide automated trading system which seems likely to replace the existing trading floors. These developments complement the already increasing internationalization of the securities market the potential for which has already been indicated by recent acquisitions and fraudulent schemes. The fact that the securities market thus transcends provincial and even national borders combined with the market's economic function make an increased federal involvement in its regulation inevitable.[543] The major questions are the nature of that involvement and the process through which it occurs.

Although all of the provinces have enacted securities acts that are clearly within their legislative jurisdiction, the inherent limitations on provincial powers necessitate federal legislation. As a result of the fact that all provincial authority is limited under the BNA Act by the territorial boundaries of each province, difficulties of enforcement exist in connection with interprovincial trading. As well, the ability of the provinces themselves to implement some policy goals may be impeded and on occasion some provincial commissions have been forced to accept policies with which they disagreed. Moreover, as the provinces lack the power to interfere with the internal affairs of and to prevent the raising of capital by

543 The economic functioning of the Canadian securities market and the reasons for federal regulation are discussed more fully *supra* in ch. I.

a federal corporation, the prospectus and proxy requirements of their securities acts may in some circumstances be ineffective. At the very least, therefore, a number of areas exist in which provincial jurisdiction to regulate the securities market is at best uncertain.[544]

In fact the regulation of the securities market is a matter over which there is concurrent provincial and federal legislative authority. While the provinces have power to regulate local matters, Parliament may legislate in relation to interprovincial trading. A traditional transactional analysis of the trade and commerce power would, therefore, permit federal regulation of interprovincial distributions and other interprovincial activities in securities.[545]

The trade and commerce power encompasses as well the regulation of "general trade and commerce" which has been interpreted by the Supreme Court to include matters which are "transprovincial" in nature and require the establishment of an administrative or regulatory structure for their supervision. The capital accumulation process and the trading markets that support it likely fall within this rubric as is indicated, *inter alia,* by the national character of the stock exchanges. Parliament may therefore adopt comprehensive legislation to regulate the securities market either on the basis of interprovincial trading or in reliance on the Supreme Court's recent statements of the scope of its general power over trade and commerce.[546]

An alternative foundation for jurisdiction over the stock exchanges may complement Parliament's authority over trade and commerce. When the exchanges move to a national automated trading system they will become little more than a communications network extending beyond provincial boundaries and will automatically escape provincial and fall within federal legislative jurisdiction. In fact it is arguable that the stock exchanges are already interprovincial undertakings in that their clearing and reporting functions, both essential to their operation, are conducted on an interprovincial basis. Parliament may, therefore, now have the power to regulate the exchanges and their members and will clearly have it when an automated trading system is in opera-

544 *See generally supra* ch. II.

545 *See supra* ch. III.B.1.

546 *See supra* ch. III.B.2. However, it is not clear that Parliament has legislative jurisdiction over purely intraprovincial transactions even as a matter of general trade and commerce and in any event it is reasonable that each province establish the policy for the protection of investors when only its citizens are affected; *see supra* text accompanying notes 196-99.

tion.[547] And, should it wish to put its authority beyond doubt, it may do so by declaring the exchanges work for the general advantage of Canada.[548]

Parliament thus has clear jurisdiction over interprovincial and international distributions of and trading in securities and likely over the whole of the trading market as well under its authority to regulate trade and commerce, complemented by its power over interprovincial undertakings. It may therefore enact legislation requiring disclosure by issuers both in connection with a distribution and on a continuing basis and regulating the stock exchanges and their members. Such legislation might also apply directly to intraprovincial transactions and, possibly, to market actors, if necessary to ensure its proper administration.[549] And the creation of civil remedies for violation of its requirements would be justifiable on the same basis.[550] In short, Parliament may under the trade and commerce power alone or in conjunction with its jurisdiction over interprovincial undertakings adopt a comprehensive scheme for the regulation of the securities market.

Nevertheless, as the results of constitutional adjudication can rarely be predicted with certainty, it would be advisable to draft a federal securities act in discrete parts segregating its various subject matters so that a finding that one aspect of the act is beyond federal legislative authority will not extend to the whole statute, especially as some parts of the legislation will invariably be more difficult to justify than others and as some may be based on powers other than trade and commerce.[551] A provision declaring that the various sections of the act are severable should be included in order to create a presumption in favour of severance where it is possible.[552]

The interaction of a federal securities act with the existing provincial legislation cannot be thoroughly analyzed in the absence of concrete provisions. It is, however, unlikely in the light of recent judicial applications of the paramountcy doctrine that a federal law could completely displace the provincial acts even in overlapping areas. While Parliament's jurisdiction over the exchanges as interprovincial undertakings would be plenary and while the federal act could be drafted to create some inconsistencies with its provincial counterparts, the provinces would generally be able to supplement disclosure requirements and the duties of

547 *See supra* text accompanying notes 217-29.
548 *See supra* text accompanying notes 230-38.
549 *See supra* text accompanying notes 200-13.
550 *See supra* ch. III.F.
551 *See e.g. supra* ch. III.E.
552 *See supra* ch. III.G.

market actors so that at least two regulatory regimes would remain in most circumstances.[553] The most effective approach to the development of a nationally integrated, comprehensive scheme of securities regulation for Canada, therefore, is through federal-provincial negotiations. Complementary legislation and administration may thus be devised through the customary means of cooperative federalism as it has developed in Canada, including, in appropriate circumstances, the use of interdelegation.[554] The present political climate necessitates such negotiations; it is hoped that they will provide the national regulatory mechanism that is required to enhance investor confidence in and the concomitant efficiency of the Canadian securities market.

553 *See generally supra* ch. III.H.
554 *See supra* ch. III.I.

The Definition of Security for Purposes of a Securities Act

Frank Iacobucci

April 1978

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Chapter I
Introduction

A. SCOPE OF SUBJECT

1. *Purpose and Rationale of a Securities Act*

The definition of a security is greatly affected by the underlying purposes and objectives of securities legislation. A discussion of the definition of a security for purposes of a securities act must, therefore, first deal with the fundamental objectives and purposes of securities legislation.

President Franklin D. Roosevelt, in commenting to the U.S. Congress on the Securities Act of 1933, succinctly stated the rationale and objective of the new securities legislation:

I should like to acknowledge the help of Philip Anisman, former director of the Corporate Research Branch of Consumer and Corporate Affairs Canada. I am greatly indebted to him for the many helpful references and materials which he sent to me and for his comments on the paper. In particular, the recommendations on the definition of security in ch. VI reflect a joint effort between Dr. Anisman and me.

I should also like to acknowledge the assistance of Mark Frawley and Corey Simpson, who prepared Appendices A, B, C and D on the scope of the provincial securities statutes. [The appendices consist, respectively, of tables listing by province (a) the various definitions of security, (b) the definitions of trade, (c) the exemptions from registration and (d) the prospectus exemptions. They are on file in the Corporate Research Branch, Consumer

"The purpose of the legislation, I suggest, is to protect the public with the least possible interference to honest business.

"This is but one step in our broad purpose of protecting investors and depositors. It should be followed by legislation relating to the better supervision of the purchase and sale of all property dealt in on exchanges, and by legislation to correct unethical and unsafe practices on the part of officers and directors of banks and other corporations.

"What we seek is a clearer understanding of the ancient truth that those who manage banks, corporations, and other agencies handling or using other people's money, are trustees acting for others."[1]

In Canada, the *Kimber Report* stated the objectives of securities legislation this way:

"While the underlying purpose of legislation governing the practices and operation of the securities market must be the protection of the investing public, it is equally true that the character of securities legislation will affect the development of financial institutions and their efficiency in performing certain economic functions. The principal economic functions of a capital market are to assure the optimum allocation of financial resources in the economy, to permit maximum mobility and transferability of those resources, and to provide facilities for a continuing valuation of financial assets....

"1.10 Securities legislation must be designed not only to serve the purpose of reducing the imperfections in the free and open capital market, but also to assure the efficient operation of the market in achieving long-run economic objectives. There is also an ever present danger that in removing one imperfection, another may be created....

"1.17 The Committee believes that changes in securities legislation in the Province of Ontario should be devised in recognition of two basic propositions. To the extent that securities legislation is improved in the interest of investors, the securities industry will benefit from increased public confidence. To the extent that the industry becomes a more effective and efficient part of the economy, the general public will benefit. Both objectives

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and Corporate Affairs Canada, and will be made available on request. For a similai tabulation as of 1966 *see* J. WILLIAMSON, SUPP. at 435-506.]

1 *Cited in* 1 L. Loss at 127.

will be met by raising the standards governing the industry to the level presently maintained by the responsible members of the securities industry and what should be maintained, as a requirement of law, in the public interest. In this context, the Committee points out that the substantial majority of its recommendations contained in this Report deal directly or indirectly with disclosure of information to investors, that is to say, with the factor of public confidence."[2]

It is beyond the scope of this paper to discuss in detail the various methods and approaches used to achieve the purposes of securities regulations.[3] It is sufficient to mention briefly what the traditional approaches have been both in the U.S. and Canadian legislation. One approach has been the designation of fraudulent practices in the legislation together with corresponding civil and criminal sanctions for engaging in such practices. A second major approach is that of licensing people in the securities industry with the objective of ensuring that honest people are involved in securities activities. The licensing of securities participants has been subject to standards aimed at obtaining honest persons of high integrity. The third approach deals with disclosure of information relating to the securities, both at the time of the original issue of the securities and on a regular basis thereafter. The fourth approach has involved "blue skying"– that is, examination of the proposed security by the regulatory agency to determine the economic viability of the security and underlying enterprise before allowing the issue to be offered to the public. Underlying these approaches is the basic concept of a security, which is vital to the whole structure of regulation.

2. *Importance of the Definition of a Security*

The definition of a security is of obvious importance, since it will determine the scope and application of a securities act. The definition has to be designed to tie in with the other basic elements involved in securities transactions such as trading or issuing securities and distributions to specified persons or the public.

Several factors which strongly influence the definition of a security must be considered in drafting a definition for a securities statute. First, the definition must be drawn so as to achieve the

2 KIMBER REPORT ¶¶ 1.06, 1.10 and 1.17.

3 *See generally* J. WILLIAMSON at 3-46; D. JOHNSTON at 1-15. For recent developments, *see also* Baillie, *Securities Regulation in the 'Seventies*, in 2 STUDIES IN CANADIAN COMPANY LAW 343 (J. Ziegel ed. 1973); Emerson, *An Integrated Disclosure System for Ontario Securities Legislation*, *id.* at 400.

objectives and purposes of the statute. In this context, the purpose and rationale of securities legislation from President Roosevelt's introductory statement, and from the statements of the *Kimber Report*, are aimed at protecting the public from false and manipulative or otherwise unlawful practices. At the same time, it should be remembered that securities are intangible interests and, as such, necessitate a requirement of full disclosure relating to such interests. Consequently, the definition of a security should be tied in with the regime of regulation that relates to securities generally. If the definition is not sufficiently wide to catch what are thought to be securities, then obviously the objectives of the statute will not be attained.

Although the definition should be sufficiently wide to catch the traditional and innovative forms of securities that entrepreneurs can create, at the same time one must balance the flexibility of the definition with some appreciation of certainty. One can argue that under present definitions it is difficult (especially looking at the United States) to predict what the ultimate holding of a court would be on the basic question of whether or not the instrument or interest was a security and therefore covered by the securities legislation. Though some people might argue that this uncertainty is indeed healthful or inevitable since it creates a more cautious or conservative conduct on the part of those who wish to comply with the law, there are also those who would argue that the uncertainty creates sufficient doubts and hesitancies which are not only wrong in principle but also a disincentive to business activity. At the same time, one cannot discount the costs of compliance with the securities legislation. Transaction costs involved in complying with securities legislation are not insignificant. To cast the net of the definition too widely may catch too many activities which could be rendered uneconomic or otherwise unprofitable and introduce a disrupting factor which does not achieve the economic end of the individuals who created the enterprise or venture.

The other general factor that is relevant here is the avoidance of over-regulation or unnecessary duplication. This is again dramatized quite vividly in the United States where more than one agency has taken jurisdiction over certain types of interests, thereby creating unnecessary duplication and resulting in increased costs to those who are caught by the jurisdictions of the agencies.

As in other federal countries, Canada in its commercial legislation must be mindful of uniformity. It may decide, as a federal unit, to have diversity within the federal structure, but there are strong pulls for uniformity; and indeed this has been already

recognized in corporate legislation of which securities legislation is a part.[4] However, there is another dimension to uniformity on this question, because it is inconceivable that Canada could have a definition of security which radically departs from that of the United States. As it is fairly easy to observe, the marketplace for securities is to a large extent an international one; even though many would try to argue that regulation should be national or provincial or state, as the case may be, it is nonetheless the fact that securities do cross borders with considerable ease. Consequently, it makes much sense to ensure that the definition of security is not substantially out of line with, or different from, that existing in other jurisdictions within Canada and with the principal definitions in the jurisdictions within the United States. These comments are equally applicable to legislative definitions of security and to judicial and administrative interpretations of the term since those interpretations ultimately determine the boundaries of the definition.

B. SCOPE OF THIS STUDY

This study will review Canadian treatment of the definition of security by examining the definitions found in the various provincial statutes and also in U.S. legislation. The U.S. legislation will be examined first, primarily because many of the concepts were developed there and the United States has produced much more jurisprudence and commentary on the definition of security. Some of this jurisprudence has been seeping into the Canadian administrative and judicial decisions on the subject.

There are several concepts of security or interests similar to securities that involve other regulatory agencies such as commodity exchanges and housing authorities, and there will not be a detailed treatment of these agencies or regulatory bodies in this study. Reference will be made to them at various points, but there is no space to discuss them in detail. Also excluded from detailed discussion are the requirements of prospectus and continuing disclosure treatment, the sanctions for the anti-fraud provisions, and indeed sanctions generally in relation to securities. These all could be discussed in this study, since they bear directly on the definition of security; but again, because of space limitations they will not be discussed in any detail. However, it should be remembered that security is not defined in a vacuum, since it really must be defined so as to relate to the prospectus requirements or the

4 *See e.g.* Canada Business Corporations Act, s. 4 (uniformity declared an objective of the act).

anti-fraud provisions or the sanctions that are provided in the securities statute generally.

The emphasis in the paper will be on the definition of "security" and not on the definitions of "trade" or "distribution" or "public". These latter definitions, since they represent the basic triggering events in securities transactions, are extremely important. But it is correct to say that, with the exception of the "public" concept, they have not given rise to as much controversy as that surrounding "security".

Chapter II
Scope of United States Securities Legislation

A. INTRODUCTION AND BACKGROUND OF U.S. LEGISLATION

It is interesting that, although the United States entered the securities legislation field after the United Kingdom, the U.S. legislation has become much more sophisticated and developed than that of the U.K. or Commonwealth countries. Yet, surprisingly, the sophisticated legislation has still not provided a clearly accepted definition of a security for purposes of the legislation. In fact, one commentator has stated that the United States is in the same position on this definition as it is with obscenity: the Supreme Court can generally tell a security when it sees one on a case-by-case basis, but has been unwilling to give a generic definition of the term.[5]

In the United States, the states were the first to introduce securities legislation, with the Kansas statute in 1911, containing its famous "blue sky" approach. In a period of two years, some twenty-three other states adopted securities acts based on the Kansas model.[6] It is interesting that the Kansas statute did not contain an elaborate definition of a security, since section 1 of the act simply provided that investment companies could not sell "any stocks, bonds, or other securities of any kind or character" without first registering them.[7] Thus, at the outset, the securities acts basically assumed that the definition of security was widely known and well understood, but as time went on the state statutes added various enumerative or illustrative definitions of securities.

5 Long, *Interpreting the Statutory Definition of a Security: Some Pragmatic Considerations, Introduction,* 6 St. Mary's L.J. 96 (1974).

6 As pointed out by Long, *id.*, it is misleading to refer to early statutes as securities acts because they were actually statutes dealing with the issuance of securities by investment companies. He states that the first true securities act (in the sense that it attempted to regulate securities rather than the company issuing them) was the Illinois Securities Act of 1919.

7 1911 Kan. Sess. Laws, c. 133, s. 1.

The basic change in the definition was made in the Illinois Securities Act of 1919, which provided that the word "securities" was to include "stocks, bonds, debentures, notes, participation certificates, certificates of shares or interest, preorganizational certificates and subscription certificates evidencing shares in trust estates or associations, and profit-sharing certificates".[8] The Illinois statute's approach to the definition provided the pattern that other legislatures were to follow. The definition in the Illinois statute contained a series of items having a fixed or generally recognized meaning, such as stocks, bonds, and debentures, followed by specific terms, and then followed by a series of general terms having no fixed or legal meaning, such as profit-sharing certificates and evidences of indebtedness, which were included in order to cover unusual or irregular forms of securities. Through the 1920s, as other irregular investment forms appeared, state legislatures added other general terms in hopes of filling in the gaps.[9]

In 1933, Congress borrowed from the earlier definitions of security in the blue sky laws in passing the Securities Act of 1933. The final definition was drafted "in sufficiently broad and general terms so as to include within the definition the many types of instruments that, in a commercial world, fall within the ordinary concept of security".[10] Congress reviewed the existing state definitions and combined most of the general terms into the single definition that is found in section 1 of the 1933 act. The 1933 act in turn became the model for the definition of security in the Uniform Securities Act, which has been adopted in one form or another in some thirty states.[11]

B. THE MAJOR SEC STATUTES

Each of the main U.S. federal securities statutes contains a definition of security and it might be useful to describe, albeit briefly, some of the major features of the federal legislation prior to dealing specifically with the definitions therein.[12]

8 Long, *supra* note 5, at 97.

9 As mentioned by Long, *supra* note 5, the Minnesota Act of 1919 added the oft-interpreted "investment contract" category and in 1923 Missouri added "certificate of interest in an oil, gas, or mining lease" and "beneficial interest in or title to property or profits".

10 H.R. REP. No. 85, 73d Cong., 1st Sess. 11 (1933).

11 Hannan & Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities*, 25 HASTINGS L.J. 219, 220 n. 6 (1974); Long, *supra* note 5, at 98.

12 On the background leading to the U.S. legislation, *see generally* 1 L. Loss at 1-128. The discussion on the U.S. statutes in this paper is based on Professor Loss's work; *id.* at 129ff.

The Securities Act of 1933 was the first in the series of securities statutes passed by Congress, and it deals principally with the initial distribution of securities. Securities issued through the mails or interstate commerce must be registered by the issuer with the Securities and Exchange Commission (SEC), which was created and made responsible for administering the 1933 act by the Securities Exchange Act of 1934. The registration is done through the registration statement which must contain prescribed information about the security issuer and the underwriters. The commission, in reviewing the registration statement, does not have any authority to approve or pass on the merits of any security. The commission's only responsibility is to ensure that the security has met the standards of accuracy and completeness described by legislation. The act imposes civil and criminal liabilities for material misstatements or omissions in the registration statement or prospectus. There are also anti-fraud provisions in the statute which are enforced by injunctive and criminal sanctions. The act also specifies securities and transactions exempt from the registration and prospectus requirements but not from the anti-fraud provisions.

The Securities Exchange Act of 1934 primarily deals with post-issuance or distribution trading in securities. Its four basic purposes are to afford a measure of disclosure to people who buy and sell securities; to prevent, and afford remedies for, fraud in securities trading and manipulation of markets; to regulate the securities markets; and to control the amount of credit which goes into those markets. Through this statute, the stock exchanges and various practices of the exchanges are regulated in a variety of ways. In addition, the whole proxy machinery and related rules and practices are subject to SEC control through the rules and regulations of the Securities Exchange Act of 1934. Also under this statute, there are general provisions dealing with fraud and manipulation with respect to which the SEC has exercised a considerable amount of rule-making authority.

The Public Utility Holding Company Act of 1935 is also administered by the SEC. Basically, the act is aimed at dealing with the geographical integration and corporate simplification requirements relating to utilities; it also contains a number of regulations on the financing and operations of utility holding company systems which were deemed desirable because of alleged abuse. Whereas the theme of the Securities Act of 1933 was full disclosure of material information relating to issuers and the securities they were offering, the 1935 act goes beyond the theme of disclosure and is basically a regulatory act for a particular industry.

The Trust Indenture Act of 1939 resulted from the SEC's

conclusion that it was important to provide that trustees under indentures should be independent and active enough to protect and enforce the rights of holders of securities issued under such indentures. The procedures under the act are melded with the registration procedure under the 1933 act. The indenture must be qualified by the SEC before securities can be issued thereunder. The indenture must contain provisions which relate to certain qualifications of the trustee in terms of independence and particular forms of conduct.

Like the Holding Company Act, the Investment Company Act of 1940 is regulatory, applying to investment companies or investment trusts which are primarily involved in investing and reinvesting in securities of other companies. Registration of all investment companies as defined is required and information similar to those statements filed under the 1933 act is also required. The regulatory provisions are aimed at dealing with selling practices of investment companies as well as relating to honest and unbiased management, greater participation in management by security holders, adequate and feasible capital structures, and financial provisions for transmission of financial statements and accounting rules.[13]

The federal statutes are not intended to override the state legislation and indeed nearly all of the statutes have clauses reserving the jurisdiction of the state securities commissions.[14]

C. STATUTORY DEFINITIONS OF SECURITY IN U.S. LEGISLATION

1. *Introduction*

The security definition in the Securities Act of 1933 was the basis for subsequent definitions of security in the other federal statutes. The 1933 act defined securities as follows:

> "When used in the sub-chapter, unless the context otherwise requires – the term 'security' means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting trust certificate, certificate of deposit for security, fractional undivided interest in

13 The SEC also plays a role with respect to the Investment Advisers Act of 1940 and ch. 10 of the Bankruptcy Act; *id.* at 154. Recent related federal statutes are the Securities Investor Protection Act of 1970 and the Interstate Land Sales Full Disclosure Act; *see* note 43 *infra.*

14 1 L. Loss at 156 nn. 89, 90.

oil, gas, or other mineral right, or, in general, any interest or instrument commonly known as a 'security', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase any of the foregoing."

The same definition is in the Investment Company Act of 1940 and the Investment Advisers Act of 1940, but the definition in the Securities Exchange Act of 1934 is slightly different.[15]

Briefly, the differences between the definitions in the 1933 and 1934 statutes are as follows: In the 1933 act, evidence of indebtedness is included as a security, whereas it is omitted from the 1934 act. In the 1934 act, the certificate of interest or participation is extended to any oil, gas, or other mineral royalty or lease, whereas in the 1933 act this type of security is expressed in terms of a fractional, undivided interest in oil, gas, or other mineral rights. In the Securities Exchange Act of 1934, there is a reference expressly excluding currency, or any note, draft, bill of exchange, or banker's acceptance, which has a maturity at the time of issuance not exceeding nine months, exclusive of days of grace or any renewal thereof, the maturity of which is likewise limited. Finally, in the 1933 act, the words "or in general any *interest* or instrument commonly known as a security" are included and a *guarantee* is expressly mentioned, but both the emphasized words are omitted from the 1934 act.

The Public Utility Holding Act definition of securities is similar to the Securities Exchange Act of 1934 definition, but it adds the terms "draft", "receivers' or trustees' certificates", "guarantee of" and "assumption of liability on...any of the foregoing". The Trust Indenture Act has a more restrictive definition of the term security, since it is used for a limited purpose in connection with the disqualification of a trustee under a trust indenture.[16]

It is arguable that, because there is the difference in the definition among the various federal statutes, there is reason to interpret security differently depending on which statute is being considered. In this connection, Professor Alan Bromberg states that:

"Full equivalence of the 1933 and 1934 definitions does not necessarily follow. There is some reason to interpret 'security' more broadly for anti-fraud purposes (now pri-

15 Hannan & Thomas, *supra* note 11, at 221 nn. 10, 11.
16 *Id.* at 221 nn. 8, 9.

marily a 1934 Act matter) than for registration purposes (primarily a 1933 Act matter)."[17]

He goes on to say that it is easier to justify a remedy for an investor who has been defrauded in a borderline security transaction than to give him an automatic remedy under the Securities Act of 1933 because the security was not registered under the 1933 act.[18]

At the same time, there has not been absolute consistency of treatment of the definition of a security among the state securities acts. As stated above, the Kansas statute did not introduce a special definition of security. In 1913, the California statute provided that the term was to include "stock, stock certificate, bonds, and other evidences of indebtedness, other than promissory notes not offered to the public by the maker thereof, of an investment company". It really was the Illinois Securities Act which provided the first substantial amendments to the definition of a security and the Minnesota Act of 1919 added the category of investment contract which has been the subject of so much litigation.[19]

Several of the state statutes have adopted a rather broad view of securities by including items not normally accepted to be securities. For example, Oklahoma and Wisconsin have specifically included commodity futures contracts within the definition, and Florida, Louisiana and New Hampshire have extended coverage to investments in all types of warehouse receipts.[20] Some states have had provisions covering different types of interest in real property located outside the state; and other states have enacted very broad, general provisions, such as Ohio which has stated that security means "any certificate or instrument representing title to or interest in...the capital, assets, profits, property, or credit of any person or any public governmental body".[21]

Although there are differences in the definitions among the various statutes in the United States, the federal statutes and the number of decisions interpreting the provisions have taken the dominant role in the development of securities legislation generally. On the whole, many of the decisions interpreting the federal statutes have been accepted by many state courts, although there are noticeable differences and exceptions.[21a] Although, as previously mentioned, the definitions of security in the federal statutes are not identical, the definition of the 1933 act has been a model for

17 1 A. BROMBERG, SECURITIES LAW: FRAUD - SEC RULE 10b-5 at 82.2 (1971).

18 *Id.*

19 Long, *supra* note 5, at 103.

20 *Id.* at 104 nn. 37, 38.

21 *Id.* at 104 nn. 39, 40.

21a *See* ch. IV *infra*.

state jurisdictions and does provide a useful starting point for looking at the U.S. legislation more closely.

2. *Specific Ingredients of the Definition of Security in the Securities Act of 1933*

a. *Introduction*

The terms "stock", "treasury stock", "bond" and "debenture", which appear in the Securities Act of 1933 as well as the other major federal statutes, are reasonably precise and have not for the most part created confusion in interpretation.[22]

It is interesting to note that several phrases found in state definitions are absent from the definition in the 1933 act. The omitted phrases are "beneficial interest in or title to property or profits" and "interests in foreign real estate".[23] With the difference in wording between the state and federal legislation, it is no wonder that Professor L. Loss states that caution must be used for two reasons:

> "Often there are slight but potentially significant variations in the wording of the particular phrase of the definition relied upon. And a case may also be distinguishable because of the presence of some other and broader phrase in the particular statute than that which is common between the two cases."[24]

The definition of a security in section 2(1) of the Securities Act of 1933 combines specific examples of securities with catch-all or general classifications within the definition. Some specific securities, such as certificates of interest in any profit-sharing agreements, are not easy to define.[25] Other specific types of securities mentioned are collateral trust certificates, preorganization certificates, transferable shares, voting trust certificates, certificates of deposit (for security receipts), and interests in oil or gas or other rights. The general classifications that are mentioned are investment contracts, any interest or instrument commonly known as a security, and any certificate or interest or participation in, tem-

22 However, as has been pointed out, "stock" and "bond" have no fixed meaning generally; 1 L. Loss at 455 n.1.

23 Apparently, the original enactment of the 1933 act included "a certificate of interest in property, tangible or intangible" but was removed as being too broad and uncertain; Long, *supra* note 5, at 98 n. 11.

24 1 L. Loss at 456.

25 As has been noted, interests in profit-sharing agreements do not have a fixed meaning and there has been some tendency to treat the term interchangeably with investment contract but recent rulings indicate an attempt to distinguish the terms; Long, *supra* note 5, at 97 n. 5.

porary certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase any of the foregoing.

In most cases, well-accepted meanings of securities are involved. However, there have been a considerable number of transactions involving securities not commonly recognized as such, and these transactions have tested the definitions in federal legislation. The specific terms have not been precisely defined either, but for the most part have not caused much confusion in terms of their technical meaning or the precise limits of their boundaries of coverage. The general terms have been tested several times and most particularly the term "investment contract" has given rise to a vast amount of litigation which will be discussed below. In looking at the definition of security, it is also important to keep the definitions of "sale" and "offer" in mind since those acts are directly related to the scope of the definition of security and of the securities statutes themselves. Finally, the exempt securities and transactions are also relevant and should be mentioned briefly.

b. *Definition of Sale and Offer*

Section 2(3) of the Securities Act of 1933 defines "sale" or "sell" to include every contract of sale or disposition of a security, or interest in a security, for value; and "offer to sell", "offer for sale" or "offer" to include every attempt or offer to dispose of, or solicitation of an offer to buy, a security, or interest in a security, for value. Several comments of interest and importance are worth making about these definitions. First, they use the word "include" rather than "means", so that the definitions of these terms are not exhaustive and are more unrestricted than the other definitions in the 1933 act which use the term "means". Second, the definitions are very broadly drawn. Third, the definitions contemplate value as an essential ingredient. Presumably, value is the same as consideration; indeed, it has been stated that no attempt has been made to distinguish between value and consideration.[26]

Because of the broadly drawn definitions, over the years questions have arisen as to the effect of exchanges, gifts, and pledges of securities, and loans in connection with securities. As a result, a complex set of rules and regulations has been promulgated by the SEC defining what the terms "sale" and "offer" mean and providing specific examples of transactions that would not be treated as a sale or an offer.[27]

One type of transaction is interesting because it raises the

26 1 L. Loss at 513.
27 *Id.*

question of interpreting both the definition of "sale" or "offer" and the definition of "security". The transaction relates to the giving of a promissory note in exchange for loans, or where goods are sold and the purchaser gives a promissory note in exchange for the goods. The questions arise as to whether or not the promissory note is a security under the 1933 act and whether or not there has been a sale of a security.[27a] Dealing with the latter question first, one can argue that the note did not involve any sale of a security since the note is simply evidence of the underlying obligation to pay, and was really not sold by the purchaser to the vendor of the goods. With respect to promissory notes as securities, this question is dealt with below in Chapter IV dealing with the types of securities adjudicated upon by the courts and administrative agencies.

It should be noted that there are other definitions in the Securities Act of 1933 which are highly relevant to the scope of the legislation. These are the basic definitions relating to "underwriter", "dealer" and "issuer".[28]

c. *Exemptions: Securities and Transactions*

i. *Exempt Securities*

Section 3 of the Securities Act of 1933 lists the securities which are exempt from the registration and prospectus requirements of the act. Section 3(a)(1) exempts transitional securities or securities which were in pre-1933 offerings. Securities of public authorities and banks are exempt under section 3(a)(2).[29] Short-term notes are exempted by section 3(a)(3) which provides that any note, draft, bill of exchange or banker's acceptance which has been or is to be used for current transactions, and which has a maturity at the time of issuance not exceeding nine months exclusive of days of grace, or any renewal thereof, the maturity of which is likewise limited, is specifically exempted. There are two conditions for exemption: the current transaction aspect, and a maturity not greater than nine months.

Securities of nonprofit issuers are exempted by section 3(a)(4) which provides that any security issued by a person organized and operated exclusively for religious, educational, benevolent, fraternal, charitable or reformatory purposes and not for pecuniary profit, and no part of the earnings of which enures to the benefit

27a *Id.* at 546 n. 289. The example given in the text arises in situations where a plaintiff is seeking redress under the anti-fraud provisions of the 1933 act (ss. 12, 17) or the 1934 act (s. 10(b) and Rule 10b-5). *See also* text accompanying note 304 *infra*.

28 For a discussion of these terms, *see* 1 L. Loss at 551.

29 *Id.* at 562-66.

of any person, private stockholder, or individual, is exempt.[30] The securities of a savings and loan or building and loan association and other institutions supervised by state or federal authorities are exempted by section 3(a)(5). In addition, securities issued by certain farmers' cooperative associations are also exempt.[31] Section 3(a)(6) exempts any security issued by a common or contract carrier, the issuance of which is subject to certain provisions of the Interstate Commerce Act. Section 3(a)(7) exempts certificates issued by a receiver or by a trustee in bankruptcy with the approval of the court. Although section 3(a)(8) exempts insurance and endowment policies and annuity contracts of corporations otherwise regulated by state or federal insurance or bank commissioners or agencies, no exemption exists for stocks or shares or other securities of insurance companies.

Section 3(a)(9) exempts any security exchanged by the issuer with its existing securityholders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange. The exemption requires that the issuer of both securities must be the same, that (under administrative interpretation) no part of the offering may be made to persons other than existing securityholders, or even to existing securityholders otherwise than by way of exchange, and that there must be no paid solicitation.[32]

Section 3(a)(10) exempts certain securities issued in exchange pursuant to reorganizations which have been approved by a court, or by any official agency of the United States, or by any state or territorial banking or insurance commission, or other governmental authority, expressly authorized by law to grant the approval. These primarily relate to security reorganizations and transactions which are required to be approved by governmental agencies.[33]

Section 3(a)(11) exempts securities forming part of an issue offered and sold only to persons resident within a state or territory, where the issuer of the security is a person resident and doing business within, or a corporation incorporated by and doing business within, such state or territory.[34]

30 *Id.* at 468. *See* Note, 51 GEO. L.J. 855 (1963).

31 It has been pointed out that the scope of this exemption was influenced by "obvious political reasons"; *see* Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 39 (1959), *cited in* 1 L. Loss at 569 n. 34.

32 These conditions and the exemption generally are discussed in 1 L. Loss at 573-84. Loss points out that the philosophy of the exemption is not easy to understand in the light of the skepticism concerning voluntary reorganizations as reflected in the legislative history; *id.* at 573.

33 *Id.* at 584-91.

34 For a discussion of the elements of the exemption *see id.* at 591-605.

An important exemption is the power given to the commission in section 3(b) to create exemptions by its rule-making authority. The original enactment of the section stated that the commission could, from time to time, by its rules and regulations subject to such terms and conditions as may be prescribed therein, add any class of securities to the securities exempted as provided in section 3, if it finds that the enforcement of the statute with respect to the securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offerings; but no issue of securities was to be exempted where the aggregate amount at which such issue is offered to the public exceeds $100,000. The $100,000 figure was changed by a 1945 amendment to $300,000 and this in turn was changed in 1970 to $500,000. There has been a considerable amount of development relating to this section and the debate continues on the advisability of the general rule-making power and the conditions under which the SEC has exercised the power.[35]

Section 3(c) was added to the Securities Act of 1933 in 1958 by the Small Business Investment Act to empower the SEC to add to securities exempted from the Securities Act those which are issued by a small business investment company under the Small Business Investment Act of 1958 if the SEC finds, having regard to the purpose of the act, that the enforcement of the Securities Act with respect to such securities is not necessary in the public interest and for the protection of investors.[36]

The above-described exempt securities are noteworthy in that some of them indicate nothing peculiar or distinctive about the securities which warrant their exemption; and many of the exempt securities are more like transactions that could be held exempt.[37] It is also important to note that the exempt securities in section 3 – and indeed the exempt transactions in section 4 – do not extend to the fraud provisions of section 17 or section 12 relating to civil liability for sale of securities by misleading statements or omissions. Thus a basic approach of the act is to exempt certain securities where the protection of the Securities Act of 1933 is not required or where to require registration would be a hindrance to

35 *Id.* at 605-39.

36 *Id.* at 640-41.

37 The exemptions in ¶¶ 2 through 8 inclusive of the Securities Act of 1933, s. 3(a), have been described as genuine security exemptions but those in ¶¶ 1, 9, 10, 11 of s. 3(a) and ss. 3(b) and 3(c) have nothing that make the securities mentioned therein peculiar. In fact, it has been pointed out that the exemptions created therein were recognized because of the circumstances surrounding the particular offering; *id.* at 708-09.

the issuer. Examples of these are exemptions relating to government securities and the "small" issues, respectively.

ii. *Exempt Transactions*

Section 4 exempts certain transactions from the registration provisions of the act. The first part of section 4(1) exempts any transactions by any person other than an issuer, underwriter or dealer. Because of the definitions of issuer, underwriter or dealer contained in the act, the main effect of this exemption is to allow persons who are not "control persons" to distribute the securities without having to file a registration statement.[38] Section 4(2) exempts "transactions by an issuer not involving any public offering". This exemption has been the subject of considerable interpretation and comment.[39] Although the legislative history relating to the exemption is not that explicit, it has been pointed out that in the discussion of the exemption it was stated that the exemption permitted an issuer to make an "isolated sale" to a particular person and that the exemptions generally were directed to transactions where there was no practical need for the application of the act or where the benefits to the public were too remote.[40] It is beyond the scope of this paper to discuss in any detail the courts' and the SEC's interpretations of this exemption. It is interesting that the broadly stated exemption has undergone detailed analysis which has led to rules, opinions and commentary on the meaning and scope of the exemption.

Section 4(3) exempts dealers' transactions but with several exceptions which relate to the periods within which dealers in securities cannot transact unless they comply with the prospectus provisions.[41]

Section 4(4) exempts "brokers' transactions, executed upon customers' orders on any exchange or in the over-the-counter market, but not the solicitation of such orders". The purpose of the exemption was explained as follows:

> "Paragraph 2 [now 4] exempts the ordinary brokerage transaction. Individuals may thus dispose of their securities according to the method which is now customary without any restrictions imposed either upon the individual or the broker. This exemption also assures an open market for securities at all times, even though a stop order against further distribution of such securities may

38 *Id.* at 641-53.
39 *Id.* at 653-97.
40 H. R. Rep. No. 85, 73d Cong., 1st Sess. 5, 7, 15-16 (1933), *cited in* 1 L. Loss at 653 n. 43.
41 1 L. Loss at 256-59.

have been entered. Purchasers, provided they are not dealers, may thus in the event that a stop order has been entered, cut their losses immediately, if there are losses, by disposing of the securities. On the other hand, the entry of a stop order prevents any further distribution of the security."[42]

By one of the Securities Reform Act of 1975 amendments, discussed below in chapter II, D.3, section 4(5) exempts promissory notes secured by a first lien on real estate which originate through banks or mortgagees approved by the Secretary of Housing and Urban Development. The exemption from the registration and prospectus requirements is apparently designed to enhance the development of a secondary market for mortgage securities to be sold to large, sophisticated investors.

iii. *Some General Comments about the Exemptions*

As previously stated, the fact that a security or transaction is exempt from registration and prospectus requirements does not mean that it is exempt from the anti-fraud provisions of section 17 or of the civil liability provisions in section 12 of the act. It is noteworthy that many of the exemptions are non-discretionary and are available without any approval or review by the SEC. However, it has been held that the burden of proving an exemption is on the person claiming it.[42a]

D. SOME RECENT LEGISLATIVE DEVELOPMENTS

1. *Introduction*

Securities regulation in the United States is an extremely dynamic if not at times volatile subject and recent years have produced a number of important developments to emphasize the rapidity of change in this area. A number of state and federal legislative changes or developments have occurred which are relevant because of their effect on the scope of U.S. securities legislation generally. Although there have been a number of significant state developments,[42b] two examples of federal legislative devel-

42 H. R. REP. No. 85, 73d Cong., 1st Sess. 16 (1933); *see generally* the discussion on points of interpretation that have arisen relating to solicitation and secondary distribution, 1 L. Loss at 697-706.

42a SEC v. Ralston Purina Co., 346 U.S. 119, 126 (1953); *see* 1 L. Loss at 712-13.

42b Some examples are: (a) Iowa's new securities act; *see* Hayes, *The New Iowa "Uniform" Securities Law*, 25 DRAKE L. REV. 267 (1975); Hansell & Neumann, *The Iowa Uniform Securities Act Exemptions Part I: The Securities Exemptions*, 2 J. CORP. L. 437 (1977); (b) Wisconsin's administrative rules under its Uniform Securities Act; *see* 5 Wisconsin Securities Bull. 1 (March, 1977); (c) California's Commodity Law which enacts a comprehensive regulation scheme for commodity trading and

opments have been chosen for brief comment.[43] These are the American Law Institute's proposed *Federal Securities Code* and the Securities Reform Act of 1975.

2. *The Federal Securities Code*

With the background of complexity and growth of federal securities regulation, many observers in the United States began to call for a codification of the applicable statutes and rules which the SEC administers.[43a] The American Bar Association's Committee on Federal Regulation of Securities held conferences on codification of the securities laws which led to cooperative support from the SEC and the American Law Institute and the appointment of Professor L. Loss as Reporter for the codification project. Various preliminary drafts and tentative drafts have been prepared and at the time of writing a proposed final draft is near completion.[43b]

Of special relevance to this paper are the *ALI Federal Securities Code*'s proposed definitions dealing with the scope of the code, particularly the definition of a security.[44] Because of its importance, the definition of security is reproduced below:

"Sec. 297. [Security.] (a) [General.] 'Security' means a bond, debenture, note, evidence of indebtedness, share in

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licensing; *see Review of Selected 1973 California Legislation*, 5 PACIFIC L.J. 205 (1974); (d) Missouri's securities law and recent amendments to it; *see* Logan, *Missouri's New Uniform Securities Act and Securities Regulations*, 37 U. MO. K.C.L. REV. 1 (1969); Logan, *Missouri's Evolving Securities Law and Regulations - Update*, 42 U. MO. K.C.L. REV. 341 (1974). In addition there have been numerous special statutes and amendments introduced by the state legislatures on top of the many decisions of the courts and agencies affecting the scope of securities legislation generally. Some of the recent cases are discussed in ch. IV *infra*. *See also* text accompanying notes 20, 21, *supra*.

43 Many other federal legislative changes have been enacted, however; *see e.g.* the Investment Company Amendments of 1970, Pub. L. No. 91-547, 88 Stat. 1413 (1970); the Securities Investor Protection Act of 1970, Pub. L. No. 91-598, 84 Stat. 1636 (1970); the Interstate Land Sales Full Disclosure Act, 15 U.S.C.A. ss. 1701-20 (West 1974) as well as recent amendments to the foregoing and other federal legislation.

43a Notably, Professor L. Loss; *see* Loss, *The American Law Institute's Federal Securities Code Project*, 25 BUS. LAW. 27 (1969).

43b *See*, *Special Symposium Issue: The American Law Institute's Proposed Federal Securities Code*, 30 VAND. L. REV. 311 (1977); especially Loss, *The Federal Securities Code - Its Purpose, Plan, and Progress*, *id.* at 315. Other contributions in the special issue deal with the substantive provisions of the code.

44 The ALI FEDERAL SECURITIES CODE uses "purchase", "buy", "sell" and "offer" to "buy" and "sell"; *see* ALI FEDERAL SECURITIES CODE, Reporter's Revision of Tent. Drafts Nos. 1-3, ss. 283, 293 ("Definitions"). Pt. III of the code deals with exemptions: *see* Cheek, *Exemptions under the Proposed Federal Securities Code*, 30 VAND. L. REV. 355 (1977). The exempt securities under the code are generally those under the Securities Act of 1933 and the Securities Exchange Act of 1934 with certain exceptions; *id.* at 384-94; and for a discussion of exempt transactions under the code, *see id.* at 394-404.

> a company (whether or not transferable or denominated 'stock'), preorganization certificate or subscription, certificate of interest or participation in a profit-sharing agreement, investment contract, collateral-trust certificate, equipment-trust certificate, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, an interest or instrument commonly considered to be a 'security,' or a certificate of interest or participation in, temporary or interim certificate for, receipt for, guaranty of, or warrant or right to subscribe to or purchase or sell, any of the foregoing.
>
> "(b) [Exclusions.] 'Security' does not include (1) currency, (2) a check (whether or not certified), draft, bill of exchange, or bank letter of credit, (3) a note or other evidence of indebtedness issued in a mercantile transaction, (4) an interest in a deposit account with a bank (including a certificate of deposit that ranks on a parity with such an interest) or with a savings and loan association, (5) an insurance policy issued by an insurance company, or (6) an annuity contract issued by an insurance company (except a contract whose benefits vary to reflect the investment experience of a separate account)."

It was the view of the draftsman that the definition of security should, in the words of the commentary to Tentative Draft No. 1,

> "be changed as little as possible, both because there is now a considerable body of jurisprudence and it was substantially followed in the Uniform Securities Act, so that there is now a degree of uniformity at both state and federal levels."[44a]

What is also interesting are the classes of items excluded from the definition.

3. *1975 Securities Acts Amendments: Municipal Securities*

The Securities Reform Act of 1975, or officially, the Securities Acts Amendments of 1975, reflect the most significant changes made in regulatory structure of the securities markets and industry since the Securities Exchange Act was adopted in 1934. There are several major thrusts to the amendments which are beyond the scope of this paper;[44b] however, one relevant change worth special

44a *See* ALI FEDERAL SECURITIES CODE, Tent. Draft No. 1, at 52-53; and ALI FEDERAL SECURITIES CODE, Reporter's Revision of Tent. Drafts Nos. 1-3, at 34-35.

44b *E.g.* the 1975 revisions have been aimed at making the securities industry more

comment involves the regulatory provisions relating to municipal securities. Financial problems in New York City and elsewhere in recent years have no doubt prompted a new look at the municipal securities field.

Until 1975, the municipal securities market in the United States, one of that nation's largest markets, was almost completely free from regulation under the federal securities laws. Persons offering and selling municipal securities were exempt under section 3(a)(2) of the Securities Act of 1933 from the registration requirements of that act. Under section 3(a)(12) of the Securities Exchange Act of 1934, persons issuing or otherwise trading in municipal securities were exempt from the registration, reporting and related provisions of that act. Although municipal securities were subject to the anti-fraud provisions of the securities laws, cases of this type were few and far between.

The above situation has now been changed by the Securities Reform Act of 1975.[45] A Municipal Securities Rulemaking Board has been established to regulate municipal securities dealers and brokers through the prescription of rules, subject to the oversight of the SEC. The registration and regulation provisions of the Securities Exchange Act of 1934 extend to securities firms and banks which buy and sell municipal securities for their own trading account, and brokers which act only as agent for buyers and sellers and do not buy or sell for their own account. There are other provisions on enforcement and consultation and cooperation among federal agencies relating to municipal securities. Especially noteworthy is the provision stating that the SEC and the new Rulemaking Board are prohibited from requiring an issuer of municipal securities to make any filing with the SEC or board prior to offering any securities. This continues the issuer exemption and

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competitive by ending fixed commissions and directing the SEC to develop a National Market System with the help of a newly-created National Market Advisory Board to make recommendations to Congress on a mechanism or agency to administer the National Market System. The SEC's authority is also strengthened and the broker and dealer registration requirement is extended to previously exempt specialists, floor traders and floor brokers. The authority and requirements of the exchanges and other self-regulatory bodies are more clearly defined. There are new restrictions on trading by exchange members for their own and other accounts. The "back office problems" of the securities industry have been the catalyst for new provisions to regulate clearing agencies, transfer agents and securities depositories and the SEC is directed to formulate the establishment of a national system for the prompt and accurate clearance of securities transactions. *See* Rowen, *The Securities Acts Amendments of 1975: A Legislative History,* 3 SEC. REG. L.J. 329 (1976); Rowen, *Securities Acts Amendments of 1975,* 8 REV. SEC. REG. 889 (June 27, 1975).

45 For a summary explanation and text of the 1975 amendments, *see* Securities Reform Act of 1975, CCH FED. SEC. L. REP. (extra edition June 4, 1975, No. 589).

confirms that the legislation does not contemplate direct regulation of issuers or registration of municipal securities.[45a]

Chapter III
Scope of Canadian Securities Legislation

A. BACKGROUND TO CANADIAN SECURITIES LEGISLATION

Canadian securities legislation, like much of commercial legislation in Canada, is traceable to experience in both the United Kingdom and United States. The English full-disclosure philosophy which originated with the company legislation in the mid-nineteenth century was reflected in the company legislation of Canada, and at the same time the blue sky laws of the United States were reflected in early provincial attempts at securities legislation.[46] In Canada, the United States, and United Kingdom, there is quite a large measure of self-regulation of participants in the securities marketplace, and in North America there is a considerable amount of cooperation among the securities administrators of the various jurisdictions – provincial, state and federal – in both the United States and Canada. Indeed, meetings are held among the North American securities administrators with the aim of cooperation and coordination in mind.

It is not within the scope of this paper to discuss the origin of the Canadian securities legislation and the approaches to securities regulation through such statutes as the companies acts, companies information acts, investment contracts acts and various securities acts. It is interesting that there has been a trend toward uniformity which was emphasized in 1966 with the passage in Ontario of its Securities Act, following the recommendations of the *Kimber Report*, and the subsequent adoption of the Ontario statute in the four western provinces. Today there is even greater uniformity among securities legislation in the country with semi-annual meetings among the provincial administrators and uni-

45a Some commentators have said that the regulation of offerings has been avoided only because the market participants have shown concern for the investors and the continued health of the market through strong self-regulatory efforts. *See* Doty & Petersen, *The Federal Securities Laws and Transactions in Municipal Securities*, 71 NW. U.L. REV. 283, 286-87 (1976); *see also* Note, *Federal Regulation of Municipal Securities*, 60 MINN. L. REV. 567 (1976); Note, *Disclosure by Issuers of Municipal Securities: An Analysis of Recent Proposals and a Suggested Approach*, 29 VAND. L. REV. 1017 (1976).

46 *Cf.* on historical company law developments in Ontario, Risk, *The Nineteenth Century Foundations of the Business Corporation in Ontario*, 23 U. TORONTO L.J. 270 (1973). On early securities law developments, *see* J. WILLIAMSON, ch. 1; D. JOHNSTON at 9-15.

form policy statement procedures that have been agreed to by the ten provincial agencies in Canada.[47]

B. CANADIAN LEGISLATIVE TREATMENT OF SECURITIES

1. *General*

As previously mentioned, there are in force in Canada various provincial statutes which deal with the broad question of securities regulation. What has evolved is a pattern of provincial securities acts separate and distinct from the companies acts of the provinces. As previously mentioned, Ontario's new Securities Act in 1966 set the pattern for Canadian provinces to follow. As a result, although there are differences among the provincial statutes, special emphasis will be given to the Ontario statute.[48] It should be noted that many basic provisions are found not only in the statute but also in the regulations made thereunder.

2. *Definition of Security*

a. *Introduction*

Nearly all of the provincial jurisdictions have employed an illustrative definition by using the word "includes" rather than "means".[49] Although there are important variations, generally it can be said that the definitions are quite similar and have tended to be uniform. Some brief comments about the interpretation of some of the terms will be made in this part of the paper, but a fuller discussion of interpretation is found in chapter V.

b. *Specific Ingredients of a Definition of Security in the Ontario Act*

i. *Any Document, Instrument or Writing Commonly Known as a Security*

All the provincial statutes have this wording. It is interesting to note that the United States Securities Act of 1933 uses the wording "any *interest* or instrument commonly known as a security"; the use of "interest" makes the definition broader since a security need not be a written instrument under that act.

The basic question under this heading relates to what is "common knowledge" and how it is to be determined. In one case

47 *See* D. JOHNSTON at 17-18, and app. II.

48 The basic definitions in the provincial acts are listed in four appendices; *see* first footnote to ch. I *supra*. Also included are the definitions under Ontario Bill 98.

49 The one exception is Québec which employs a colon after the defined term.

dealing with commodity futures contracts, the Quebec Securities Commission referred to trade usage and stated:

> "Proof of common knowledge must be based on an overwhelming set of facts and conclusive evidence. On that basis and notwithstanding the fact that they are viewed by the securities industry as speculative opportunities, we are unable to conclude that commodity futures contracts are commonly known as securities in the trade, at the present time."[50]

ii. *Any Document Constituting Evidence of Title to or Interest in the Capital, Assets, Property, Profits, Earnings or Royalties of Any Person or Company*

This heading of the definition is one of the widest in scope. In *Swain v. Boughner*,[51] the Ontario Securities Commission (OSC) appealed the dismissal of a charge that the defendant traded in securities without being registered as a broker or salesman. The alleged securities transaction involved the sale of half interests in a pair of chinchillas and was evidenced by several documents. Along with the sale of the interests, the seller retained the animals under what could be styled a management contract and profit-sharing arrangement. The court held that the transaction was the sale of or trade in securities connected with a sale of specific chinchillas or of an undivided interest in specific chinchillas. In *Regina v. Dalley*,[52] the appellant was convicted of trading in securities without registration. The transaction involved the sale of prospecting permits which he received from the British Columbia Department of Lands and Forests. Upon the payment of fees, the owner obtained an exclusive drilling licence and eventually a lease. Although the court did not hold that the permits were securities, it did decide that the agreement of sale was a security by stating that the document constituted evidence of title to or interest in the property of any person, namely, the appellant. The court also said that the court should not give too broad a definition to security, but where the meaning of the statute was plain, as it appeared to be in the case, the court had to give effect to it.[53]

50 *In re* John T. Geldermann & Co. Inc., 3 OSC Bull. No. 65 (July 11, 1972); *cf.* R. v. Bird and International Claim Brokers Ltd., 43 W.W.R. 241 (B.C.S.C. 1973), which held a mineral claim campaign to be a security under this heading of the definition as well as two other headings. *See* D. JOHNSTON at 27 n. 60.

51 [1948] O.W.N. 141 (H.C.).

52 [1957] O.W.N. 123, 8 D.L.R. (2d) 179 (C.A.).

53 J. Williamson criticizes the decision and provision as too broadly drawn and points out that the U.S. Securities Act of 1933 originally defined security to include "any certificate of interest in property, tangible or intangible" but this was withdrawn because of its breadth and uncertain application; J. WILLIAMSON, SUPP. at 105.

Arguably, arrangements or instruments falling within this heading of the definition would also be caught by the "investment contract" heading, discussed below.

iii. *Any Document Constituting Evidence of an Interest in an Association of Legatees or Heirs*

The wording is pretty much the same in all the provincial statutes. As J. Williamson points out, it is not clear why this provision was included in the statutes. He says that it presumably followed the introduction of the game of "lost heir" in which a promoter informed a large number of people of the existence of a sizable estate (which would be fictitious) and of their possible claim to it and then persuaded them to contribute to a litigation fund.[54]

iv. *Any Document Constituting Evidence of an Option, Subscription or Other Interest in or to a Security*

The original wording of this heading of security read: "any document constituting evidence of an interest in any option given upon a security". The 1966 Ontario Securities Act amendments changed the provision to its present wording. The effect of the change was to make this heading much closer to that of the United States Securities Act of 1933. It is interesting to note that that act also specifically mentions warrant or right to subscribe or purchase; in addition, there is no requirement of any document or writing.

v. *Any Bond, Debenture, Share, Stock, Note, Unit, Unit Certificate, Participation Certificate, Certificate of Share or Interest, Preorganization Certificate or Subscription*

All of these terms would probably be included under the heading "commonly known as a security" since they are examples of what one thinks of when the term security is mentioned. It is interesting to note that the New Brunswick Securities Act specifically includes "promissory note or other commercial paper when traded by the maker or acceptor thereof in the course of continued and successive transactions of a like character".[55]

None of these terms has an entirely precise legal meaning. The reference to unit and unit certificates likely applies to participations in a trust although this does not have to be the case. The reference to preorganization certificate or subscription appears in most of the provincial statutes. Participation certificate and certificate of share interest might have been included under the

54 *Id.* at 108.

55 *See* New Brunswick Securities Act, s. 1.

heading dealing with the evidence of title to or interest in the capital, assets, or property, etc., of any person or company. Participation certificate along with certificate of share interest is fairly broad in its scope and, if it covers an interest in property, then one might argue that it goes too far, whereas if it is limited to participating in profits or earnings, then one might argue that it is proper in scope even though it would overlap with the investment contract definition which is a separate item.[56]

vi. *Any Agreement Providing That Money Received Will Be Repaid or Treated as a Subscription to Shares, Stock, Units or Interests at the Option of the Recipient or of Any Person or Company*

This item appears in many of the jurisdictions, again with several wording variations. It has been pointed out that, although the provision possibly covers a loophole in the subscription coverage, in that a contribution may not be a subscription until the choice of the recipient makes it so, it seems likely that such an arrangement would be treated as a subscription anyway so that the provision probably serves no purpose.[57]

vii. *Any Certificate of Share or Interest in a Trust, Estate or Association*

This provision is in all the jurisdictions except Québec which has not included the "or association". The 1966 Ontario Securities Act, by adding a comma, changed the provision from "trust, estate or association" to read "in a trust, estate, or association". If "security" is defined to include an interest in a person and "person" is defined to include a trust, estate or association, this heading becomes unnecessary.

viii. *Any Profit-Sharing Agreement or Certificate*

This provision is present in all the Canadian legislation and in substantially the same form. It also appears in U.S. legislation and would appear to overlap with the interpretation given certain types of securities listed in the definition, namely, participation certificates, certificate of share or interest and, indeed, an investment contract. However, it is arguable that it is not superfluous to have the separate heading to make it absolutely clear that such an arrangement is a security.

56 *See* J. Williamson, Supp. at 109, where he argues that to ensure coverage of any interest in earnings and profits generally, it might be better to use the term "interest or participation in the profits, earnings or royalties of any proposed or existing company or person".

57 *Id.* at 113.

ix. *Any Certificate of Interest in an Oil, Natural Gas or Mining Lease, Claim or Royalty Voting Trust Certificate*

Oil and gas and related interests have been quite differently treated among the various provincial securities statutes.[58] The differences include both wording and punctuation variations. There are several other headings which deal with such interests and a comprehensive heading is much needed.[59]

x. *Any Oil or Natural Gas Royalties or Leases or Fractional or Other Interest Therein*

Several provincial jurisdictions include this item. As previously mentioned, the United States Securities Act of 1933 refers to a "fractional undivided interest in oil, gas or other mineral right".[60] It is questionable whether an oil or natural gas lease should be included as a security since one wonders why this form of lease is more of a security than any other.

xi. *Any Collateral Trust Certificate*

This term is present in all the Canadian provincial legislation except that of Québec. It has been noted that this term is probably within the "commonly known as security" heading but there may be some doubt.[61]

xii. *Any Income or Annuity Contract Not Issued by an Insurance Company or an Issuer within the Meaning of the Investment Contracts Act*

This definition excludes income or annuity contracts issued by an insurance company or an issuer within the meaning of the Ontario Investment Contracts Act on the grounds that these types of arrangements will be regulated under insurance and investment contracts legislation. Some provinces exclude only the insurance company contracts but not those issued by an issuer under the investment contract statute.[62] Under this act, issuers and salesmen must register, deposits of assets are required, and investment powers are specified.

The Ontario Investment Contracts Act[63] does not define an income or annuity contract, but the effect of the definition of

58 *Id.* at 109-11.

59 Williamson suggests: "any certificate of interest in an oil, natural gas, or mining lease, claim or royalty or trust or any interest therein", J. WILLIAMSON at 113; *but* J. WILLIAMSON, SUPP. omits the suggestion as such.

60 *See* text accompanying notes 14, 15 *supra*.

61 J. WILLIAMSON, SUPP. at 107.

62 *Id.* at 113.

63 R.S.O. 1970, c. 226.

"issuer" and "investment contract" under that act is that an income or annuity contract issued by a corporation other than an insurance company or "investment contract issuer" will come under this heading of security under the securities statute.[64]

xiii. *Any Investment Contract, Other Than an Investment Contract within the Meaning of the Investment Contracts Act*

An investment contract within the meaning of the Ontario Investment Contracts Act is an agreement to pay a fixed sum on a specified date, containing optional settlement values with cash surrender or loan privileges having instalment or single sum payments, but excluding contracts within the meaning of the Ontario Insurance Act.[65]

It is the two words "investment contract" which have given rise to a vast number of interpretations, both administrative and judicial, in Canada and the United States. The phrase has generated more comment about its meaning than any other heading in the list of definitions of securities; more about the term will be discussed below.[66]

c. *Other Definitions*

As discussed by J. Williamson, there are several other definition headings found in the various provincial laws.[67] For example, in the regulations of Newfoundland, Prince Edward Island and Nova Scotia, reference is made to agreements of sale and purchase by instalment or otherwise. As noted by Williamson, this heading is beyond any reasonable scope of the securities act. Also mentioned in regulations of New Brunswick, Newfoundland, Nova Scotia and Prince Edward Island are agreements to purchase any fur-bearing animal which is not to be appropriated to the contract or cannot be identified as so appropriated. Such agreements can amount to investment contracts or profit-sharing agreements which have already been covered.[68]

64 *See* D. JOHNSTON at 29-30. Johnston points out that the definition of "income or annuity contract" is not exhaustive for purposes of the Ontario Securities Act so that it is conceivable that an agreement could fall within a broader meaning of "income or annuity contract", in which case it could be held to be a security, notwithstanding that it was issued by an insurance company or issuer as defined by the Ontario Investment Contracts Act; *id.* at 30.

65 The Ontario Investment Contracts Act, s. 1(b). The Québec securities statute does not refer to an investment contract as a security.

66 *See* chs. IV, V *infra*.

67 J. WILLIAMSON, SUPP. at 113-15.

68 Other examples are: any contract or agreement to give advice or information concerning investments; membership in any organization, league or association, whether incorporated or not, which has for its object the rendering of a special

d. *Summary*

In short, the Canadian definitions of security contain much overlap among the definitional headings, appear to have been added to in a rather *ad hoc* manner, and are extremely broad in scope. There is no requirement of a document or writing since an oral agreement is sufficient for some headings of the definition. In some cases the instrument itself is treated as a security and in others the legal relationship is.[69] Finally, in many statutes, express regulatory power is conferred to expand the definitional headings of security.[70]

3. *Definition of Trade or Trading*

Section 1(1)24 of the Ontario Securities Act[71] defines "trade" or "trading" to include:

"(i) any sale or disposition of or other dealing in or any solicitation in respect of a security for valuable consideration, whether the terms of payment be on margin, instalment or otherwise, or any attempt to do one of the foregoing,

"(ii) any participation as a floor trader in any transaction in a security upon the floor of any stock exchange,

"(iii) any receipt by a person or company registered for trading in securities under this Act of an order to buy or sell a security, and

"(iv) any act, advertisement, conduct or negotiation directly or indirectly in furtherance of any of the foregoing."

Since the word "includes" introduces the subparagraphs, the definition of trade is not exhaustive. Also noteworthy is the requirement of valuable consideration so that a gift would not be a trade. It has been stated that the Ontario Securities Act is a "selling" act rather than a "dealing" act which is aimed to require compliance with the act by sellers as opposed to buyers of securities.[72] However, the words "or other dealing in" in subparagraph (i) and the broad wording of subparagraph (iv) could be interpreted as meaning "buying" as well.[73]

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protective service or services to motorists or other special services; any document constituting evidence of an interest in a scholarship or educational plan or trust; *id.*

69 D. JOHNSTON at 23 n. 41.

70 *E.g.* New Brunswick, Nova Scotia, Prince Edward Island and Newfoundland Securities Acts.

71 R.S.O. 1970, c. 426.

72 D. JOHNSTON at 34.

73 The definition of trade or trading in Ontario's proposed Securities Act (Bill 30),

One writer has illustrated the very broad scope of the definition of trade with the following examples:

> "a telephone call by a customer instructing his broker to sell a security, the mailing of a confirmation slip to the customer by the broker, the publication of a market letter or a newspaper advertisement concerning a security, in addition to the actual offer for sale of a security, the acceptance thereof and completion of the resulting contract, are all acts which constitute trading."[74]

Several cases have interpreted the definition of trade in some of the provincial securities statutes. The Saskatchewan statute was at issue in *Prudential Trust Co. Ltd. v. Forseth and Forseth*[75] in which the Supreme Court of Canada held no trade took place where an oil lease was granted to a company by a farmer who subsequently assigned, subject to the lease, an undivided one-half interest in all oil rights in the land to the defendant, receiving cash in return. The transaction was characterized by the court as a purchase of an interest in mineral rights and the acquisition of an option to lease mineral rights. The court stated that the securities act definition of trade contemplated solicitations for the making of sales but not for the making of purchases.[76]

In *Re Sanderson and Ontario Securities Commission*[77] the Ontario Court of Appeal construed a gambling scheme that employed newspaper advertisements to solicit deposits which were to be used in betting on horseraces in the United States. The court held that the arrangement was a security, and a trade was involved since the acts constituted "other dealing" within the definition of trading in the Ontario Securities Act.

On the other hand, the acts of a firm which provided account-

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discussed in note 138 *infra*, is clearer in this respect since it does not have the words "or other dealing in" and expressly provides that a purchase is not included. However, this wording poses interpretive difficulties when one examines other provisions of the act; *see e.g.* Ontario Bill 30, s. 132, dealing with liability for unlawful trades, which include takeovers; a takover involves a purchase of securities and hence does not fit the use of trade in s. 132.

74 Dey, *Exemptions under the Securities Act of Ontario*, in LAW SOCIETY OF UPPER CANADA, SPECIAL LECTURES: CORPORATE AND SECURITIES LAW 127, 129 (1972).

75 [1960] S.C.R. 210, 21 D.L.R. (2d) 587 (1959).

76 [1960] S.C.R. at 225 (*per* Martland, J.). For a companion case, *see* Prudential Trust Co. Ltd. v. Olson, [1960] S.C.R. 227, 21 D.L.R. (2d) 603. These cases should be contrasted with Meyers v. Freeholders Oil Co. Ltd., [1960] S.C.R. 761, 25 D.L.R. (2d) 81, which also dealt with the Saskatchewan statute. In that case the defendant company issued shares as consideration for the assignment of mineral rights and argued that the transaction was in effect an agreement to acquire mineral rights to which the issuance of shares was incidental. The court held that a trade was involved because defendant's argument could not prevail where the agreement itself contained the provision for the issuance of shares.

77 [1972] 3 O.R. 329, 28 D.L.R. (3d) 171 (C.A.); also discussed in note 371 *infra*.

ing and administrative services to mutual fund dealers did not constitute trading under the Ontario act.[78] The defendant firm received a commission for handling and arranging funds for investment, which funds came from periodic payments from mutual fund subscribers and dividends and interest from the fund. Stark, J., held that because the services were merely administrative the firm was not a dealer. In addition the trade which was the subject of registration under the act had already been completed and there was no "furtherance" of trade as a result.[79]

A fundamental question arising from the definition of trade relates to where the trade takes place. This question in turn is concerned with the territoriality or reach of the provincial securities statutes. As a general rule, a province's laws extend only as far as its borders.[80] Could the acts which constitute trading be split among two or more provinces such that each province could take jurisdiction or alternatively neither would be able to do so? In one case,[81] the Supreme Court of Canada upheld action taken by the Quebec Securities Commission against a company with its head office in Montréal that published and mailed weekly bulletins relating to shares of companies to persons who resided outside Québec. The Court in effect held that the initiation of trading activities within a province's borders gave it jurisdiction.[82]

4. *Definition of Distribution to the Public*

A person who trades in a security must register or obtain a licence under the appropriate provincial securities act unless such person can come within one of the statutory exemptions.[83] Reflecting another theme of securities regulation, namely, full, true and plain disclosure of all material facts relating to the security to be issued, a person who trades in a security where such trade would be a "distribution to the public" must comply with the prospectus provisions of the securities act[84] unless a statutory exemption can

78 Re Ontario Securities Commission and C.A.P. Ltd., [1972] 1 O.R. 205, 22 D.L.R. (3d) 529 (H.C.).

79 As noted by Johnston, the decision is sensible but the reasoning is less satisfying; *see* D. JOHNSTON at 35 n. 93.

80 *Id.* at 36, *citing* Hretchka v. Attorney-General for British Columbia, [1972] S.C.R. 119, 19 D.L.R. (3d) 1 (*per* Martland, J.).

81 Gregory and Co. Inc. v. Quebec Securities Commission, [1961] S.C.R. 584, 28 D.L.R. (2d) 721.

82 *See also* R. v. W. McKenzie Securities Ltd., 56 D.L.R. (2d) 56 (Man. C.A. 1966) where the court held that an Ontario-located broker telephoning Manitoba residents amounted to trading in Manitoba requiring registration under the Manitoba statute.

83 *See e.g.* s. 6(1)(a) of the Ontario Securities Act.

84 Section 35 of the Ontario Securities Act prohibits a distribution to the public unless

be found. Thus the definition of "distribution to the public" is of paramount importance.

Paragraph 6a of section 1(1) of the Ontario Securities Act defines "distribution to the public" as *meaning*:

"(i) trades that are made for the purpose of distributing to the public securities issued by a company and not previously distributed to the public, or

"(ii) trades in previously issued securities for the purpose of distributing such securities to the public where the securities...are derived from the holdings of any person, company or any combination of persons or companies holding a sufficient number of any of the securities of a company to materially affect the control of such company...."[85]

In short, (a) any person trading with the public in securities not previously distributed to the public, or (b) a "control person" trading with the public, must comply with the prospectus requirements set forth in the statute.[86] Although the effect of the definition can be rather easily summarized, the exact meaning of the scope of the definition is another story.

Central to the definition is the meaning of what constitutes the "public". There have been a number of cases and countless opinions expressed as to the meaning of the term which have drawn on the U.S. and U.K. experience. Not much can be gained by reviewing these authorities since they have been well canvassed elsewhere.[87] One commentator has succinctly summarized the matter by stating that Canadian law distinguishes among three classes of people:

"(1) those who are not members of the public either because

"(a) they do not have a need to know the information contained in a prospectus, or

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the prospectus provisions are complied with. Again, however, there are exemptions from the prospectus requirements which are discussed below.

85 The emphasis is supplied because the definition does not use "includes" as do the definitions of "security" and "trade" or "trading". It is interesting that the latter terms are the only defined terms in s. 1(1) which employ the non-exhaustive form "includes" rather than the exhaustive "means".

86 Section 66 of the Ontario Securities Act extends the prospectus requirements to securities of persons other than companies, which are the only entities mentioned in the definition of distribution to the public.

87 The leading and more helpful cases are Nash v. Lynde, [1929] A.C. 158 (H.L.); SEC v. Ralston Purina Co., 346 U.S. 119 (1953); R. v. Piepgrass, 23 D.L.R. (2d) 220 (Alta., C.A.1960); R. v. McKillop, [1972] 1 O.R. 164 (Prov. Ct.) and are well discussed in D. Johnston at 148-55; Dey, *supra* note 74, at 134-40.

"(b) they are close friends or business associates of an issuer,
"(2) those who are members of the public, and
"(3) those who are members of the public but have been statutorily exempted from the forced disclosure provisions."[88]

It is particularly noteworthy that Ontario's proposed new securities act has deemphasized the "public" concept by eliminating it from the definition of distribution[89] and almost entirely from other provisions of the act.[90]

Also problematic with respect to trades and resales is the meaning of "not previously distributed to the public" which appears in the first branch of the definition of "distribution to the public", and "previously issued securities" which appears in the second branch of the definition.[91]

5. *Exemptions from Registration and Prospectus Provisions*

a. *General*

Having examined the definitions of "security", "trade" and "distribution to the public" in the Ontario Securities Act as the Canadian model, one can easily conclude that such definitions give an extremely wide scope to the coverage of the act. Without specific exemptions it would be unusual to have a securities transaction which was not in some way subject to the registration or prospectus provisions or both. Thus the approach taken by the act is to assume the need for protection of the act for everyone and to stipulate situations where for some reason the act's regulatory provisions need or should not apply. Although there is considerable overlap, the exemptions can be divided into those relating to registration, and prospectus requirements, whether by specific statutory provision or exemption made by order of the OSC on application by an interested party.

As previously mentioned, section 6 of the Ontario Securities

88 D. Johnston at 154-55.

89 *See* s. 1(1)12 and s. 54 of Ontario Bill 30. The proposal to eliminate the concept was based on the recommendation of the Ontario Securities Commission Disclosure Report. The report argued that since regulation under the securities statute was all-inclusive with residual discretion in the OSC, the reference to "public" should be dropped. This would result in a prohibition of a "distribution" to anyone unless a prospectus had been accepted for filing; *see id.* ¶ 3.20.

90 One instance where the concept remains is in the exemptions from registration, s. 35(2)(12), and from prospectus filing, s. 74(1)(a), which refer to "[s]ecurities of a private company where they are not offered for sale to the public". However, this limited retention of the concept is not nearly as perplexing as the role of "public" in the present legislation.

91 *See* Dey, *supra* note 74, at 140-44.

Act requires registration of various persons who trade in securities.[92] Section 18 provides exemptions from registration as an adviser under section 6(1)(e). Section 19(1) and 19(3) provide exemptions from registration with respect to some eleven specific trades, and section 19(2) provides exemptions with respect to trades in thirteen specified securities.

The exemptions from the prospectus requirements are described in section 58. While incorporating many of the registration exemptions in section 19, section 58 is not as comprehensive as the latter.

In addition to the foregoing specific statutory exemptions, sections 20 and 59 of the Ontario Securities Act provide for discretionary power in the OSC to grant an exemption.[93] Both sections (a) give the OSC power to exempt an applicant from the registration and prospectus requirements if, in the opinion of the OSC, it would not be "prejudicial to the public interest" to do so, and (b) allow the OSC to subject the exemption to such terms and conditions as the OSC decides to impose. However, as has been noted, there are several important differences between the two sections.[94] It is interesting that Ontario's proposed Securities Act

92 The prohibition in s. 6 against trading without registration is expressed as persons trading in a security unless registered as:
(a) a dealer or salesman of a registered dealer;
(b) a partner or officer on behalf of a person or company;
(c) a salesman on behalf of a person or company;
(d) an underwriter; and
(e) an adviser.

93 For a discussion of the two Ontario sections *see* D. JOHNSTON at 236-39; Dey, *supra* note 74, at 174-81. As Johnston notes, there is wide variance in the approach taken by the provinces ranging from similarity to the Ontario sections to not having similar provisions; D. JOHNSTON at 236 n. 373.

94 *See* D. JOHNSTON at 236-39. Some of the major differences are:
(a) Section 20(2) requires notice of a s. 20 order and a summary of facts to be published as soon as possible and the order to be laid before the Legislative Assembly if in session. There is no similar requirement for s. 59 orders.
(b) A s. 20 order is subject to appeal whereas s. 59(4) states that a ruling of the commission under the section is final and without appeal.
(c) Section 20 is rarely used compared to s. 59; *see In re* J.D. Carrier Shoe Co. Ltd., [1967] OSC Bull. 32 (September); *In re* Hawkesbury Golf and Curling Ltd., [1968] OSC Bull. 161 (July).
(d) Section 20 is broader in that it applies to any trade, security, person or company named in the order whereas s. 59 relates only to a trade or intended trade. In addition, s. 59 allows a s. 6 exemption only as a supplementary order to the application for an order that the trade is not deemed to be a distribution to the public.
(e) The OSC has issued policy statements on s. 59 applications; *see* OSC Policy No. 3-18, April 5, 1971, CCH CAN. SEC. L. REP. ¶ 54-912; and OSC Policy No. 3-18A, May 9, 1974, CCH CAN. SEC. L. REP. ¶ 54-912A. Applicable to both s. 20 and s. 59 applications is OSC Policy No. 3-19, December 6, 1971, CCH CAN. SEC. L. REP. ¶ 54-913 (Applications to the Commission Re Rulings-Procedure). For a discussion on the nature and effect of the rulings made by the OSC on resales made by the applicants

contains only one discretionary exemption section which is analogous to the present section 59 in that it sets forth similar conditions and powers for the exercise of the exemption discretion.[95]

b. *Rationale of the Specific Exemptions*

Before dealing directly with specific exemptions from the registration and prospectus requirements, it might be useful to discuss the rationale for the specific exemptions found in the statute. A basic rationale for the exemptions is that in situations covered thereby there is no need to have the protection of the securities act. It would seem that this reason can exist where, for example, the parties involved in the transaction are able to fend for themselves, where the issuer or vendor is a person subject to fairly intense regulation already so that additional regulation under the securities statute is superfluous and wasteful, or where the security being traded is of an issuer of obvious integrity such that the securities act need not apply.

A second rationale for the exemptions relates to cost-benefit considerations in that the transaction costs of compliance with the securities act outweigh the benefits obtained by requiring compliance. In some situations, for example, where the security trading is insignificant in terms of frequency and economic impact, it is impractical to require compliance with the act. In addition there may be certain transactions which are of a special or extraordinary nature which, by a business efficiency or commercial expediency standard, compels freedom from compliance with the securities statute.

A third rationale for exemptions in provincial securities statutes is the avoidance of constitutional confrontations. For example, some exemptions can be explained by the unwillingness of a province to regulate a federally created and regulated entity through the province's securities act.

It is difficult to identify all the reasons for the specific exemptions.[96] Of course, one hopes that, although effective lobbying for exemptions by affected groups may take place, such lobbying *per se* is not a basic reason for granting exemptions.

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who have obtained favourable s. 59 rulings, *see* Dey, *supra* note 74, at 175-76; D. Johnston at 238.

For the Alberta and B.C. policy statements *see* D. Johnston at 237 n. 378.

95 Ontario Bill 30, s. 75.

96 *See* D. Johnston at 118; Dey, *supra* note 74, at 131-32.

c. *Specific Exemptions*

i. *Introduction*

As previously discussed, a person is not subject to the registration or prospectus requirements if the transaction involved does not come within the definition of security, trade or distribution to the public. In addition, there are specific exemptions under the Ontario Securities Act which can be classified as registration exemptions only, prospectus exemptions only, and both registration and prospectus exemptions. Within each of these groups, further subclassifications can be identified, namely, exempt trades, exempt securities, exemption by the regulations, and discretionary exemption orders (sections 20 and 59 of the Ontario Securities Act, which have already been discussed). Finally, the statute contains specific provisions on the denial of registration exemptions. What follows is a brief discussion of the exemptions under the classifications just mentioned.[97]

ii. *Exemptions from Registration Requirements*

Section 18 of the Ontario Securities Act deals with exemptions from registration as an adviser under section 6(1)(e). The persons exempted are: (a) banks, trust and loan companies and insurance companies,[98] (b) specified professionals (lawyer, accountant, engineer, teacher) "whose performance of...services is solely incidental to the practice of...[their] profession", (c) a person or company registered for trading under the act "...whose performance of...services is solely incidental to the conduct of his or its business as such", (d) disinterested publishers giving advice through their publication as solely incidental to their business and not receiving any consideration for giving the advice, and (e) other persons designated by regulations.[99] The above exemptions contain many interpretive questions and consequently must be approached with much caution.[100]

Section 19 of the Ontario Securities Act lists both trades and

97 For a fuller treatment *see* Dey, *supra* note 74, at 144-81; D. Johnston at 117-34, 189-239.

98 It has been stated that the exemption of the federally chartered banks and the Federal Business Development Bank "...is in part to avoid sensitive constitutional issues": D. Johnston at 119.

99 No regulations have been passed under this provision. It is interesting that s. 33(e) of Ontario Bill 30 adds a "management company" to the list of exemptions under this heading. In addition, s. 34 provides for the exemption from registration as a mutual fund (required by s. 24(1)(d)) of an investment club meeting prescribed tests of size and operation, a trust company, and an insurance company.

100 For some interesting comments on the interpretation of the s. 18 exemptions, *see* D. Johnston at 119-22.

securities which are exempt from registration. Those which are exempt only from the registration requirements will be discussed here with the others being discussed under the heading dealing with exemptions from both registration and prospectus requirements. The section 19 registration exemptions deal only with the following exempt trades: judicial trades, isolated trades, special institutional trades, specified employee trades, agent trades, and finally trades exempted by regulations.

Section 19(1)1 of the Ontario act exempts trades at a judicial sale involving any one of a number of officials including an executor, administrator, guardian, committee, authorized trustee or assignee, receiver or custodian under the Bankruptcy Act (Canada), receiver under the Judicature Act or liquidator under the Ontario Corporations Act, the Ontario Business Corporations Act or Winding-Up Act (Canada). The exemption reflects the special nature of the transaction and the fact that with the judicial supervision of the party trading, registration under the act is not necessary.

The isolated trades exemption in section 19(1)2 is clouded by several questions of interpretation. The exemption is described as "an isolated trade in a specific security by or on behalf of the owner, for the owner's account...not made in the course of continued and successive transactions of a like nature, and [not] by a person or company whose usual business is trading in securities". Several questions arise: what is isolated and what time frame is applicable to measure it?[101] What is meant by a *specific* security? What is meant by "by or on behalf of the owner, for the owner's account"? And finally, what is the meaning of "not made in the course of continued and successive transactions of a like nature"?[102] The rationale of the exemption clearly relates to allowing the "amateur" holders of securities to dispose of their securities without having to register under the securities act since to require such registration would act as a real disincentive to the acquisition of securities as investments.

Section 19(1)3 allows an exemption where a party to the trade is an institution that is already subject to fairly comprehensive government regulation, or where the purchaser is a person, other

101 *See* R. v. McKillop, [1972] 1 O.R. 164 (Prov. Ct.) where the court held that some ten trades over a 20-month period were not isolated. The court emphasized the plurality of transactions stating that isolated meant a single transaction; *id.* at 167. *See also* R. v. Malcolm and Olson, 42 D.L.R. 90 (Alta. C.A. 1918); Canadian Bank of Commerce v. Johnson, [1926] 4 D.L.R. 1179 (Alta. C.A.).

102 For a discussion on the question, *see* D. JOHNSTON at 112-16.

than an individual, recognized by the OSC as an "exempt purchaser".[103]

Section 19(1)4 exempts a trade made by a pledgee, mortgagee or other encumbrancer for the purpose of liquidating a *bona fide* debt by selling a security pledged or encumbered in good faith as security for the debt. Again from a business expediency standpoint, the exemption makes sense since there will generally be only one transaction and requiring registration will increase the transaction costs of the pledge unnecessarily.

Section 19(1)5 provides that registration is not required with respect to "a trade in a security that may occasionally be transacted by employees of a [registrant] where the employees do not usually sell securities to the public and have been designated by the Director as 'non-trading' employees, either individually or as a class". It is difficult to see the underlying reason for this exemption.[104]

Section 19(1)7 provides an exemption for trades by persons acting solely through an agent who is a registrant. As has been pointed out, this exemption is important since it is relied on by investors trading through, *inter alia*, the Toronto Stock Exchange.[105]

Finally, section 19(1)11 provides for exemption from registration by regulations, but no such regulations have been passed in Ontario to date.[106]

iii. *Exemptions from Prospectus Requirements*

The exemptions from prospectus requirements, which are found in section 58 of the Ontario Securities Act, can be classified into three groups: (1) those which repeat and adopt the registration exemptions in section 19, (2) those which adopt but modify the registration exemptions in section 19, and (3) those which are found only in section 58. The prospectus exemptions in groups (2) and (3) will be discussed under this heading and those in group (1) will be dealt with in the next section.

There are two registration exemptions which are altered in section 58, both of which are important. First, section 58(1)(a) modifies the institutional and exempt purchaser trade in paragraph 3 of section 19(1) to require that the purchaser or proposed

103 *See* s. 7 of the Ontario Securities Regulations which prescribes the form for the application and other conditions.

104 According to Dey, *supra* note 74, at 170, the exemption has been provided as a matter of convenience to registrants.

105 *Id.*

106 As noted by Johnston, several other provinces use the regulations power to grant exemptions whereas Ontario uses the act; *see* D. JOHNSTON at 128 n. 174.

purchaser contemplated by the exemption must be purchasing "...as principal for investment only and not with a view to resale or distribution".[106a] The requirements of purchasing as principal and investment intent introduce two elements to the prospectus exemption not found in the registration exemption in section 19(1)3.[107] A major problem of interpretation relates to the requirement of investment intent.[108] The second alteration in section 58 is that the so-called private placement exempt trade in section 19(3) is amended by section 58(1)(b) to require that the purchaser or proposed purchaser is also acquiring as principal.[109]

The prospectus exemptions found only in section 58 deal with trades between registrants, statements of material facts, trades by control persons, and exemptions by regulation. Section 58(1)(d) provides that section 35 does not apply to a trade in the course of a distribution to the public where the trade is made from one person or company registered for trading in securities to another person or company registered for trading in securities, where the purchaser is acting as principal. One can assume that the theory for this exemption from prospectus qualification is that registrants are probably able to fend for themselves and thus do not need the protection that a prospectus would afford them under the Ontario Securities Act.[110]

Section 58(2)(b) of the Ontario act provides that section 35 does not apply to a distribution to the public of securities that are listed and posted for trading on any stock exchange recognized by the OSC where such securities are distributed to the public through the facilities of such stock exchange pursuant to the rules thereof and the requirements of the commission, if a statement of material facts, which complies with the regulations as to form and content, is filed with and is acceptable to the stock exchange and

106a However, a trust company investing for accounts fully managed by it, such as pension funds, is deemed to be acting as principal for purposes of Ontario Securities Act ss. 58(1)(a), (b), (d); *see* s. 58(1)(a).

107 The modifications are traceable to the concerns expressed in the ONTARIO SECURITIES COMMISSION DISCLOSURE REPORT relating to purchasers buying securities through institutions exempt from registration and prospectus requirements; *see id.* at ¶ 5.15.

108 In addition, the regulations to the act require a report to be filed in connection with such investment intent. For a discussion of investment intent and the reporting requirements under the act as well as the Toronto Stock Exchange, *see* Dey, *supra* note 74, at 147-51.

109 Both ss. 19(1)3 and 19(3) expressly exclude an individual from the exemptions. Since s. 19(3) on private placements already provides for an investment intent requirement, there is really not much difference in substance between the 19(1)3 and 19(3) exemptions. The major difference is that the latter exemption requires a minimum acquisition cost to the purchaser of not less than $97,000.

110 Dey, *supra* note 74, at 171; D. JOHNSTON at 201.

commission.[111] The statement of material facts, which has been usually associated with mining company issuers, is similar to a prospectus, and by section 58(3) it is deemed to be a prospectus for purposes of the sections providing remedies to purchasers of securities for false or misleading statements: sections 64, 65 and 142 of the act.[112]

Section 58(2)(c) provides that section 35 does not apply to a distribution to the public of securities that are listed and posted for trading on any stock exchange recognized by the commission where such securities are distributed to the public within the meaning of section 1(1)6a.ii[113] through the facilities of such stock exchange by way of isolated trades not made in the course of continued and successive transactions of a like nature. It is important to note that the exemption is available only to a "control person" under the second branch of the definition of distribution to the public as previously discussed.[114] One of the difficulties of this prospectus exemption is the meaning of the words "isolated trades not made in the course of continued and successive transactions of a like nature". This wording was discussed above[115] since it appears in section 19(1)2; but trade is singular in that provision whereas it is pluralized in section 58(2)(c), which may further cloud the issue.[116]

Section 58(2)(d) states that section 35 does not apply to a distribution to the public of securities that are exempted by the regulations. One regulation enacted under this section deals with puts and calls and is subject to several conditions.[117]

111 In OSC Policy No. 3-17, April 5, 1971, CCH CAN. SEC. L. REP. ¶ 54-911, the OSC recognizes the Toronto Stock Exchange but it has recognized the Alberta Stock Exchange for purposes of the statement of material facts exemption, and will apparently recognize others for specific purposes; *see* D. JOHNSTON at 229-30, 393.

112 Sections 51 to 63 of the Ontario Securities Regulations provide for the content of the statement. *See also* form 23 of the regulations and OSC Policy No. 3-05, April 5, 1971, CCH CAN. SEC. L. REP. ¶ 54-899. The Toronto Stock Exchange also has a detailed policy on the statement of material facts; *see* Dey, *supra* note 74, at 172.

113 The reference in the statute is erroneously stated to be ¶ 13 of s. 1(1).

114 It is interesting to note that, for making isolated trades, it is preferable to be a control person rather than an ordinary shareholder holding shares "not previously distributed to the public" since the latter, unlike the former, does not have a similar prospectus exemption for isolated trades.

115 *See* text accompanying notes 101, 102 *supra*.

116 Dey, *supra* note 74, at 173, suggests that the exemption would be available for prearranged trades which are "crossed" on the stock exchange but would not be available to the control person who requested his broker to "dribble" his shares out over a period of time without restriction.

117 *See* Ontario Securities Regulations, s. 86. This exemption regulation is a consequence of the decision of the OSC to permit members of the Toronto Stock Exchange to trade in options of the Chicago Board Options Exchange; D. JOHNSTON at 230 n. 357. Section 87 exempts trades in securities issued on the conversion of a security previously issued to the public by a reporting issuer.

iv. *Exemptions from Both Registration and Prospectus Requirements*

The exemptions from registration and prospectus requirements[118] are based primarily on the qualities of the persons trading or the nature of the securities involved. A brief description of these exemptions is given followed by a discussion of circumstances relating to denial of exemptions.

aa. Exempt Trades

Sections 19(1)6 and 58(1)(c) exempt from both registration and prospectus requirements a trade between a person or company and underwriter acting as purchaser, and trades between or among underwriters. Under the definition in section 1(1)25, an underwriter can act either as principal or agent. As the former the underwriter purchases securities with a view to distribution to the public; as agent the underwriter offers or sells securities in connection with a distribution to the public. An important question of interpretation relates to the scope of the exemption from registration, that is, whether section 19(1)6 exempts from all registration requirements or only from registration as a dealer under section 6(1)(a). Under the latter interpretation registration as an underwriter is required to be entitled to the exemption in section 19(1)6.[119]

A number of registration-prospectus exemptions relate to trades by a company with its shareholders. Sections 19(1)8 and 58(1)(c) exempt trades by a company:

(i) in its own securities by way of stock dividend;
(ii) of securities pursuant to a *bona fide* reorganization[120] or winding up or distribution of its assets for the purpose of winding up its affairs;
(iii) of its securities pursuant to a "rights offering".[121]

With respect to the stock dividend and reorganization exemptions, section 19(1)8 stipulates that no commission or other remuneration may be paid except for ministerial or professional services.

Paragraphs 9, 9a, and 9b of section 19(1) exempt certain kinds

118 *See generally* Meech, *Prospectus and Registration Requirements*, in LAW SOCIETY OF UPPER CANADA, SPECIAL LECTURES: DEVELOPMENTS IN COMPANY LAW 211 (1968).

119 *See* Dey, *supra* note 74, at 152.

120 On the meaning of reorganization in this context *see* R. v. Santiago Mines Ltd., [1947] 1 D.L.R. 642 (B.C.C.A.). Some guidance on the meaning of *bona fide* can be gleaned from *In re* Panacea Mining & Exploration Ltd., [1971] OSC Bull. 156 (October).

121 With respect to the many interpretive questions involved in the three exemptions and the various policy statements relating thereto, *see* Dey, *supra* note 74, at 153-57; D. JOHNSTON at 203-11.

of transactions that could be styled as "business combinations". The rationale for the exemptions from registration and prospectus requirements relates to the fact that the "purchasers" will already be receiving considerable information relating to the transaction pursuant to the corporation law requirements or other provisions of the Ontario Securities Act, *e.g.*, the takeover bid provisions; or, because a small number of shareholders is involved, the protection afforded by the act need not be invoked. One can surmise that in such circumstances the small group of persons could get the material information through discussions leading to the particular transaction. Specifically the exemptions provided under this topic are:

(i) trades in securities exchanged in connection with:
  (a) a statutory amalgamation or arrangement;
  (b) any other "merger or consolidation";[122]
  (c) a takeover bid under Part IX of the act;
(ii) trades in connection with offers to purchase
  (a) shares by private agreement with less than fifteen shareholders; or
  (b) all of the shares in a private company;
(iii) trades in a security by a company as consideration for a portion of or all of the assets of a person, other than an individual, or company who agrees to hold the securities for investment only and not with a view to resale or distribution, if the fair value of the assets so purchased is not less than $100,000.[123]

Based on a recommendation in the *Ontario Securities Commission Disclosure Report*,[124] sections 19(1)9c and 58(1)(c) exempt trades by companies to their promoters[125] from the registration-prospectus requirements. Again it can be argued that the exemption is sound because promoters are likely to have access to, or the

122 "Merger" and "consolidation" are U.S. terminology and the specific exemption in Ontario Securities Act s. 19(1)9b describes what takes place in a merger or consolidation under the corporation statutes of many states.

123 The assets acquisition is found in Ontario Securities Act s. 19(1)9b and is similar to the private placement exemption found in s. 19(3). It is not exactly clear why an investment intent is required or, put another way, why ¶ 9b should be analogized to the private placement exemption at all.

124 ONTARIO SECURITIES COMMISSION DISCLOSURE REPORT ¶ 8.08. Without such an exemption, a sale of shares by a company to its promoters arguably offended both the registration and prospectus requirements unless a private company was involved since its securities are exempt.

125 "Promoter" is defined in Ontario Securities Act, s. 1(1)15. Like several exemptions the promoters' exemption relates to companies; *see also* the trades to employees exemption under s. 19(1)10. Arguably the exemption should be extended to "issuers" generally.

ability to obtain, considerable knowledge about the company to obviate the need for securities act protection.

However, not as easily rationalized are the registration-prospectus exemptions relating to trades with employees. Sections 19(1)10 and 58(1)(c) provide such exemptions, covering trades by a company of securities of its own issue with its employees or those of an affiliate who are not "induced to trade by expectation of employment or continued employment".[126] It may be that some employees are able to fend for themselves and thereby not need the protection of the securities statute, but it is difficult to accept the breadth of the present employee exemption in comparison with the objectives of the statute generally.[127]

bb. Exempt Securities

Section 19(2) of the Ontario Securities Act lists some thirteen types of securities which are exempt from the registration requirements and section 58(2)(a) exempts such securities from the prospectus requirements. One writer has explained and characterized the securities exempted by the following descriptions: "extremely stable; regulated under other legislation; where the buyers thereof are able to fend for themselves; where expediency for business or social reasons require exemption; or where it is impracticable for the securities to be regulated."[128]

Specifically the exempt securities relate to:

(i) various government and bank debt securities;

(ii) certificates or receipts of a trust company registered under The Loan and Trust Corporations Act issued for moneys received for guaranteed investment;

(iii) negotiable promissory notes or commercial paper maturing not more than one year from the date of issue if each such note or paper traded to an individual is not less than $50,000;

(iv) mortgages or other encumbrances, other than those contained in or secured by a bond or similar obligation in a trust deed or other instrument, if such mortgages or encumbrances are not offered for sale to the public except by a person registered under The Ontario Real Estate and Business Brokers Act;

(v) securities of indebtedness due under any conditional sales

126 *See* D. Johnston at 203.

127 The narrower view of employees not needing securities act protection is illustrated by SEC v. Ralston Purina Co., 346 U.S. 119 (1953), in which the Supreme Court held that some senior employees fell outside the definition of public because of their access to a greater amount of information; *see also* Ontario Securities Commission Disclosure Report ¶ 8.07; Lumley v. Broadway Coffee Co. Ltd., [1925] 2 D.L.R. 417 (Ont. C.A.).

128 D. Johnston at 223.

contract or other title retention contract for the acquisition of personal property if such securities are not offered for sale to the public;

(vi) securities issued by a person or company which

(1) is organized exclusively for educational, benevolent, fraternal, charitable, religious or recreational purposes and not for profit, where no part of the net earnings enure to the benefit of any securityholder,

(2) is a corporation operated on a cooperative basis as defined by Part V of The Ontario Corporations Act;

(vii) shares of a credit union within the meaning of The Credit Unions Act;

(viii) securities of a private company[129] issued by the private company if the securities are not offered for sale to the public;

(ix) securities sold by a prospector for the purpose of financing a prospecting expedition;

(x) securities issued by a prospecting syndicate which has complied with the filing and other requirements relating to such syndicates;[130] and

(xi) securities issued by a mining or mining exploration company as consideration for mining claims where the vendor enters into such escrow or pooling agreement as the Director considers necessary.[131]

Under section 58(2)(a), it is provided that section 35 does not apply to the distribution to the public of securities exempted by section 19(2) which are described above. A number of the above exemptions are based on the condition that the securities specified are not offered for sale to the public.[132] Thus the combined effect of section 58(2)(a) and these exempt securities is tautological: section 35 does not apply to an offer of securities to the public if securities are not offered to the public.[133]

v. *Denial of Registration Exemptions*

Subsections (5), (6), and (7) of section 19 deal with the power of the commission to order the denial of the registration exemp-

129 Defined in Ontario Securities Act, s. 1(1)14.

130 *See* s. 34 of the Ontario Securities Act calling for, *inter alia*, the filing of the prospecting syndicate agreement. Paragraph 11 of s. 19(2) exempts the securities of a prospecting syndicate where the securities are sold by the prospector who staked the claim and the prospector has delivered a copy of the prospecting syndicate agreement to the purchaser before accepting payment of the securities. Paragraph 12 of s. 19(2) requires that such securities must not be offered for sale to the public and not sold to more than 50 persons or companies.

131 In addition ¶ 13 of s. 19(2) specifies securities exempted by regulation.

132 Paragraphs 4 (mortgages), 5 (conditional sales), 9 (securities of a private company), and 12 (prospecting syndicates).

133 *See* Dey, *supra* note 74, at 165.

tions in subsections (1), (2), and (3) of section 19. Such an order may be made by the commission where in its opinion such action is in the public interest. The order will be directed at a named person or company. Subsection (6) provides that the order will not be made without a hearing unless in the opinion of the commission the length of time required for a hearing might be prejudicial to the public interest, in which event a temporary order will be made which expires fifteen days from the date of making the order. Subsection (7) provides that, if a temporary order is made, notice must be given of the order forthwith together with notice of the hearing required by section 5 of the act to every person or company that in the opinion of the commission is primarily affected thereby. It is interesting to note that the commission has used its power under section 19(5) where it appears that exemptions in the act are being used to contravene the spirit of the statute.[134]

C. SOME RECENT DEVELOPMENTS IN CANADIAN SECURITIES LEGISLATION

1. *Introduction*

Since the enactment of Ontario's Securities Act in 1966 following the recommendations of the *Kimber Report*, there have been a number of reports and legislative developments bearing directly or indirectly on the scope of the securities statutes. Most notable are the 1971 securities act amendments which are traceable to the report by a committee of the Ontario Securities Commission on matters involving the disclosure of information[135] and the *Canadian Mutual Fund Report* of 1969. Shortly after, Ontario introduced a basic overhaul of the Securities Act in its Bill 154, "The Securities Act, 1972",[136] which apparently was presented

134 *Id.* at 180-81. Dey discusses the decisions of the OSC; *see e.g. In re* Pyrotex Mining & Exploration Co. Ltd., [1968] OSC Bull. 115 (June) (promoters spending more money on stock promotion than mining development); *In re* Charter Oil Co. Ltd., [1968] OSC Bull. 243 (November) (company selling shares through TSE without a prospectus or statement of material facts); *In re* New Hosco Mines Ltd., [1968] OSC Bull. 259 (November) (failing to comply with TSE requests for disclosure of information); *In re* J.T. Blume, [1960] OSC Bull. 90 (May) (failure to comply with takeover bid provisions); *In re* Midgaul Investments Ltd., [1970] OSC Bull. 91 (June) (control group selling shares at a price much greater than contemplated by prospectus). For an example of applying s. 19(5) to corporate insiders who arguably contravened the insider trading liability sections of the Ontario Securities Act, *see In re* Harold P. Connor, [1976] OSC Bull. 149 (June).

135 ONTARIO SECURITIES COMMISSION DISCLOSURE REPORT. For a review of the REPORT *see* Grover, Book Review, 23 AD. L. REV. 309 (1971).

136 *See* Ontario Bill 154.

after discussion with the other provinces.[137] Successor bills have been introduced[138] and at the time of writing a new statute has not been enacted. Also introduced are proposals to regulate franchises and commodity futures based, respectively, on the 1971 report of the committee on franchises appointed by the Minister of Financial and Consumer Affairs, and the 1975 *Report of the Interministerial Committee on Commodity Futures Trading*.[139]

Because of their relation to this study, the proposals relating to a revised securities act, franchises and commodity futures will be briefly discussed.

2. *Ontario's New Securities Act*

Bill 30, the Securities Act, 1977,[140] introduces fundamental changes to Ontario's securities legislation based primarily on the reports mentioned above.[141] Several of the innovations materially affect the scope of the legislation and the exemptions under the current statute.

a. *Definitions*

i. *Security*

Bill 30 has made several additions to the definition of a security under the heading "bond, debenture, note", etc. The words "or other evidence of indebtedness" have been added as have the words:

> "or any agreement under which the interest of the purchaser is valued for purposes of conversion or surrender by reference to the value of a proportionate interest in a specified portfolio of assets."[142]

The first change has been added to cover all debt obligations and the second to cover variable annuity contracts.[143]

Also added are documents constituting evidence of an agreement to grant an exclusive right to use real property for residen-

137 D. JOHNSTON at 17.

138 Ontario Bill 154 was followed by Bill 75, Bill 98, Bill 20 and Bill 30.

139 Also important have been the proposals of the ONTARIO SECURITIES COMMISSION DISCLOSURE REPORT and REPORT OF THE SELECT COMMITTEE ON COMPANY LAW OF THE ONTARIO LEGISLATURE ON MERGERS, AMALGAMATIONS AND CERTAIN RELATED MATTERS (1973) [hereinafter cited as SELECT COMMITTEE MERGER REPORT].

140 For a full discussion of a predecessor bill, *see* Dey, *Securities Reform in Ontario: The Securities Act, 1975*, 1 CAN. BUS. L.J. 20 (1975).

141 Principally the ONTARIO SECURITIES COMMISSION DISCLOSURE REPORT; the CANADIAN MUTUAL FUND REPORT; and the SELECT COMMITTEE MERGER REPORT, *supra* note 139.

142 Ontario Bill 30, s. 1(1)38.v.

143 *See* D. JOHNSTON at 29.

tial, recreational or vacation purposes on a time-sharing basis.[144] The definition of security in Bill 30 also specifically includes commodity futures options[145] and commodity futures contracts.[146]

ii. *Trade or Trading*

There are some important changes to the definition of trade or trading in Ontario Bill 30. The first heading of the definition of trade mentions that a sale or disposition of a security for valuable consideration is a trade, and goes on to provide expressly that trade or trading *does not include a purchase of a security.*[147] The present act refers to any sale or disposition or *other dealing or solicitation* in respect of a security, which, as mentioned above,[148] is arguably broad enough to include the purchase of a security. However, by the new language in Bill 30, a purchase is clearly excluded so that trades relate to sales only.

A specific item that is listed in Bill 30 as a trade or trading is any transfer, pledge, or encumbrancing of securities of an issuer from the holdings of any person or company, or combination of persons or companies, who are control persons for the purpose of giving collateral for *bona fide* debt. This definition makes it absolutely clear that a transfer or pledge or encumbrance by a control person of its shares is a trade, and, barring an exemption, the registration and disclosure requirements would have to be complied with.[149]

In the present act, the definition of trade includes an attempt to make a sale or dispose of a security or to deal or to make a solicitation in respect of a security. The "attempt" wording is taken out of Bill 30, but left in is the present language which provides that any act, advertisement, conduct, or negotiation directly or indirectly in furtherance of any of the foregoing illustrations of trade is also a trade. One addition is made to this list, providing that any "solicitation" in connection with any of the

144 Ontario Bill 30, s. 1(1)38.xv. Arguably this specific heading would be interpreted as coming within other headings of the definition of security, *e.g.* investment contract.

145 Commodity futures options within the meaning of the Commodity Futures Act, 1977, Bill 32, 31st Leg. Ont., 1st Sess., 1977 (1st reading) are included except those options traded on commodity futures exchanges registered or recognized by the commission under said act; Ontario Bill 30, s. 38(1)38.xvi. This will be discussed further in note 164 *infra.*

146 An exception is made for a commodity futures contract within the meaning of the Commodity Futures Act, 1977, in Ontario Bill 30, s. 38(1)38.xvii.

147 Ontario Bill 30, s. 1(1)40.i.

148 *See* the discussion in note 71 *supra.*

149 Ontario Bill 30, s. 1(1)40.iv; *see* the discussion on "Distribution" in ch. III.C.2.a.iii *infra.*

foregoing is also a trade.[150] This again confirms that the solicitation has to be in connection with the sale or disposition of a security rather than in connection with the purchase of a security.

iii. *Distribution*

The definition of distribution reflects probably the most significant change in the definitions of Bill 30 and the approach taken by the bill generally. Under the present act, distribution is used in connection with distributions to the public. The public concept is dropped from distribution and that term is now defined to mean:

(a) a trade in securities of an issuer that have not been previously issued,
(b) a trade by or on behalf of an issuer in previously issued securities of that issuer which have been redeemed or purchased by or donated to that issuer,
(c) a trade in previously issued securities of an issuer from the holdings of any person, company, or combination of persons or companies, holding a sufficient number of any securities of that issuer to affect materially the control of that issuer, but any holding of any person, company, or combination of persons holding more than 20% of the outstanding voting securities of an issuer shall, in the absence of evidence to the contrary, be deemed to affect materially the control of that issuer,
(d) a trade in securities previously issued through specified prospectus exemptions, and
(e) the first trade in previously issued securities of a company that has ceased to be a private company.

The present Ontario Securities Act treats sales of securities by control persons as distributions to the public, which require prospectus compliance. Bill 30 continues this treatment, but section 73(7) of the bill provides an exemption from the prospectus requirements (a) if the distribution involves specified exempt trades, (b) if the issuer is a reporting issuer which complies with prescribed requirements, and (c) no unusual effort to prepare the market or to create a demand for the securities is made or no extraordinary commission is paid. The prescribed requirements relating to the reporting issuer are that it must have been a reporting issuer, as that term is defined,[151] for at least eighteen

150 Ontario Bill 30, s. 1(1)40.v.

151 The definition of reporting issuer is wide enough to include companies which have distributed securities through a prospectus or takeover bid circular under the Ontario Securities Act or any predecessor thereof, or whose securities were listed for trading on a recognized stock exchange, or which are corporations offering securities to the public under the Ontario Business Corporations Act, or companies

months, and must not be in default with respect to any requirements under the act or regulations. In addition, the control person must file with the commission, and, if securities are listed, with the stock exchange, within a specified period prior to the proposed sale, information which includes a notice of intention to sell, and details about the control position and numbers of securities proposed to be sold and in what manner, as well as a declaration certifying that the control person or persons have no knowledge of any material change which has occurred in the affairs of the issuer which has not been generally disclosed, and no knowledge of any other material adverse information concerning the issuer. In addition, within three days after the completion of the sale the control person must file a report in prescribed form. The notice and declaration must be renewed sixty days after the original date of filing of the notice and declaration and every twenty-eight days thereafter, so long as any of the securities specified in the original notice have not been sold or until notice has been filed that the securities will not be sold. As has been noted, this complicated exemption allows the control person to dispose of all or a portion of his control bloc without having to qualify a prospectus or to obtain a section 59 order under the present act.[152]

With respect to secondary issues or trades in previously issued securities contemplated by the fourth paragraph of the definition of distribution (paragraph (d) above), Ontario Bill 30 takes a different approach from the treatment under the present act. Under the Ontario Securities Act, a trade in a security, even though issued, is a distribution to the public if the issued security is not previously distributed to the public and the trade in the security is made for the purpose of distributing to the public such security. Under the bill, the trade in an issued security can only be a distribution when the trade is the first trade in the security immediately after a trade pursuant to a section 73 exemption, which first trade is not made in compliance with the requirements for first trades in securities after being traded through a section 73 exemption.[153]

b. *Exemptions*

The exemptions from registration are set forth in part XI (sections 33–36) of Ontario Bill 30. Section 33 deals with exemp-

continuing after an amalgamation or merger of companies where one of the companies included was a reporting issuer for at least twelve months; Ontario Bill 30, s. 1(1)36.

152 Dey, *supra* note 140, at 34.

153 This conclusion is reached by the combined effect of ss. 73(4), (5), (6), (7).

tions from registration as an adviser and is basically similar to section 18 of the present act. Section 34 deals with those exemptions which are occasioned by the regulation of mutual funds. Section 35 of Bill 30 deals with the general registration exemptions and corresponds with section 19 of the present act, although it contains numerous improvements over the wording of the present act. For example, the isolated trade exemption in Bill 30 is stated to apply not only to an owner of a security, but also to the issuer, if the trade is for the issuer's account.[154] The agency trade exemption is extended to orders placed with a bank to which the Bank Act applies or a trust company registered under the Ontario Loan and Trust Corporations Act if the purchase is made through an agent who is a registered dealer.[155] A new exemption arising from commodity futures regulation is found in section 35(1)18 which exempts a trade in a commodity futures option or contract where such trade is a *bona fide* hedging transaction within the meaning of the Commodity Futures Act, 1977, as is discussed below.

A most important exemption is in paragraph 17 of section 35(1) which deals with an exempt trade between an issuer and not more than twenty-five purchasers or between such purchasers, if each of the specified requirements is met. These are:

(1) each purchaser purchases as principal;

(2) each purchaser

(a) is an investor who, by virtue of his net worth and investment experience, or by virtue of consultation with or advice from a registered adviser, is able to evaluate the prospective investment on the basis of information respecting the investment presented to him by the issuer, or has access to substantially the same information concerning the issuer which the filing of a prospectus under this Act would provide; or

(b) is a senior officer or director of the issuer or his spouse, parent, brother, sister, or child;

(3) the offer and sale of the securities are not accompanied by an advertisement and no selling or promotional expenses have been paid or incurred in connection therewith, except for professional services or for services performed by a registered dealer;

(4) solicitations in respect of the securities have not been made to more than 50 prospective purchasers; and

154 Ontario Bill 30, s. 35(1)2.

155 Ontario Bill 30, s. 35(1)10. Improvements are also made in the issuers' trades exemptions in ¶ 11 of s. 35(1) and the business combination exemptions in ¶¶ 12 to 15 of s. 35(1).

(5) there are not more than 25 beneficial owners of securities as a result of trades pursuant to this exemption.

This is the limited offering exemption and the various requirements, including the arbitrary twenty-five limit, replace the concept of "public" in the present act. In effect paragraph 17 defines what will be considered as not trading with the public for exemption purposes.

Section 35(2) deals with exempt securities and there are some changes from the present act. In paragraph 2 of subsection (2), contracts of insurance issued by an insurance company licensed under the Ontario Insurance Act, other than variable contracts that do not guarantee to return on the termination of the policy an amount equal to at least three-quarters of the payment paid to the date of termination, are exempt securities. Also exempted are securities issued by a trust company registered under the Loan and Trust Corporations Act in respect of an account maintained by the company solely to service a retirement savings plan registered under the Canada Income Tax Act, or a common trust fund as defined by the Ontario Loan and Trust Corporations Act, or a pooled account for facilitating investment.[156] Again, this exemption recognizes the special types of securities with respect to corporations already regulated by the Ontario Loan and Trust Corporations Act. Securities issued by an investment club are another example of exempt securities, if the club's shares or units are not held by more than fifty persons, it does not pay or give any remuneration under a management contractor in respect of a trade of securities except normal brokerage fees, and all of its members are required to make contributions in proportion to the shares or units each holds for the purpose of investment.

Some of the securities exemptions under the present Ontario act which are conditional on their not being offered for sale to the public are changed in section 35 to eliminate the public concept. For example, securities evidencing indebtedness under a conditional sales contract are exempt as long as they are not offered for sale to an *individual*.[157] However, securities of a private company are exempt provided they are not offered for sale to the public.[158]

The prospectus exemptions are in part XVI of Ontario Bill 30 (sections 73–75) and have become extremely complicated because Bill 30 treats every issue as a distribution and thereby subject to prospectus requirements and then proceeds to specify exempt trades in section 73, exempt securities in section 74, and then a

156 Ontario Bill 30, s. 35(1)4.
157 Ontario Bill 30, s. 35(1)8.
158 Ontario Bill 30, s. 35(1)12. This is one of the few instances where the word "public" appears in Bill 30.

familiar provision, reminiscent of present sections 20 and 59, section 75 under which an application can be made to the commission for exemption from the registration and prospectus requirements.

As previously mentioned, the only situation under Bill 30 where a trade in an issued security can be a distribution is where the trade is the first trade in a security immediately following a trade pursuant to a section 73 exemption, which first trade is not made in compliance with the requirements for a first trade in securities after being traded pursuant to a section 73 exemption. These requirements are specified in subsections (4), (5), and (6) of section 73 and generally require that the issuer is a reporting issuer not in default of any requirement of the act or regulations, the securities have been held for specified periods and no unusual effort is made to make a market and no extraordinary consideration is paid for the trade.[159] This is part of the continuous disclosure approach of Bill 30 which makes it possible to avoid the concept of the public and to reduce the number of situations in which application to the commission for a specific exemption is necessary as is the case under section 59 of the present act.

Section 73 continues many of the trades in the present Ontario Securities Act which are exempt from the prospectus requirements, albeit with certain modifications.[160] The most important change in the prospectus exemptions is that provided by section 73(1)m dealing with the limited offering exemption, which corresponds with the limited offering registration exemption found in section 35(1)17 discussed above.[161]

Section 74 exempts certain securities from the prospectus requirements. First to be exempted are those securities specifically made exempt from registration by section 35(2) with the exceptions of securities issued by a mining company as consideration for mining claims, and securities in respect of which the regulations provide registration is not required.[162] Securities also exempted from the prospectus requirements are those for which a statement of material facts is accepted for filing by a recognized stock exchange and the commission. The third exemption relates to options to sell or purchase securities known as puts and calls or any combination thereof which provide that the holder may sell to or

159 Subsection (6) of s. 73 provides that the first trade in securities purchased under the underwriter exemption in s. 73(1)(o) is a distribution.

160 It is interesting that the isolated trade exemption where it relates to a trade by or on behalf of an issuer for its account is now found in the prospectus exemptions; Ontario Bill 30, s. 73(1)(b).

161 For a discussion of those conditions, *see* Dey, *supra* note 140, at 24-25.

162 Ontario Bill 30, s. 74(1)(a).

purchase from the writer of the option the specified amount of securities at a specific price and subject to other conditions, provided that (i) the option has been written by a member of an exchange recognized by the commission for this purpose or the performance under the option is guaranteed by a member of an exchange recognized by the commission for this purpose, (ii) the securities that are subject to the option are listed and posted for trading on an exchange recognized by the commission for this purpose, and (iii) the option is in the form from time to time prescribed by the regulations. This exemption relates to the fact that the commission has permitted options of the Chicago Board Options Exchange to be traded by members of the Toronto Stock Exchange.[163]

3. *Commodity Futures*

a. *Report of the Interministerial Committee on Commodity Futures Trading*[164]

i. *Background to the Report*

Trading in commodity futures contracts and variations thereof has been largely unregulated in Canada. As will be seen in the next section of this paper, there have been certain types of agreements involving a commodity which have been held to be securities by securities administrators and the courts, but there has been a reluctance to interpret "trading" and "security" within the Securities Act to embrace commodity contracts.[165] Recently the Ontario Minister of Consumer and Commercial Relations, acting on a recommendation of the Ontario Securities Commission, proposed an interministerial study of commodity contracts and, accordingly, a committee was set up with representatives from the following departments: Attorney-General; Agriculture and Food; Treasury, Economics and Intergovernmental Affairs; Natural Resources; and Consumer and Commercial Relations. The purpose of the study was to establish the appropriate regulatory mechanisms to control and regulate trading in commodity futures in Ontario in order to protect the customers of commodity futures brokers and to determine the desirability of encouraging estab-

163 In fact the regulation was passed pursuant to s. 58(2)(d) of the Ontario Securities Act; *see* Ontario Securities Regulations, s. 86. *See also* forms 30, 31 relating thereto.

164 REPORT OF THE INTERMINISTERIAL COMMITTEE ON COMMODITY FUTURES TRADING (1975) [hereinafter cited as COMMODITIES REPORT].

165 *Id.* at 1. As the COMMODITIES REPORT mentions, although there are similarities between securities and commodity futures contracts, there are substantial differences and the regulatory tools and techniques for investors in securities are not fully appropriate for commodity contracts; *id.*

lishment of an exchange for trading in commodity futures contracts in Ontario.

The scope of the study was extremely wide, covering all commodities in which futures were to be traded, such as agricultural products, minerals, petroleum and its by-products, forest products, and metals, and any other personal property whose futures can be traded. The study also was to focus on the question of licensing brokers and their salesmen dealing in commodity futures contracts. The feasibility of establishing an Ontario exchange was also to be investigated, and the nature and extent of possible federal participation in such an exchange.[166] Regulatory practices in other jurisdictions, such as New York, California, Wisconsin and the U.S. federal level, were to be reviewed, as well as the questions of a proper agency for administration and supervision and of continuing to allow registered security dealers to trade in futures.

ii. *The Major Recommendations*

The recommendations of the *Commodities Report* are of considerable importance to the question of security regulation. The report dealt with three specific topics in its conclusions and recommendations: commodity futures contracts, the marketplace, and the participants.

The study recommended that the participants be licensed and felt this was extremely important in order to protect the small speculator in the commodity futures market. The committee reviewed regulatory schemes in other jurisdictions, and its recommendations were based on the elements they thought were most appropriate for Ontario. With respect to the marketplace, the study anticipated that proposed legislation would have a regulatory framework within which an exchange could be established and supervised in Ontario. The commodity exchange under the legislation would have to comply with general government policies on self-regulatory bodies, for example, similar to the Toronto Stock Exchange.[167]

The study acknowledged that the distinction between those types of contracts which are more appropriately regulated as securities and those which should be the subject of commodities legislation is not easy to draw. The recommendation of the report is that, where the contract is a commodity futures contract or a

166 Relevant to federal involvement is the Grain Futures Act of 1939, R.S.C. 1970, c. G-17, which regulates futures trading in certain grains on the Winnipeg Commodity Exchange through the Canadian Grain Commission; *see* COMMODITIES REPORT, *supra* note 164, at 69–77.

167 *Id.* at 79–80.

commodity futures option traded on an established exchange and carrying the collateral guarantee of a clearinghouse, it clearly falls within the scope of the proposed commodities legislation as being the type of contract for which the regulatory tools and techniques designed for the protection of investors in securities are not wholly suitable. On the other hand, contracts that were felt to be of the nature of investment contracts, where the investor is directly at risk with the grantor or writer of a contract, should be governed under the Ontario Securities Act.

> "These are: a) commodity futures options not guaranteed by the clearinghouse of an established exchange and those commodity futures options not 'accepted' for trading under the proposed new legislation; b) coin-dealers' margin account contracts and their like; c) options on physical commodities offered to other than producers, dealers, or users of the particular commodity."[168]

The study went on to say that these issuers would have to file a prospectus under the Ontario Securities Act and comply with all the other requirements of the act. In addition, the definition of security in the Ontario Securities Act would have to be amended specifically to encompass all of the commodity-related contracts suggested above.

The *Commodities Report* also said that the definition exemptions in the proposed commodities legislation and in the Ontario Securities Act should be framed to exclude for greater certainty and clarity *bona fide* hedging transactions through commodity futures contracts, commodity futures options and commodity options, all spot commodity transactions and forward contracts entered into by *bona fide* hedgers.[169]

In addition, trading in certain options would be prohibited on the ground that they are without any utility and have been demonstrated to be probable vehicles for fraud. Examples of these are options to buy commodities (calls), unless their performance is guaranteed by a recognized "commodity exchange or clearinghouse or the option grantor has a demonstrated present and continuing ability to meet the obligation to deliver the physical commodities called for under the contract". Similarly, options to sell commodities (puts) would be prohibited unless their performances were guaranteed or they were written by a viable option grantor. In short, the study concluded that, except for *bona fide* hedging transactions, only those commodity futures contracts, (a) traded on a commodity exchange, recognized by the regulatory

168 *Id.* at 81.
169 *Id.* at 82.

authority responsible for administration of the proposed new legislation, and (b) accepted by that regulatory authority, would be permitted to be traded in Ontario. Also, recognition of a commodity exchange would mean that the commodity futures contracts traded on its floor carried the collateral guarantee of a clearinghouse.[170]

In other words, it is a condition precedent that the commodity futures contract underlying the option must first be "accepted". If acceptance is not obtained, trading in the commodity futures options, except for *bona fide* hedging transactions, would not be permitted in Ontario, except as a security under the Securities Act. The definition of security in the Securities Act should be amended to reflect this position.[171] This would mean that commodity futures options could not be publicly traded without a prospectus filed under that act.

The committee also recommended, instead of setting up a new bureaucracy, that the Ontario Securities Commission should be responsible for supervising the regulatory scheme and administering the new legislation.[172] However, it did recommend that a commissioner be added who would have experience in the commodity and related fields.[173] Moreover, at the administrative level, an individual would be designated Deputy Director, Commodity Futures Regulation.[174] It would be expected that this person would give guidance and direction to the registration and surveillance program and have overall responsibility for the initial registration program.[175] It is also interesting to note that the commission would have available for consultation a body which was to be known as the Commodity Futures Advisory Board with a role similar to that of the Financial Disclosure Advisory Board that the commission has available as its adviser on financial disclosure matters under the Ontario Securities Act.[176] The Commodity Board would consist of five members with varying experience in the field and would be appointed by the Lieutenant Governor in Council to advise the Ontario Securities Commission on matters

170 *Id.* at 83.

171 *See* Ontario Bill 30, ss. 1(1)38.xvi, xvii; *but* ss. 35(1)18 and 73(1)(p) exempt from the registration and prospectus requirements commodity futures options or commodity futures contracts which are *bona fide* hedging transactions within the meaning of the Commodity Futures Act, 1977, which is discussed *infra*.

172 COMMODITIES REPORT, *supra* note 164, at 85.

173 *Id.* at 85-86.

174 *Id.* at 86.

175 *Id.*

176 *Id.* at 87.

of policy and planning as well as on specific questions referred to it by the commission.[177]

b. *Bill 32, The Commodity Futures Act, 1977*

Bill 32, The Commodity Futures Act, 1977,[178] reflects the major recommendations of the *Commodities Report.* As such, Bill 32 stipulates that the OSC[179] is charged with regulating trading in commodity futures contracts and commodity futures options except *bona fide* hedging transactions as defined.[180] Persons acting as dealers or advisers in commodity futures contracts or options must be registered.[181] Exemptions from registration are provided for *bona fide* hedging transactions, trades in commodity futures contracts or options by persons acting solely through agents who are registered dealers, and trades in commodity futures options for which a preliminary prospectus and prospectus have been filed and receipts therefore obtained under the Securities Act.[182] The last exemption confirms that commodity futures contracts or options other than *bona fide* hedging transactions will be regulated either under the Commodity Futures Act or the Securities Act.

Regulatory requirements relating to commodity futures exchanges and recognition of such exchanges by the commission are also provided.[183] Trading rules covering such matters as customers' statements, margin requirements, confirmation of trades, and various trade practices are specified with wide enforcement and regulation-making powers given to the commission and Lieutenant Governor in Council, respectively.

4. *Franchises*

As will be discussed in the next section, franchise arrangements have been held to be securities under the securities statutes. Based on U.S. legislation, notably the California statute, Alberta

177 *Id.* at 87-88.
178 Bill 32, 31st Leg. Ont., 1st Sess., 1977 (1st reading).
179 Section 2 of Bill 32, *id.*, sets up the Commodity Futures Advisory Board to consult with and advise the commission on commodities futures matters. Section 3 of Bill 32 empowers the commission to appoint experts to assist it.
180 *Id.* s. 1.2 defines the term to cover those purchases or sales of commodities contracts for the *bona fide* purpose of offsetting price risks incidental to commodity dealings which are necessary to the hedger's business activities. Such hedging transactions are not regulated either under the Ontario Commodity Futures Act or the Ontario Securities Act.
181 *Id.* ss. 22-30.
182 *Id.* s. 32.
183 *Id.* ss. 33-40.

passed its Franchises Act in 1971.[184] The Ontario Minister of Financial and Commercial Affairs appointed a committee to study franchises and the committee submitted its report in 1971 recommending legislation similar to that of Alberta.[185]

Although the Alberta statute has a very wide definition of franchise,[186] it does not require franchisors to register; but it requires qualifying a prospectus before concluding a franchise agreement. Under proposed Ontario legislation, we are told that the statute will require registration which may be withheld at the discretion of the OSC if the "franchisor is not honest and of good repute and integrity".[187] Commenting on the blue sky theme, one writer anticipates that the approval of the prospectus will be based on the "fair, just and equitable" standard and that there will have to exist a reasonably equal bargaining relationship between the franchisor and franchisee.[188]

Chapter IV
Interpretations of "Security" under U.S. Legislation

A. INTRODUCTION

Probably no term in securities legislation has received more interpretation and comment than "security". Securities promoters, administrators, practitioners and the courts have combined their efforts to produce a surprisingly large body of cases and commentary on the meaning of security under U.S. federal and state legislation. Indeed the decisions are so numerous that a separate treatise could be written about them.[189]

This section of the paper will touch on some of the federal and state decisions under headings which have been chosen primarily for purposes of discussion: first, some major U.S. Supreme Court and state court decisions, and next, the special transactions or arrangements that have given rise to judicial and administrative

184 Alberta Franchises Act, S.A. 1971, c. 38.

185 Ontario Dept. of Financial and Commercial Affairs, REPORT OF THE MINISTER'S COMMITTEE ON REFERRAL SALES, MULTI-LEVEL SALES AND FRANCHISES (1970) [hereinafter cited as the GRANGE REPORT].

186 *See* Alberta Franchises Act, S.A. 1971, c. 38, s. 1(1)6, which excludes arrangements between manufacturers or where the franchisor is the Crown, a Crown agency or a municipal corporation.

187 *See* D. JOHNSTON at 33.

188 *Id.* Johnston also states that unacceptable advertising literature of the franchisor or a lack of appropriate provisions for arbitration of disputes will be grounds to refuse a prospectus; *id.*

189 A useful collection of the vast number of decisions is found in BLUE SKY NEWS, October-December 1977, where some 50 pages of the issue are devoted to listing decisions interpreting security under U.S. federal or state law.

interpretation. These have been classified under various categories – again, for purposes of discussion only.

At the outset it should be mentioned that much of the litigation has centred around the meaning of the investment contract branch of the definition of security which, as previously stated,[190] has been a separate ingredient of the definition for some time. In fact, the investment contract phrase has permitted the courts and administrators to keep up with the fertility of invention of promoters of schemes and arrangements designed to avoid the impact of securities legislation.

B. U.S. SUPREME COURT DECISIONS

The first decision of the U.S. Supreme Court interpreting investment contract was *SEC v. C.M. Joiner Leasing Corp.*[191] In this case, the defendants offered to sell oil leases and represented that they would drill a test well which would indicate the productivity of the acreage to be sold to the lessee. The defendants argued that this was merely the offer of leasehold rights.

Justice Jackson stated:

> "It is clear that an economic interest in this well-drilling undertaking was what brought into being the instruments that the defendants were selling and gave to the instruments most of the value and all of their lure. Trading in these documents had all the evils inherent in the security transactions which it was the aim of the Securities Act to end."[192]

In reversing the lower court, he preferred to adopt a case-by-case analysis rejecting any attempt to define investment contract by a specific verbal formula:

> "The test rather is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect. In the enforcement of an Act such as this, it is not inappropriate that promoters' offerings be judged as being what they were represented to be."[193]

One of the most important and oft-cited cases decided by the Supreme Court on the definition of investment contract is that of *SEC v. W.J. Howey Co.*[194] The arrangements in question involved the sale of citrus acreage accompanied by an option to purchase

190 *See* text accompanying note 9 *supra*.
191 320 U.S. 344 (1943).
192 *Id.* at 348.
193 *Id.* at 352-53.
194 328 U.S. 293 (1946).

service contracts that would require an affiliated corporation of the vendor to cultivate and market the fruit. It was impractical for the purchasers to participate in developing their own land because they would not, among other things, have the necessary sophistication. Justice Murphy, unlike Justice Jackson in *Joiner*, was very willing to enunciate a general test of investment contract which he said he discerned from the state decisions on the question.[194a] In so doing, he noted that the U.S. Congress in enacting the federal legislation was influenced by the state securities laws. The test enunciated by Justice Murphy was:

> "An investment contract for the purposes of a securities act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed by the enterprise."[195]

Although the decision has been criticized insofar as it purported to rely on prior cases erroneously,[196] the case is referred to in nearly all the subsequent decisions, particularly the test advanced by Justice Murphy. In fact the test, which the Court stated was a flexible rather than static one, adaptable to meet countless new schemes to attract money, has itself come under microscopic analysis. The emphasis is now on defining "investment contract" as opposed to "security".

In *SEC v. The Variable Annuity Life Insurance Company of America*[197] the U.S. Supreme Court, by a five-to-four majority, held that the insurance exemptions in section 3(a)(8) of the Securities Act of 1933, which exempts conventional life insurance annuity contracts, were not applicable to a variable annuity with the result that these contracts had to be registered under the Securities Act of 1933. The Court acknowledged that variable annuity contracts have many features similar to those of customary insurance, for example, that the payments on both are made periodically and continue until the annuitant's death or some other fixed time,[198] but the Court felt that variable contracts are distinguishable because they guarantee no fixed monthly or yearly amount.

Justice Douglas emphasized the importance of the allocation

194a Notably State v. Gopher Tire & Rubber Co., 177 N.W. 937 (Minn. 1920).

195 328 U.S. at 298-99.

196 *See e.g.* Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135, 177 (1971).

197 359 U.S. 65 (1959).

198 *Id.* at 70.

of risk, which he thought was the factor on which the issue turned. In his view the holder of a variable annuity got only a *pro rata* share of what the portfolio of the equity interest reflected. Thus, all of the investment risk was placed on the annuitant, and not on the company, whereas in insurance there is some investment risk-taking on the part of the insurer.[199] Justice Brennan, in concurring, stated that the situation changes where

> "the coin of the company's obligation is not money but is rather the present condition of its investment portfolio. ... Prescribed limitations on investment and examination of solvency of reserves become perfectly circular to the extent that there is no obligation to pay except in terms measured by one's portfolio.... Where the nature of the obligation assumed is such, the federally protected interests in disclosure to the investor of the nature of the corporation to whom he is asked to entrust his money and the purposes for which it is to be used become obvious and real. The contract between the investor and the organization no longer squares with the sort of contract in regard to which Congress in 1933 thought its 'disclosure' statute was unnecessary."[200]

The risk analysis of Justice Douglas and the policy comments of Justice Brennan were developed further in *SEC v. United Benefit Life Insurance Company*.[201] Again, the question was whether or not annuities, which were called "flexible fund annuities", were exempt under section 3(a)(8) of the 1933 act. The contracts were similar to the variable annuities in the prior Supreme Court decision, in that the purchaser's premiums were invested in the defendant's managed funds. However, whereas in the prior case there was no fixed return, in *United Benefit* the defendants guaranteed a minimum cash value which ranged from 50% of net premiums in the first year to 100% after ten years. Thus the issue was how much risk must the insurer assume to qualify for the exemption contained in section 3(a)(8) of the 1933 act. The Court stated that there was still, despite the defendant's guarantee, a substantial part of the investment risk remaining with the policyholder and not the insurer. Thus the *Variable Annuity* and *United Benefit Life* cases emphasized the risk to the investor. Even though the two cases are limited to determining the breadth of the insurance exemption, it has been suggested that the risk allocation emphasis is sensible since it means that where there is a scheme

199 *Id.* at 71.
200 *Id.* at 78.
201 387 U.S. 202 (1967).

designed to shift substantially all of the investment risk to the purchaser, public policy weighs heavily in favour of disclosure of these material facts.[201a]

In *Tcherepnin v. Knight,*[202] the U.S. Supreme Court held that the withdrawal of capital shares in an Illinois savings and loan association fell within the definition of an investment contract (and other definitional branches of security) under the Securities Exchange Act of 1934. The Court based its decision on policy considerations:

> "[W]e are guided by the familiar canon of statutory construction that remedial legislation should be construed broadly to effectuate its purposes. The Securities Exchange Act quite clearly falls into the category of remedial legislation. One of its central purposes is to protect investors through the requirement of full disclosure by issuers of securities.... In searching for the meaning and scope of the word 'security' in the Act, form should be disregarded for substance and the emphasis should be on economic reality."[203]

The decision has been succinctly summarized as follows:

> "The Court appears to be saying unanimously: (1) do not ignore the other definitional pegs in analyzing securities transactions; (2) the legislative history of the 1933 and 1934 Acts may be read together to afford broad coverage in the definition of the term security; and (3) with an eye toward federal policy, look to substantive economic realities to determine as a matter of federal law whether these realities constitute a security."[204]

In its most recent decision on security, *United Housing Foundation v. Forman,*[205] the United States Supreme Court applied the substance-over-form principle from *Tcherepnin v. Knight* and reasserted the *Howey* test to exclude a financing device from the requirements of the federal securities statutes. In the case, purchasers of certain stock were granted options to lease apartments in a subsidized nonprofit housing cooperative in New York City. Each purchaser was obligated to buy eighteen shares of "stock"

201a Hannan & Thomas, *supra* note 11, at 228.

202 389 U.S. 332 (1967). The decision is also noteworthy in that the Supreme Court discussed other definitional headings of "security", namely, "certificates of interest or participation in any profit sharing agreement", "stock", "transferable shares" and "instruments commonly known as 'security' " under the Securities Exchange Act of 1934; *id.* at 339–40. In addition, the omission of the term "evidence of indebtedness" from the 1934 act was not thought to be significant by the Court.

203 389 U.S. at 336.

204 Hannan & Thomas, *supra* note 11, at 229.

205 421 U.S. 837 (1975).

for each apartment room at a cost of $25 per share or a total cost per room of $450. An information bulletin issued prior to construction of the cooperative predicted that the average monthly rental cost would be about $23 a room; however, because of increased costs in construction the average monthly rental charge rose to about $40 a room. Some tenants filed a class action under federal and state securities provisions seeking in excess of $30 million in damages, forced rental reductions and other appropriate relief alleging misrepresentation through the information bulletin. Thus the action turned on whether a security was involved.

The U.S. Court of Appeals for the Second Circuit reversed the trial court and held that the shares in the cooperative were "investment contracts" and that the use of the word "stock" required that a literal approach be used to include the arrangement as a security.[206] The U.S. Supreme Court, in looking at the economic realities of the situation, reversed this holding, stating that close examination of the disputed transaction disclosed none of the characteristics traditionally associated with stocks (such as dividends, voting, alienation rights) despite their being called that. Moreover, the shares in the cooperative were not investment contracts because the inducement to purchase was solely to acquire subsidized low-cost living space and not to invest for profit.[207]

The Court noted that profit for the investment contract definition means either capital appreciation of the initial investment or a participation in earnings resulting from the use of the investor's funds. The profit expectation in terms of capital appreciation was absent, since the purchasers of the apartments were required to offer them back to the defendant at the purchase price. Also, with respect to participation in earnings, the Court of Appeals had ascertained three separate grounds for profit expectation: (1) the deductibility for tax purposes of the shareholder's payments made for real estate taxes and interest; (2) the offering of an apartment at a cost below the rental charge for comparable housing as a profit to the stockholders, and (3) the possibility of income resulting from commercial facilities established for the convenience of apartment residents. The Supreme Court, however, disagreed with the Court of Appeals on its conclusions in this respect.

The Supreme Court said that the deductibility of interest is simply a tax benefit available to any homeowner, and to equate a deduction which merely results in a reduction in taxable income with an expectation of profit is pure sophistry. The Court also said

206 500 F.2d 1246 (2d Cir. 1974).
207 421 U.S. at 851.

that the offering of an apartment at a cost below the rental charge for comparable housing was merely a state-supported financial subsidy. Because its welfare benefits cannot be liquidated into cash, the real estate had no connection with the expectation or production of profits or reliance on the managerial efforts of others. Finally, on the possibility of income from commercial enterprises in the project, there was no evidence to indicate that the return from these enterprises exceeded the expenses incurred in providing the rental space. The possibility of income from this source was rejected as "too speculative and insubstantial". In fact, the Court said that the true rationale of the commercial enterprise involvement was not to produce profit for the tenants but to provide essential services to the residents, thereby making the complex a more attractive housing facility. In short, the Court concluded that there was no hope of receiving profits from the efforts of others because what was involved was the purchase of living quarters for personal use.[208]

What is to some attractive about the Court's reasoning is that it illustrates substance over form to *exclude* securities jurisdiction. What is attractive about the result is keeping federal securities legislation out of local subsidized residential accommodation plans. On the other hand, both reasoning and result have been criticized as leading to undesirable consequences.[209]

C. SOME MAJOR STATE COURT DECISIONS: HEREIN THE RISK CAPITAL AND RELATED TESTS

In looking at decisions of state courts, it should be kept in mind that, although many of the state statutes have definitions of security similar to those in the federal securities statutes, the objectives and approach of the state securities acts are fundamentally different. As previously mentioned, the state legislatures adopted the blue sky philosophy which resulted in a merit standard involving fairness and equity being applied to the issuing of securities. On the other hand, the federal objectives were aimed at

208 The Court also held there was no distinction between an investment contract and "an instrument commonly known as a security"; *id.* at 852.

209 *See* the discussion of the case in Comment, *What Is a Security?*, [1974] Wash. U.L.Q. 815, 852–54. As mentioned therein, the U.S. Supreme Court was too conservative in its concept of profit and should have focused on the valuable benefit received. Moreover, on a policy level, the article states that the scheme in *Forman* is capable of abuse such that the anti-fraud measures of the securities acts are an appropriate remedy. For a recent decision subsequent to *Forman, see* Grenader v. Spitz, 537 F.2d 612 (2d Cir. 1976), *cert. denied,* 97 S. Ct. 541 (1976). *See also* Guard, *Shares in Privately Financed Cooperative Apartment Corporations and the Federal Securities Laws after Grenader v. Spitz*, 30 RUTGERS L. REV. 433 (1977).

full disclosure of information and prevention of fraudulent practices in security trading without regulating the appropriateness of the security for public sale. This difference in objectives and approach can account for a correspondingly different interpretation of the term "security" for the purposes of the state or federal statute involved.[210]

One of the early state decisions interpreting the term "investment contract" was *State v. Gopher Tire & Rubber Co.*[211] In that case, the defendant sold certificates to investors who paid $50 for them and agreed to help "by word of mouth and in other ways" in the sale of tires and tubes manufactured by the defendant in exchange for a percentage of the price of goods sold by the defendant's representative in a designated area for some twenty years. With no precedent to refer to, the court turned to the dictionary meaning of the words concerned to hold that the arrangement was a security. The court defined investment as:

> "The placing of capital or laying out of money in a way intended to secure income or profit from its employment is an 'investment' as that word is commonly used and understood."[212]

The court in very expansive language also stated:

> "If the defendant issued and sold its certificates to purchasers who paid their money justly expecting to receive an income or profit from the investment, it would seem that the statute should apply."[213]

This broad view of investment could include any contract with investment overtones and could bring within the securities statutes, for example, contracts to purchase real estate or commodities.[214] Nonetheless the broad range of the definition has been adopted by state legislatures and other decisions of state courts.[215]

The most celebrated departure from the federal test enunciated by the U.S. Supreme Court in *Howey* is the decision of the Supreme Court of California in *Silver Hills Country Club v. Sobieski.*[216] In *Silver Hills*, the promoters contracted to buy a ranch for $75,000, putting only $400 down as a deposit, with the rest of the purchase price to come from the sale of memberships in a

210 Long, *supra* note 5, at 102-03.
211 177 N.W. 937 (Minn. 1920).
212 *Id.* at 938.
213 *Id.*
214 *See* Long, *supra* note 5, at 103-04.
215 It is interesting that, in a recent Minnesota case, the court reaffirmed its decision in State v. Gopher Tire & Rubber Co. and rejected the Howey definition of investment contract; *see* State v. Investor Sec. Corp., 209 N.W. 2d 405 (Minn. 1973).
216 55 Cal. 2d 811, 361 P.2d 906 (1961). The definition of security in the CALIFORNIA CORPORATIONS SECURITIES CODE is similar to that found in the Securities Act of 1933.

country club to be constructed on the ranch. A membership was to include rights revocable only for misbehavior or failure to pay the dues. The California Commissioner of Corporations, John Sobieski, in realizing that the risk of loss was to rest almost exclusively on the public, issued a desist and refrain order pursuant to the provision of the California Corporations Securities Code which empowers the commission to make such an order when the sale of securities would be "unfair, unjust or inequitable". The plaintiffs sought judicial review arguing that the memberships were not securities because they conveyed no rights in the assets or income of the club, and because they were purchased not as an investment but for the personal enjoyment of the purchasers. In other words, although the purchasers were passively relying on the efforts of the promoters, there was no expectation of profit but merely the right to use the club facilities.

The court held that the memberships were securities, even though the members were not to participate in the club's profits, and said nothing like the ordinary sale of a right to use existing facilities was involved. The promoters solicited "the risk capital with which to develop a business for profit".[217] As has been pointed out, although there is some language in the opinion which suggests that the blue sky policy of "fair, just, and equitable" regulation was a factor in the court's decision, its reasoning was based primarily on the functional similarity of the solicitation of capital for new ventures, whether through an offering of stock or membership in a club.[218]

Justice Traynor found that the membership fell within the literal definition of a "beneficial interest and title to property", but also concluded that the scheme fell within the regulatory purpose of the statute. He stated:

> "[The objective of the corporate securities code] is to afford those who risk their capital at least a fair chance of realizing their objectives in legitimate ventures whether or not they expect a return on their capital in one form or another."[219]

The novel aspects of the statement are the expectation of the non-material benefit and the concept of risk capital. The emphasis on the regulatory purpose of the blue sky law allowed the court to feel more comfortable in relaxing the traditional requirement that investment contracts contain an element of monetary return.

217 55 Cal. 2d at 815.

218 Comment, *supra* note 209, at 822. For a helpful article on club memberships and securities, *see* Regan, *Securities Regulations: When Is a Club Membership a Security?*, 10 Loy. L.A.L. Rev. 356 (1977).

219 55 Cal. 2d at 815.

In this respect, the court pointed to the language of the California statute which includes non-interest-bearing notes or other evidence of indebtedness of nonprofit corporations within the definition of a security:

> "[The Code] extends even to transactions where capital is placed without expectation of any material benefits. Thus, from its exemption of securities of certain non-profit companies, the [Code] specifically excepts 'notes, bonds, debentures, or other evidence of indebtedness, whether interest-bearing or not'."[220]

What is especially noteworthy about *Silver Hills* is that even in the absence of a profit motive, the promoter who seeks to finance his operation by the public solicitation of risk capital will be involved in security transactions. The presence of a profit motive on the part of the investors, of course, is a strong indication of a security as enunciated in fact in the *Howey* test. On the other hand, as the California court held, a promotional scheme should not escape the coverage of the securities statute merely because there was no profit motive on the part of the investor. The country club in *Silver Hills* was to be a profit-making venture for the promoters with the venture to be financed by using money obtained from the public, just as was done with respect to the citrus groves in *Howey* and the oil leases in *Joiner*.[221]

The approach of the *Silver Hills* decision has been called the "risk capital" test after the words used by Justice Traynor. The decision has been heralded as the first major attempt to avoid the mechanical use of the *Howey* test and to use an analysis emphasizing the economic and policy realities behind the transaction.[222] Other commentators have said that the *Howey* and *Silver Hills* decisions are reconcilable and indeed are complementary because they focus on different factors: the former emphasizing profit from investment, the latter emphasizing risk to the investor.[223] A major difficulty with *Silver Hills* is that the court did not sufficiently explain what risk capital means and thus introduced another subjective term in an attempt to provide an alternative to the definition of investment contract enunciated in *Howey*. It is interesting that in its most recent decision on security, *United Housing Foundation v. Forman*,[224] the U.S. Supreme Court did not accept the risk capital analysis for federal securities law. Without

220 *Id.*
221 Hannan & Thomas, *supra* note 11, at 233.
222 Comment, *supra* note 209, at 822-23.
223 Hannan & Thomas, *supra* note 11, at 248-49.
224 421 U.S. 837 (1975).

clearly rejecting the theory the Court dodged the issue in the following way:

"Respondents urge us to abandon the element of profits in the definition of securities and to adopt the 'risk capital' approach articulated by the California Supreme Court....Even if we were inclined to adopt such a 'risk capital' approach we would not apply it in the present case. Purchasers of apartments in Co-op City take no risk in any significant sense."[225]

Although the federal courts have been reluctant to adopt the *Silver Hills* reasoning,[226] the decision has proved to be a catalyst for commentators who have offered analyses and tests to be used in defining a security.[227] Professor Coffey has analyzed the economic realities of a security by ascertaining the characteristics or features of a transaction which necessitate its being subject to the specialized anti-fraud protection afforded by the securities laws. His resulting definition of a security is as follows:

"A 'security' is:

"(1) A transaction in which

"(2) a person ('buyer') furnishes value ('initial value') to another ('seller'); and

"(3) a portion of initial value is subjected to the risks of an enterprise, it being sufficient if –

"(a) part of initial value is furnished for a proprietary interest in, or debt-holder claim against, the enterprise, or

"(b) any property received by the buyer is committed to use by the enterprise, even though the buyer retains specific ownership of such property, or

"(c) part of initial value is furnished for property whose present value is determined by taking into account the anticipated but unrealized success of the enterprise, even though the buyer has no legal relationship with the enterprise; and

"(4) at the time of the transaction, the buyer is not familiar with the operations of the enterprise or does not receive the right to participate in the management of the enterprise; and

225 421 U.S. at 857 n. 24 (citations omitted).

226 As to be expected, the reasoning of Silver Hills has been adopted in other California decisions; *see* Hamilton Jewelers v. Dept. of Corps., 112 Cal. Rptr. 387 (3d Dist. Ct. App. 1974); People v. Walberg, 69 Cal. Rptr. 457 (2d Dist. Ct. App. 1968).

227 *See e.g.* Coffey, *The Economic Realities of a Security: Is There a More Meaningful Formula?*, 18 Western Res. L. Rev. 367 (1967); Hannan & Thomas, *supra* note 11; Long, *supra* note 5.

"(5) the furnishing of initial value is induced by the seller's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above initial value, will accrue to the buyer as a result of the operation of the enterprise."[228]

Coffey's definition is designed to meet what he regards as major deficiencies in the *Howey* test: the attenuation or the ignoring of the risk of loss of the original value furnished by the purchaser, the ambiguity of "common enterprise" in the *Howey* test, and its undue emphasis on the inducement of future "profits" (which is itself ambiguous) coupled with a de-emphasis of the risk of immediate loss of initial investment.[229]

The first three paragraphs of the Coffey test basically follow the *Silver Hills* risk capital approach, with amendments to reflect arrangements that have been invented by various promoters recently. Under the fourth paragraph, however, Coffey adds a new dimension by stipulating that the buyer not be familiar with the operations of the enterprise or not receive the right to participate in the management of the enterprise, since if he does either of these things he should not be entitled to the protection afforded by registering the security or by having the anti-fraud remedies under the securities act. In other words, investor participation or sophistication would take the instrument out of the ambit of the securities act by reducing the possibility of fraud in the transaction.

Other commentators have formulated similar tests emphasizing the risk capital aspect of the transactions. For example, Professor Long has offered the following definition:

"A security is an investment of money or money's worth including goods furnished and/or services performed in the risk capital of a venture with the expectation of some benefit to the investor where the investor has no direct control over the investment or policy decisions of the venture."[230]

Coffey's analysis was adopted by the Supreme Court of Hawaii in *State Commissioner of Securities v. Hawaii Market Center, Inc.*[231] This case involved a securities prosecution against a founder-member contract arrangement which involved recruiting investors by selling cards to be used at a store that was to be built. In

228 Coffey, *supra* note 227, at 377.

229 *Id.* at 374-75.

230 Long, *supra* note 5, at 128. The definition has been adopted by the Oklahoma legislature as one of the alternative definitions of security; *id.* at n. 150.

231 485 P.2d 105 (Hawaii 1971).

holding an investment contract was present, the court felt that the *Howey* test was too mechanical and that

> "courts become entrapped in polemics over the meaning of the word 'solely' and fail to consider the more fundamental question whether the statutory policy of affording broad protection to investors should be applied even to those situations where an investor is not inactive, but participates to a limited degree in the operation of the business."[232]

The Supreme Court of Hawaii went on to hold that, for purposes of the Hawaii Uniform Securities Act, an investment contract is created whenever: (a) an offeree furnishes initial value to an offeror, and (b) a portion of this initial value is subjected to the risks of the enterprise, and (c) the furnishing of the initial value is induced by the offer or a promise or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise, and (d) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.[233]

D. SPECIAL TRANSACTIONS OR ARRANGEMENTS AS SECURITIES

There seems to be no end to the cases that have arisen in the United States on the question of whether or not certain transactions or arrangements involve securities. What follows is a brief review of some of the major areas of dispute which have been grouped under headings by subject matter for purposes of convenience only.

At the outset, it is interesting to note that all of the cases dealing with special transactions or arrangements involve a common element, namely, the sale or exchange of property or services or a combination of property and services. The question becomes one of deciding whether that is *all* that is involved, since if that is the case, then a commercial transaction has taken place without any implications for the securities statutes. On the other hand, if something more than the sale of goods or services is present, the courts and administrators have held that a security is also involved. The difficulty has been to define or identify the factors which indicate that a security has been traded. In this section of the paper, the investment contract phrase is also relevant since that phrase has been interpreted to embrace many of the special

232 *Id.* at 108.
233 *Id.* at 109.

transactions or arrangements held to be securities. However, there are also other branches of the definition of security which have been resorted to in order to hold that such transactions or arrangements are securities.[234]

Somewhat prophetically, the U.S. Supreme Court in the *Joiner*[235] decision cautioned that:

> "the reach of the Act does not stop with the obvious and commonplace. Novel, uncommon, irregular devices, whatever they appear to be, are also reached if it be proved as a matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as 'investment contracts', or as 'any interest or instrument commonly known as a security'."[236]

Some of the "novel, uncommon, irregular devices" to be examined for purposes of illustration are multi-level distributorships, franchises, commodities, land-related transactions, and notes.[237]

234 The commentary on the subject is almost as extensive as the cases dealing with the various transactions or arrangements. In addition to the articles already cited - *e.g.* Hannan & Thomas, *supra* note 11; Long, *supra* note 5; Long, *supra note* 196; Coffey, *supra* note 227; and Comment, *supra* note 209, at 815 - some other recent and useful articles are: Newton, *What Is a Security? A Critical Analysis*, 48 Miss. L.J. 168 (1977); Mofsky, *Some Comments on the Expanding Definition of "Security"*, 27 U. Miami L. Rev. 395 (1973); Selvers, *Investment Contracts: Expanding Effective Securities Regulation*, 48 St. John's L. Rev. 525 (1974); Bonnett, *How Common Is a "Common Enterprise"?*, 16 Arizona St. L.J. 339 (1974); Tew & Freedman, *In Support of SEC v. W.J. Howey Co.: A Critical Analysis of the Parameters of the Economic Relationship between an Issuer of Securities and the Securities Purchaser*, 27 U. Mo. L. Rev. 407 (1973).

235 320 U.S. 344 (1943).

236 *Id.* at 351.

237 One of the many transactions or arrangements not discussed herein but of considerable importance is the recent controversy in the United States over whether non-contributory pension plans are subject to the securities laws. It is well accepted that employee interests in contributory private pension plans may be subject to the federal securities legislation; *see* Mundheim & Henderson, *The Applicability of the Federal Securities Laws to Pension and Profit-Sharing Plans*, 29 Law & Contemp. Probs. 795 (1964). In Daniel v. Int'l Bhd. of Teamsters, 516 F.2d 1223 (7th Cir. 1977), the Seventh Circuit held that the plaintiff-employee's interest in a non-contributory pension plan was an investment contract and hence a security thereby entitling the plaintiff to the protection provided by the anti-fraud provisions of the securities laws. The reasoning was that Daniel's investment was his labour and the excess of retirement benefits over contributions was the expectation of profit so that the requirements of the Howey test, namely, an arrangement whereby a person invests his money in a common enterprise with an expectation of profits from the efforts of others, was fulfilled. A "sale" of the security pursuant to s. 2(3) of the Securities Act of 1933 which defines sale as a "disposition for value" was involved because Daniel gave value (his labour) in exchange for the pension interest. The Seventh Circuit did not concede a sale had to be voluntary but said the employees' vote ratifying the union contract which included the pension plan and subsequent votes reflected the necessary voluntary investment decision as did the continuing

1. *Multi-Level Distributorships: Pyramid Sales and Plans and Founder Membership Programs*

There can be a variety of so-called multi-level distributorship schemes. Under one, the pyramid scheme, an arrangement exists for selling a product or service through a multi-level network of independent distributors. The purchase of a distributorship entitles the purchaser to recruit other investors and to earn a finder's fee for each new purchaser. It becomes much more profitable to recruit purchasers than to sell the product or service. The recruits are lured by promises of easy money which are made in high-pressure recruiting sessions that have been characterized as revival meetings.[238] Another type of multi-level distributorship scheme involves the founder's contract. Under this arrangement, a promoter recruits investors by selling cards to be used at a store that he will build. The purchaser of the cards also buys the right to sell other people the cards and to earn commission fees for every card sold. Very often no store is ever built. The effect is similar to that in chain letters: those who come in late realize the market is saturated.[239]

One of the most notorious individuals involved in these schemes was Glenn W. Turner who promoted two well-known multi-level distributorship plans: motivational courses through his company called "Dare To Be Great, Inc." and cosmetics through another company, Koscot Interplanetary Inc. In looking at ways to halt these promotions, many of the states found that the schemes involved a security, while others rejected the claim that the arrangements involved securities.[240] A major stumbling block to

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employment. The U.S. Supreme Court granted *certiorari* on February 21, 1978; *see* Nimkin, *The Daniel Case*, 11 REV. SEC. REG. 963 (February 28, 1978).

Because of the amount of money and persons affected, a decision of the Supreme Court is anxiously awaited. *See also* Gunderson, *Application of the Federal Securities Laws to Non-Contributory, Defined Benefit Pension Plans*, 45 U. CHI. L. REV. 124 (1977); Brown, *Securities Regulation of Employee Pension Plans: In the Wake of the Daniel Decision*, 38 U. PITT. L. REV. 697 (1977).

238 Comment, *supra* note 209, at 826.

239 *Id.* at 827. In one scheme, the SEC calculated that, if each person were to get five new investors a month as requested, there would be 305,175,780 people selling at the end of one year; *id.* at n. 41.

240 For decisions holding that a security was involved, *see e.g.* Hurst v. Dare To Be Great, Inc., 474 F.2d 483 (9th Cir. 1973); Frye v. Taylor, 263 So. 2d 835 (Fla. Dist. Ct. App. 1972). For decisions holding that no security was involved, *see e.g.* Gallion v. Alabama Market Centers, Inc., 213 So. 2d 841 (Ala. 1968); Georgia Market Centers, Inc. v. Forston, 171 S.E.2d 620 (Ga. 1969). *See generally* Note, *Pyramid Scheme Regulation: The Evaluation of Investment Contracts As a Security under the Federal Securities Law*, 25 SYRACUSE L. REV. 690 (1974).

holding that a security was involved centred on the fourth element of the *Howey* test, namely, that the profit had to arise "solely" from the efforts of another. The first three elements of *Howey*, investments in a common enterprise with the expectation of profits, presented no problem. But since the investor was required to solicit more purchasers himself, he obviously was involved and participated such that his participation and effort were part of making a profit, and hence he arguably did not "solely" rely on others.

However, in *SEC v. Glenn W. Turner Enterprises, Inc.*[241] the Ninth Circuit held that the pyramid scheme did fit into the definition of a security as defined by the *Howey* decision. The court interpreted "solely" in the *Howey* decision as meaning: "...whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise"[242] and explained its decision as follows:

> "We hold, however, that in light of the remedial nature of the legislation, the statutory policy of affording broad protection to the public, and the Supreme Court's admonitions that the definition of securities should be a flexible one, the word 'solely' should not be read as a strict or literal limitation on the definition of an investment contract, but rather must be construed realistically, so as to include within the definition those schemes which involve in substance, if not form, securities."[243]

In addition to finding that the investor's efforts in *Turner* were not "essential" enough to negate the existence of a security, and to pointing to potential loopholes by interpreting "solely" too literally or strictly, the court characterized these efforts as part of the initial investment required to capitalize the operation at the outset.[244]

Turner has received considerable comment and criticism. One critic says that the court interpreted the efforts made by the purchasers not to be significant compared to the efforts of the Turner professional men on whom the purchasers relied to make the scheme successful because it was the Turner salesmen who ran the meetings and persuaded the recruits that they would make

241 348 F. Supp. 766 (D. Ore. 1972), *aff'd*, 474 F.2d 476 (9th Cir. 1973), *cert. denied*, 414 U.S. 821 (1973).

242 474 F.2d at 482.

243 *Id.*

244 Because of its holding that an investment contract was present, the 9th Circuit did not deal with the alternative findings of the district court in 348 F. Supp. at 772

such easy money.[245] The conclusion of the court was that those who bought into the ventures were really buying the right to share in the selling efforts of the professional salesmen without whose efforts the scheme would have failed. To get their return, the purchasers invested their money, efforts to find prospects and bring them to meetings, and whatever costs they incurred to create an appearance of affluence sufficient enough to lure others to join the venture. Pointing this out, the critic goes on to say that the court's reasoning was flawed, because from a factual standpoint, the court assumed the non-managerial efforts were insignificant to the success of the venture.[246] However, he points out that in such a scheme the role of the purchaser-salesman appears essential, since without his solicitation, sales and profits would not materialize. Furthermore the court played down the purchaser's active role implying that the purchasers contributed only a modicum of effort when in fact the record disclosed otherwise by the fact that they put in long hours seeking out prospects and attending meetings. This critic also says that the legal reasoning of the court is equally assailable because prior cases established that "any effort, physical or otherwise, exerted by the investor, regardless whether this effort had any bearing on the control of the enterprise", would disqualify a scheme as a security.[247]

Another critic of the decision states that the test of *Turner* misses the point. The efforts provided by the investor should not refer to physical activities of the investor but his right to share in the management or decision-making process of the project and, under those terms, the "solely" test from *Howey* is the appropriate one.[248] This critic also says that the test should be not solely through the efforts of others, but rather does the investor have any direct control over the investment or policy decisions of the venture.[249] To illustrate his point, he gives the example of the two-person law partnership where each under the *Turner* test would render significant efforts and therefore a partnership interest would not be a security;[250] but in the case of a 400-person

that the pyramid scheme was "commonly known as security" or that the scheme involved a "certificate of interest in a profit-sharing agreement".

245 Press, *Securities Regulation: Investment Contract Redefined,* 27 U. MIAMI L. REV. 487, 492 (1973). For other case comments, *see* 6 CREIGHTON L. REV. 450 (1973); 52 N.C.L. REV. 476 (1973); 51 TEX. L. REV. 788 (1973).

246 Press, *supra* note 245, at 492.

247 *Id.* The quoted language is from Long, *supra* note 196, at 145.

248 Long, *supra* note 5, at 122.

249 *Id.*

250 On partnership interests as securities, *see* Erwin, *Partnership Interests As Securities: An Alice in Wonderland Tour,* 9 CREIGHTON L. REV. 310 (1975); Higgins, *Is a Limited Partnership Interest a "Security"? The Current State of the California and*

partnership the *Turner* court would hold that an individual member's management voice would be so small as to be insignificant and therefore the partner's interest *would* be a security. Under the analysis suggested above, however, in the case of each partnership there would be a sharing in the control over the investment and policy decisions of the venture, so that neither partnership would create a security interest.[251]

In *SEC v. Koscot Interplanetary Inc.*[252] a multi-level distributorship scheme involving cosmetics run by the Turner empire was also held to be a security based on the analysis of the Ninth Circuit in the *Turner* case. Again the court found the first three elements of *Howey* were met but had more difficulty finding the "solely" requirement fulfilled. The court mentioned it would apply a functional analysis to avoid frustrating the remedial purposes of the Securities Act of 1933 and noted that the trend among circuit courts was to liberalize the strict adherence to the *Howey* test.[253]

2. *Franchises*

Franchising has become an extremely popular form of business organization both in the United States and Canada.[254] Under the so-called product and service franchise system, the franchisor will license the distribution of its manufactured products under its name and trademark, such as with gasoline and automobile dealers. A second type of franchise involves the "trademark licence" by which the franchisee purchases the right to sell goods and services which he obtains under the franchisor's name, as in the fast food business. One of the major questions on characterizing franchise arrangements as securities is whether or not the franchisee is relying "solely on the efforts of others" as required by the *Howey* test.[255]

Federal Definitions Add a Legal Dimension to Economic Speculation, 16 SANTA CLARA L. REV. 311 (1976); *see also* Hirsch v. duPont, 396 F. Supp. 1214 (S.D.N.Y. 1975).

251 Long, *supra* note 5, at 122.

252 497 F.2d 473 (5th Cir. 1974).

253 Other federal courts have followed the 9th Circuit in *Turner*: *e.g.* Lino v. City Investing Co., 487 F.2d 689 (3d Cir. 1973); Mitzner v. Cardet Int'l, Inc., 358 F. Supp. 1262 (N.D. Ill. 1973). For a reference to legislative attempts by the U.S. Congress to deal with pyramid schemes, *see* Note, *supra* note 209, at 833-34.

254 For descriptive works on franchising, *see* E. LEWIS & R. HANCOCK, THE FRANCHISE SYSTEM OF DISTRIBUTION (1963); J. CURRY, PARTNERS FOR PROFIT (1966); in Ontario, *see* GRANGE REPORT, *supra* note 185.

255 For commentary on the question of whether franchises are securities, *see* Goodwin, *Franchising in the Economy: The Franchise Agreement As a Security under Securities Acts, Including 10b-5 Considerations*, 24 BUS. LAW. 1311 (1969); Comment, *The Franchise Agreement: A Security for Purposes of Regulation*, [1970] U. ILL. L.F. 130;

In an opinion of the California Attorney-General, he concluded that in certain situations, where the franchisee participates fairly actively but also furnishes some of the risk value to the franchisor, two separate business ventures are being carried on: one, the franchise business, and the other, the enterprise conducted by the franchisor which in fact is financed by the franchisee's risk capital.[256] This was the so-called "dual investment" theory which provoked considerable favourable and unfavourable criticism.

In *Mr. Steak, Inc. v. River City Steak, Inc.*,[257] the Federal District Court for Colorado held that a restaurant franchise arrangement was not a security within the meaning of section 2(1) of the Securities Act of 1933. In that case the franchise agreement provided that the franchisor, which was a national restaurant chain, had the right to control the franchisee-restaurant's operations including the selection of the manager. On the other hand, the franchisee had the right to terminate the manager's employment and had the right to participate in the conduct of the restaurant's business. The court concluded that the exercise of control over the franchise operation was not conclusive, since the franchisee exercised some control and had delegated or abandoned other powers under the agreement. In effect, because the investor in *Mr. Steak* was informed of the nature of the investment and had the right, even though unexercised, to affect the investment's success, the arrangement did not satisfy the "solely" requirement of the *Howey* test. Several other courts since the decision of *Mr. Steak* have held that franchises are not securities within the meaning of the federal legislation.[258]

There is no question that considerable potential for abuse is present in the franchise field. This abuse arises from the disparate economic power between the franchisor and the franchisee as well as the possibility that the franchisor might not account fully to the franchisee. It has been pointed out that these abuses can be controlled by an effective disclosure system provided by the securities laws or a similar system.[259]

Note, *Franchisor Liability under Securities Laws*, 13 WASHBURN L.J. 68 (1974); Comment, *Franchise Sales: Are They Sales of Securities?*, 34 ALB. L. REV. 383 (1970).

256 49 Cal. Op. Att'y Gen. 124 (1967) *cited in* Comment, *supra* note 209, at 836. The opinion characterized the situation where the franchisee participates only nominally in the enterprise as a security and not a security where he participates actively and the franchisor provides goods and services.

257 324 F. Supp. 640 (D. Colo. 1970).

258 *See e.g.* Hill York Corp. v. American International Franchises, Inc., 448 F.2d 680 (5th Cir. 1971); Mitzner v. Cardet International, Inc., 358 F. Supp. 1262 (N.D. Ill. 1973).

259 Comment, *supra* note 209, at 838-39. It has been effectively argued that the franchisee is like the investor in the multi-level distributorship in that both rely

In *Wieboldt v. Metz*[260] the franchise agreement contemplated active participation by the franchisee who actually controlled and operated the franchise. The question was whether the franchisee's active participation was outweighed by his being dependent on the franchisor. The court held that it was not and found that there was no investment contract. The court stated that it was necessary only that the franchisee exercise policy-making power over his particular unit of the franchise enterprise, since to require control over the franchisor's entire system would be incompatible with the franchising method and indeed would make all franchises investment contracts.[261]

3. *Commodities*

Commodity-based transactions have given rise to many cases under the U.S. securities laws. To a layman, the sale of gold or silver coins, whisky, hogs, or cocoa would not be thought of as sales of securities; however, owing to the ingenuity of promoters, the cases in this area have not been so simple. Again, there is a lengthy commentary on the treatment of commodities under the securities laws,[262] but only a few aspects will be dealt with in this paper – commodity-based transactions (whisky warehouse receipts), commodity futures contracts, naked commodity options and discretionary commodities trading accounts – followed by some brief comments on recent legislative regulation of the commodities field.

a. *Commodity-Based Arrangements: Whisky Warehouse Receipts*

The SEC has been fairly vigilant about the sale of whisky warehouse receipts. It has warned that promotion and sales literature on such receipts are subject to the anti-fraud provisions of the

almost entirely on the promotional efforts of the franchisor and neither anticipates a decision-making role with respect to their investment. "Their profit-making activity consists mainly of physical labor and following the rules"; Hannan & Thomas, *supra* note 11, at 260.

260 355 F. Supp. 255 (S.D.N.Y. 1973).

261 *Id.* at 260. The court found that the franchise was also not a security under the risk-capital analysis of Silver Hills Country Club v. Sobieski, *supra* note 216.

262 *See generally* Note, *Federal Regulation of Commodities Futures Trading*, 60 YALE L.J. 822 (1951); Borton & Abrahams, *Options on Commodity Futures Contracts As Securities in California*, 29 BUS. LAW. 867 (1974); Bromberg, *Commodities Law and Securities Law - Overlap and Pre-emptions*, 1 J. CORP. L. 217 (1976); Roberts, *Abuses in the Commodity Markets: Some Suggestions for Control*, 25 SYRACUSE L. REV. 788 (1974).

federal securities laws because the receipts have been interpreted as securities.[263]

In the first of some recent decisions involving whisky warehouse receipts, *SEC v. M.A. Lundy Associates*,[264] the district court held that whisky warehouse receipts are securities within the meaning of section 2(1) of the Securities Act of 1933. The defendants had placed newspaper advertisements inviting "investments in profit and growth in scotch whisky". Relying on the *Joiner* and *Howey* decisions of the U.S. Supreme Court, the district court found that the whisky warehouse receipts were investment contracts. In rejecting the defendants' argument that the sales involved commodities only, the court stated that the investor's purpose was to realize a profit on resale, and to do that he depended on the broker's advice. In this and similar cases,[265] the courts have pointed to the investment representations made by the defendants and the reliance by the investors on the expertise of the defendants in managing the investments.

b. *Commodity Futures Contracts*

A commodity futures contract is basically an agreement to buy a fixed amount of a commodity at a future date. In most cases, there is no intention to take delivery of the commodity, and obligations to buy are frequently offset by agreements to sell at the time of delivery. Buying and selling commodity futures can provide valuable benefits[266] and have attracted a number of investment speculators. There is now considerable trading on the various commodity exchanges.

In *Sinva, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,[267] the district court applied the *Howey* test to hold that a typical commodity futures contract was not a security. The court stated that there was no "common enterprise to realize a profit"

263 *See* SEC, Securities Act of 1933 Release No. 5451, Securities Exchange Act of 1934 Release No. 16586, January 7, 1974, [1973-74 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,618; *see also* SEC Securities Act of 1933 Release No. 5018, November 4, 1969, [1969-70 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,757. As pointed out by the SEC, many false and misleading statements are made with respect to sale of receipts which are of fundamental importance, *e.g.*, the promised returns often turn out to be losses, facts about the types and prices of whisky are not given and facts about difficulties in reselling the receipts are also omitted.

264 362 F. Supp. 226 (D.R.I. 1973). But there was an earlier flurry of whisky cases: *see* Penfield Co. v. SEC, 143 F.2d 746 (9th Cir. 1944); SEC v. Bourbon Sales Corp., 47 F. Supp. 70 (W.D. Ky. 1942).

265 A similar conclusion to Lundy was reached in SEC v. Haffenden-Rimar, International Inc., 362 F. Supp. 323 (E.D. Va. 1973).

266 One of the principal benefits in the purchase of commodity futures contracts is the hedge against unfavourable price changes.

267 253 F. Supp. 359 (S.D.N.Y. 1966).

(within the *Howey* test) between the plaintiff and its broker, the defendants. There was in fact simply a broker-client relationship with the plaintiff having the right to decide whether to accept the commodity or offset the future contract by another trade.[268] Other cases have also made it clear that ordinary commodity futures contracts are not securities.[269] In short, the cases have concluded that the "common enterprise" and "reliance on efforts of others" elements of *Howey* are not applicable in the sale or purchase of a commodity futures contract.

c. *Naked Commodity Options*

Under the "naked" commodity option schemes, the investor purchases an option to buy or sell (or both buy and sell) a futures contract from or to the promoter at a fixed price within a specific period. The options are "naked" because the promoter has not bought the futures contract to which the option relates. The promoter uses the funds to raise additional capital. The investor gains when he correctly guesses the position of the market at the future time and exercises his option with the promoter; the investor loses if he misjudges the market or if the promoter is unable to raise the funds to pay the investor's claim upon exercise of the option – an event which happens quite frequently and has given securities administrators considerable concern.

One of the major decisions on naked options is *People v. Puts & Calls, Inc.*[270] The court rejected the argument made by the defendant that the option took on the character of the underlying instrument, a commodity futures contract which by *Sinva*[271] was held not to be a security. The court held that coupled with the sale of options was the sale of an investment contract. In this respect the defendant argued that the "common enterprise" element of *Howey* was not present since the gain or loss of the investor was attributable to his reading the market properly. In addition, the defendant argued that profit was not "solely" dependent on the efforts of others. The court in answer stated the profit was dependent on the promoter's ability to raise additional capital through investing the commingled accounts of the investors' pay-

268 *Id.* at 366. The court also said that the SEC should not be accorded jurisdiction to regulate commodities in light of the congressional intent to regulate through another agency, The Commodity Exchange Authority, under the Commodities Exchange Act, 7 U.S.C. ss. 1-17a (1970); 253 F. Supp. at 367; *cf.* text accompanying note 284 ff. *infra.*

269 *E.g.* Glen-Arden Commodities, Inc. v. Constantino, 493 F.2d 1027 (2d Cir. 1974); Berman v. Dean Witter & Co., 353 F. Supp. 669 (C.D. Cal. 1973); Schwartz v. Bache & Co., 340 F. Supp. 995 (S.D. Iowa 1972).

270 3 CCH Blue Sky L. Rep. ¶ 71,090 (Cal. 1973).

271 253 F. Supp. 359 (S.D.N.Y. 1966).

ments.[272] Other similar schemes, notably those promoted by one individual, Harold Goldstein, who attracted millions of dollars from investors through his company, Goldstein Samuelson, Inc., were also held to be securities.[273]

d. *Discretionary Commodity Trading Accounts*

Between the commodity futures contract and the naked commodity option for purposes of finding a security is the discretionary commodities account.[274] These arrangements involve investors advancing funds to a broker in a joint account in the expectation of profits on the efforts of the broker. Under the *Howey* test, the only element in question is whether there is a "common" enterprise associated with discretionary commodities accounts.

In one of the first cases dealing with such accounts, *Maheu v. Reynolds & Co.*,[275] the court concluded that an investment contract was present and rejected the argument that the common enterprise requirement was not met.[276] However, the reasoning leading to this result was somewhat cryptic. Other cases followed *Maheu*[277] and the issue seemed clearly decided until the 7th Circuit decision in *Milnarik v. M.S. Commodities, Inc.*[278] which held that a discretionary commodities account was not a security.[279]

In that case, the only compensation received by the defendant was from commissions on the trades and not on the profitability of the transactions made by the defendant. Also, there was no commingling of funds with any other discretionary commodity accounts. The court found no common enterprise element, pointing

272 It is interesting that the California court did not apply the risk-capital analysis of Silver Hills which seemed to be appropriate because the investors provided capital in a speculative high-risk enterprise; *see* Bloomenthal, *Calls, Puts and Commodity Options*, 2 Sec. Reg. L.J. 101 (1974).

273 After only a two-year period the Samuelson corporation declared bankruptcy with some $17 million in assets and $76 million in liabilities; *see* Hannan & Thomas, *supra* note 11, at 270; *see generally id.* at 269–74 for an analysis of the Samuelson litigation.

274 Comment, *supra* note 209, at 844.

275 282 F. Supp. 428 (S.D.N.Y. 1967).

276 The common enterprise requirement was given close analysis in Los Angeles Trust Deed & Mortgage Exchange v. SEC, 285 F.2d 162 (9th Cir. 1960). The case involved purchasers advancing money for notes secured by deed of trust on property managed by the seller. The money was pooled and reinvested by the promoters. The court stated the common enterprise element of Howey was met by either a pooling of interests or a commonality of interest between the purchaser and seller.

277 Berman v. Orimex Trading, Inc., 291 F. Supp. 701 (S.D.N.Y. 1968); Johnson v. Arthur Espey, Shearson Hammill & Co., 341 F. Supp. 764 (S.D.N.Y. 1972).

278 320 F. Supp. 1149 (N.D. Ill. 1970), *aff'd*, 457 F.2d 274 (7th Cir. 1972), *cert. denied*, 409 U.S. 887 (1972).

279 Another argument made was that, even if a security were involved, a private offering exemption was available pursuant to s. 4(2) of the Securities Act of 1933. The court held the exemption was applicable; *but see* Comment, *supra* note 209 at 846 n. 171.

out: (1) that assuming money was collected from numerous parties, no allegation was made that there was a common enterprise comprising all those who had discretionary accounts with the defendant, (2) no claim was made that the defendant traded in a uniform manner for each account, or even if there had been uniform trading, no pooling of funds for common purpose was alleged, and (3) plaintiffs in no way could be viewed as having invested in a common enterprise with other suppliers of venture capital. The court said that an agency relationship was involved, not a security, and relying on the lower court found that each contract between the customer and broker was unitary and independent of the others. The decision has been followed by others.[280]

Thus there are two lines of cases on the question of whether discretionary commodities accounts are securities. From an analytical viewpoint the *Milnarik* analysis holding no security is more acceptable;[281] on the other hand, if one looks to the general policy of protection under the Securities Act of 1933, the *Maheu* conclusion of treating such accounts as securities is more attractive.[282]

e. *Legislative Intervention*

It should be mentioned that there is a federal agency in the United States which has been given regulatory authority over the commodities field. The Commodity Exchange Act of 1922 was passed by Congress to regulate brokers trading on commodity exchanges. Certain provisions of the act regulated such matters as excessive speculation, financial integrity of brokers, and the handling of customers' accounts. The act also contained an anti-fraud provision and created the Commodity Exchange Authority which was responsible for the regulatory features of the statute. However, two major limitations of the act and the authority were that the former concerned a restricted number of commodities (largely agricultural products only) and the latter did not have the resources to perform effectively.[283] Added to these difficulties was the fact that the volume of commodity futures trading increased dramatically to the extent that in 1972–73 the total of $400 billion

280 Wasnowic v. Chicago Board of Trade, 352 F. Supp. 1066 (M.D. Pa. 1972), *aff'd*, 491 F.2d 752 (3d Cir. 1973); Stuckey v. DuPont Glore Forgan, Inc., 59 F.R.D. 129 (N.D. Cal. 1973); *but cf.* SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974).

281 This is the conclusion reached by Hodes & Dreyfos, *Discretionary Trading Accounts in Commodity Futures - Are They Securities?*, 30 Bus. Law. 99 (1974).

282 *See* Comment, *supra* note 209, at 846-49.

283 *Id.* at 848, *citing* Wolff, *Comparative Federal Regulation of the Commodities Exchanges and the National Securities Exchanges*, 38 Geo. Wash. L. Rev. 223, 263-64 (1969).

exceeded the total value of securities trading.[283a] Concerns were expressed about the ability of the commodity exchanges to regulate themselves and market practices generally.

To achieve a more comprehensive and effective regulatory system, the U.S. Congress enacted the Commodity Futures Trading Commission Act of 1974[284] which transferred existing powers in various officials and agencies to a newly created Commodity Futures Trading Commission. The operation of the act has been summarized as follows: (1) the subject matter regulated has been substantially expanded to cover a very wide range of commodities, (2) fraud protection and the power of the commission to control excessive speculation have been broadened, (3) registration and regulation are provided for floor brokers, futures commission merchants, commodity trading advisers, and commodity pool operators, and (4) the commission is empowered to regulate boards of trade and designate them as contract markets.[285] The approach of the act appears to emphasize regulating the market actors in the commodities field, which is arguably preferable to expanding the meaning of investment contract under the definition of security for purposes of the securities laws.[286]

4. *Land-Related Transactions: Land Sales Contracts, Condominiums and Cooperatives*

Under this heading can be grouped a large number of disputes centring on the question of whether a transaction or arrangement involving realty could be termed a security. Just as the previous headings dealing with distributorships, franchises and commodities evoked an analysis of whether the sale of services or personalty was involved as opposed to a security, here the issue is whether real property or a security is involved. Again there are many real estate interests which are not discussed since only a few examples

283a *See* COMMODITIES REPORT, *supra* note 164, at 47, *citing* REPORT ON COMMODITY FUTURES TRADING COMMISSION ACT OF 1974, H.R. REP. No. 13113, 93d Cong., 2d Sess. 39 (1974).

284 Pub. L. No. 93-463 (1974). California had passed its Commodity Law in 1973 as part of the California Corporations Code; CAL. CORP. CODE, ss. 29500-92 (West 1977). The Commodity Law in regulating various commodity market actors provided for some coordination between the California law and the old federal statute; now the law applies only to matters not within the exclusive jurisdiction of the Commodity Futures Trading Commission; *see* Johnson, *The Perimeters of Regulatory Jurisdiction under the Commodity Futures Trading Commission Act*, 25 DRAKE L. REV. 61, 67-70 (1975).

285 Comment, *supra* note 209, at 849. For a brief but helpful discussion of the U.S. Commodity Exchange Act and the CFTC and the California Commodity Law of 1973, *see* the COMMODITIES REPORT, *supra* note 164, at 47-68.

286 This was advocated by Hodes & Dreyfos, *supra* note 281, at 110.

have been chosen. These are land sales contracts, condominium units and cooperative housing arrangements.[287]

At the outset it should be recalled that two of the U.S. Supreme Court decisions interpreting security, *Joiner* and *Howey,* involved land transactions. As so cogently put by L. Loss:

> "[N]o 'investment contract' is involved when a person invests in real estate, with the hope perhaps of earning a profit as a result of a general increase in values concurrent with the development of the neighbourhood, as long as he does not do so as part of an enterprise whereby it is expressly or impliedly understood that the property will be developed or operated by others."[288]

As with distributorships, franchises and commodities, it is not *what* is being sold that counts, but *how* it is being sold and on what basis.[289]

There is a great variety of land sales contracts which involve the sale of land coupled with the seller-promoter's representation to resell the land at a profit for the purchaser-investor.[290] In *Johnson v. Suburban Land Investment Co., Inc.,*[291] the promoter sold land in Virginia on instalment notes to investors under an agreement which allowed the promoter to build a residential subdivision. In following the *Howey* analysis, the court looked to the economic reality of the arrangement to override the provision of the agreement giving control of the land improvement to the investors. The reality was that only the developer had the necessary expertise to carry out the planning and construction of the new subdivision. The court concluded that the promoters obtained their required financing from the investors who bore the risk.[292]

287 Oil and gas interests as securities are a notable omission from the land-related interests discussed. *See* Meer, *The Securities Laws and Oil and Gas Financing,* 20 TEX. B.J. 211 (1957); *Student Symposium - Oil Interests As Securities: The Enumerated vs. The General Definition,* 6 ST. MARY'S L.J. 151 (1974). The sale of a fractional undivided interest in mineral rights, royalties or a mineral lease involves a security since such interests are contemplated by the definition of security under the Securities Act of 1933; Whittaker v. Wall, 226 F.2d 868 (8th Cir. 1955). Of course, oil and gas leases can also give rise to security interests; *see* SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943), discussed in text accompanying note 191 *supra.*

288 1 L. Loss at 491-92.

289 Hannan & Thomas, *supra* note 11, at 274.

290 For a good description of typical arrangements, *see id.* at 275-77.

291 [1973-74 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,022 (Super. Ct. D.C. 1973).

292 *See also* SEC v. Lake Havaser Estates, 340 F. Supp. 1318 (D. Minn. 1972). On related matters, *see* Note, *Regulation of Real Estate Syndications: An Overview,* 49 WASH. L. REV. 137 (1973); Note, *Securities: Another Way to Regulate the Resort Development Boom,* 27 OKLA. L. REV. 104 (1974); Burton, *Real Estate Syndications in Texas: An Examination of Securities Problems,* 51 TEX. L. REV. 239 (1973); and Perelson, *State Securities Law: A Valuable Tool for Regulating Investment Land Sales,* 7 NEW MEX. L. REV. 266 (1977).

The sales of condominium and cooperative housing schemes present more difficult problems. The purchaser of these interests does not normally expect any profit or monetary return since he is simply buying a residence, and thus the securities laws should not apply. On the other hand, if the purchaser is acquiring an investment in that he expects a profit, then the securities acts should apply just as they do with other investments.

With respect to condominium units,[293] there can be several features present that indicate a security is involved. One of these is the so-called "rent-pooling" arrangement whereby the owner rents his unit for a period in return for a percentage of the total rents pooled from all the condominium units involved.[294] A second investment feature is the sale of a condominium unit accompanied by a long-term management contract which is more akin to the classic *Howey* investment contract than the buying of a residence. The third feature of investments is the nature of advertising effort and effect: if the promoter's advertising effort emphasizes economic advantages to the purchaser from the management efforts of the promoter, the condominium could be characterized as a security. The SEC recently published a release condensing these features as guidelines to distinguish between condominiums and similar types of real estate developments on the one hand, and a security on the other.[295] As has been pointed out,[296] the SEC, instead of trying to differentiate between the "profits" expected by the purchaser of a security and of a residence within the *Howey* test and approach, has adopted a more pragmatic analysis by identifying the factors which make the condominium transaction look like one which presents abuses that could be rectified by the securities laws.

Under the cooperative housing schemes, a corporation or association is usually formed to buy an apartment building from the developer. The tenants buy "stock" or "shares" in the cooperative corporation or association entitling them to leases in the

293 On securities law aspects of condominiums, *see* Hoisington, *Condominiums and the Corporate Securities Law*, 14 HASTINGS L.J. 241 (1963); Clurman, *Condominiums As Securities: A Current Look*, 19 N.Y.L.F. 457 (1974); Dickey & Thorpe, *Federal Securities Regulation of Condominium Offers*, 19 N.Y.L.F. 473 (1974); Ellsworth, *Condominiums Are Securities?*, 2 REAL EST. L.J. 694 (1974); Berman & Stone, *Federal Securities Laws and the Sale of Condominiums, Homes and Homesites*, 30 BUS. LAW. 411 (1975).

294 *See* Rohan, *The Securities Law Implications of Condominium Marketing Programs Which Feature a Rental Agency or Rental Pool*, 2 CONN. L. REV. 1 (1969).

295 SEC, Securities Act of 1933 Release No. 5347, January 4, 1973, [1972-73 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,163; and *see Student Symposium - Real Estate Investments As Securities: The Sufficiency of the Howey Test*, 6 ST. MARY'S L.J. 166, 172 (1974).

296 Comment, *supra* note 209, at 851.

building and to vote in the election of directors who manage the corporation or association. Again the question becomes one of distinguishing between an investment giving rise to a security and the acquisition of a residence. This issue raises the elements of the *Howey* test and in particular whether the element of "expectation of profits" is present. Of paramount importance to this question is the recent U.S. Supreme Court decision in *United Housing Foundation, Inc. v. Forman*,[297] which held that stock in a cooperative housing nonprofit corporation was not a security; and reference should be made to the previous discussion of the case.[298]

5. *Notes*

As previously noted, the "investment contract" branch of the security definition has received more attention than any other. However, another branch of the definition which recently has been the focus of attention is the language "any note...or other evidence of indebtedness". If a literal reading of the statute were adopted, any note regardless of the circumstances under which it was issued would be subject to the securities laws unless a specific exemption could be found.[299] The cases have gone both ways, some holding that notes are securities and others that notes are not securities.[300]

Several important points have arisen from the various cases on notes. Initially, some courts were constrained to fall on the plain meaning of the statutory language which stated "any note" was a security.[301] This result was reinforced by applying the broad, remedial purpose of the securities statute to the question.[302]

297 421 U.S. 837 (1975).

298 *See* text accompanying notes 205-09 *supra*.

299 To accommodate commercial paper, the Securities Act of 1933 exempts from the registration but not fraud provisions notes used to finance current transactions and the Securities Exchange Act of 1934 excludes from the definition of security any note which has a maturity at time of issuance of not more than nine months; *see* Hicks, *Commercial Paper: An Exempted Security under Section 3(a)(3) of the Securities Act of 1933*, 24 U.C.L.A. L. Rev. 227 (1976).

300 The U.S. cases holding notes to be and not to be securities are listed in Lipton & Katz, *"Notes" Are Not Always Securities*, 30 Bus. Law. 763, 770-71 (1975). For an earlier article by the same authors; *see* Lipton & Katz, *"Notes" Are (Are Not?) Always Securities*, 29 Bus. Law. 861 (1975), *see also* Comment, *A Note Is a Note Is a Note*, 52 Neb. L. Rev. 478 (1973); Konstant, *The Status of the Promissory Note under the Federal Securities Laws*, 17 Ariz. St. L.J. 175 (1975); Note, *Notes As Securities under the Securities Act of 1933 and Securities Exchange Act of 1934*, 36 Md. L. Rev. 233 (1976).

301 *E.g.* Movielab, Inc. v. Berkey Photo, Inc., 321 F. Supp. 806 (S.D.N.Y. 1970), *aff'd*, 542 F.2d 662 (2d Cir. 1971).

302 *E.g.* MacAndrews & Forbes Co. v. American Barmag Corp., 339 F. Supp. 1401 (D.S.C. 1972).

However, other courts looked at the introductory language preceding the definition of security, namely, "unless the context otherwise requires", to hold that the securities acts were not intended to cover ordinary consumer or commercial transactions.[303] In addition, some courts have held that the issuance of notes did not involve the "purchase" or "sale" of a security.[304] The conclusion to be drawn from the recent cases[305] is that notes issued in what can be styled as commercial transactions are not securities, whereas those issued in investment transactions are securities. Although this is a flexible and adaptable test, there remains the difficulty of applying it to particular situations.

Chapter V
Interpretations of "Security" under Canadian Legislation

A. INTRODUCTION

In Canada, the number of cases on the definition of security is quite small when compared to the U.S. experience. However, a variety of arrangements and transactions have been presented in Canada which have similar features to those that have been the subject of judicial and administrative inquiry in the United States. This fact underscores the importance of cooperative administrative efforts among the various securities administrators in Canada and between those in Canada and their counterparts in the United States so that they can keep abreast of the new devices or schemes that are in reality securities. As with some of the U.S. jurisprudence, the Canadian decisions interpreting security have for purposes of discussion been grouped according to the subject matter of the arrangement or transaction. Because many of the Canadian decisions have not been commented on elsewhere, they have received more detailed attention in this paper.

303 *E.g.* Joseph v. Norman's Health Club, Inc., 336 F. Supp. 307 (E.D. Mo. 1971) (plaintiffs issued promissory notes to defendant for membership in health club). *See also* McClure v. First National Bank of Lubbock, Texas, 497 F.2d 490 (5th Cir. 1974).

304 Lino v. City Investing Co., 487 F.2d 689 (3d Cir. 1973) (personal promissory notes issued by plaintiff in part payment for a franchise sold by defendant). The court said that the notes did not involve the "purchase" or "sale" of a security since to accept plaintiff's argument would mean that any consumer who bought an article on time and issued a note would be able to sue in a federal court on the theory that the retailer had purchased his security.

305 These are discussed in Lipton & Katz, *supra* note 300, 30 BUS. LAW. 763.

B. INTERPRETATIONS OF SECURITY

1. *Commodities and Other Types of Personalty*

a. *Swain v. Boughner*

In *Swain v. Boughner*,[306] the Ontario Securities Commission appealed the dismissal of a charge that the accused traded in securities without being registered as a broker or salesman under the Ontario Securities Act. The disputed transaction involved the sale of a half interest in a pair of chinchillas but the seller retained the chinchillas under a type of management contract and profit-sharing arrangement. The court held that it was a sale of or a trade in a security in conjunction with the sale of specific chinchillas or of an undivided interest in specific chinchillas. Accordingly, under the heading "any document constituting evidence of or title to or interest in the capital, assets or property...of any person or company", the arrangement was a security. However, as J. Williamson notes, the transaction might arguably have been held to be an "investment contract" within the meaning of that term especially as it has been subsequently determined.[307]

b. *Brigadoon Scotch Distributors*

Swain v. Boughner was recently applied in *Re OSC and Brigadoon Scotch Distributors (Canada) Ltd.*[308] In this case, warehouse receipts for Scotch whisky were traded through a broker, and the OSC brought an application for an order restraining the respondent company from trading in securities, which were alleged to be the Scotch whisky warehouse receipts, without being registered for trading as required under the Ontario Securities Act. Hartt, J., in granting the restraining order, referred to *Swain v. Boughner* and to the definition of security under clause (ii) of paragraph 22 defining security, which was the heading of the definition interpreted in the *Swain* case, and stated:

> "The definition would not include documents of title which are bought and sold for purposes other than investment, for example, bills of lading and receipts for goods purchased for inventory or consumption purposes. Such

306 [1948] O.W.N. 141 (H.C.). *See also* text accompanying note 51 *supra*.

307 J. Williamson, Supp. at 103. The author cites Hollywood State Bank v. Wilde, 160 P.2d 846 (Cal. 2d Dist. Ct. App. 1945). For a recent decision concluding that a tax shelter scheme involving a cattle breeding arrangement was an investment contract and hence a security under the Alberta Securities Act, *see In re* Canadian Exotic Cattle Breeders Association, Alberta Securities Commission Summary, January 31, 1977, at 4 (denial of exemption).

308 [1970] 3 O.R. 714 (H.C.).

an intention on the part of the legislature can be inferred from the basic aim or purpose of the *Securities Act, 1966*, which is the protection of the investing public through full, true, and plain disclosure of all material facts relating to securities being issued....The respondent is a minimum capitalization private company and does not own any of the whisky or the warehouse receipts forming the subject-matter of the dispute. However, the fact that the respondent company acts only as a broker or agent in the sales would not exempt it from the registration requirements of the *Securities Act, 1966*, as S. 6(1)(c) of the Act, quoted above, specifically includes acting as a salesman of or on behalf of a person or company in connection with a trade in a security."[309]

c. *John T. Geldermann*

In *Re John T. Geldermann & Company Inc.*,[310] the Quebec Securities Commission held that a commodity futures contract was not a security under the Quebec Securities Act. In coming to this conclusion, the commission examined two heads of the definition of security which are found in the various securities acts of the provinces. The first heading was any certificate, instrument or other document constituting the evidence of a right, share, or interest in the capital, assets, earnings or profits of any existing or proposed company, or of a person. On this branch of the definition, the commissioners concluded that the definition was not applicable because at the time of the trading, the company or person underlying the arrangement was not known and was impossible to determine.

The other branch of the definition of security dealt with by the commission was "generally any certificate, instrument or document commonly known in the trade as a security or designated as such by the regulations". With respect to this branch, the commission stated that, although commodities futures contracts are viewed by the securities industry as speculative opportunities, the commission was unable to conclude that such contracts are commonly known as securities *in the trade* at present.[311] It is interesting to note that in arriving at this conclusion, the commis-

309 *Id.* at 716-17. *See also* B.C. Securities Commission Weekly Summary, February 8, 1974, advising that investments in whisky warehouse receipts are securities requiring compliance with the prospectus provisions of the B.C. Securities Act. The Weekly Summary reproduced an article on the subject published by the SEC.

310 3 QSC Bull., No. 65 (July 11, 1972).

311 The Ontario Securities Act does not contain the phrase "in the trade" as a part of this branch of the definition.

sion relied on evidence submitted at the hearing and on information sought from persons engaged in the trade of securities and commodities. Counsel for Geldermann presented the views of the president of the Montreal and Canadian Stock Exchanges, a produce broker whose company was associated with a U.S. commodity futures broker, and a professional commodities speculator. The commission also examined the status of commodity futures brokers operating under various North American jurisdictions and cited the test of the Supreme Court of the U.S. in *SEC v. C.M. Joiner Leasing Corp.*:[312]

> "The test [of the definition of a security]...is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect."

The commission also stated that proof of common knowledge must be based on an overwhelming set of facts and conclusive evidence. And on that basis they were unable to conclude that commodity futures contracts are commonly known as securities in the trade at present.[313]

d. *Farmex Enterprises*

Another animal-related transaction was involved in a recent decision of the Ontario Securities Commission, *In the Matter of Farmex Enterprises Incorporated.*[314] Farmex marketed "exotic beef breeding programs" whereby an investor could buy, for $2,500, a half-blood heifer or a cow inseminated pure-bred in the case of the non-availability of half-blood heifers. Purchase of the cow was accompanied by purchase of a participation in a breeding program designed to produce a pure-bred Chianina cow. The aim of the transaction was to get, through successive breeding, a pure-bred cow so that it would bring a high price on the market or that it could be used for further breeding, in which case the offspring would be sold to produce the profit.

The Ontario Securities Commission noted that the contract with Farmex involved much more than the purchase and sale of a heifer. Under the contract, Farmex undertook to maintain the animal and also to breed the animal to a full-blooded sire in the hope of producing a full-blooded cow, and also to provide adequate

312. 320 U.S. 352 (1943); *see* text accompanying note 191 *supra*.

313 As noted above under the U.S. interpretations of security, an ordinary commodity futures contract has been held not to be a security under the investment contract heading; *see* text accompanying note 267 ff. *supra*. However, as previously stated in note 65 *supra*, the Quebec Securities Act does not contain the "investment contract" phrase in the headings of the definition of security.

314 [1974] OSC Bull. 50 (March). *See also* the decision of the Alberta Securities Commission regarding a cattle breeding arrangement, *supra* note 307.

veterinary supervision. Farmex automatically owned all the offspring of the purchaser's animal. Throughout the program, Farmex undertook to arrange for the sale of the purchaser's animal and also to maintain adequate insurance on the purchaser's animal against death and theft.

Counsel for Farmex argued that the agreement constituted the outright sale of an animal to investors. He also argued that there was no investment in a common enterprise in that the purchaser did not share in Farmex's profits. The purchaser owned his own animal throughout and was free at any time during the program to sell it. If the cow produced a female offspring he would naturally exchange the cow for that offspring so the program could continue. If a pure-blood were produced, the purchaser would profit by sale or further breeding. The purchaser's fortunes were dependent on the fate of his own property – the cow and the offspring for which it may be exchanged in the breeding program. Farmex's counsel also argued that the profits and losses were the purchaser's alone and related exclusively to his own property; and furthermore, the purchase of a cow was analogous to the purchase of an antique or a work of art which would appreciate over time.

Commission counsel relied on the principles laid down by the Supreme Court of the U.S. in *SEC v. W.J. Howey Company.*[315] It was noted that the Supreme Court, in giving the term investment contract a very broad meaning, emphasized that the intent of securities legislation was to afford the investing public a full measure of protection. Furthermore, when the question of security arises, emphasis should be placed on economic reality, and form is to be disregarded for substance so that the investing public receives full and fair disclosure relating to the issuance of "the many types of instruments in our commercial world that fall within the ordinary concepts of a security". Counsel also noted that this approach to securities legislation was adopted in recent Canadian decisions.[316]

The commission noted that it agreed with that approach in interpreting the Ontario Securities Act and stated:[317]

> "We are of the opinion that the economic reality in this case is clearly an investment by unsophisticated investors in a breeding program in the hope that through the efforts, the expertise, and the management of others, a profit will be realized. This is the essence of an investment

315 328 U.S. 293 (1946); *see* text accompanying note 194 *supra.*

316 Attorney-General of Alberta v. Great Way Merchandising Ltd., [1971] 3 W.W.R. 133 (Alta. S.C.); *In re* Bestline Products of Canada Ltd., [1972] 6 W.W.R. 245 (B.C.C.A.). These cases are discussed in text accompanying note 375 ff. *infra.*

317 [1974] OSC Bull. 50, 54 (March).

> contract which brings it within the definition of a security in the Act."

In rejecting the argument that what was involved was simply the sale and purchase of an animal, the commission viewed the nature of the entire arrangement as an investment contract. This conclusion was reinforced by one of the sections in the Farmex sales literature which asked the question: "Why shouldn't I simply buy the animal and not the program?" The answer supplied in the literature was: "You could, but you would need a lot of expertise and more money." On this point, the commission stated:[318]

> "This, surely, is the essence of the matter. A passive investor invests in a joint enterprise with additional funds being supplied by many other passive investors and depends upon the expertise, management and good faith of others to return a profit. In such cases, the full, true, and plain disclosure that is required by the Act is necessary for the protection of the investing public. That this is clearly so can be seen from the operation of the enterprise."

The commission then referred to the facts that Farmex did not own any of the farms and that it had to get continual financing of the program from further sales and from further sales of the investors' own cow when they were exchanged. Also, the evidence disclosed that the cost of a heifer was between $600 and $750, whereas the cost of investment in the program was some $2,500. The commission concluded that the money invested was used to pay for all the other services that Farmex provided. These facts were felt to illustrate the risks involved in the enterprise and the need for the type of disclosure that an investor would be entitled to have pursuant to the prospectus provisions of the Ontario Securities Act.

e. *Regina v. Ausmus*

In *Regina v. Ausmus*,[319] the appellant was charged with failing to comply with the Alberta Securities Act, and the issue was whether the appellant's activities constituted trading in a security. The appellant described himself as an "investment representative" of a company that was to manufacture a machine which would be installed in taverns and restaurants where a person for a fee could obtain a reading to determine the alcoholic content of his or her blood. The machines were to be sold to a purchaser for about $2,200 and leased back to the company for a $42.50 monthly

318 *Id.* at 55.
319 [1976] 5 W.W.R. 105 (Alta. Dist. Ct.).

rental for a term of five years, after which the machine would be resold to the company for $100 under arrangements which would provide a sharing of subsequent revenue from the machine. Under the agreements entered into, the company agreed to look after and maintain the machines, records and statements. Counsel for the Crown argued that the arrangement was a security and submitted that two headings of the definition were relevant: (1) "any profit-sharing agreement or certificate",[320] and (2) "any investment contract, other than an investment contract within the meaning of the Alberta Investment Contracts Act".[321] The argument of the appellant was that the arrangement was simply a sale of a chattel with a lease-back and repurchase agreement.

The court, after citing recent Canadian cases[322] which in turn adopted the test of an investment contract as enunciated by the U.S. Supreme Court in *Howey,* held that the arrangement was an investment contract. After referring to the main features of the arrangement, the court concluded:

> "In other words, it seems to me that the economic realities of the situation were that this was an investment contract and the actual ownership of the machine was of little importance. The facts were that certain benefits were to accrue to the investors in return for moneys that they paid to the company. In this sense the present circumstances meet the tests of economic realities as an investment contract, as that definition was followed in the *Great Way Merchandising* case. In my view it also meets all of the tests that were required of an investment contract as set out in the *Howey* case."

f. *Pacific Coast Coin Exchange*

Arrangements involving gold and silver coins have come up for consideration before the Ontario Securities Commission on two occasions. In the first case, *In re Pacific Coast Coin Exchange of Canada Limited,*[323] the OSC held that what was involved was an arrangement that fell within the definition of a security and issued a cease trading order. Pacific Coast Coin Exchange of Canada Ltd. was incorporated in Canada and was the agent for a company called Monex International Ltd. The commission was

320 Alberta Securities Act, s. 2(1)(27)viii.

321 Alberta Securities Act, s. 2(1)(27)xiii.

322 Attorney-General of Alberta v. Great Way Merchandising, *supra* note 316; *In re* Pacific Coast Coin Exchange of Can. Ltd., 55 D.L.R. (3d) 331 (Ont. Div'l Ct. 1975), *aff'd*, 57 D.L.R. (3d) 641 (Ont. C.A. 1976).

323 [1974] OSC Bull. 209 (November). The other case, *In re* Xantrex Management Corporation, is discussed in text accompanying notes 344, 345 *infra*.

faced with the argument that a margin contract for the purchase of silver was in essence a contract for a commodity and not a security. The commission noted that through the margin contract the investor was induced to advance money to Pacific Coast with the only security for the money being a contract called a "Current Commodity Account Agreement". The commission concluded that until the investor paid the balance owing under the margin contract, including all of the continuing and collateral charges, he stood as a creditor of Monex and subject to whatever risks were inherent in that position. Also, the commission stated that he would receive no objective information, such as that provided by a prospectus, as to the nature and extent of the risk he was asked to assume and in particular information about Monex and its assets and liabilities as well as the security being offered.

The commission noted that, although California chose to regulate this type of business through its commodity law which was a part of the corporation law of the state, other states such as Texas, Wisconsin and New York had brought actions to declare that margin contracts were investment contracts under their respective securities laws. Professor L. Loss gave testimony that the scheme of the Ontario legislation through its definition of security was to cast a wider net than at least some of the U.S. jurisdictions. In this connection, the commission referred to the definition of security under section 1(1)22.ii: "any document constituting evidence of title to or interest in the capital, assets, property, profits, earnings or royalties of any person or company". The commission also referred to the categories of documents that are exempt from the registration and prospectus requirements of the act as indicating the wide scope of the definition.

The commission held that the margin contract, subject as it was to the commodity account agreement, was a security and did not involve trading in a commodity, and stated that this view was consistent with that of Mr. Justice Hartt in *Re OSC and Brigadoon Scotch Distributors.*[324] In that case, the inducement to trade was the piece of paper, the warehouse receipt, rather than the underlying commodity; and the inducement to the investor in the present case was the leverage he could obtain by investing his available funds in the margin contract as opposed to the outright purchase of a lesser number of units with the same amount of money. The commission also said that the margin account was in addition an investment contract and therefore a security under section 1(1)22.xiii of the Ontario act.

Pacific Coast appealed the OSC cease trading order to the

324 [1970] 3 O.R. 714 (H.C.).

Divisional Court.[325] The judgment of the court was given by Houlden, J., who confirmed the commission holding that a security was involved but only on the investment contract branch of the definition. He did not find a security on the basis of section 1(1)22.ii: any document constituting evidence of title to or interest in the capital, assets, profits, earnings or royalties of any person or company.[326]

With respect to the investment contract branch of the definition, Houlden, J., referred to numerous U.S. authorities and adopted the *Howey* test, the investment of money in a common enterprise with the expectation of profit solely from the efforts of others. He found the common enterprise element present[327] since the fortunes of the purchaser depended on Pacific and the purchaser relied on the skill and success of Pacific in hedging future contracts. Any effort on the part of the purchaser was minimal, which did not take it out of the *Howey* test.[328] Houlden, J., was also prepared to adopt the risk capital test as enunciated in *State Commissioner of Securities v. Hawaii Market Center, Inc.*[329] However, most interestingly, the learned judge felt the tests used in

325 55 D.L.R. (3d) 331 (Ont. Div'l Ct. 1975).

326 With respect to this branch of the definition, Mr. Justice Houlden stated that there were two requirements to be fulfilled: first, trading in a document by Pacific, and second, that such document must constitute evidence of title to or interest in the capital, assets, property, profits, earnings or royalties of any person or company. The learned judge then stated that there was a trading in the document even though there was no right in the purchaser to assign the commodity account agreement. The learned judge felt that the fact that the contract was not assignable by a purchaser was immaterial to the question. On the second requirement, that the document constitute evidence of title, he cited the *Swain* case which held that the interest in the property does not have to be that of another person in order to come within the language of this branch of the definition of security. In other words, the fact that the Commodity Account Agreement constitutes evidence of title to or interest in the purchaser's own property does not take the arrangement out of the provisions of this clause of the definition. He also noted that the words in the act do not say any document *creating* title to or interest in capital, and so on, but any document *constituting evidence* of title. The words "any document" rebut the suggestion that the document must conform to the common conception of a security in everyday use. However, Mr. Justice Houlden concluded that the construction of the statute must not so strain the words to include cases plainly omitted from the natural meaning of the language. Although securities legislation should be construed broadly, the learned judge felt that the statutory words could not be construed to include the Commodity Account Agreement because on a fair reading of the agreement it does not constitute evidence of title to or interest in property; *id.* at 341-44.

327 Counsel for the commission cited Los Angeles Trust Deed & Mortgage Exchange v. SEC, 285 F.2d 162 (9th Cir. 1960), *cert. denied*, 366 U.S. 919 (1961), which held that a common enterprise is present where the fortunes of the investor are interwoven with and dependent on the efforts and success of those seeking the investment.

328 *See* the discussion of SEC v. Glenn W. Turner Enterprises, Inc., in text accompanying note 241 *supra*.

329 485 P.2d 105 (Hawaii 1971).

the United States to interpret investment contract were too rigid and restrictive. He preferred a test, simply stated, that an investment contract was a contract or scheme for the placing of capital or laying out of money in a way intended to secure income or profit from its employment.[330]

The Court of Appeal dealt only with the investment branch of the definition and held that both by the *Howey* test and by the risk capital test, an investment contract was present.[331] The court also added that, although there was much to be said for Mr. Justice Houlden's views that the tests provided in the U.S. authorities ought not to be considered as exhaustive, it was unncesssary to determine that issue.

By a majority of eight to one (Laskin, C.J.C., dissenting), the Supreme Court of Canada dismissed the appeal and upheld the finding of the lower courts that the transactions constituted investment contracts under the Ontario Securities Act.[332] Because of the importance of the decision, it is proposed to discuss the majority and dissenting reasons in detail.

In writing the reasons for the majority, Mr. Justice de Grandpré made some important general observations. He noted that, although the Ontario act and U.S. securities legislation differed in wording, the expression "investment contract" is found in both and that the policy behind the legislation in the two countries is exactly the same, so that in considering the lack of Canadian authorities it was wise to look at decisions of the U.S. courts.[333] In this respect, he stated that the policy of the securities legislation was the protection of the public,[334] and the scope of the legislation was extremely broad as shown by the fourteen subdivisions of the definition of security, which required specific statutory exemptions to curtail the scope of the legislation.[335] As remedial legislation, the Ontario Securities Act had to be construed broadly and read in the context of the economic realities to which it is addressed; and in that connection, the substance of the transac-

330 55 D.L.R. (3d) at 347-48. Houlden, J., cites Murphy, J., in Howey, *supra* note 194, at 298. The test is reminiscent of the early attempt to define investment contract in State v. Gopher Tire & Rubber, *supra* note 211.

331 57 D.L.R. (3d) 641 (Ont. C.A. 1976).

332 *In re* Pacific Coast Coin Exchange of Canada Ltd., 18 N.R. 52 (S.C.C. 1977).

333 In fact, it was pointed out that this had already been done in Attorney-General of Alberta v. Great Way Merchandising, *supra* note 316; and *In re* Bestline Products of Canada Ltd., *supra* note 316.

334 *Citing* Hartt, J., in *In re* Brigadoon Scotch Distributors, *supra* note 308.

335 Mr. Justice de Grandpré said comments on the U.S. legislation that various categories in the definition of security are not mutually exclusive and are meant to be catchalls were also applicable to the Ontario statute; 18 N.R. at 60, *citing* 1 L. Loss at 483, 488-89, 4 L. Loss at 2501.

tion, not its form, is to be the governing factor.[336] The final general observation made by Mr. Justice de Grandpré related to the need for a flexible definition of investment contract. On this point, he adopted the approach of the U.S. Supreme Court in *Howey* which stated that, in order to fulfill the statutory purpose of compelling full and fair disclosure, it is important to have a flexible rather than static principle capable of adapting to the variable schemes which can be devised. Mr. Justice de Grandpré added that this does not mean that the legislation is aimed solely at schemes that are actually fraudulent, but rather it relates to arrangements that do not permit the buyers to know exactly what the value is of the investment they are making.

Like the lower courts, Mr. Justice de Grandpré adopted the *Howey* test to determine an investment contract. The learned judge stated that it was obvious that an investment of money had been made with an intention of profit, so that those elements of *Howey* were present. The remaining questions were whether there was a common enterprise and whether the profits were to come solely from the efforts of others. His Lordship chose to deal with these questions together, since he felt that they were so interwoven.[337]

The learned judge pointed out that "solely" as used in the *Howey* test had been criticized and modified by several decisions in the United States[338] with the result that this element meant not so much that the efforts were made *solely* by persons other than the investor, but rather that those efforts were undeniably the significant ones and the essential managerial efforts which affected the success or failure of the enterprise.

In dealing with the common enterprise element, the learned judge emphasized two aspects of the dependence of the customer upon the appellant, namely for the success of the venture and for the existence of the true market.[339]

As to the dependence of the customer for the success of the enterprise, Mr. Justice de Grandpré pointed out that the appellant in its literature underlined the danger for the ordinary investor dealing in commodity futures contracts. He stated that, although

336 *Citing* Tcherepnin v. Knight, 389 U.S. 332 (1967), discussed in text at note 202 *supra*.

337 In many cases the "common enterprise" and "profits solely from the efforts of others" are closely interwoven but they can be mutually exclusive elements.

338 Reference was made to SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir. 1973); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974); *see* text accompanying notes 241, 252 *supra*.

339 18 N.R. at 62-63. Mr. Justice de Grandpré stated that the commonality necessary for an investment contract is that between the investor and the promoter; there is no need for the enterprise to be common to the investors "between themselves". Hence the test of common enterprise was met in his view.

the appellant attempted now to recant from that position stating that there is nothing mysterious about dealing in commodity futures contracts, both courts below refused to accept that submission, holding quite rightly that the end result of the investment made by each customer is dependent on the quality of the expertise brought to the administration of the funds obtained by the appellant from its customers. Mr. Justice de Grandpré stated that if Pacific did not properly invest the pooled deposit, the purchaser would obtain no return on his investment, regardless of the prevailing value of silver and there was nothing that the customer could do to avoid that result. This dependence was also reinforced when one looked at the margin aspect of the transaction. The purchaser could only look to Pacific for the performance of his contract, and until the investor paid the full purchase price, he had no title to any physical property, but only a claim against Pacific. Should the price of silver go down, there was no possibility for the investor to finance his balance except through his own resources, and from that moment he was at the mercy of Pacific.[340]

Mr. Justice de Grandpré pointed out that the key to the success of the venture was the efforts of the promoter alone, for a benefit that would accrue to both the investor and the promoter. Hence the nature of the relationship between Pacific and its margin customers established that it satisfied the *Howey* test; it did not matter that the relationship was built around an object that is a commodity and which in another context could be the subject matter of transactions in the futures market that would not attract the restrictions of the Ontario Securities Act.[341]

Like the courts below, Mr. Justice de Grandpré was willing to apply the risk capital test as stated in *State Commission of Securities v. Hawaii Market Center, Inc.*[342] He agreed with the Divisional Court that the risk capital approach would also bring about the same conclusion in this case. As a final word, Mr. Justice de Grandpré mentioned that he would, like the Divisional Court, be inclined to take a broader approach to these questions, since legislative policy is clearly to replace the harshness of the *caveat emptor* rule when securities transactions are involved. The courts there-

340 His Lordship agreed with the Court of Appeal observation that the matter was not a pure question of solvency since the conclusion of Houlden, J., for the Divisional Court did not rest on such a narrow basis; *id.* at 63.

341 On this point, he referred to two U.S. cases: Jenson v. Continental Financial Corporation, 404 F. Supp. 792 (D. Minn. 1975); Park v. International Silver Mint Corporation, 3 CCH Blue Sky L. Rep. ¶ 71,066 (Idaho Dist. Ct. 1972). In the Jenson case, the court said that the method of operation of the defendants transformed something that appeared to be a commodity futures contract into an investment contract.

342 485 P.2d 105 (Hawaii 1971).

fore seek to attain that goal even if judicial tests carefully formulated prove ineffective, since it is the policy and not the subsequently formulated judicial test that is decisive.[343]

Quite an opposite approach was taken by Chief Justice Laskin in his dissent. He stated that it is easy in a case like the present one, when faced with a widely approved regulatory statute embodying a policy of protection of the public against fraudulent or misleading investment schemes, to give broad, undefined terms a wide meaning so as to bring doubtful schemes within the regulatory authority. But he pointed out that if the legislature, in an area as managed and controlled as security trading, has deliberately chosen not to define a term which, admittedly, embraces different kinds of transactions of which some are innocent, and prefers to rest on generality, he saw no reason of policy why courts should be oversolicitous in resolving doubt in enlargement of the scope of statutory control.

Chief Justice Laskin in reviewing the facts stated that the purchase of the commodity account agreement gave the appellants a pool of money which became theirs and tied the customers to the appellants in the consummation of their purchases, either by taking delivery of bags of coins (which was rarely done) or by closing out their accounts by selling them at the market price through the appellants, paying a commission on selling as well as buying. The appellants controlled the so-called base price; that is, the price at which the investors bought bags of silver coins for future delivery was fixed by the appellants in relation to the then market price, which was not controlled by the appellants. Counsel for the appellants submitted that it was immaterial to the customers whether the appellants hedged or not on their future obligations to them, and that hedging concerned only the financial position of the appellants. It was only their solvency which created any risk to the customer. It was the view of the Ontario Court of Appeal that the solvency issue was not enough to bring the commodity account agreements within the scope of the Ontario Securities Act. Chief Justice Laskin understood the reluctance to find that solvency or insolvency is a determining factor, since it is equally a factor in the realization of future benefits under any commercial contract.

Chief Justice Laskin stated that what was really involved was in fact the solvency of the appellants to meet its obligations to its customers. In that respect, it would be the market that would

343 Having reached the conclusion that the commodity account agreement was an investment contract, Mr. Justice de Grandpré said there was no need to determine

determine whether and when the customer would have a profit, and he was free to close out his account and to ask for delivery *in specie* at his instance and not when the promoter chose to permit him to do so. Chief Justice Laskin did not see any controlling factor in managerial effort as the U.S. court did in *Jenson*, when in his view it is the market that determines profitability and not the promoter. The notion of managerial effort, he pointed out, came from the *Howey* case where, on the facts, the citrus grove enterprise promoted by the respondents there was managed and serviced by them. In the case at bar, there was no parallel, any more than there was with a manufacturing company whose shares are purchasable on the open market.

Chief Justice Laskin doubted that a test deriving from a particular set of facts such as those in *Howey*, or the broader risk capital approach based on another set of facts as in *Hawaii*, can or should be generalized to fix the conclusion in the different facts presented in the case at bar. In the *Howey* and *Hawaii* cases, the courts were concerned with schemes relating to land management and to merchàndise selling, respectively, under which managerial control rested in the promoters. There was no substantial reliance on the market, outside of the promoter's control, as in the present case. It was apt, in Chief Justice Laskin's view, to refer to the dissent of Frankfurter, J., in the *Howey* case where he objected to bringing every innocent transaction within the scope of securities legislation simply because a perversion of them is covered by it.

It is interesting to note that although technically the only legal obligation that Pacific owed its customers was to deliver the silver when the balance of the purchase price was paid, the majority of the Supreme Court of Canada took a broader view of the situation. It emphasized the efforts of Pacific and its expertise but seemed to ignore that there was no special obligation to supply the individual customer with that expertise. On the other hand, looking at it from a substantive point of view, the customer did expect such service and expertise when it bought a commodity contract with Pacific. At the same time, it is interesting to note that the role of and efforts made by Pacific were of course subject to the market price fluctuations in silver; yet it is difficult to divorce Pacific's efforts from the market price, since both factors were involved in the question of whether or not a return would be made to Pacific and to the participants who advanced funds. In this respect, the reasoning of the majority is preferable, especially when one con-

whether the agreement was also a security under s. 1(1)22.ii of the Ontario Securities Act; 18 N.R. at 64.

siders the policy behind securities legislation as recognized by Canadian courts in other cases.

g. *Xantrex Management*

In another case involving gold and silver bullion, the Ontario Securities Commission held that purchase orders relating to such bullion issued by a company called Xantrex Management Corporation were securities within the meaning of the Ontario Securities Act.[344] The ultimate right to the purchaser under the scheme if Xantrex failed to deliver the bullion or "repurchase" the bullion was to demand the return of his money with interest at 7% and failing that to take action against Xantrex in the courts. Although there were dissimilarities between the Xantrex scheme and the Pacific Coast arrangement, the commission felt that the comments made by it in its *Pacific Coast* decision, and indeed the observations of Mr. Justice Houlden in the Divisional Court dismissing Pacific's appeal, were applicable to the facts before the commission in Xantrex. Xantrex's counsel had cited the language of Mr. Justice Houlden in support of the proposition that the substance of this contract of Xantrex was that it was a commodity contract and emphasized dissimilarities between it and the Pacific Coast margin account. The commission held otherwise, stating on the basis of the judgment of Houlden, J., that the arrangement was an investment, and therefore a security. The commission also added that there could be a question of whether or not the contracts involved might be gaming contracts and therefore illegal.[345] As in *Pacific Coast*, a security was found even though at the centre of the arrangement lay a commodity contract.[346]

344 *In re* Xantrex Management Corporation, [1975] OSC Bull. 93 (March).

345 *Id.* at 99. The commission referred to s. 341 of the Criminal Code and cases involving commodity futures contracts executed on a commodity exchange: Beamish v. James Richardson & Sons, 49 S.C.R. 495 (1914); Maloof v. Bichell & Co., 59 S.C.R. 429 (1919); Prudential Exchange & Co. v. Edwards, [1939] S.C.R. 135. Those cases dealt with the question of whether or not the purchase of commodity futures contracts were in fact gaming contracts because the parties were anticipating a rise in the market price of the commodities forming the subject matter of the futures contracts. It was mentioned by the commission that those cases were different from the present case where the purchaser was not obliged to purchase nor the seller to deliver the physical commodity. Reference was also made to Universal Stock Exchange v. Strachan, [1896] A.C. 166 (H.L.).

346 *See also* B.C. Corporate and Financial Services Division Weekly Summary, January 10, 1975, which contained a notice from the B.C. Superintendent of Brokers dealing with investing in gold and silver bullion. The notice listed some of the risks of the "investments" and indicated that these were not fully disclosed and would be difficult for an ordinary investor to detect without the most careful inquiry. The notice also mentioned that it was a distinct possibility, "depending upon the terms of the particular contract, that the investment may be a security subject to the

h. *London Commodity Options*

In its most recent decision relating to the definition of security, the Ontario Securities Commission held that London commodity futures options and any documents or agreements based on such options were securities within the meaning of the "investment contract" and "title to or interest in assets" clauses of section 1(1)22 of the Ontario Securities Act.[347] After reviewing the nature of the agreements sold, the OSC noted that the benefit of the commodity option compared to the commodity futures contract was that, with the former, the most the investor can lose is the premium paid for the option; whereas with the futures contract, margin and margin maintenance requirements may result in major losses requiring the investor to have substantial capital to meet potential demands.[348] The OSC in arriving at its conclusion followed the decision of the Texas court in *Clayton Brokerage Co. of St. Louis, Inc. v. Mouer*.[349]

The OSC noted that the court in that case found the London options to be securities, emphasizing that the customers made no contribution toward making their investment profitable since they looked to the Clayton brokerage firm for their profit. In both the *Clayton* case and the procedures followed by the three Ontario options dealers concerning which the OSC had evidence, the recorded client on the books of the London dealer in the option was the North American dealer and not the ultimate purchaser. Moreover, whereas in the *Clayton* case the broker appeared to act as agent for its clients in London transactions, the Ontario dealers sold their own contracts to customers, relating their contracts to a London option on a futures contract with a specific price.

This aspect of the decision is most interesting because the OSC concluded that not only were the London commodity futures options "securities" but that the agreements and documents the Ontario dealers issued granting the customer rights under specified London options were also "securities".[350] The commission noted that, although the documents emanating from the Ontario dealer were similar to a confirmation in an ordinary brokerage

provisions of the British Columbia Securities Act, and may be sold in violation of the requirements of that statute".

347 *In re* London Commodity Options, [1977] OSC Bull. 80 (April). For a discussion on commodity futures contracts and commodity futures options, *see* text accompanying note 267 ff. *supra*.

348 [1977] OSC Bull. 80 (April).

349 520 S.W.2d 802 (Tex. Ct. App. 1975).

350 *In re* London Commodity Options, *supra* note 347, at 87. The commission applied the reasoning in Brigadoon Scotch Distributors to find a security under s. 1(1)22.ii, and Howey and Pacific Coast to find an investment contract under s. 1(1)22.xiii.

transaction, there were several differences. The document did not disclose where the option was bought and at what price, the name of the dealer holding the option, or whether the Ontario dealer acted as principal or agent in the transaction. The commission stated:

> "In the language of clause ii of paragraph 22 [of section 1(1)], this is the only document [the customer] receives. It constitutes evidence of an interest in the property of the Ontario dealer amounting to an option on a commodity futures contract of specific month, year and striking price. These rights are enforceable only through and against the dealer who sold the security."[351]

In effect, then, there were two securities being sold: one by the Ontario dealers emanating from themselves, the other consisting of the options on commodity futures contracts which derived from London.[352] What is also interesting is that the OSC did not wish to relinquish applying the clause (ii) heading of the definition of security despite the holding of Houlden, J., in *Pacific Coast* that the clause was not applicable in that case on what some might argue were similar facts.

2. *Land-Related Transactions*

a. *Regina v. Dalley*

Although the sale of land or an interest in land is not normally a security, there have been arrangements involving real estate

351 *Id.*

352 Other action has been taken with respect to commodity futures options: *see* Notice by the B.C. Superintendent of Brokers in August 1975 dealing with commodity futures trading, B.C. Corporate and Financial Services Division Weekly Summary, August 15, 1975, at 1. The notice stated that a company was locating in Vancouver which intended to act as agent for a Chicago commodities broker in trading commodities futures in British Columbia. The notice cautioned that the subject of trading commodities futures and commodities options was under review to determine what would be the most appropriate form of controlling and regulating this type of activity. It was suggested that in the interim, speculators and investors inexperienced in this type of trading should consult one of the national securities firms in Vancouver having a commodities section before getting involved. The Toronto Stock Exchange in March 1974 indicated that, in view of the increased trading activity in commodity futures, and the record prices that these commodities had achieved, as well as the high risk factor in commodities trading where substantial exposure can be taken with a relatively low margin requirement, and deficient reporting requirements, a by-law had been passed by the Board of Governors requiring members to submit semi-monthly a report on all commodities futures contracts purchased and sold during the preceding 15-day period; TSE, Notice to Members: Re: Commodities Futures Trading Report (March 1974) (By-law No. 118). The Alberta Securities Commission has issued a news release stating that the commission ordered Locan Commodity Options Inc. to stop trading in alleged London commodity options in Alberta. Locan was one of the companies involved

that Canadian courts have held to be securities. In *Regina v. Dalley*,[353] the appellant had been convicted of trading in a security without registration by selling permits received from the Department of Lands and Forests of British Columbia. The permits entitled the owners to prospect and do surface geology upon the payment of fees and they received an exclusive drilling licence and ultimately a lease. The court, although not holding that the permits were securities, did say that the agreement of sale was a security since it was clearly a document constituting evidence of title to or interest in the property of the appellant. The court acknowledged that even though it would be giving a very wide meaning to the term security, where the meaning of the statute is plain, as in the case before it, the court must give effect to it. This view has been criticized, since it follows that if the agreement to sell is a security, then it would seem that a deed to land would also be a security, with the consequence that a real estate broker would be required to be registered as a security broker.[354]

b. *Avoca Apartments*

Whether a cooperative apartment suite could be considered a security came up for interpretation in *In the Matter of Avoca Apartments Limited*.[355] Under the arrangement, the ownership of each apartment suite was to be represented by shares in the capital of the cooperative company; the arrangement was described as the purchase of the exclusive right to occupy, use, and enjoy an apartment suite in the building through the ownership of shares in the capital stock of the Avoca company. Counsel for Avoca argued that, even though there was a sale and issuance of shares, the substance of the transaction was the sale of real estate; the issue of shares was only incidental and could not have been intended by the legislature to be subject to regulation by the Ontario Securities

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before the OSC in its decision of April 1977; *see* Alberta Securities Commission Summary, March 31, 1977, at 1.

353 [1957] O.W.N. 123 (C.A.); *see* the discussion of the case in text accompanying note 52 *supra*.

354 *See* J. Williamson, Supp. at 104. As noted by Williamson, the chairman of the OSC distinguished the sale of real estate from the sale of units of participation in a real estate trust in holding the units to be securities; Parkdale Investment Syndicate, Spadina Road - Bloor Syndicate, [1958] OSC Bull. 1 (March). In R. v. Bird and International Claim Brokers Ltd., 43 W.W.R. 241 (B.C.S.C. 1963), the court held that a campaign to sell mineral claims was trading in securities under the "commonly known as a security" heading, the "constituting evidence of title" one, or the "certificate of interest in a mineral lease or claim" heading but did not say which one and did not give reasons.

355 [1968] OSC Bull. 154 (July).

Commission. The argument was that the purchaser was not buying securities which needed a prospectus, but he was buying property that he could see and inspect for himself; thus it was not necessary to obtain the protection of the OSC or of the registration and prospectus requirements of the act. Counsel for the commission argued that the legislature deliberately phrased the act in broad and general terms so that its plain wording should not be cut down by reference to supposed considerations of policy. He also argued that although there were real estate aspects to the transaction they were highly sophisticated ones in which the purchaser would require the protection of some government agency; and since there was an issue of shares involved, this pointed to regulation by the commission. The commission said that they were bound by the law as laid down in the act and did not see, after considering the opposing policy considerations, sufficient reason for departing from the literal meaning of the words used in the act.

c. *Western Ontario Credit*

In *Western Ontario Credit Corporation Limited,*[356] the Ontario Securities Commission was faced with the question whether the Securities Act applied to what were alleged to be mortgage transactions. Western Ontario Credit Corp. Ltd. (Western) and its subsidiary, WOCCO Investments Ltd. (WOCCO), carried on mortgage-related businesses. Counsel for the commission argued that the respondent companies had offered investment contracts under section 1(1)22.xiii of the definition of security and not mortgages entitling the respondents to the registration and prospectus exemption provisions under sections 19(2)4 and 58(2)a, respectively.

Under the investment plan, WOCCO guaranteed an 8% return on mortgage investments to the investor. The arrangement involved indentures, assignments, and other documents whereby WOCCO would administer and collect a mortgage on behalf of the assignees and retain all funds collected subject to its obligation to pay the principal plus interest to the investors. The investment involved a group of individuals forming one syndicate, in effect, to take a portion of the mortgage. Counsel for WOCCO argued that the OSC had to identify the document that constituted the security and that the assignment was not an investment contract but rather a mortgage within the meaning of section 19(2)4, and thus exempt from registration and prospectus provisions.

The commission ruled that the entire range of documents must be looked at before determination can be made as to what is

356 [1974] OSC Bull. 87 (May).

the investment plan or alleged investment contract. There was no single document which spelled out all the rights and obligations of the purchaser, and the particular rights and obligations which evolve are added to as one moves from one document to the next in a chronological package. The commission stated that even if one focused on the last document in the chain, that is, the assignment, it introduced terms and conditions which had not appeared before. Furthermore, the commission concluded that it is not the actual language of the document but the substance of the transaction which is relevant to the issue.[357]

After referring to various decisions, the commission concluded that an investment contract was involved, not a mortgage.[358] This conclusion derived from several features of the transaction. The proceeds to the investor were based on a rate of return set out in an "investment agreement" and not the rate of return set out in the mortgage documents. The investor had an option of investing as late as the tenth day of the month and yet received the rate of return as if he had invested on the first day of the month. WOCCO also permitted the individual investor to make payments on a periodic basis rather than in a lump sum, which was felt to be repugnant to the "notion of a contribution to and the purchase of a specific item of or interest in real property".

The commission concluded:[359]

> "Taking all of the evidence together, we conclude that the investor here was putting money out essentially to purchase the skills, expertise and administrative services of Western and the use or employment of those skills and ability to produce a guaranteed investment return. The investor was not essentially buying a specific interest in real property, *i.e.*, a mortgage."

357 In support of these conclusions the commission referred to, and applied the reasoning of, several U.S. and Canadian authorities: SEC v. W.J. Howey Co., *supra* note 194; SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967); Tcherepnin v. Knight, *supra* note 202; Attorney-General of Alberta v. Great Way Merchandising, *supra* note 316.

358 In addition to the cases listed in note 357 *supra*, the OSC also cited with approval what it regarded as an additional test provided by the B.C. Court of Appeal in *In re* Bestline Products of Canada Ltd., 29 D.L.R. (3d) 505 (B.C.C.A. 1972), namely:

> "[T]he salient feature of securities sales is the pubiic solicitation of venture capital to be used in a business enterprise - subjecting investor's money to the risk of an enterprise over which he exercises no managerial control." [1974] OSC Bull. at 100.

359 [1974] OSC Bull. at 102. The commission noted that its conclusion was similar to that reached in Los Angeles Trust Deed & Mortgage Exchange v. SEC, *supra* note 276. Applying Attorney-General of Alberta v. Great Way Merchandising Ltd., [1971] 3 W.W.R. 133 (Alta. S.C.), the OSC characterized the investment contract as the primary or essential feature of the plan and the interest in real property as the collateral or secondary feature of the plan.

The *WOCCO* decision was affirmed by the Divisional Court which cited with approval Mr. Justice Houlden's views in *Pacific Coast* about giving a wider definition to investment contract and his opinion that the U.S. tests were too rigid and restrictive.[360] Speaking for the Divisional Court, Mr. Justice Hughes, in referring to Mr. Justice Houlden's view and the U.S. jurisprudence, said that he would have preferred the words of Frankfurter, J., in his dissenting judgment from the *Howey* case, where he said:[361]

> "Investment contract is not a term of art; it is a conception dependent upon the circumstances of a particular situation."[362]

The Divisional Court also adopted the approach taken in *Re Maher Shoes Limited and Ontario Securities Commission*,[363] in which Mr. Justice Aylesworth cautioned that where the evidence has been understood and weighed by the commission, the court should not be quick to substitute its opinion for that of the commission. Acknowledging a difference between the role of the commission in *Maher* and in the case before him, Mr. Justice Hughes nonetheless said a similar approach should be taken. The learned judge added:

> "Moreover, where a regulatory tribunal, acting within its jurisdiction, makes an order in the public interest with the experience and understanding of what that interest consists of in a specialized field accumulated over many years, the court would be especially loath to interfere. We are of the opinion that there was ample evidence to support the findings of the Commission as to the existence of an investment contract subject to the registration and prospectus provisions of the Securities Act, and that there was no misapprehension of the law applicable to the facts as found."[364]

360 9 O.R. (2d) 93 (Div'l Ct. 1975).
361 SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946).
362 *Cited in* 9 O.R. (2d) at 102.
363 [1971] 2 O.R. 267 (C.A.).
364 9 O.R. (2d) at 103. Also with respect to mortgage interests, *see* the Notice of the B.C. Superintendent of Brokers (April 20, 1977) stating the circumstances under which an exemption under the B.C. Securities Act will be granted for mortgage syndication interests. A prospectus will be required unless the following conditions are fulfilled:

> "1. where the interest in the mortgage acquired by the investor is registered 'on title' in his name or in the name of a trust company or a member of the Law Society of British Columbia in good standing as his trustee;
> "2. where there is no guarantee of return on the investment offered by the offeror; and
> "3. where the rate of interest offered to the investor is not different from that stated in the mortgage itself."

B.C. Corporate, Financial and Regulatory Services Weekly Summary, April 22, 1977, at 1.

d. *Palomar Developments Corporation*

A recent decision of the Saskatchewan District Court held that an arrangement involving the building and sale of fourplex private dwellings was not a security either under the investment contract or the profit-sharing agreement or certificate headings of security under the Saskatchewan Securities Act.[365] The accused negotiated agreements with investors to build the fourplex dwellings on land owned by the accused, and if the parties agreed the accused would proceed to register the development as a condominium. The accused had the right to sell the condominium units and receive a commission on the sales as well as sharing the net profits from the sale of the units. The accused was convicted at trial of selling securities without complying with the prospectus requirements of the Saskatchewan Securities Act. The District Court allowed the appeal stating that the building contracts did not come within the definition of security.

The result is questionable especially when one examines, with respect, the rather unsatisfactory reasoning of the court. The court dispensed with the investment contract argument based on *Great Way Merchandising* and *Bestline Products* by simply saying that those cases dealt with pyramid selling which was covered by the Combines Investigation Act. The court also said that the investment provisions of the building contracts were minor – whatever that means. In dealing with *Howey*, the court stated tersely that the case before it was not one where "American authorities" were of assistance to the court.[366] One can only hope that the decision in *Palomar* will not be followed.

3. *Franchises and Service Ventures*

a. *Century 21 Real Estate Corporation*

The B.C. Corporate and Financial Services Commission recently reviewed a franchise agreement for real estate brokers and held it was not a security under the B.C. Securities Act.[367] Under the franchise agreement, the franchisee paid an initial franchise fee and an annual service fee equal to 6% of the franchisee's gross income derived from all transactions for which a real estate licence or securities licence was required, in return for which the franchi-

365 R. v. Palomar Developments Corporation, [1977] 2 W.W.R. 331 (Sask. Dist. Ct.).

366 *Id.* at 337. The court said that a presentation of a few select U.S. cases is not of much help because of the court's lack of knowledge of the relevant legislation and other related cases.

367 *In re* Century 21 Real Estate Corporation, B.C. Corporate and Financial Services Division Weekly Summary, May 30, 1975, at 1.

see obtained the right to the use of the Century 21 system. The agreement between the franchisor (Century 21) and the franchisee provided that the latter was an independent contractor and that it was responsible for carrying on its business; however, the franchisor retained ownership and all rights, title and interest in the trade name, trademarks, goodwill and trade secrets of Century 21. The Deputy Superintendent of Brokers issued a cease trading order based on his decision that the franchise agreement constituted a security under clause (ii) of the definition of security in section 2(1) of the act, namely, "any document constituting evidence of title to or interest in capital, assets, property, profits, earnings or royalties of any person or company". At the hearing before the commission, it was also argued that the agreement fell within clause (xiv) of the definition, that is, an investment contract.

The commission acknowledged the broad approach of courts to remedial legislation like the British Columbia Securities Act citing the usual cases.[368] Also the commission noted that, if the words of the statute are broad enough in their plain meaning to cover the arrangement in issue, effect must be given to the plain meaning regardless of the consequences. However, the commission repeated the exhortation of Mr. Justice Houlden in *Pacific Coast* that the construction of a statute should not be strained to include cases plainly omitted from the natural meaning of the language.

As to the first branch of the security definition argument, the commission (acknowledging that it was not clear what the reasons of the deputy superintendent were) assumed that he viewed that the interest of Century 21 was in the earnings of the franchisee. The commission said that the deputy superintendent misunderstood the differences between "earnings" and "gross income", admitting that the terms are not precise in meaning. Since what was involved here was a percentage of gross income, the commission felt that that was similar to a rental or other cost which was incurred by a business in arriving at its net income, earnings or profits. The commission said that earnings were similar to profits and in their view the agreement in question here did not constitute evidence of any interest in either the earnings or the profits of the franchisee.[369]

368 *E.g.* Tcherepnin v. Knight, 389 U.S. 332 (1967) as approved by Canadian cases.

369 The conclusion of the B.C. commission on this point shows how easy it is for franchise promoters to avoid this heading of the definition of security since an interest in gross returns, sales, or revenues presumably falls outside the language of the heading. One also wonders whether the commission misapplied this heading in looking at an interest of the franchisor in the property of the franchisee instead of

On the question of whether the franchise was an investment contract, the commission referred to U.S. authorities as approved in the *Pacific Coast* case and others. The commission referred to the *Hawaii Market Center* risk capital analysis, in addition to the four elements of the *Howey* test. The commission approved of the wider meaning of investment contract that Mr. Justice Houlden in *Pacific Coast* preferred to give the term, and felt that this view had considerable merit; the danger with the risk capital analysis was that it invited the same sort of semantic and mechanical response by promoters as that evoked by the *Howey* formula.

However, the commission stated that even on Mr. Justice Houlden's broad interpretation the agreement in issue did not constitute an investment contract. Although the franchisee expected to profit from the laying out of money or the placing of capital in the form of franchise and service fees, this was literally true of contracts for the purchase of goods for resale. The commission noted that a retailer must pay a wholesaler money to acquire goods for resale to the public at a profit. In this sense, literally applying Mr. Justice Houlden's wider meaning, a contract of sale would constitute an investment contract, and to do this in the context of the British Columbia Securities Act definition would disregard substance for form and ignore economic reality. In the opinion of the commission, what took a sale out of the scope of investment contracts for the purposes of the British Columbia Securities Act was the fact that the price the purchaser paid for the goods did not, quoting the judgment of *Hawaii Market Center*,[370] "subject it to the risks of enterprise" of the vendor.

Thus the commission thought that the sale of a commodity was similar to the sale of the franchise for which the franchisee pays a sum of money. Upon payment, he loses all title to or interest in that money. Consideration in the form of the franchise and service fees become the absolute property of the franchisor to be disposed of by Century 21 in whatever way it is thought most appropriate, and the franchisee has no residual claim on the money thus paid over. Should Century 21 go into solvent liquidation, the franchisee will have no claim in the liquidation against any of the assets of Century 21. Furthermore, should Century 21 suffer trading losses, the franchisee will not suffer at all. If Century 21 makes profits, then no part of the profits will redound to the benefit of the franchisee. In other words, the commission stated that the profits the franchisee will make will come from its own efforts in exploit-

vice versa. It would seem that the investment contract analysis is more appropriate for arrangements like franchises.

370 485 P.2d 105 (Hawaii 1971).

ing the Century 21 system in exactly the same way that the profits of a retail distributor come from its efforts in selling merchandise bought from a wholesale supplier.

In short, Century 21 was offering its system for sale and in doing that was carrying on its business and not investing in the business of the franchisee. The commission did say, however, that it did not feel its conclusion that the disputed franchise agreement was not an investment contract meant that in every case a franchise agreement was necessarily beyond the scope of the definition of a security.

b. *Re Sanderson*

A rather novel service contract was at issue in *Re Sanderson and Ontario Securities Commission*[371] in which the Ontario Court of Appeal held that a betting arrangement was an investment contract. Under a contract, individuals deposited $400 to be bet on horseraces by one Sandy Sanderson who styled himself as "an old pro". An individual was told that he would get $75 a week for sixteen weeks, netting him a profit of $720. The lower court held that no security was involved.

The respondent argued *inter alia* that the document in question was not a security within the meaning of the Ontario Securities Act. The Court of Appeal reversed the decision of the lower court and held that there was in fact a security within the branch of the definition which provides that any income or annuity contract not issued by an insurance company or an issuer within the meaning of the Ontario Investment Contracts Act is a security.[372] Unfortunately, the judgment is not supported by any reasoning – it is quite simply stated that the court was satisfied that the document in question was in the nature of an income contract and all parties had agreed that it did not come within the Investment Contracts Act.[373]

There are other instances of service-oriented arrangements which have attracted the attention of securities administrators; hence this type of scheme can be quite problematic.[374]

371 [1972] 3 O.R. 329, 28 D.L.R. (3d) 171 (C.A.).

372 Ontario Securities Act, s. 1 (1)22.xii.

373 For an interesting epilogue to Sandy Sanderson *see* D. Johnston at 32 n. 79.

374 *See* the Notice, dated June 17, 1975, in which the B.C. Superintendent of Brokers noted recent advertisements for the sale of so-called vacation licences, vacation time sharing agreements or the like and stated they are considered to be securities within the meaning of the Securities Act. The superintendent proposed to require the filing of a prospectus in compliance with the Securities Act to ensure that full, true, and plain disclosure be made by those distributing or proposing to distribute these securities. The notice also cautioned the public to insist on the production and careful perusal of a duly filed prospectus prior to purchasing any such licence or

4. *Pyramid Ventures or Distributorships*

a. *Great Way Merchandising*

In *Attorney-General of Alberta v. Great Way Merchandising Ltd.*,[375] the Appellate Division of the Alberta Supreme Court dismissed an appeal against the finding that the appellant had traded in securities while not being registered as a broker or otherwise under the Alberta Securities Act. The appellant proposed to establish a retail discount store, and it used in its promotion campaign an agreement called an "Authorized Representatives Agreement" with the aim of recruiting a maximum of 3,000 representatives who in turn would recruit up to fifty potential customers of the store. A representative on his recruitment paid a sum of money to the appellant, some of which was to be used to purchase stock in trade for the store and some of which was to be retained by the appellant. In return for his payment, the representative was given, under the agreement, rights to earn money in various ways, including commissions on store sales made to customers recruited by him. The question was whether the Authorized Representatives Agreement constituted a security within the meaning of the Alberta Securities Act.

The court held that the agreement clearly contained provisions for investment and a promise or expectation of a return to the investor. In the court's view, it did not matter that intermingled with such provisions in the agreement were others which dealt with non-investment matters, because such intermingling did not rob the agreement of its essential character as an investment contract; and this element was a substantial, if not the predominant, characteristic of the document, which thereby made it come within the definition of a security in the act.[376]

The principal argument made was that the agreement was an investment contract. Mr. Justice McDermid, in giving the judgment of the court, cited Chief Justice Stout in *Commissioner of*

agreement; B.C. Corporate and Financial Services Division Weekly Summary, June 20, 1975, at 1. In this connnection, *see* the decision of the Deputy Superintendent of Brokers of B.C., *In re* Securities Act and Leisure World Enterprises Ltd., B.C. Corporate and Financial Services Division Weekly Summary, November 15, 1974. The deputy superintendent held that a vacation scheme which comprised, among other features, an instructional course and a share participation in the promoter was a security within the meaning of the definition under the B.C. Securities Act.

375 [1971] 3 W.W.R. 133 (Alta. S.C.).

376 It is interesting to note that a specific term of the Authorized Representatives Agreement provided that the agreement or other document was not in any way to be considered a security.

Taxes v. Australian Mutual Providence Society,[377] where investment was defined by referring to its dictionary meaning of the laying out of money or putting out capital for the purpose of obtaining interest for it. Mr. Justice McDermid also stated that the Alberta Securities Act was remedial legislation and should be interpreted as such and that it did not absolutely prohibit transactions such as the one at bar but required that they be approved first for the public protection. He also noted that the investment of monies in this case was a substantial, if not the predominant, element in the arrangement but that there could be an arrangement where the investment provisions were so minor and so submerged in non-investment provisions that in essence the resulting contract would not be an investment security as provided in the act.

Mr. Justice McDermid referred to the *Howey* case and cited the test and approach of the court in that case relating to form being disregarded for substance and the emphasis on economic reality. Counsel for Great Way had urged that the test of *Howey* was not met because the individual earned money on a commission basis; hence the effort did not come from Great Way but rather from the individual concerned so that the "solely on the efforts of others" element was not present. Mr. Justice McDermid replied that he did not think the *Howey* case was authority for the proposition that, by a combination of non-investment terms with investment terms, the resulting contract ceases to be subject to the Alberta Securities Act.[378]

Mr. Justice McDermid concluded that it was unnecessary, in view of his holding, to decide whether the arrangement was a security under clause (ii) ("any document constituting evidence of title to or interest in capital, assets....") or clause (viii) ("any profit-sharing agreement or certificate") of the Alberta Securities Act definition of a security.

b. *Bestline Products*

Another pyramid sale arrangement came up for consideration in *Bestline Products v. British Columbia Securities Commission*[379] which was initially decided by Mr. Justice Aikins in chambers not to be an investment contract. The British Columbia Securities Commission had issued an order prohibiting the applicant's sales organization from recruiting others into its sales force

377 22 N.Z.L.R. 445 (C.A. 1903).

378 Mr. Justice McDermid referred to other U.S. cases dealing with similar distributorship arrangements which went different ways on the question. [1971] 3 W.W.R. at 148.

379 [1972] 2 W.W.R. 287 (B.C.S.C.).

on the ground that the recruitment amounted to the sale of a security. The business of the applicant was selling cleaning materials directly to the public and its sales organization consisted of three levels of salesmen: local distributors, who sold the applicant's products to the public from door to door; direct distributors, who managed and controlled the local distributors and provided them with merchandise to sell; and general distributors, who trained and generally controlled the direct distributors. One could progress from one level of distributorship to the next. The returns were by way of commission based on the efforts of the entire sales force. To become a direct distributor, some $2,000 had to be paid, the bulk of which went to the purchase of the applicant's merchandise and the remainder to the purchase of a training kit and membership in the organization. There was no guarantee that the purchaser would receive any benefits from the money paid; the purchaser could earn benefits only through his own efforts. The argument was made that the opportunities for making money as a direct distributor made the sale of such distributorships the sale of a security within the investment contract branch of the definition of security.

Mr. Justice Aikins held that there was no investment in the applicant company since the money that was paid was for clearly defined things, namely, cleaning material for sale, the sales kit, and the membership in the applicant's organization. There was therefore no investment and any money made by the purchaser of a direct distributorship was made solely as a result of the purchaser's own efforts.[380]

This decision was confirmed by the B.C. Court of Appeal.[381] Mr. Justice Nemetz cited the *Great Way* case and the U.S. cases that were referred to in *Great Way* which went opposite ways on the question of interpreting pyramid sale arrangements. Mr. Justice Nemetz adopted the view of Mr. Justice McDermid in *Great Way* on the latter's interpretation of the *Howey* case relating to the combination of non-investment terms with investment terms in the contracts under dispute. He noted that in *Great Way* there was an actual investment made in the store and stock owned by the company; in other words, an investment ingredient was proved and, accordingly, the court was able to bring the scheme under the Alberta Securities Act. Mr. Justice Nemetz said that the Crown was not able to show that the sum of $2,000 paid by a direct distributor to Bestline was anything other than the purchase for

380 Mr. Justice Aikins also ruled that the distributorship was not "any document, instrument or writing commonly known as a security" under s. 2 of the B.C. Securities Act. However, no reasons were cited for this conclusion; *id.* at 294.

381 [1972] 6 W.W.R. 245 (B.C.C.A.).

value of the cleaning materials, plus other legitimate merchandising charges. The situation would have been entirely different, in his view, if it had been proved that the sum of $2,000 did not represent a purchase for value. In those circumstances it might be inferred that an investment ingredient existed. The Crown was unable to show, even though it asserted that the distributor received a "bundle of opportunities", that Bestline received any consideration for the opportunities so received. The learned judge also said that, although the direct distributors placed sums of money in trust with Bestline in order to become general distributors, it was not shown that Bestline received that money. In fact, he said, to the contrary, the evidence was that the bulk of it went to other general distributors and the remainder to provide transportation and accommodation for the direct distributor when he visited another city to receive further merchandising instructions.

At the conclusion of his judgment, Mr. Justice Nemetz cited and adopted the risk capital test from *Hawaii Market Center*[382] to ascertain whether a selling scheme is a security.[383] However, he concluded with no discussion that the Crown failed to prove that the present facts came within the *Hawaii Market Center* criteria.[384]

Chapter VI
Summary and Recommendations

A. INTRODUCTION

The foregoing chapters have dealt with the scope of the U.S. and Canadian securities legislation, and this chapter contains a brief summary of the basic definitions followed by some recommendations. The recommendations deal primarily with the definition of "security", but reference will also be made to related definitions and the question of exemptions generally. It is important to note that the definitions of security and related terms and the nature of the exemptions relate to the overall approaches toward securities regulation desired for a particular securities act. Thus the objectives of the act must be specified first, followed by how those objectives are to be attained.

382 485 P.2d 105 (Hawaii 1971), discussed in text accompanying note 231 *supra*.
383 [1972] 6 W.W.R. at 250.
384 Separate reasons for dismissing the appeal were given by Tysoe, J.A., with whom Maclean, J.A., concurred; *id.* at 246.

B. THE DEFINITION OF SECURITY

1. *Summary of Canadian Legislative Provisions*

Several conclusions emerge from an examination of the definitions of security in Canadian securities legislation.[385] First, although important differences exist, the general thrust of the definition is similar among the various provincial jurisdictions. Second, a security is broadly defined with branches of the definition having a very wide scope,[386] supplemented by branches with a very narrow or specialized meaning.[387] Third, much overlap appears to be present and some types of securities, notably those relating to oil and gas, are not clearly delineated. In fact, the definition of a security has been described as a "heterogeneous clutter".[388] Fourth, the approach taken among the various Canadian securities statutes has been to define security in the act *and* the regulations promulgated thereunder.[389] Finally, the definitions of security have been influenced by the development of the securities laws of the United States both at the state and federal levels.

2. *Summary of Canadian Interpretations of Security*

In comparison with the United States experience, there have been relatively few examples of interpretations of the definition of security by either Canadian courts or securities administrators.[390] However, some important principles can be gleaned from the decisions we have.

Courts and administrators in interpreting security have emphasized the underlying purposes or objectives of securities regulation, for example, the protection of the investing public.[391] In addition, the interpreters of security have also stated that, in

385 *See* discussion in text accompanying notes 49-70 *supra*.

386 *E.g.* "investment contract"; "any document constituting evidence of title to or interest in the capital, assets, property, profits, earnings or royalties of any person or company".

387 *E.g.* interests in scholarship or educational plans or trusts in Ontario Securities Act, s. 1(1)22.xiv; and certain agreements to purchase fur-bearing animals, which heading is found in the regulations under the securities statutes of New Brunswick, Newfoundland, Nova Scotia and Prince Edward Island.

388 J. WILLIAMSON, SUPP. at 100. Williamson adds: "To some extent, the defining terms seem to have been added piecemeal, and without much justification"; *id.*

389 *See generally* New Brunswick, Nova Scotia, Prince Edward Island and Newfoundland Securities Acts.

390 *See generally* ch. V *supra*.

391 *E.g. In re* Brigadoon Scotch Distributors, *supra* note 308 (*per* Hartt, J.), discussed in text accompanying notes 308, 309 *supra*.

reviewing the myriad of transactions or arrangements alleged to be securities, substance not form should govern.[392]

Although some of the earlier holdings of a security were based on the "evidence of title to or interest in the capital, assets, property...of any person" heading, recent Canadian cases have focused on the meaning of "document, instrument or writing commonly known as a security"[393] and more particularly the meaning of "investment contract".[394] With respect to the latter term, the Canadian courts and securities administrators have referred to and adopted well-established U.S. tests and analyses, notably the U.S. Supreme Court's decision in *Howey*[395] and the risk capital approach of the California Supreme Court's decision in *Silver Hills.*[396]

Like their U.S. counterparts, the Canadian judges and securities administrators have looked not only at what was being sold but also *how* the arrangement or transaction was set up. If property or service alone was involved, then a security was not present; if more than the sale of property or service was involved, a security was present. In this connection emphasis has been placed on the policy of the securities act and whether the arrangement or transaction was basically of an "investment" or "commercial" nature, with only the former attracting the requirements of the securities act.[397] It is also interesting that one Canadian judgment was prepared to go even further than the U.S. tests of *Howey* and *Silver Hills* in order to apply a less rigid and restrictive test for an investment contract by defining the term as a contract or scheme for the placing of capital or laying out of money in a way intended to secure income or profit from its employment.[398] At the same time, the judgment recognized the general principle of statutory interpretation that the construction of the securities act should

392 *E.g. In re* Farmex Enterprises, *supra* note 314, discussed in text accompanying notes 314-16 *supra*; Attorney-General of Alberta v. Great Way Merchandising Ltd., *supra* note 316; *In re* Bestline Products Ltd., *supra* note 316.

393 *In re* John T. Geldermann, *supra* note 310, discussed in text accompanying notes 310-13 *supra*.

394 Notably the Supreme Court of Canada in *In re* Pacific Coast Coin Exchange, 18 N.R. 52 (S.C.C. 1977).

395 328 U.S. 293 (1946), discussed in text accompanying notes 194-95 *supra*.

396 55 Cal. 2d 811, 361 P.2d 906 (1961), discussed in text accompanying notes 216-24 *supra*.

397 *See In re* Brigadoon Scotch Distributors, *supra* note 309 (*per* Hartt, J.).

398 *In re* Pacific Coast Coin Exchange, *supra* note 323 (*per* Houlden, J.). The Supreme Court of Canada approved of Houlden, J.'s views; *see* text accompanying note 341, *supra*. *See also* the approval given by the B.C. Securities Commission in *In re* Century 21 Real Estate Corporation, *supra* note 367, discussed in text accompanying notes 367-69 *supra*.

not be strained to include cases plainly omitted from the natural meaning of the language employed.[399]

As a general comment, the Canadian decisions, especially the recent ones, have for the most part been well reasoned and have reached the right results.[400] As a consequence, entrepreneurs and their legal advisers are now in a better position because of the jurisprudence to predict whether a particular transaction or arrangement is likely to be regarded as a security.

3. *Recommendations*

a. *General: Influencing Factors*

As previously discussed,[401] a number of factors directly influence the definition of security in a securities act. These are: the importance of having a definition which meets the objectives of the securities act and which fits the approaches taken to achieve those objectives;[402] the need for a flexible yet reasonably certain definition which meets new devices used to attract investors, but which is not so broad as to introduce unnecessary regulation or duplicate regulation effected other than through the securities act; and the desirability of uniformity of legislation because securities cross provincial and indeed international boundaries with relative ease.

The broad approach of the present statutory provisions relating to securities is worth adopting, although specific recommendations discussed below should improve the clarity of the coverage of the definition by reducing duplication. The broad scope of the present definitions has not proved to be unworkable especially since the Canadian legislation rightly provides for a fairly comprehensive list of exemptions as well as a power to exempt securities or transactions by regulation.[403]

b. *Specific Recommendations*

i. *Evidence of a Security and Interests Therein*

As can be seen from the provincial acts, most branches of the definition of security speak of the written instrument or document as the security.[404] It is recommended that the definition of

399 *See* the discussion of this point in *In re* Century 21 Real Estate Corporation, *supra* note 367.

400 A notable exception is *In re* Palomar Developments Corporation, *supra* note 365.

401 *See* text accompanying notes 1-4 *supra*.

402 *See* text accompanying notes 1-3 *supra*.

403 *See* text accompanying notes 92-134 *supra* for a discussion of exemptions.

404 Certain branches do, however, mention an interest; *see e.g.* Ontario Securities Act,

security include a reference to not only the written instrument or document but also to any interest therein to prevent a possible loophole.[405] In this connection, the right to acquire or sell a security should also be specifically mentioned in the definition of a security.

ii. *Any Document, Instrument or Writing Commonly Known as a Security*

Although this heading of the definition has not been referred to as often in the Canadian cases[406] the wording is necessary if only as a prospective tool to catch novel types of documents which become known as securities.

iii. *Any Investment Contract*

As illustrated by the discussion in chapters IV and V of this paper, "investment contract" has been the phrase of the definition of security which has received the most attention from the courts and securities administrators. There is no question that the phrase should appear in the definition of security. But should the words "investment contract" themselves be defined in the statute to give greater certainty and precision to the scope of the statute? Several commentators have suggested definitions of investment contract based on their analyses of the statutory objectives and the cases interpreting the phrase.[406a] The *ALI Federal Securities Code* does not define the term[407] and this omission has been criticized as disappointing.[408]

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s. 1(1)22.x ("any oil or natural gas royalties or leases or fractional or other interest therein").

405 *See* J. WILLIAMSON, SUPP. at 102; text accompanying note 50 *supra.*

406 *But see In re* John T. Geldermann, *supra* note 310.

406a *See* Professor Coffey's suggestions *cited in* text accompanying notes 227-29 *supra*; Professor Long's proposal *cited in* text accompanying note 230 *supra.*

407 ALI FEDERAL SECURITIES CODE, Reporter's Revision of Tent. Drafts Nos. 1-3, s. 297.

408 Hannan & Thomas, *supra* note 11, at 230. It is interesting that Australian state legislation defines investment contract in the Securities Industry Acts, 1975, by incorporating the definition of investment contract found in s. 76 of the Companies Acts. Section 76(1) of that act defines investment contract in the following terms:

> " 'Investment contract' means any contract scheme or arrangement which in substance and irrespective of the form thereof involves the investment of money in or under such circumstances that the investor acquires or may acquire an interest in or right in respect of property whether in the State or elsewhere which under or in accordance with the terms of investment will, or may at the option of the investor, be used or employed in common with any other interest in or right in respect of property whether in the State or elsewhere acquired in or under like circumstances."

See e.g. Companies Act 1961, Victoria Acts of Parliament, 10 Eliz. 2, No. 6839; Securities Industry Act 1975, Victoria Acts of Parliament, No. 8788. For a recent

It is recommended that investment contract not be defined in the statute for several reasons. First, the general tests which have been offered are themselves capable of wide interpretation and some ambiguity, to the extent that one wonders what really is gained by trying to define investment contract. Second, the decisions of the courts and securities administrators (admittedly borrowing from U.S. experience) have shown an increasing familiarity with the term, and the results to date provide reasonable guidance to promoters and lawyers on what is or is not an investment contract. A good example is the decision of the Supreme Court of Canada in *Pacific Coast Coin Exchange*. Finally, uniformity among the provincial statutes - especially in basic definitions such as that of a security - is extremely important, and so a definition of investment contract should probably await further experience and consultation among the various jurisdictions in Canada.

With the expansive interpretation of "investment contract", it is questionable whether a number of headings found at present in the definition of "security" are really necessary. Most notable is the following heading:

> "any document constituting evidence of title to or interest in the capital, assets, property, profits, earnings, or royalties of another person."[409]

This heading has also been described as too broad and uncertain for inclusion in a securities act and should probably be rejected on that basis.[410]

iv. *Specific Types of Securities*

The provincial securities statutes list various types of securities which are specifically included as illustrative of the definition of security. It is recommended that these be adopted; however, a more logical grouping of these securities should also be made. The types of securities recommended are:

(1) any bond, debenture, note or other evidence of indebtedness,[411]

decision interpreting the definition, *see* Waldron v. Auer, 2 CCH AUST. CORP. AFFAIRS REP. ¶ 40-314 (S. Ct. Vict. 1977).

409 *See* text accompanying note 51 ff. *supra.*

410 As noted above, J. WILLIAMSON, SUPP. at 105 correctly criticizes the heading as too broad. If one examines the decisions which have applied this branch of the definition (*e.g. In re* Brigadoon Scotch Distributors, *supra* note 308) the investment contract heading could have been easily used to be the basis for holding that a security was involved.

411 It might be worthwhile to consider excluding such things as cheques, currency, drafts and bills of exchange as is done in the ALI FEDERAL SECURITIES CODE, Reporter's Revision of Tent. Drafts Nos. 1-3, s. 297 (b) (definition of a security). In

(2) any share, stock, unit, unit certificate, participation certificate or certificate of share or interest,
(3) any preorganization certificate or subscription,
(4) any agreement under which the interest of the purchaser is valued for purposes of conversion or surrender by reference to the value of a proportionate interest in a specified portfolio of assets,[412]
(5) any interest in, or document constituting evidence of an interest or participation in,
(a) a profit-sharing agreement
(b) a trust, estate or association, or
(c) an oil, natural gas or mining lease, claim or royalty or other mineral right,
(6) any collateral trust certificate.
To the above should be added the following new specific types of security which are listed in the *ALI Federal Securities Code:*[413]
(7) any voting trust certificate,
(8) any equipment trust certificate.

It is hoped that the above enumeration of specific types of security will be an improvement, for example, over the various oil and gas interests now in the provincial acts.[414] In addition, the heading "any preorganization certificate or subscription" probably eliminates the need to retain a separate heading dealing with:

"any agreement providing that money received will be repaid or treated as a subscription to shares, stock, units or interests at the option of the recipient or of any person...."[414a]

It should be mentioned that the foregoing types of securities do not include such items as "any document constituting evidence of an interest in a scholarship or educational plan or trust"[415] or other types of specific securities which have been recently added to the definition of security in the provincial acts.[416] Such particular items would be covered by the expansive definition of invest-

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this connection, reference should be made to Bank of Canada v. Bank of Montreal, 76 D.L.R. (3d) 385 (S.C.C. 1977) which upheld the conclusion that banknotes were promissory notes within the meaning of the Bills of Exchange Act, R.S.C. 1970, c. B-5.

412 This heading was added by Ontario's Bill 30 to cover variable annuity contracts; *see* text accompanying notes 142, 143 *supra.*

413 ALI FEDERAL SECURITIES CODE, Reporter's Revision of Tent. Drafts Nos. 1-3, s. 297.

414 *See* the discussion in text accompanying notes 58-60 *supra.*

414a *See* text accompanying note 57 *supra.*

415 Ontario Securities Act, s. 1(1)22.xiv.

416 *See e.g.* Ontario Bill 30, s. 1(1)38.xv. This heading lists rights to use real property for residential, recreation or vacation purposes; *see* text accompanying note 144 *supra.*

ment contract and should be so announced from time to time, as these new devices appear, by the appropriate securities administrator or commission under the securities act.

C. RELATED MATTERS: THE DEFINITIONS OF TRADE AND DISTRIBUTION AND EXEMPTIONS

As stated above,[417] the definition of trade in the Ontario Securities Act is fairly broadly drawn to include a great number of acts and transactions. The definition of trade in Ontario's Bill 30 makes it clear that a purchase is not included as a trade, although this can give rise to problems in other areas of the statute.[418] The breadth of definition is important to adopt, and it would appear that some parts of the act would require that both the sale and purchase sides of trade be included.[419]

The definition of distribution and the exemptions (for securities or transactions, or by commission order) depend on the securities statute's particular scheme of regulation. These matters were briefly discussed in dealing with the present Ontario Securities Act[420] and the proposed treatment of these subjects under Ontario Bill 30.[421] No specific recommendations will be made on these matters, but the general rationale for the exemptions should be recognized in any proposed securities act and these have also been discussed previously.[422] In addition, the commission should also be given wide exempting powers.[423] Finally, it should be remembered that, although securities or transactions may be exempt from certain aspects of regulation under the statute, they nonetheless should not be exempt from other measures such as the anti-fraud provisions.[424]

417 *See* text accompanying note 71 ff. *supra.*

418 *E.g.* in the takeover provisions which involve a purchase; *see* discussion in note 73 *supra.*

419 This is in fact the case in the ALI FEDERAL SECURITIES CODE, Reporter's Revision of Tent. Drafts Nos. 1-3, ss. 283, 293.

420 For the discussion on "distribution to the public" in the present Ontario Securities Act, *see* text accompanying note 83 ff. *supra*; for the discussion on the various exemptions under the present Ontario Securities Act, *see* text accompanying note 92 ff. *supra.*

421 For the discussion on "distribution" under Ontario Bill 30, *see* text accompanying note 151 ff. *supra.* For the discussion of the various exemptions under Ontario Bill 30, *see* text accompanying note 154 ff. *supra.*

422 *See* text accompanying note 96 *supra.*

423 As is done in the ALI FEDERAL SECURITIES CODE, Reporter's Revision of Tent. Drafts Nos. 1-3, s. 302.

424 *See* the discussion under the U.S. legislation in text accompanying notes 37, 42a *supra.*

Disclosure Requirements

Warren M.H. Grover and James C. Baillie

September 1976

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Chapter I
Preface

This report has been prepared at the request of Consumer and Corporate Affairs Canada as one of the background studies conducted under the auspices of that department to assist in decisions as to a federal securities law for Canada. The scope of the report, while wide-ranging, has been limited in certain areas because of our understanding that these areas are being dealt with by others; for example we have dealt only peripherally with insider trading, with takeover bids and with the entire question of remedies, although all of these topics relate directly to those which are discussed. Some modification of the recommendations in this or in other reports might be necessary to arrive at a workable integrated disclosure pattern.

Even more than other topics in the fertile area of securities regulation, disclosure has been a well-tilled field during the past decade. In Canada, in the United States and elsewhere major studies have been undertaken and substantial legislative and

Our sincere thanks are due to our secretaries, Barbara Persaud and Mary Green, who not only typed our manuscripts, corrected our errors and managed to keep us in frequent communication but who also came up with a good sense of humour when all else failed. We also acknowledge the assistance of our research student, Peter Stein, who laboriously dug out literally hundreds of articles for us to consider, and Philip Anisman, the overall project coordinator, who sent us many helpful references.

regulatory changes made. Our instructions were, in essence, to review the existing and proposed requirements in this country and elsewhere and to propose an integrated disclosure system appropriate for adoption at the federal level in Canada. In so doing, we have supported most of the principles upon which existing law is based but recommend a number of changes of detail. In some cases, these details deviate significantly from existing law and may well prove controversial. That is appropriate, for this paper reflects nothing more than the judgment of the two writers.

One point should be stressed, for it has shaped our approach to the writing of this paper. This is that certain premises are assumed and hence do not require consideration. Since some of the premises may be even more controversial than the recommendations in the paper, it is helpful to refer to them here. (A more detailed statement appears in chapter VII.) We have assumed in the preparation of this report that Parliament is to adopt a federal securities statute and that it is within the constitutional authority of Parliament to deal in that statute with all of the topics traditionally encompassed by securities regulation. While we make no assumptions as to whether provincial securities regulation will continue in effect, we do assume that Parliament is to adopt the best possible system even if it is not congruent with the requirements of present provincial law.

These assumptions have had a significant impact upon the report. Yet at least some of them may be open to serious question. We do not purport to make political judgments or to predict provincial reaction to a federal initiative, but we must recognize the possibility that provincial regulation will continue in effect after the adoption of federal regulation. If the federal regulation were to reflect the recommendations in this report, substantial confusion and inconvenience to all affected by securities regulation would result unless the continuing provincial regulation was made uniform with the federal requirements. Further, arrangements for interjurisdictional cooperation would be necessary to attain uniformity in the exercise of discretionary powers and to avoid having the federal authority as simply an additional level to which applications must be made.

While we believe that implementation of the recommendations in this report would result in an improvement on present law, we do not believe that the improvement would be so great as to justify the chaos that would result if interjurisdictional uniformity and administrative arrangements did not accompany the new rules. Of course, the situation might not be so black and white in practice; each jurisdiction involved might take some steps towards uniformity and adequate administrative arrangements without

fully attaining these objectives. While we recognize that each situation must be analyzed on its merits, we trust that all concerned will accord priority to arriving at a workable regulatory pattern. The system currently in effect contains no deficiencies so glaring as to necessitate federal involvement to impose a different system. In our view it would be better for the federal government simply to adopt existing provincial legislation, changing the names where necessary, rather than to add extra complications for the sake of a slightly improved system which would not integrate with provincial systems that were to remain in force.

Chapter II
Historical Analysis

It is useful to research earlier materials if one is to make suggestions for new legislation because the modes of effectively regulating the conduct of human beings, which is the primary object of legislation, have been relatively constant. Some insight into what is necessary and feasible, particulary in disclosure requirements imposed on business enterprises, can be gained by considering previously enacted requirements, their successes and failures. Thus if one were to find that the introduction of legislation imposing large penalties had eliminated most fraudulent schemes, one would be inclined to recommend stiff penalties against fraud. On the other hand, if the fraudulent schemes continued unabated despite such legislation, other methods of regulation would be proposed.

It would be impossible in this paper to attempt a complete historical survey of the regulations requiring disclosure by business enterprises which have significant contact with the public. Indeed even if the field is narrowed to public corporations, the task is still enormous as such corporations cover many different kinds of business organizations which, depending on their importance to the economy or the jurisdiction involved at the time of analysis, were subjected to various forms of required disclosure. Categories such as canal companies, railway companies, banks and insurance companies have historically been subject to extensive governmental regulation which presupposes some disclosure. Accordingly, we have only attempted to canvass some of the concepts developed in earlier periods which we believe may be of some use today. In so doing we have found that the disclosure requirements had four different sources:

(1) requirements set forth in statutes or other emanations of governments, federal or provincial;

(2) requirements set forth by self-regulatory associations such as the stock exchanges;
(3) requirements set forth by the corporations themselves, usually in the constating documents;
(4) requirements developed because of judicial decisions imposing some form of liability in the absence of disclosure.

Each of these four sources has been important to a greater or lesser degree in each area of disclosure relevant to securities regulation. Broadly speaking those areas include both disclosures made by public corporations concerning their own activities (whether on a periodic basis or at the time of an initial issue of securities or at the time of significant changes such as amalgamations) and disclosures related to secondary market activity in the corporations' securities (whether for the account of the corporations themselves, insiders of the corporations, securities dealers or financial intermediaries). Our historical survey has been limited to England and the United States of America,[1] as these are the jurisdictions which have long traditions in establishing regulatory systems in the economic arena. In 1974 Australia introduced but has not yet enacted draft federal legislation in the field; reference to the Australian proposals will be confined to later parts of this paper.

In any survey of the history of disclosure in the United States and England, one must be conscious of the different political institutions in the two countries. England is a unitary jurisdiction whose legislative requirements for corporate disclosure have been embodied in the Companies Act. Broadly speaking, at least until recently, unincorporated or foreign enterprises had to satisfy no statutory disclosure requirements of a general character at all. On the other hand the United States is a federation in which the constitutional division of powers is such that the central government, except in a few specified areas, has no mandate to incorporate companies and has no equivalent to a Companies Act in which it could include disclosure requirements. Originally such requirements in the United States were contained in state corporate legislation. The enormous advance to federal disclosure legislation was not undertaken until the economic chaos of the late 1920s and early 1930s forced the government to reexamine the whole structure of the securities industry in much the same way, if not with the same result, that England reexamined the industry after the South Sea Bubble. Even at the state level the disclosure require-

1 France, for example, has only recently embarked on any disclosure regime; *see* Beaman, *Disclosure Requirements in France*, 12 VA. J. INT'L L. 358 (1972). Indeed

ments had been separated from the general incorporating statutes in the early years of the twentieth century, presumably because of the simplicity of avoiding corporate law restrictions by jurisdiction shopping for corporate charters. This is an important point as it indicates the futility of confining securities legislation in a federal jurisdiction to corporations of a particular jurisdiction. It would be foolish to confine federal disclosure requirements in Canada to federal companies.

It is also important to note that the concept of a general incorporation law, as opposed to incorporation by special act or by the exercise of the royal prerogative, developed earlier in the United States than it did in England. While there is some quibble in the literature as to what constitutes a "general" incorporation statute, the consensus seems to be that the New York statute of 1811 is the first modern statute. It has even been claimed that the English Act of 1844 was modelled on the New York Statute.[2] The reason why the United States developed general incorporating statutes before England may be attributable to the absence of a royal prerogative after the American revolution. In addition, there was and is a widespread belief in the United States that incorporation by special act is inappropriate.[3] Thus while England or Canada could require disclosure for major institutions incorporated by special act or royal prerogative within the incorporating statute or document itself, the United States was forced to think in terms of more general disclosure requirements.

A. THE EARLY PERIOD

Perhaps the earliest business corporations in England were the merchant guilds, which were chartered, or guildated (which was synonymous with "incorporated" until the time of Henry VI) by the King. Early in the fourteenth century the weavers and the goldsmith guilds were formed while mercers, haberdashers, fishmongers and vintners were added during the following one hundred years. The guilds had the power to pass by-laws which governed their respective trades and every person carrying on the trade whether or not a member of the guild was subject to those by-laws so long as they were not inconsistent with the law of the land or public policy. Because of this outward reach of the power in the by-laws, the guilds were required to keep books and those

disclosure requirements are generally new on the continent; *see* OECD, ADMISSION OF SECURITIES TO PUBLIC SALE AND STOCK EXCHANGES (Paris 1974).

2 F. WEGENAST, THE LAW OF CANADIAN COMPANIES 20 (1931).

3 H. BALLANTINE, CORPORATIONS 36 (1946).

books were opened for inspection by non-members under certain circumstances. This appears to be the earliest form of disclosure required by business corporations.[4]

During the sixteenth century the search for treasures overseas inspired the establishment and incorporation of companies of foreign adventurers which were similar to the guilds except that their members were traders in foreign as opposed to domestic markets. Perhaps the most famous company to be incorporated was the East India Company,[5] chartered by Queen Elizabeth in 1600. Its charter was the first to provide that members could employ their capital in a joint stock if they so desired. When one considers that the fundamental difference in the constitution of modern business corporations as compared with earlier forms of organization is the joint-stock capital concept, the East India Company is justly famous. It is the joint-stock concept which allowed for the rise of public corporations and, eventually, the regulation of securities.

It should not be surmised that a huge number of these joint-stock companies existed in the seventeenth century. Williston asserts that, in 1692, when trading on other than joint stock was prohibited to members of the East India Company, there were only two other joint-stock companies of any importance in England – The Royal African Company and the Hudson's Bay Company. Except for the 200 joint-stock companies formed about the year 1720 to take advantage of the extravagant commercial speculations which culminated in the Bubble Act, there was not an appreciable number of joint-stock companies incorporated in the eighteenth century either. Adam Smith, writing in 1776 said of joint-stock companies:

> "The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in private copartnery frequently watch over their own.... They have, accordingly, very seldom succeeded without an exclusive privilege; and frequently have not succeeded with one."[6]

Smith therefore felt such companies were only appropriate in the banking, insurance, canal and waterworks fields, all being businesses where it was unlikely for private copartners to be able to amass sufficient capital.

4 *See* the excellent article by Williston, *History of the Law of Business Corporations Before 1800*, 2 Harv. L. Rev. 105, 149 (1888).

5 Formally called the "Company of Merchants of London Trading to the East Indies".

6 A. Smith, 5 The Wealth of Nations, ch. 1, pt. 3 (1776).

Indeed, even in the nineteenth century there were relatively few joint-stock companies formed. As late as 1886 the New York Exchange had less than a hundred companies listed, of which over 80% were in railroads and the four fields mentioned by Smith.[7] With this lack of importance of publicly-traded corporations of a general nature it is perhaps not surprising that corporate disclosure requirements in the statute law were very late in arriving. However, the lack of statutory requirements did not mean that public corporations or even private corporations were not busily keeping records which were open to inspection by the directors or others. As Dubois puts it:

> "Clearly no business, even in the eighteenth century, could be conducted with quite the same indifference to keeping its affairs of record that prevailed at Whitehall."[8]

Accordingly we shall turn our attention to the corporations themselves, for in their charters or by-laws are to be found the earliest disclosure requirements.

The earliest reference we have been able to find to a specific requirement of corporate disclosure comes from the minutes of the Hudson's Bay Company where it was ordered, at a General Court held in 1673:

> "That the names of all the Adventurers in this Company and their several stocks respectively be put in print and a copy thereof sent to each member."[9]

It is interesting to note that this minute goes on to authorize one vote for each £100 of stock held and to permit voting by sending the shareholder's desire to the general court when the shareholder could not be present. In 1679 the Rules and Orders of the Company incorporated these provisions and extended the voting right by absent shareholders so that the shareholder "shall if he please send his suffrages to the Court which shall be received and allowed as if he himself were present". As well, the 1679 Rules and Orders provided that:

> "Every Member having Share or part in any Goods to be sold to the Company, or Ship to be Freighted for the Company's use, shall if he be then present or any way privy to any such Bargain declare his interest to the Company and cause the same to be Recorded or otherwise

7 *See* J. Hurst, The Legitimacy of the Business Corporation in the Law of the United States 1780-1970 at 86 (1970).

8 A. Dubois, The English Business Company After the Bubble Act at xi (1971) (introduction).

9 Minutes of the Hudson's Bay Company 1671-74 (E. Rich ed. 1942). A "general court" is the same thing as a shareholders' meeting.

on discovery to be made thereof it shall be deemed fraud in the Company and every such member shall forfeit his whole stock or submit to such Mulct as a General Court Shall Impose."[10]

Similar provisions are to be found requiring full disclosure of insider interests in contracts or dealings with the company in other early English corporations, such as the Bank of England.[11] These provisions relating to disclosure of director's interests in contracts were incorporated into the earliest general incorporating statues in England[12] and have been retained in both England and Canada ever since[13] with little modification to the basic concepts.

It also appears that in the early eighteenth century the directors did present reports to the general courts, or annual meetings of joint-stock companies. Misrepresentations made to a general court were considered to be a breach of a director's obligations and penalties ensued, imposed by the company itself. Similarly recorded minutes were kept of general court meetings and deliberate alteration of such recorded minutes was an offence punishable by the general court.[14] Thus we see that some disclosure, at least to existing shareholders entitled to be at the meeting, was a requirement of the corporations themselves.

B. THE EIGHTEENTH CENTURY

The continued existence of joint-stock companies was threatened in the early eighteenth century by the excrescences of the speculative fervour of promoters and stock-jobbers. The Mississippi scheme of John Law in France and the South Sea Company of the Earl of Oxford in England were but the most obvious examples of a general avarice which cast joint-stock companies into a century of disrepute.[15] The English Parliament, panic-stricken by the wild trading in the stock of various joint-stock companies, passed The

10 We wish to record our thanks to Rolph Huband, secretary of the Hudson's Bay Company and Shirlee Anne Smith, the archivist of the Hudson's Bay Archives for their assistance in turning up the disclosure provisions relating to this renowned company.

11 BANK OF ENGLAND, SELECTED TRACTS: 1694-1804 (London 1968). Dubois claims that a similar approach was tried but failed with the East India Company in 1727; A. DUBOIS, *supra* note 8, at 296.

12 *See* An Act for the Registration, Incorporation and Regulation of Joint-Stock Companies, 7 & 8 Vict., c. 110, s. 29 (1844).

13 *See e.g.* Canada Business Corporations Act, s. 115.

14 A. DUBOIS, *supra* note 8, at 295.

15 The most readable account is found in C. MACKAY, EXTRAORDINARY POPULAR DELUSIONS AND THE MADNESS OF CROWDS (12th ed. 1967). *See* for a more complete picture, W. SCOTT, JOINT-STOCK COMPANIES TO 1720 (1909-20).

Bubble Act[16] in 1720 which effectively outlawed joint-stock companies at least where a large stock of freely transferable shares was involved.[17] So effective was that statute, or so in harmony with the beliefs of the business community of the day, that only one case under the act was ever reported in the eighteenth century and that resulted in only a five-pound fine![18]

Incorporation by special act was still permitted although the price was high.[19] Most of these private act corporations were canal companies although a few, such as the British Linen Company, were conceived to be of a manufacturing nature.[20] Usually, in order to deal with the perceived problem of undue stock promotion, the charters contained provisions prohibiting the transfer of stock for a fairly lengthy period of years.[21] Thus the English system at this time, at the legislative level, was based on direct regulation and not on any concept of disclosure. On the other hand, at the enterprise level, unincorporated joint-stock companies formed pursuant to deeds of trust became common.[22] All these companies, like their royal charter cousins, had provisions requiring frequent "general courts".[23] In most deeds of settlement the accounts of the company had to be submitted to the general court and, in a few cases, proprietors had free access to all accounts of the company.[24] During the same period the courts became an accessible forum for the settlement of business corporation disputes. Writs of mandamus to compel disclosure required by the charter or complaints concerning misdeeds of directors were two areas where the courts felt free to intervene.[25] In both these cases full disclosure was an almost absolute defence, with the result that the court, in effect, became an instrument for requiring disclosure.[26]

At this point, it may be worth digressing to consider the position of creditors. While it is generally regarded in basic law school courses as written on a tablet of stone that limited liability

16 6 Geo. 1, c. 18 (1720).

17 *See* the opinions of Sargeant Pengelley quoted in A. DUBOIS, *supra* note 8, ch. 1.

18 R. v. Cawood, 2 Ld. Raym. 1361, 92 E.R. 386 (K.B. 1723).

19 *See* B. HUNT, THE DEVELOPMENT OF THE BUSINESS CORPORATION IN ENGLAND 1800-1867 at 110 (1936).

20 In fact, the British Linen Company soon gave up the linen business and became a bank; W. LAWSON, THE HISTORY OF BANKING (1850).

21 A. DUBOIS, *supra* note 8, at 110.

22 A. MACHEN, MODERN LAW OF CORPORATIONS at 7 (1908).

23 Unlike the modern corporation statutes, these joint-stock companies generally required several stockholders' meetings each year.

24 A. DUBOIS, *supra* note 8, at 302.

25 *Id.* at 123-37.

26 In this period, the courts themselves were seldom resorted to by businessmen but opinions of barristers were frequently sought as to what a court would likely do if

arrived only with the incorporating statutes of the late nineteenth century, this position seems open to grave doubt;[27] it is doubtful if creditors could, in fact, recover from shareholders if the corporation was insolvent. Moreover, the borrowing powers of corporations were often circumscribed by the incorporating legislation.[28] But protection for creditors was generally not afforded in corporate constitutions. Apparently it was assumed by the legislatures that those astute enough to lend as opposed to invest were astute enough to look after themselves.[29] Of course, the courts would permit rescission of a borrowing contract just as they would of a share contract if the contract was based on a misrepresentation.[30]

It should also be mentioned that the remedy of damages for misrepresentation, which was of ancient lineage and not cut down to fraudulent misrepresentations until the infamous case of *Derry v. Peek*,[31] had its effect on truthful disclosure. To sell stock in any enterprise required some representations, even to the most gullible. Accordingly, a custom arose very early of issuing a prospectus to accompany every proposed new share issue. Even on sales in the secondary market, there had to be some information available to attract the interest of investors.[32] Again we see a corporate development, necessitated by business reality, giving rise to disclosure requirements. Court sanctions for fraud and misrepresentations provided a theoretical inducement to accuracy, although they were often ineffective in practice. Direct sanctions by the general court of the corporation were likely more effective. Until the end of the eighteenth century it is fair to say that neither statutes nor self-regulatory organizations played any part in disclosure requirements.

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a matter were brought to its attention. These opinions circulated in business circles and were acted upon.

27 An interesting brief account of the early English cases and commentaries is found in E. Dodd, American Business Corporations Until 1869 at 84 (1954).

28 Perhaps the best known case is Baroness Wenlock v. River Dee, 10 App. Cas. 354 (H.L. 1885).

29 Much later, some incorporating statutes expressly provided for double liability on the part of shareholders. Indeed, such a provision was contained in the Bank Act until 1967.

30 *See* Colt v. Woolaston, 2 P. Wms. 154, 24 E.R. 679 (Ch. 1723); Green v. Barrett, 1 Sim. 45, 57 E.R. 495 (Ch. 1826). Indeed, a non-disclosure by the promoters where a scheme was impracticable *ab initio* had been held to constitute grounds for rescission of a share contract; *see* E. Manson, Trading Companies (2d ed. 1893). This, in effect, forced at least a minimal disclosure to shareholders. Whether the same standard would be applied to creditors' transactions was doubtful.

31 14 App. Cas. 337 (H.L. 1889).

32 *See* C. Mackay, *supra* note 15.

C. THE NINETEENTH CENTURY

With the nineteenth century came the advent of legislative and self-regulatory disclosure requirements. While stock dealers in London had met informally during the eighteenth century, it was in 1802 that the original Deed of Settlement established the London Stock Exchange as a legal undertaking and in 1812 that the first Rules and Regulations of the Exchange were formally adopted.[33] It is important to note that, in England, self-regulation is older than any general legislation. This may explain why the members of the London Stock Exchange are exempted from broker registration requirements and why virtually no over-the-counter market exists for public securities in the United Kingdom. Disclosures required by the stock exchange are perhaps more important in England than statutory disclosure requirements.

On the other hand, while a brokerage fraternity existed in New York at the end of the eighteenth century, the brokers were in rival camps during the first half of the nineteenth century and the New York Stock Exchange only became united into one body in 1869.[34] We have already noted the factors which resulted in the first general incorporating law, that of New York State in 1811. Similarly in Montréal and Toronto, while the brokers had organized themselves as a group in the 1830s and 1840s respectively, official recognition only took place in Montréal in 1874 and in Toronto in 1878,[35] long after the enactment of the first corporation statutes.

In England, in the early nineteenth century, a host of insurance companies were formed as unincorporated joint-stock companies with transferable shares.[36] Two legal difficulties however led to a desire for legislation clearly legitimating corporations. The first difficulty was that, although the early nineteenth century court cases suggested that the Bubble Act was outmoded[37] (and hence encouraged formation of unincorporated joint-stock companies), there were lingering doubts as to the legality of unincorporated bodies with freely transferable shares.[38] Secondly the courts tended to support unlimited liability for members of deed of

33 D. SPRAY, THE PRINCIPAL STOCK EXCHANGES OF THE WORLD 178 (1964).

34 H. NOBLE, THE STOCK EXCHANGE: ITS ECONOMIC FUNCTION (1933); B. SHULTZ, THE SECURITIES MARKET AND HOW IT WORKS (1948).

35 W. EITEMAN, NINE LEADING STOCK EXCHANGES (1968).

36 B. HUNT, *supra* note 19, ch. II.

37 *See* R. v. Webb, 14 East. 406, 104 E.R. 658 (K.B. 1811); Brown v. Holt, 4 Taunt. 587, 128 E.R. 460 (C.P. 1812).

38 Josephs v. Pebrer, 3 B. & C. 639, 107 E.R. 870 (K.B. 1825).

settlement companies.[39] However the desire for clear legislation was thwarted by economic occurrences. In 1825 a post-war speculative fever was running high in England with promoters launching a host of schemes.[40] All these promotions were accompanied by prospectuses[41] which told prospective investors of the marvellous plans for the enterprise involved. Some 624 Special Act companies and joint-stock companies were floated in the years 1825 and 1826, of which only 127 existed in 1827, after the crash. But the mounting pressure for a simple incorporating statute was only sidetracked, not derailed by these events. Eventually, in 1844, the Joint-Stock Companies Registration Act was passed.

The English Act of 1844[42] was the statutory result of a report prepared under the chairmanship of William Ewart Gladstone who was then president of the Board of Trade. Gladstone was a great believer in disclosure as the way to ensure investor protection.[43] Accordingly, the act required every joint-stock company to file in a central registry the charter and, more importantly, "a copy of every prospectus or circular, handbill or advertisement or other such document at any time addressed to the public, or to the subscribers or others, relative to the formation or modification of such company".[44] The statute also required an annual financial statement to be prepared which was open for inspection by shareholders for fourteen days prior to and thirty days subsequent to the annual meeting.[45] In the absence of contrary provisions in the deed of settlement, a copy of the financial statement and the auditor's report were required to be sent to shareholders.[46] A third disclosure requirement embodied in the act was the filing of a complete shareholders' list as well as a semi-annual report of any changes in the shareholders' list.[47] Not only insider trading, but all trading in shares was therefore a matter of public record.[48] In short, it would be fair to say that the disclosure concept of the 1844 Act was, if anything, wider than the disclosure concepts now current. But there was much less specificity; for example, the contents to be contained in the prospectus were not set out in the statute at all. This lack was relatively quickly supplied by the

39 B. Hunt, *supra* note 19, ch. II.

40 *Id.*

41 *Id.*

42 7 & 8 Vict., c. 110 (1884).

43 His most famous quote in this regard is "publicity is all that is necessary. Show up the roguery and it is harmless"; *see* 75 H. C. Deb. (Eng.) 277 (1844).

44 7 & 8 Vict., c. 119, s. 4(8) (1844).

45 *Id.* s. 37.

46 *Id.* s. 42.

47 *Id.* s. 11.

48 *Id.* s. 18 provided for inspection by anyone of all the records required to be filed with the registrar.

courts. In the leading case of *New Brunswick and Canada Railway and Land Company v. Muggeridge*, Kindersley V.C. said:

> "[T]hat those who issue a prospectus setting forth great advantages to accrue to those who will take shares in the undertaking, and inviting them to take shares on the faith of the representations contained, are bound to state everything with strict and scrupulous accuracy; and not only to abstain from stating as facts that which is not so, but to omit from stating no one fact within their knowledge, the existence of which might in any way affect the nature or extent or quality of the privileges and advantages which the prospectus holds out as an inducement to take shares."[49]

Later the courts retreated from the proposition that non-disclosure was as objectionable as false disclosure,[50] a retrograde step which probably lies behind the detailed list of disclosure requirements in many modern statutes.

The English provisions are in marked contrast to the early New York statute of 1811,[51] where there was much less emphasis on disclosure. The real difference lay in the amount of material required to be filed in the central registry for, as we have seen, the companies themselves produced the type of information which Gladstone's Act required to be filed. The New York statute required very little to be filed, in the same way as the letters patent jurisdictions in Canada required very little to be filed with the provincial or federal incorporating authorities. There were requirements in the New York statute for publication in the local newspapers of the time and place of the annual meetings. Outside of this provision, there were no statutory disclosure requirements except those required on the initial filing of the incorporating documents.

The lack of specificity in prospectus requirements and the changing view of the English courts to non-disclosure, prompted statements in prospectuses to become less expositive and more fanciful. Thus a finance company in 1863 announced that its objects were "in a word, to undertake all such operations as an intelligent and experienced capitalist might effect on his own account with a capital of millions".[52] In addition, limited liability,

49 1 Dr. & Sm. 363, 62 E.R. 418 (Ch. 1860); *see also* Pulsford v. Richards, 17 Beav. 87, 51 E.R. 965 (C.A. 1853).

50 Peek v. Gurney, L.R. 6 H.L. 377 (1873); *see generally* J. STEVENS, JOINT STOCK COMPANIES, ch. 2 (1881); F. WEGENAST, *supra* note 2, at xxvi.

51 N.Y. SESSION PAPERS, c. 67 (1811).

52 *Cited in* B. HUNT, *supra* note 19.

which had become statutory in 1855,[53] encouraged, or was subsequently thought to have encouraged, more reckless speculation. The result was the familiar market boom followed by the inevitable crash which occurred in 1866. In the usual way, loud cries again arose to abolish companies with limited liability; a Parliamentary Committee on Limited Liability Acts was established. As a result came the Act of 1867[54] which, for the first time included a statutory definition of the contents of a prospectus.[55]

In the United States, the absence of a uniform federal system[56] and the differing economic realities in the various states made for a patchwork that ensured little or no disclosure requirements through corporation law, if the promoters were prepared to look for a friendly jurisdiction. The laws generally did not require a continuing flow of corporate information to a public registry. The nearest approach to such a development was through informal pressures of investment bankers and the New York Stock Exchange.[57] Even this pressure could not be expected to be very heavy for in late 1886 there were only ninety issues listed on the exchange, of which sixty were by railroads. The "public" investor was still likely to be a businessman who demanded to see records before he would put any money into a venture.[58] It was not until after World War I that the roster of listed stocks and bonds became widely expanded.[59] But as early as 1866 the New York Stock Exchange required some reports from companies desiring to list, and by 1895 this had developed into a strong suggestion for periodic reporting. However it was only in 1909 that the exchange required listed companies to distribute annual earnings reports and balance sheets to their stockholders.[60]

D. EARLY CANADIAN REQUIREMENTS

The early Canadian experience borrowed much from the practice of the English in setting up joint-stock companies, although

53 18 & 19 Vict., c. 133 (1855). L. GOWER, chs. 2, 3, contains an excellent description of the development of English company law. The reader is referred *id.* for more detail on the Companies Clauses Consolidation Act of 1845, 8 & 9 Vict., c. 16 (1845) which was a complementary statute dealing with corporations which still had to be chartered by private act.

54 30 & 31 Vict., c. 131 (1867).

55 *See* B. HUNT, *supra* note 19.

56 *See* H. CHERRINGTON, THE INVESTOR AND THE SECURITIES ACT, ch. 2 (1973).

57 A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 319 (1932); B. SHULTZ, *supra* note 34, ch. 1.

58 J. HURST, *supra* note 7, at 86.

59 By 1930, there were 2,407 issues by U.S. companies listed on the NYSE; *see* J. MEEKER, THE WORK OF THE STOCK EXCHANGE 538 (1930).

60 J. HURST, *supra* note 7, at 91.

incorporation statutes, at least in the east, initially seemed to borrow more from the United States.[61] For example, the Canada Life Assurance Company was originally established by a Deed of Settlement, dated January 1, 1848.[62] The deed provided an annual meeting at which an annual "statement of the affairs of The Company shall be laid before the Stockholders". Notice of meetings was required to be given by mail to each shareholder at least twenty days before the meeting and, as well, advertised in the local newspaper. The notice was to "distinctly specify the particular business or motion to be brought before the meeting". There is nothing in the document suggesting that shares were to be offered to the public, in fact the detailed transfer and registration of members' provisions suggest that a public subscription was not contemplated. The deed clearly contemplated an application to Parliament for a special act which in fact was granted in April of 1849.

The first general incorporating statute for usual commercial companies in Canada was the 1850 Act of the United Provinces. This act required annual reports to be published in the local newspaper and required the company to keep a list of shareholders which was open to both creditors and shareholders. It did not however provide for the filing of extensive documentation in a central register like the English Act of 1844.[63] It was not until the twentieth century that the prospectus concepts were really introduced into Canadian law. In the federal act of 1917 there was still no requirement for a prospectus although if a prospectus was not used, a statement in lieu of a prospectus had to be filed.[64] On the other hand the provincial statutes were clearly ahead of the federal statutes in this regard. The Ontario act of 1907 required that a prospectus, whose contents were detailed in the legislation, be filed and delivered to each prospective purchaser.[65]

E. THE FIRST HALF OF THE TWENTIETH CENTURY

Until recently in England, disclosure was contained in the

61 *See* F. WEGENAST, *supra* note 2, at 20; *but see* LaBrie & Palmer, *The Pre-Confederation History of Corporations in Canada*, in 1 STUDIES IN CANADIAN COMPANY LAW 59 (J. Ziegel ed. 1967). A more recent interesting article on early Ontario corporations is Risk, *The Nineteenth Century Foundations of the Business Corporation in Ontario*, 23 U. TORONTO L. J. 270 (1973).

62 Apparently, there was an earlier agreement dated August 21, 1847 but the first formal Deed of Settlement was dated January 1, 1848. We are indebted to the officers of Canada Life for their assistance in providing us with a photocopy of this early deed.

63 *See* LaBrie & Palmer, *supra* note 61, at 57.

64 F. WEGENAST, *supra* note 2, at 690.

65 7 Edw. 7, c. 34, ss. 97, 99 (1907).

Companies Act although the London Stock Exchange, with its stringent system of vetting and exercising control over new issues, was probably more important than the applicable British statutory provisions.[66] Very recently there has been some agitation to change the system as more and more writers come to doubt the efficacy of a system based on self-regulation and the "reputation" of issuing houses.[67] In any event the English system, as a system, is not suitable to conditions in Canada. In England there is but one incorporating authority, one stock exchange and one financial centre while in Canada there are eleven jurisdictions of incorporation, several stock exchanges, an over-the-counter market and at least three financial centres. That is not to say that certain English requirements should not be integrated into a Canadian regime. Clearly in some areas, particularly in takeover bids, the English have led the way. But for the most part, the United States is a more fertile ground for useful historical research.

In the United States, the permissiveness of the state incorporating laws[68] led first to state regulatory laws and later to the federal securities laws. At the federal level, in the early decades of the twentieth century, the Federal Trade Commission was active not only in blocking the sale of some securities but also in sending promoters of fraud to jail. Yet the constitutional basis of its interference as well as the practical difficulties made this agency ineffective on any broad basis. Several bills were introduced into Congress but none passed through both Houses until the Securities Act of 1933.[69] At the state level however, a more direct form of regulation was imposed starting with the Kansas Statute, in 1911.[70] These state laws are generically known as "blue sky" laws[71] although they appear to fall into at least two different

66 *See* H. CHERRINGTON, *supra* note 56, at 91, where he points out some of the ways ingenious English lawyers invented to get around the statutory provisions.

67 *See* L. GOWER at 310; and *see* the excellent article by Emerson, *An Integrated Disclosure System for Ontario Securities Legislation*, in 2 STUDIES IN CANADIAN COMPANY LAW 400 (J. Ziegel ed. 1972) which is a revised version of an article which first appeared in 10 OSGOODE HALL L. J. 1 (1972).

68 *See* W. FLETCHER, 1 CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS at 527 (M. Wolfe ed. 1974).

69 For a brief discussion of the role of the FTC and of various congressional attempts, *see* H. CHERRINGTON, *supra* note 56, ch. 2; 1 L. Loss at 116.

70 Direct regulation of stock jobbers had existed in England since 1285; *see* 1 L. Loss, ch. 1. There had also been disclosure-type laws at the state level, Nevada's 1909 law being the earliest.

71 The term "blue sky" is said to come from various sources but the most often cited is Hall v. Geiger Jones Co., 242 U.S. 539, 550 (1917), the earliest state securities case to come before the U.S. Supreme Court. The idea of "blue sky" is the same as "moose pasture"- *i.e.* that promoters of a given scheme have nothing of value to promote. Mulvey refers to a report by the Kansas State Banking Commission, published

categories.[72] One type is direct regulation: no securities can be sold without the approval of the state "blue sky" commission, although of course there are many exceptions for securities such as government bonds.[73] The other type of "blue sky" law does not interfere with a flotation of any security unless it appears that fraud has been or is about to be committed.[74] The Kansas Statute was of the direct regulation variety and was quickly copied in many states and in four Canadian provinces.[75] The fraud variety was eventually followed in Canada as well when Ontario enacted the Security Frauds Prevention Act in 1928, which act was said to combine "the desirable features of the New York Martin Act and the 'blue sky' laws of forty other states".[76] The Ontario Act became the basis for statutes in all the other provinces[77] and was the basic securities registration statute until 1945.

The 1928 statute is important as it combined two distinct features from other legislation and omitted our major concern, namely, corporate disclosure, which was left to the Companies Information Act.[78] The Securities Fraud Prevention Act listed certain practices which were declared to be frauds and attached to these practices criminal penalties.[79] In addition the statute provided for registration of brokers but it did so by prohibiting all "trading" without registration, defining "trading" very broadly and then setting out a series of exemptions.[80] The prospectus provisions contained in the Companies Information Act were not integrated into the Securities Act (as it then became) until 1945.[81]

So matters stood in 1933 when the really significant develop-

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September 1, 1912 which clearly uses "blue sky" as though it were already a familiar phrase; *see* Mulvey, *Blue Sky Law*, 36 CAN. L. J. 37 (1916).

72 The categories were set out initially by F. ASHBY, THE ECONOMIC EFFECT OF BLUE SKY LAWS (1926). Loss further divides the registration category into regulation of salesmen and registration of securities; *see* 1 L. Loss at 33.

73 California is the usual example cited of this type of direct regulation.

74 The New York Martin Act of 1921 is the usual example; *see* H. CHERRINGTON, *supra* note 56, at 51.

75 Manitoba, Saskatchewan, Alberta and New Brunswick. The Manitoba Sale of Shares Act of 1912, 2 Geo. 5, c. 75 was almost a verbatim copy of the Kansas Act; *see* Mulvey, *supra* note 71; and *see* J. WILLIAMSON at 12.

76 J. WILLIAMSON at 21.

77 The reason for the adoption was likely the decision of the Privy Council in Attorney-General for Manitoba v. Attorney-General for Canada, [1929] A.C. 260 which declared the Manitoba Statute *ultra vires*.

78 S.O. 1928, c. 33. The act had a "blue sky"-type regulation whereby the prospectus could be rejected by the administrator.

79 No civil penalties were attached and courts in Canada are extremely reluctant to read in civil penalties in the securities area; *see* Ames v. Investo-Plan Ltd., 35 D.L.R. (3d) 613 (B.C.C.A. 1973), *noted in* Beck, Comment, 32 CAN. B. REV. 589 (1974).

80 This pattern of dealer registration has been carried forward into the current provincial statutes, virtually unamended.

81 Securities Act, S.O. 1945, c. 22.

ments started to take place in the United States at the federal level. The conflicting philosophies between a Martin Act-type fraud statute, a "blue sky"-type registration system and a Gladstonian disclosure system,[82] were finally resolved in favour of a disclosure system. In brief the Securities Act of 1933 prohibits a company from offering securities to the public unless a registration statement has been filed with the Securities and Exchange Commission (SEC).[83] No sales can take place until twenty days after filing with the SEC and a prospectus, which forms part of the registration statement, must be sent to the prospective purchaser at or before the time of sale. The two major advances from the Gladstone theory were the twenty-day waiting period and the fact that the SEC checked the registration statement for misstatements and omissions. The high quality of the administrative effort by the SEC is what permits investors even today to rely on the prospectus.[84] But the 1933 act is not a continuing disclosure act, nor does it deal with secondary trades except out of a control block. In theory at least, the SEC has no authority to approve any security or to pass on its effectiveness.[85] There are exemptions for certain types of securities and certain transactions from the registration provisions which will be discussed in more detail later. A separate provision prohibits generally fraudulent or manipulative conduct.

The 1933 act was quickly followed by the Securities Exchange Act of 1934 which deals with the secondary markets and the registration of brokers. Essentially that statute required every corporation that listed securities on an exchange to file with the SEC both registration statements and periodic reports. In addition, where proxies were solicited, it required that the solicitation be accompanied by a proxy statement[86] and that periodic reports be made to shareholders. Insider trading reports and insider trading liability were also covered. In quick succession a series of

82 The Gladstone of the United States in this area was Louis D. Brandeis who wrote in 1914, "Sunlight is said to be the best of disinfectants; electric light the most efficient policeman"; L. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT at 62 (1914 R. Abrams ed. 1967). William O. Douglas, on the other hand would have opted for more direct regulation; *see* Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305 (1934). *See generally* 1 L. Loss at 111; Loss suggests part of the 1933 act is the fraud theory of the Martin Act.

83 Knauss, *A Reappraisal of the Role of Disclosure*, 62 MICH. L. REV. 614 (1964). Note, in the United States the securities are registered. This has not been the system in the Canadian provinces where only the prospectus is filed.

84 *Id.*

85 This gave rise to the legend on the prospectus to the effect that the issue was not to be construed as approved by the SEC. This same legend has been adopted in provincial legislation in Canada although the basic reason for its existence in the United States appears to be lacking in Canada.

86 Which statement has been referred to by Loss, amongst others, as the most important document in the disclosure arsenal.

other statutes were put under SEC jurisdiction – The Public Utility Holding Company Act of 1935 (a regulatory statute in a particular industry which had been found to have more than its share of corrupt practices), chapter X of The Bankruptcy Act (under which the SEC may, at the request of the court, advise on a plan of reorganization), the Trust Indenture Act of 1939 (which relates to the terms of trust indentures and promotes the independence of trustees), the Investment Company Act of 1940 (which allows more direct regulation over industries covered thereby, particularly mutual funds) and the Investment Advisers Act of 1940 (which requires anyone giving investment advice to register with the SEC). This panoply of statutes with various extensions[87] forms the basis of securities regulation at the federal level in the United States. Slowly but surely the provinces of Canada have come closer to copying the provisions of these various statutes.

F. THE CANADIAN EXPERIENCE FROM 1933 TO 1967

Shortly after the introduction of federal securities legislation in the United States, the call was revived[88] for federal securities legislation in Canada. In 1935 the Royal Commission on Price Spreads strongly recommended the formation of an "Investment or Securities Board" which would have a "blue sky" function at least with respect to Dominion companies. In its report, the Royal Commission stated:

> "We are not so optimistic as to believe that any legislation, however wisely conceived and effectively administered, will prevent all foolish investments or all unsound company promotion. We have, indeed, no right even if we had the desire, to take away from the citizen his inalienable right to make a fool of himself. We do, however, feel that we have the right to attempt to prevent others making a fool of the citizen. We would emphasize also, first, that permission for a group of persons to be incorporated into a company should be viewed as a valuable concession granted by the state, especially in relation to the convenience of a general restriction of personal liability, and, second, that such a concession involves corresponding obligations and responsibilities. Not the least of these obligations is to ensure that there shall be full and accurate information as to all the facts concerning every

87 Such as the Williams Act for takeover bids; *see* Pub. L. No. 90-439, 82 Stat. 454 (1968) *amended by* Pub. L. No. 91-567, 84 Stat. 1497 (1970) *amending* Securities Exchange Act of 1934, ss. 13-14.

88 It had sounded before in 1916; *see* Mulvey, *supra* note 71.

> company that seeks incorporation or financial support from the public after such incorporation."[89]

The federal government, however, opted to follow along in the tradition of the English acts thereby including in federal legislation no provisions for checking the material required to be filed in Ottawa even by federal companies.[90] Again the initiative was left to the provinces which proceeded on a province-by-province basis with Nova Scotia leading the way in 1936. Eventually the Ontario Act of 1945 was enacted which was the real beginning of a comprehensive securities regulation regime in Canada. While the legislation was studded with loopholes, some of gargantuan proportions,[91] the essential features which characterized provincial legislation until at least 1967 were presented. Disclosure requirements were refined and expanded, the Ontario Securities Commission (OSC), was given an important role in checking the prospectus[92] and requirements for dissemination of the prospectus to prospective investors were clarified.[93] But two important provisions of the United States Securities Act of 1933 were not introduced, namely the twenty-day waiting period and the concept of delivery of the prospectus as the first document to reach the prospective investor. Nor were the other seven statutes administered by the SEC integrated into the provincial securities legislation. This was particularly important with respect to periodic reporting, insider trading reporting and timely disclosure. The 1945 statute was aimed at new issues only, including within that phrase distributions by persons in a control position. In addition, the melding of the new issue requirements with the broker registration requirements of the 1928 statute gave the draftsman an opportunity to try to utilize or at least to cross refer to the same exempting requirements for each. This produced an unsatisfactory set of exemptions, which has been a feature of Canadian securities legislation ever since.

89 REPORT OF THE ROYAL COMMISSION ON PRICE SPREADS 38-39 (1935).

90 *See* J. WILLIAMSON at 171. In fact, the federal statute of 1934 did not even adopt the extension in the English Act of 1928 to cover disclosure requirements on new issues by firm commitment underwriters as opposed to underwriters acting merely as agent for the issuer itself. This was inserted in the 1935 amendments as was one other important piece of new disclosure - an annual report by directors of their trading in securities. The provision, however, was ineffective in practice as the shareholder had to ask for the record of the director's trading and seldom, if ever, did so.

91 The phrase is taken from Baillie, *The Protection of the Investor in Ontario*, 8 CAN. PUB. ADMIN. 172, 180 (1965).

92 The legislature was told by the responsible Minister that the legislation was of a disclosure, not of a regulatory nature, but that is open to considerable doubt; *see* J. WILLIAMSON at 32; Baillie, *supra* note 91, at 175.

93 *See* J. WILLIAMSON at 30.

While the 1945 statute was the basis of Canadian legislation until 1967, it is not necessary to examine its workings in detail, as this topic has been thoroughly treated in the works of Williamson and Baillie.[94] In the early 1960s, a series of important reports, the necessary antecedents of legislative change in Canada, emerged. These reports resulted in the statutes which we now have in Canada, although a major effort at revision has again been going on almost constantly since 1970. The first report was the *Porter Report*[95] which emanated from a federal Royal Commission and therefore was not expected to concern itself with securities regulation. Its rather extensive recommendations in the securities area have been ignored by most subsequent writers,[96] perhaps because his report was directed to the federal government. But Porter examined the securities industry in more depth, not only from a legislative perspective, but also from a practical administrative point of view, than any government report has either before or since. It noted that the provincial administrators were trying to promote uniformity and, to this end, were meeting ever more frequently, a trend which has continued up to the present. Its reaction to this was to strongly recommend a federal agency as the problem was obviously a national one. This is more remarkable when one remembers that Porter himself was a provincial cabinet minister and, at one time, the minister reponsible for securities legislation in Ontario. With respect to disclosure, the report said:

> "Standards of disclosure in this country are still generally inadequate. Even in the case of prospectus requirements, where the greatest improvements have taken place, more information should be required on the salaries of executives and material contracts affecting the business, on the names of beneficial owners of 10% or more of the voting stock and how much they own, and on details of executive stock options, bonuses and pension plans. Most important, the financial statements accompanying the prospectus should be in the form normally required by good auditing standards and should contain sales figures. Canadian prospectuses would also be more comprehensible if they were prepared in the narrative style of United States prospectuses rather than in a legal-

94 It is one of the sad features of Canadian legal writing that there is never enough of it. J. Williamson appeared in 1960, Baillie, *supra* note 91, in 1965, and J. Williamson, Supp. (which, like the 1969 Supplement to L. Loss, was as large as the first treatise) in 1966. The new legislation appeared in 1967 since which time there have been only a few good articles and no complete review.

95 The chairman was the late Chief Justice of Ontario, Dana Porter.

96 Baillie, *supra* note 91, does mention the Porter Report at some length.

istic manner in which the statutory information is presented point by point in a way which often deters the readers.

"The enforcement of 'full, true and plain' disclosure ends in Canada with the securities acts...the provisions of the companies acts are neither so exacting nor so well enforced. In our view, companies should be required under these acts to provide annually prompt and comprehensive information containing sales figures, comparative data going back several years, and information about long-term lease payments and contingent liabilities such as obligations to unfunded pension plans. Accounts of subsidiaries should be consolidated, and wherever there are securities of a subsidiary in the hands of the public, a balance sheet and profit and loss statement for the subsidiary should be published. Moreover, corporate financial data should be available, not necessarily in audited form, more frequently than once a year. While we are not prepared to recommend the legal requirement of quarterly reports at this time, such a step may well be necessary to arrive at standards of disclosure already practised in the United States and essential to the development of an informed investing public. These are matters in which the proposed federal agency could play an important and constructive role.

"We believe that more stringent disclosure laws are essential if the stock exchanges are to be successful in their campaign to achieve more extensive and frequent corporate reporting in Canada. While the situation is improving, the attitude of too many corporations is that the intelligent and informed investor is a nuisance rather than a partner in the enterprise and that, if necessary, listing on the stock exchanges could be sacrificed rather than provide the full disclosure found in the United States....Quite independently of stricter company laws, we think the stock exchanges should be more insistent on requiring high standards – we cannot believe that all companies whose disclosure practices are inadequate would be prepared calmly to contemplate delisting of their shares. In this connection, the Toronto Stock Exchange's provisions relating to the disclosure of material changes in a company's affairs could usefully be broadened to require more companies to inform their shareholders of such changes....

"The Canadian shareholder is relatively exposed to insid-

er abuse. We recommend therefore the adoption of disclosure requirements similar to those now in effect in the United States but extended to all public companies. These requirements might be included in the securities acts and administered by the securities commissions, although the stock exchanges should take an independent lead in this matter. A similar tightening up in the enforcement of stock exchange and securities act provisions with respect to the dissemination of insider tips and rumours could well be carried out. Finally, the law should provide for fuller disclosure of how funds raised for natural resource exploration and development have actually been spent and should provide for express shareholder approval of all contracts with insiders or their agents.

"Another and closely related problem on which we believe some legislation is necessary is that of take over bids. New management or amalgamation can play an important role in improving the efficiency of Canadian corporations, but if brought about by take overs there can be undesirable side effects if shareholders are not given the time or information necessary to judge the proposal on its merits....

"Another area where Canadian corporations, including mutualized insurance companies, are not required to fulfil their normal obligations to shareholders is in the solicitation of proxies. It was pointed out to us that notification of a shareholders' meeting in Canada all too often is confined to a brief and very general agenda and a request for a proxy signed in favour of the management. Generally, no provision is made to allow the shareholder to direct the voting of his shares, either for directors or on particular issues; no space is provided for him to appoint any other person as his proxy, and no information is provided to enable him to form judgments about the matters on the agenda. As a consequence, investors are discouraged from taking a responsible and intelligent interest in their company....

"We strongly urge, therefore, that both the stock exchanges and the securities commissions require that proxy material be expanded...."[96a]

This extensive quotation, we believe, puts into perspective as of 1964 the major lacks in the Canadian disclosure system. Once again the federal government opted for inaction.

96a PORTER REPORT at 349-52.

More often referred to but less dramatic in its phraseology was the *Kimber Report* of 1965,[97] which ultimately resulted in a new wave of provincial securities acts which have formed the basis for Canadian securities regulation for the past eight years. The report recommended new provisions with respect to insider trading, financial disclosure, revised prospectus disclosure, periodic disclosure through mandatory annual reports and "information circulars"[98] and a suggested new disclosure on takeover bids.[99] One of the most important changes suggested was the introduction of the "waiting period" which had been such an important concept in the United States.[100]

Meanwhile, the great Texas Gulf discovery of a rich copper-zinc-silver property near Timmins, Ontario, announced in June 1964, sparked a speculative mining boom which in turn gave rise to other inquiries, the most important of which in Canada were the *Timmins Area Inquiry* of the Ontario Securities Commission[101] and the *Windfall Report*.[102] These reports focused on the speculative mines, their financing and regulatory control as opposed to the more tranquil world of industrial companies.[103] Mr. Justice Kelly did not criticize the recommendations of the *Kimber Report* but he did feel that the changes suggested "would seem to be premature until the scope of the job required to be done by the Securities Commission has been determined and the extent of the necessary reorganization measured against that job".[104] Kelly, quoting the sentiments of Justice William O. Douglas, also called for regulation of the secondary markets, an area largely ignored in the *Kimber Report*.[105] In short, he saw a vastly expanded role for

97 The chairman was J.R. Kimber, then chairman of the Ontario Securities Commission, later president of the Toronto Stock Exchange.

98 Although the SEC legislation was the basis for these proposals, the terminology "proxy statement" was changed to "information circular".

99 The Ontario takeover bid legislation predated the Williams Act in the United States. It will be recalled that the PORTER REPORT had called for disclosure in this area. *See also* Baillie, *supra* note 91, at 207.

100 It still remains only a paper concept in Canada because the preliminary prospectus is not widely distributed in many issues. Criticisms of the Kimber proposals are found in Baillie, *supra* note 91.

101 SPECIAL INQUIRY SECTION OF THE ONTARIO SECURITIES COMMISSION, TIMMINS AREA INQUIRY (1967).

102 The chairman was Mr. Justice Arthur Kelly of the Ontario Court of Appeal.

103 It will be recalled that "trading companies" were the speculative problems of the eighteenth century. Their counterpart in the twentieth century in Canada has been "penny" mining companies whose stock fluctuations have fascinated those with a predilection for gambling; *see* WINDFALL REPORT at 95.

104 WINDFALL REPORT at 97; *see also* KIMBER REPORT ¶ 8.07, to the same effect. Mr. Justice Kelly also called for "the establishment of a body with national jurisdiction, to regulate the procedure of all exchanges in Canada"; WINDFALL REPORT at 102.

105 The KIMBER REPORT had recommended that primary distributions through the Toronto Stock Exchange be discontinued; *see id.* at 63. Kimber pointed out that the

the Securities Commission, a role with which Mr. Kimber, as its chairman, no doubt agreed with but felt more diffident in expressing.[106]

Both the *Windfall Report* and the *Timmins Area Inquiry* were directed largely, although not exclusively, to practices prevalent at the time on the Toronto Stock Exchange. It will be recalled that both in the United States and in England, disclosure requirements of the stock exchanges had filled legislative disclosure vacuums from time to time and indeed the London Stock Exchange is still considered to have the major disclosure requirements for public companies in the United Kingdom. In Canada, the stock exchanges were formally structured after statutory disclosure requirements and it is likely fair to say that, at least until recently, they had little impact on disclosure by public companies. This is not to denigrate the role of the exchanges. When the various states in the United States were concerned about Canadian brokers pushing unregistered stock in their states, effective legislative action was not forthcoming in Canada[107] and it was the stock exchanges together with the securities commissions that closed down the bucket shops.[108] On the other hand, the unrestricted use of the stock exchanges to effect primary distributions of mining securities had been widely criticized before the Act of 1967.[109]

In the disclosure area, the Toronto Stock Exchange, followed closely by the Montreal and Canadian exchanges, did insist upon filing statements in 1958 which required any listed company to advise the exchange and to secure its permission before any major transaction of any kind was entered into. In addition, the exchanges imposed annual reporting requirements to shareholders which, in general, were more onerous than those required by the companies acts. Perhaps most significant, however, were and are the requirements of timely disclosure, pursuant to which every listed company agrees to notify the exchange of any material change in its affairs.[110] But the consensus before 1965 at least appeared to be that, if a prospectus was filed with the Ontario Securities Commission, that body was far more searching in its examination of the company than was the Toronto Stock Ex-

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practice had ceased on the London Stock Exchange after a court case in 1892 and had ceased on the exchanges in the United States in the early 1930s as a result of the 1929 crash.

106 KIMBER REPORT at 66-68.

107 *See* J. WILLIAMSON, ch. XIII.

108 PORTER REPORT at 346-47.

109 *See* Baillie, *supra* note 91, at 357; PORTER REPORT at 334; WINDFALL REPORT at 113.

110 A good summary of the requirements as at 1960 can be found in J. WILLIAMSON at 270. A much more extensive analysis is given by Baillie, *supra* note 91, at 335.

change.[111] Nor was there any system of adequate dissemination of the information disclosed to the exchanges, thus rendering the disclosure of little value to the investor.[112] Further complicating the issue was the "exempt list" which specified certain companies to which the more rigorous disclosure standards did not apply. Thus the exchange disclosure system, which was the only effective disclosure system relating to information of importance to secondary trading prior to 1967 was incomplete at best.[113]

Since 1967 there have been several important reports, statutory amendments and changes required by the stock exchanges. It is unclear at the time of writing exactly what current securities legislation will look like by the end of 1977 at the provincial level in Canada, in view of proposed statutory changes in Ontario. An exposition of the position since 1967 will be deferred until we consider the purposes of disclosure legislation and its relationship to "blue sky" regulation. For it is against these purposes that the present system and the proposed provincial system must be judged.

Chapter III
Reasons for Disclosure Requirements

When one looks at the alternative forms of securities regulation, we have noted above that historically there have been at least three types of regulation suggested; direct regulation through registration, whereby all securities[114] to be sold to the public must be first registered with and approved by a commission; prevention of fraud statutes whereby possible frauds are investigated by and prosecuted by a commission; and disclosure of information statutes which ensure that information about the issuer and its securities is publicly available. In England, the United States and Canada, where all three systems have been tried, it is safe to say that disclosure has formed the keystone of the legislative schemes in the past few decades.[115] Over the last ten years the disclosure

111 *Id.* at 343.
112 *Id.* at 344.
113 *Id.* at 352.
114 This may include registration of the vendors or brokers as well.
115 *See* SECURITIES AND EXCHANGE COMMISSION, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS (1963); contrast the European system where disclosure concepts are only now gaining ground; *see* Beaman, *supra* note 1. For recent U.K. developments *see* REPORT OF A WORKING GROUP OF THE LABOUR PARTY INDUSTRIAL POLICY SUBCOMMITTEE, GREEN PAPER: THE COMMUNITY AND THE COMPANY, REFORM OF COMPANY LAW (London 1974); Council of the Stock Exchange, Comments on the Green Paper on the Reform of Company Law (London, July 1974); and *see* Knauss, *Securities Regulation in the United Kingdom: A Comparison with the United States Practice*, [1971] VAND. J. TRANSNAT'L L. 49.

requirements have expanded considerably in all three countries, but particularly in the United States.[116] Perhaps as a result of this expansion, the dialogue has intensified between those who support a full disclosure regime and those who decry, as not only useless but also economically wasteful, the current disclosure requirements let alone any proposed extensions thereto.[117] It may well be that disclosure is a form of regulation which is an alternative to what might otherwise be a perceived necessity for more direct regulation of security issues by business enterprises, just as a strong competition policy may be an alternative to direct government regulation in other areas.[118] If so, then even if its benefits be difficult to quantify, abandonment of the march towards a full disclosure regime may portend what to many would be a more distasteful and certainly more costly form of regulation, namely, direct regulation of transactions in the securities markets.

Even more difficult to grapple with is the emergence of disclosure requirements whose relevance to securities regulation in the sense of investor protection or as useful information to the sophisticated investor[119] is nowhere apparent. In introducing proposed new legislation in Australia, the Attorney-General called for disclosure of "arrangements made by the corporation for protecting the safety and health of its employees and of the public and for protecting the environment; and arrangements made by the corporation for the protection of its consumers".[120] In a similar vein is the current pressure in the United States to disclose bribes paid to foreign officials and political contributions.[121] Indeed the limits

116 *See* Garrett, *The Role of Financial Public Relations*, PUB. REL. J., October 1974, at 14.

117 The controversy in a nutshell, including the thrust, parry and counter-parry, is admirably set out in three short articles: Benston, *Evaluation of the Securities Exchange Act of 1934*, FINANCIAL EXECUTIVE, May 1974, at 28; Sommer, *The Other Side*, FINANCIAL EXECUTIVE, May 1974, at 36; Benston, *"Comments" on the Other Side*, FINANCIAL EXECUTIVE, May 1974, at 40. Benston's basic paper was originally published as *Required Disclosure and the Stock Market: An Evaluation of the Securities Act of 1934*, 63 AM. ECON. REV. 132 (1973). The original paper is difficult to understand for anyone not attuned to mathematical economics.

118 Competition policy has also provoked a heated debate in the United States for decades and, more recently, in Canada. The classic exposition of the futility of anti-trust laws is probably J. SCHUMPETER, CAPITALISM, SOCIALISM AND DEMOCRACY (1942); J. GALBRAITH, THE NEW INDUSTRIAL STATE (1967) is a more popular version of essentially similar arguments.

119 A very good article on this distinction is Anderson, *The Disclosure Process in Federal Securities Regulation: A Brief Review*, 25 HASTINGS L. REV. 311 (1974).

120 Speech by Senator L.K. Murphy, Attorney-General of Australia, on the Corporations and Securities Industry Bill, 1974, Parl. Deb. (Aust.), December 5, 1974 (reprint accompanying bill).

121 *See, Telling All*, The Wall Street Journal, May 15, 1975. A. Sommer, a former SEC commissioner, is quoted as saying that some members of the SEC ignore the distinction between disclosure as a means for informing investors and disclosure as

of required and "discretionary" disclosure are constantly expanding.[122] New concepts of social responsibility together with a felt need for the public to influence corporate decision-making are among other factors which may be identified as partially responsible for the continuing clamour for ever more disclosure.[123] Even a member of the SEC has vindicated disclosure requirements on the basis of benefit "to the economy at large" as a distinct head of justification alongside benefit "to the investing public".[124]

It is with a recognition of the current controversy over the extent of useful disclosure coupled with a belief that the society would prefer to avoid more costly direct regulation of business enterprises if indirect techniques, such as disclosure, prove sufficiently efficacious, that we have reexamined the purposes of disclosure legislation. In so doing we have considered what we see as two separate concepts – disclosure necessary for securities regulation itself in the sense of investor protection and the extension of such disclosure requirements for purposes other than securities regulation. It is not necessary for us to agree with all such extensions to admit that such extensions presently exist and that further extensions are currently being advocated. Where such extensions are logically and pragmatically attainable and where the extensions do not dwarf the original purpose of investor protection, we would acquiesce in their inclusion in statutes primarily aimed at the regulation of transactions in securities.

Put another way, a society characterized by large financial institutions, large corporations, large labour organizations and large governments leads naturally in a democracy to demands for accountability. Large size, by itself, while necessary to support an advanced society, is believed by many to be justified only if some system exists to ensure that the controllers of large institutions do not misuse the powers and wealth which arise as a result of their positions.[125] to the detriment of the public or of an identifiable part of society. Accountability presupposes disclosure.[126] It is to be expected therefore that rules will evolve in the society to ensure disclosure by any institution where it is perceived that some

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a means of altering conduct in Guzzardi, *An Unscandalized View of Those "Bribes" Abroad*, FORTUNE, July 1976, at 119, 121.

122 Weiss, *The Limits of Disclosure*, 7 REV. SEC. REG. 943 (April 10, 1974); Gillis, *Corporate Disclosure*, 30 FINANCIAL ANALYSTS J. 14 (July-August 1974).

123 Blumberg, *The Public's "Right to Know": Disclosure in the Major American Corporation*, 28 BUS. LAW. 1025 (1973).

124 Sommer, *supra* note 117, at 37.

125 Thus, commissioner John Evans said it is the SEC's responsibility to use its legal powers to "encourage high ethical and moral standards of corporate conduct"; 303 BNA SEC. REG. & L. REP., May 21, 1975, at A-13.

126 *Id.*

segment of the public might need to be protected against possible adverse action by the disclosing institution or its controllers. If statutes regulating securities issues are the most convenient place to add such disclosure requirements, then that is a proper legislative action, so long as the additions do not emasculate the original purpose of the legislation. While our proposed system concentrates on investor protection we acknowledge the wider goals that disclosure requirements may satisfy and have tried to allow for them within our system.

Before proceeding with a more detailed look at the reasons for disclosure we should first sketch an outline of what we mean by "disclosure" – *i.e.*, the what, to whom, and when dimensions, which will be expanded upon later in this paper. It is obvious that there are several dimensions to the disclosure concept which are logically severable but which may form part of a whole envelope that is seen in its totality as a protection for society. One dimension is the total extent of required disclosure whether in statutes regulating securities issues or in diverse other statutes, such as environmental protection legislation.[127] A second dimension, closely related to the first, is the focal point to which parts or all of the required disclosure are directed; the nature of the interests or functions of the recipient may largely dictate the extent of the disclosure required to that recipient, although we have already noted that securities commissions may be required to seek information which is of little concern to investors. A third dimension is the effective dissemination of the disclosed information in digestible form to those focal points.[128] An extension of this dimension is the dissemination to wider groups than the initial focal points, perhaps based on the belief that other elements in society, particularly the news media, may identify problems which have not previously been considered relevant. A fourth dimension is timing of the disclosure; stale news is no news. A fifth dimension is the remedies, actions or results foreseen as a consequence of the disclosure and, separately, of the requirement for disclosure. It is the totality made up of these dimensions which we view as "disclosure" and not just the extent of the information publicly available. With these dimensions in mind we can suggest the fundamental tenet that we believe lies behind all requirements for disclosure and thus answers the "why" question: if each interested societal element is apprised of sufficient facts with respect to any business then a

127 *See*, *Telling All*, *supra* note 121, for some indications of the embarrassment of corporations forced to disclose contributions made to foreign officials.

128 The indigestibility of "full" disclosure is at the root of some clarion calls for less disclosure, such as Kripke, *The Myth of the Informed Layman*, 28 Bus. Law. 631 (1973).

rational compromise between the competing interests which each element represents will be facilitated. There exist mechanisms within the society to ensure that such a compromise will ensue if the competing interests cannot all be satisfied at once.[129] Disclosure changes the dispute from one based on facts to one based on competing policy objectives. While this may seem simplistic, it is a useful starting place from which to expand on the purposes of disclosure.

Another point, based largely on Canada's tendency to adopt precedents in the securities regulation area from the United States, should be made here. If one accepts that corporations are the key business institutions in Canada today, then corporate disclosure becomes the central focus in any discussion of disclosure by business institutions. As we have already noted total required corporate disclosure will be much wider than the disclosure which could rationally be required of business institutions if the focus was purely on questions of investor protection.[130] One might expect that general requirements of corporate disclosure would be largely promulgated by the jurisdiction of incorporation in the constating legislation. But in any country where there are eleven incorporating jurisdictions[131] it is evident that, in the absence of uniform legislation, unevenness in corporate disclosure requirements would result. This may be appropriate for local businesses. Indeed with respect to those businesses it is logical to expect that local requirements should be controlling and such requirements may well differ between various localities. But with respect to businesses which either operate in more than one locality or whose influence pervades other localities the disclosure requirements must be acceptable to each such locality where interested societal elements are affected. Thus disclosure requirements in Canada are likely to be contained in statutes other than the basic corporate laws. Similarly, in the United States, where there is no federal incorporation power,[132] the disclosure requirements for corpora-

129 In the securities regulation area, *see* Knauss, *supra* note 83.

130 Although if a standard is drawn widely enough, quite full disclosure can be obtained under the concept that a corporation must reveal all "facts which a reasonable shareholder might consider important", which was the standard set by the 7th Circuit Court of Appeal in 1975. That standard has now been cut back by the United States Supreme Court in TSC Industries v. Northway Inc., 90 S. Ct. 2126 (1976). *See also* Whitmore, *Why Wider Disclosure Is Good for Business*, The Times (London), June 24, 1976.

131 This problem is exacerbated in the United States where there are 50 incorporating jurisdictions, the most popular of which for large corporations is likely little Delaware, the statutes of which tend to be highly management-oriented.

132 Federal incorporation in the United States has been recently proposed but is not without its critics and is likely some years off yet; *see* report of the ABA Symposium in 307 BNA FED. SEC. L. REP., June 18, 1975, at A-1.

tions with more than local activities are contained mainly in the federal securities laws. While those disclosure laws have been justified on the basis of investor protection, it is suggested that those disclosure requirements are also seen as the general disclosure requirements for public corporations in the United States. The protection of the investor could be therefore just one of many societal goals which the disclosure requirements of the U.S. statutes seek to protect.[133] We do not wish to suggest that securities legislation is an inappropriate place to centre most corporate disclosure, including disclosure required for purposes other than investor protection. We do suggest however that the result would be in Canada, and has been in the United States, that the reasons for the extent of the disclosure required are masked if one pretends that investor protection is the only goal. No doubt there could be a Canada business disclosure act which would fulfil the same disclosure purposes as we suggest in this paper and indeed the Corporation and Labour Unions Returns Act now fulfils this function to some extent. However, we assume that the disclosure requirements that might be contained in such a statute are to be embodied in the Canada Securities Act as this approach is consistent with the developing practice in the United States[134] and in the various provinces of Canada. That the disclosure is not just for investor protection has been more clearly articulated in the recently proposed Australian legislation[135] than it has been in either Canada or the United States.

As a further introductory point, it should be noted that disclosure, by itself, is now generally acknowledged to be an insufficient regulator of the securities markets.[136] In the following section of this paper we have explained in some detail the augmentation of a basic disclosure system by direct regulation through an appropriate regulatory body. Direct regulation may be necessary, for example, where each individual investor has an insufficient economic interest to justify any effort at concerted action, yet the combined investment is significant. One example of this would be the promulgation of rules for the trading of shares in the secondary market. In other areas, there may be a public policy against permitting any solicitation of funds from the public except on

133 For a readable overview of the U.S. provisions, *see* Ruder, *Federal Restrictions on the Sale of Securities*, 67 Nw. U.L. Rev. 1 (1972 Supp.).

134 *See Hearings on H.R. 10570 and H.R. 13986 before the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce*, 93d Cong., 2d Sess. (1974).

135 *See* speech of Senator Murphy, *supra* note 120.

136 Knauss, *supra* note 83.

terms approved by the government directly. Lotteries are an obvious example.

A. PURPOSES OF GENERAL DISCLOSURE REQUIREMENTS

Turning to the purposes themselves, we can say that to the extent disclosure under a proposed federal statute is viewed as general disclosure of information which ought to be publicly available with respect to large enterprises[137] operating in Canada, regardless of whether such disclosure protects the investor or not, then the broad purpose of all disclosure legislation, stated above, becomes more meaningful. The public availability of information as to quality of performance of specific business enterprises should provide interested sectors of society with the facts to commend or condemn that performance. As a corollary to the public availability of facts, the requirement of disclosure will ensure that senior management officers of business enterprises are themselves apprised of those same facts, which in itself may be a healthy discipline. It is self-evident that steps taken within an enterprise to ensure compliance with standards that are acceptable to the general public are more effective than any judicial or quasi-judicial regulation that might be imposed to enforce such standards.

Secondly, but also at the level of general business disclosure, a requirement of frequent, periodic disclosure should minimize the likelihood of corporate scandals or inappropriate corporate behaviour and contribute to law enforcement by facilitating detection of improper behaviour at an early stage. While it can be argued that improper behaviour will still occur but simply not be adequately disclosed, there is a huge difference between denying a knowledge of what constitutes improper behaviour once confronted with it, and denying that the behaviour in question was concealed. Additionally, we would suggest that most senior business officials are responsible citizens who are responsive to articulated standards. Without disclosure of the facts, it is difficult for the public through its elected representatives to articulate standards.

Thirdly, there is a widespread belief that we live in a secretive society.[138] Where information is not available, secrecy breeds dis-

137 If one considers only the needs of the investor, there may be a case for less disclosure by very large institutions as compared to smaller ones, at least at the time of additional issues of outstanding securities; *see* Schneider, *An Administrative Program for Reforming the Federal Securities Laws*, 23 BUS. LAW 737 (1968).

138 J. CRISPO, THE PUBLIC RIGHT TO KNOW, ACCOUNTABILITY IN THE SECRETIVE SOCIETY (1975).

trust. Full disclosure dispels fears.[139] Thus a major purpose of any general disclosure requirement is to reinforce the public acceptability of existing societal institutions by providing the information to refute charges of unacceptable behaviour. It is difficult for detractors to avoid the label of irresponsibility if readily available information exists which proves the contrary of their assertions. Without such information the hand of the dissident is strengthened.

Fourthly, there is the purpose of equality of opportunity.[140] This is sometimes phrased as a negative – that one should not take advantage of information which is confidential. But phrased that way, the reprehensible conduct is seen as breaking, or using to one's own advantage, a confidence reposed in the user by a third party. Seen in the more positive ethic of equality of opportunity the reprehensible conduct is seen as taking advantage of a situation of which others, if they had knowledge of the facts,[141] are equally entitled to take advantage but are precluded from so doing because of their ignorance.

These four purposes are sufficient to justify a statutory requirement of general disclosure by business enterprises, which disclosures would obviously have some elements of vital concern to investors. But so to state only begs the real questions for no dimensions have been put into the general disclosure requirement. What information must be disclosed? To whom are the various bits of required information directed? By what means is the information to be disseminated?[142] When and how often is the information to be disclosed? What are the anticipated results? At least some of these questions should be addressed at this point. The extent of the information to be disclosed must be balanced against two fundamental principles:

(1) There are competing values in the society which protect the non-disclosure of certain information or require disclosure only on the basis of restraints on use of the information by others.[143] Thus it is fundamental that trade secrets, such as the formula or process used to manufacture a patent medicine or a soft drink, may be kept confidential by the business enterprise involved, although confidential disclosure to health authorities may be required in some instances. Like-

139 *Hearings on H.R. 10570, supra* note 134, at 23 (statement of Philip A. Loomis).

140 *See* Knauss, *supra* note 83.

141 Cohen, *A Guideline for Equalizing Investment Opportunity: Avoiding the Pitfalls of Selective Disclosure,* 46 S. CAL. L. REV. 139 (1972).

142 Some of the possible media are discussed in Bromberg, *Disclosure Programs for Publicly Held Companies – A Practical Guide,* [1970] DUKE L.J. 1139, 1167.

143 *Id.*

wise, letters patent of invention are granted on the basis of disclosure of the invention to the public but denial of public use of the disclosure, within certain limits. Similarly where complete disclosure would put the discloser at a disadvantage vis-à-vis his competitors then the disclosure principle may yield to the equality of opportunity principle.

(2) The cost of the public obtaining each required item of information must at least equal the anticipated value of the disclosure of the information so obtained.[144] While a cost-benefit analysis is neither desirable nor practical for each individual item of information required, there are some items where the costs of obtaining the information are significant. Such items are usually identifiable by the enterprises involved and they can be relied upon to complain if specifically invited so to do.[145] More fundamental however is the general recognition that the public will ultimately bear the full cost of any required disclosure. Business enterprises are simply intermediaries. They obtain funds from the public through sales to consumers of their products and expend these funds on their employees, their security holders or, through taxes, on the government. If costs rise then either the consumer will pay more for the product or the wages of employees, returns on invested capital or taxes must decrease. In any case it is the public, or a substantial portion thereof, that pays the cost. Put another way, the cost of disclosure is inflation as no extra consumable product is produced for the extra cost involved.

These two factors should not be blown out of proportion so that only minimal disclosure requirements are enacted but, where significant new costs may result, additional disclosure requirements should be preceded by a careful cost study.

Of equal importance to the extent of disclosure is the focal point to which the information is disclosed. To some extent, general public disclosure can be obtained by filing the material in a central depository with only an indexing system.[146] Assuming complete disclosure, the utility of the disclosure then varies directly with the sophistication of the indexing system. Often the repository of the information has at least some responsibility to check that the facts disclosed appear to comply with the disclosure

144 *See* Notice of Public Proceedings on Corporate Disclosure of Environmental Impact, SEC, Securities Act of 1933 Release No. 5569, February 11, 1975, [1974-1975 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 80,110.

145 One example is the various voluminous briefs submitted to the Ontario Securities Commission at each of its several stages of attempting to attain agreement on a new securities statute.

146 This is essentially the British system, although query the indexing system.

standards imposed. If, as is sometimes the case, the person to whom the information is disclosed has some obligation or possibility to act on the information, then the information disclosed might be limited to the interests of the recipient so he is not sorting through irrelevant information and, perhaps, the amount of information should vary with the ability of the recipient to understand the information.[147] This concept, sometimes called "differential disclosure", is becoming generally accepted in the United States.[148] The furnishing of excess information to the uninterested or incapacitated is a waste that the system can ill afford. But lack of ability to understand on the part of the recipient should not preclude all disclosure to that recipient – the disclosure should be put in terms that he can understand.[149]

Allied to the question of to whom the disclosure is directed and particularly to the question of differential disclosure is the question of the dissemination techniques to be employed.[150] Traditionally, expositive material has been disseminated by means of written communications, a medium which relies on the recipient to read what is received. While it is realistic to expect people whose livelihood requires that they digest such material to make the effort to understand it, even if the phraseology is somewhat obtuse, it may be unrealistic to expect members of the public to be equally motivated.[151] Thus, for example, the current consensus appears to be that investors seldom if ever read lengthy disclosure documents such as a prospectus.[152] It is even doubtful if shareholders read information circulars. It is more likely that shareholders at least look at annual reports,[153] especially if the reports are set up in a fashion to catch the eye.[154] Even then one wonders if anything

147 The GLADSTONE COMMITTEE REPORT in 1844 stated that the greatest benefit of disclosure would probably be derived by those "professionally employed in making investments to learn more easily and accurately the real nature of these companies"; *quoted in* B. HUNT, supra note 19, at 94.

148 Although a countervailing consideration is the problem of "selective" disclosure which the courts have criticized when information is made available to one set of analysts and not another; Gillis, *Trends in Disclosure*, 32 FINANCIAL ANALYSTS J. 8 (January-February 1975).

149 Sommer, *Random Thoughts on Disclosure as "Consumer" Protection*, 26 BUS. LAW. 85, 91 (1971).

150 Thus H. CHERRINGTON, *supra* note 56, at 150 complains that the gathering of information by "blue sky" commissions before 1933 was of little consequence to the investor because the information remained hidden away in commission offices.

151 Kripke, *supra* note 128.

152 Indeed, full disclosure has been said to defeat fair disclosure; *see id.*

153 The chairman of the SEC on March 13, 1974, wondered if the annual report contents should become subject to more detailed requirements; *see* SEC News Digest, March 14, 1974. It is interesting to note that the least regulated document, the annual report, is the most widely read.

154 Corporate advertising is clearly one way of bolstering investor relations; *see* South-

but the pictures, captions and perhaps the president's letter are perused.[155] Certainly many investors lack the expertise required to read the financial statements.[156] In short, the less motivated the recipient the more ingenious the dispatcher if there is to be effective communication. Naturally ingenuity comes at a high cost. Increasing the amount of information which it is mandatory for enterprises to send to a large number of passive recipients is of questionable value. More disclosure to a select audience who in turn have access to warmer media if the disclosure so warrants is likely a more fruitful approach. But the cry for public disclosure suggests that this process will be evolutionary not revolutionary.[157]

Considerable attention has been focussed in recent years on the timeliness of disclosure.[158] This has been manifested, for example, in requirements for increased frequency of financial reporting and in requirements of regulatory authorities, including stock exchanges, for immediate disclosure of material information. In addition to the cost-benefit question and the problems of adequate dissemination techniques, two countervailing policies must be balanced against the concept involved in immediate disclosure:

(1) Premature disclosure may raise expectations which in fact are not fulfilled. In the securities markets, this is likely to cause exaggerated fluctuations in prices, which fluctuations usually hurt the little investor. In addition, unnecessary portfolio churning may result with attendant service costs. In the environmental protection area, unnecessary concern may generate a lot of wasted time.

(2) Reactions by other enterprises, especially where the disclosure suggests a large potential for profit, will likely lead to an inefficient allocation of resources in the ensuing scramble for participation. The entrepreneur or enterprise that had the good fortune or wisdom to sow in fertile fields is entitled to

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ern, *Can Corporate Advertising Help Your Investor Relations Program*, PUB. REL. J., November 1974, at 20.

155 As Hurst puts it: "The most tangible accomplishments of the [disclosure to shareholders] movement were to make management more aware and more adept at the polite forms of relations with shareholders"; J. HURST, *supra* note 7, at 97.

156 *See* the recent proposal to require auditors to ensure that there is "fair representation". Does this mean understandable? *See* Slain, *Fair Representation*, 8 REV. SEC. REG. 982 (January 29, 1975).

157 Lowry, *Lord Mansfield and the Law Merchant*, 7 J. ECON. ISS. 611 (1973), mentions a report by Cicero of an argument between Diogenes and Antipater in which Antipater felt that the seller's obligation to society was to "tell everything, so that the buyer can be just as much in possession of the facts as the seller" while Diogenes felt the seller was only bound to make no misrepresentations. *Plus ca change, plus c'est la meme chose.*

158 *See e.g.* Bromberg, *supra* note 142.

reap the harvest in the absence of some unfair dealing or social policy to the contrary.

In the securities area, it is argued that slow disclosure may provide opportunities for those with advance knowledge to make unfair gains.[158a] This could be prevented by adequate insider trading rules. It is also argued that lack of disclosure can prejudice any person dealing directly with the enterprise or with securities of the enterprise. Thus additional trade credit might not be available if negative prospects were announced promptly. But if in fact those prospects did not develop, the enterprise would be denied otherwise available credit on the basis of a supposition which, with hindsight, proved wrong.

Finally, the results expected from extensive disclosure should be considered. It could be argued that positive increases in efficiency are likely to be produced in the overall system. Even if there are not, it may be that sufficient prevention of improper behaviour will occur to justify the effort required. Certainly psychologically the society will feel better equipped to deal with changing economic realities, which in itself is probably a sufficient result to justify considerable disclosure requirements tailored within the parameters outlined above.

B. PURPOSES RELATED SPECIFICALLY TO INVESTOR PROTECTION

Leaving the question of general disclosure by business enterprises and turning to the specific disclosure requirements for investor protection which are the primary focus of this paper, there are two major, purely investor-related reasons for significant disclosure by business enterprises which seek funds from the public or which have sought funds from the public in the past with the result that their securities are currently traded in the public marketplace. These two reasons are:

(1) to facilitate the effective assessment by investors or prospective investors of the value and price of securities offered for purchase or sale in the marketplace;[159]

(2) to contribute to the effective use by security holders of their voting rights, or other contractual or statutory rights that they may have as security holders.[160]

158a *See* the remarkable judgment of the Ontario Securities Commission in *In re* Harold P. Connor, [1976] OSC Bull. 148 (June).

159 This is sometimes subdivided into providing opportunities for sophisticated analysis by those capable of so doing and providing warning signals for the unwary; *see* Anderson, *supra* note 119.

160 The Ontario commission has held that annual reports are useful to debt as well as equity holders and therefore should not be discontinued merely because all the

While there are other subsidiary reasons for requiring certain types of disclosure, such as insider trading reports and market trading data, we will first consider these two fundamental reasons.

It has been obvious for at least 250 years that an unregulated securities market with uninformed investors leads to chaos.[161] As we have earlier indicated, the advent of modern corporation legislation in the middle of the nineteenth century providing for easy incorporation was coupled with requirements for disclosure by corporate entities, particularly where they sought to interest the public[162] in investing in the enterprise. The concept then, as now, was based on the assumption that only an investor who was provided with adequate information could make a rational decision as to whether he should expend his funds in purchasing an available security. That the focus of securities disclosure has been on a purchase of a security at the time of initial issue can be rationalized in two ways. First, the secondary market is really only an adjunct of the primary market.[163] Its function is to facilitate trading in already issued securities which thereby allows any investor the freedom to dispose of his original investment before its maturity date. The ready marketability of a security makes it a liquid asset, which is a decided advantage from the investor's point of view. Indirectly there is an advantage to the issuer as the existence of a trading market ensures that people with money available only on a short-term basis can, if they choose, invest in securities with long-term maturities. This is particularly important with respect to common shares where the investment is, in theory, permanent if no trading market exists. Nevertheless, in terms of the basic economy of a country, only new infusions of money on primary issues result in increased capital in the operating sector. Accordingly, the necessity of full disclosure to investors so that available new capital would be efficiently allocated within the operating sector was more important to the overall economy than was disclosure at the time of secondary transactions. Secondly, a new issue normally results in substantial purchases of identi-

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shares are controlled by one group; *see In re* Toronto-Dominion Centre Ltd., [1975] OSC Bull. 139 (April).

161 *See* C. MacKay, *supra* note 15, for an interesting account of the frauds of the early eighteenth century.

162 The "public" is a very difficult term to define. This is discussed later in this paper. For present purposes, we shall presume that we are dealing with cases where the term "public" is obviously not a limiting factor. For a recent discussion *see* the decision of Judge Wong in R. v. Kiefer, B.C. Corporate & Financial Services Division Weekly Summary, May 14, 1976, at 2 (Prov'l Ct.).

163 This interrelation of the primary and secondary markets was espoused in the Kimber Report at 8.

cal securities by investors within a reasonably short period of time. Thus it is practical to require an enterprise as a condition of selling a substantial amount of securities, to bear the cost of preparing and disseminating information to would-be purchasers. On a secondary sale the issuer gets no direct benefit while the seller lacks access to the necessary information regarding the issuer to make it sensible to put the burden on him at the time of sale. That this problem does not obtain when the seller in fact is in control of the issuer, explains in part the requirement of disclosure on a secondary-primary, which has been a feature of Canadian securities legislation for decades.

A continuous flow of new primary share issues inevitably meant that shares available for trading in the secondary market increased. Indeed it was to be expected that the dollar volume of trading in the secondary market would exceed the dollar volume of trading in the primary market in any given year. Today the dollar volume of trading in shares in the secondary market so far overshadows the dollar volume of new issues that a prospective investor is much more likely to invest through the secondary market than through the primary market. Accordingly, if the reason for disclosure is to facilitate the effective assessment by investors of the value and price of securities, it is obvious that disclosure must be made to investors in the secondary market. The answer to the question of who should supply the information is equally obvious – the person who knows or has access to the facts. The answer to the question of who should bear the cost of assembly and dissemination of the facts is not so obvious. Under a continuous disclosure system, some data would be available to every potential purchaser. The cost of producing such continuous disclosure would probably be borne by the issuer. Information might also be available from research reports prepared by investment dealers for their clients, usually at no direct cost to the client. If a more direct burden were put on the purchaser to inform himself before purchasing on the secondary market then the cost of entry into the market as an investor would preclude the small investor from entering the market at all. If a similar burden were imposed on the seller, then the cost would cut into his return on the sale of the securities in question. Accordingly, if a more direct disclosure is to be made on secondary market transactions, the cost must be borne by a third party, which, inevitably, will spread those costs onto the segments of the public from which his sources of funds are derived. The two most likely candidates as the intermediary cost absorbers are the original issuer of the securities[164] and the trad-

164 *See*, Jacobs, *Disclosure by Nontraders*, 8 REV. SEC. REG. 911 (May 21, 1975).

ing houses[165] whose livelihood depends on the existence of the secondary market. The allocation of the responsibility and hence the cost of disclosure as between these two institutions will be further adumbrated later in this paper. At this point we simply wish to emphasize that the primary reason for disclosure to the investor forces a solution which may be difficult to accept in all its ramifications. It may well be that further evolution of the securities markets themselves will lead to a more easily acceptable solution but that is beyond the scope of this paper.

The second major purpose of disclosure in the securities regulation area is to contribute to the effective use of the contractual and statutory rights which the security holder has with respect to the issuer.[166] The most obvious right is the right of the common shareholders to elect the directors of the company. While it has been recognized since at least 1932[167] that shareholders in a corporation whose shares are widely dispersed have no effective control over the election of directors,[168] various devices have been invented to ensure that minority views can be ventilated. Such ventilation may directly influence the direction in which the management of the corporation is headed or may result in government action or castigation of the corporation concerned by the media. The media may themselves be the instigators if the business enterprise is required to publicly disseminate information. This is a good example of dissemination beyond the focal point (*i.e.*, the securityholders) having a potential for positive effect.[169] To inform the securityholder on a regular basis of material facts concerning the issuer of those securities has been the major development in North American disclosure requirements over the past ten years. The ready availability of such information has had the important consequence of partially fulfilling the need of the potential investor in the secondary market. While the disclosure requirement was premised on the informational needs of existing shareholders, it serves another useful purpose.

165 Municipal bond dealers in the United States now have the burden of making full disclosure to their clients; *see Big Board Likes Securities Bill*, The New York Times, May 27, 1975.

166 It is, of course, difficult to get information to beneficial as opposed to nominee holders, although efforts in this regard are increasing; *see* 290 BNA SEC. REG. & L. REP., February 19, 1975, at A-2. It may be that such holders, by holding through nominees, have already evidenced that they are not interested in receiving any information.

167 A. BERLE & G. MEANS, *supra* note 57.

168 1 L. Loss at 12.

169 Similarly, insider trading reports are often noted by the press which gives shareholders indirect knowledge of the contents of the reports; *see* Knauss, *supra* note 83, at 633.

Subsidiary reasons for disclosure in the securities area really relate to the application of the general reasons for disclosure, discussed above, to the securities markets. Thus insider trading reports may disclose improper behaviour on the part of insiders or at least give the regulatory authority some basis on which to base an inquiry. That present insider trading legislation has been labelled "impotent"[170] is more a result of the substantive and administrative difficulties than it is of the disclosure requirements. Similarly, periodic disclosure by brokers of their financial position ensures compliance with minimum capital requirements and allows the authorities to formulate new regulations consistent with the evolving requirements of the industry.

C. CONCLUSION

In conclusion, for the reasons set out above, we believe that detailed disclosure by business enterprises is essential but that care must be taken in the formulation of rules to ensure that the regulatory pattern reflects a balance of the benefits to be gained against the costs and other burdens involved. Specifics of the existing disclosure requirements in the securities area and our suggestions for changes are set out later in this paper. Before turning to that area, we wish to discuss the recognized supplementation of the disclosure requirements in the securities regulation area, namely, regulatory intervention where complete disclosure still leads to inadequate investor protection.

Chapter IV
Supplementation of Disclosure by "Blue Sky" Rules

It is generally agreed that disclosure requirements, no matter how far-reaching and how widely disseminated, are not in themselves an adequate system of regulation for the securities industry.[171] In Australia, the United Kingdom, the United States and Canada, there is some system which limits the ability of potential issuers to sell their securities to the public, regardless of how much they disclose. Some restrictions may be based on a belief that the financial markets cannot absorb all the issues desired to be marketed with the result that priority may be given to certain types

170 By the Minister then responsible for the Ontario legislation; *see* the Globe and Mail (Toronto), June 11, 1969.

171 *See* L. Loss, Proposal for Australian Companies and Securities Legislation: Comments from the American Experience (July 13, 1973) (Report tabled by the Attorney-General of Australia in Senate, September 12, 1973), CCH AUST. SEC. L. REP., Special Report, September 20, 1973.

of financing.[172] But more generally such restrictions are placed on issuers going to the public marketplace through a discretionary veto power vested in an administrator, such discretion to be exercised on the basis that the issue itself, or the issuer's plan, is not appropriate for submission to the public. The administrator in whom the discretion resides is given the power to preclude, either on the basis of a general discretion or on the basis of particular standards set forth in the legislation. The justification for the imposition of such a "blue sky" regime inevitably rests on the degree of protection which it affords to the investing public.[173] In this paper we will not deal with the anti-fraud provisions pursuant to which brokers or issuers who engage in any artifice to defraud are investigated or prohibited from trading, although those provisions are commonly subsumed under the "blue sky" heading in the literature.[174] Nor will we deal with provisions requiring licensing of certain persons engaged in the securities business although it is clear that denial of a licence to trade in a given security, if a licence is required before trading takes place, is effectively direct regulation over that security.[175] Our concern is the general discretion granted to an administrator to refuse to permit a primary issue of securities to go to the public at all.[176]

172 Thus, in the United Kingdom, permission must be obtained from the Bank of England before a new issue can be marketed. In effect, there is a queue of private enterprises seeking to release new issues.

173 1 L. Loss at 35. For an interesting article on state regulation, *see* Mofsky, *Reform of the Florida Securities Law*, 2 FLA. ST. U.L. REV. 1 (1974).

174 L. Loss & E. COWETT, BLUE SKY LAW (1958) is the basic text in the United States.

175 A cease trading order is likely the most effective form of direct regulation but appears to be somewhat overworked in Ontario at least. A list of outstanding cease trading orders appears in [1976] OSC Bull. 123 (June). The list goes on for 26 pages and comprises over 500 companies. The orders are based on 144(1) of the Ontario Securities Act which simply provides:

> "The Commission may, where in its opinion such action is in the public interest, order, subject to such terms and conditions as it may impose, that trading shall cease in respect of such securities for such period as is specified in the order."

This provision is carried forward unamended into Ontario Bill 98, s. 122(1). For examples of orders and reasons given, *see In re* Capital Growth Real Estate Fund, [1970] OSC Bull. 117 (August); *In re* Toronto Star Ltd., [1971] OSC Bull. 17 (February); *In re* Gray Industries Inc., [1971] OSC Bull. 15 (January); *In re* Canusa Holdings Ltd., (Can.), [1971] OSC Bull. 173 (October); *In re* Rodney Gold Mines, [1972] OSC Bull. 159 (July); *In re* Belgium Standard Ltd., [1973] OSC Bull. 94 (July). The courts have not reviewed many cease trading orders and when they have, there has been a reluctance to interfere with a commission's decision. For an interesting case where the court did interfere *see* Re Chromex Nickel Mines Ltd., 16 D.L.R. (3d) 273 (B.C.C.A. 1971). The Supreme Court of Canada quashed an appeal in the *Chromex* case on the ground that the Court of Appeal judgment was the exercise of a discretionary power; *see* Hretchka v. Attorney-General for British Columbia, [1972] S.C.R. 19, 19 D.L.R. (3d) 1 (1971). Cease trading orders are dealt with in *Leigh*.

176 We will ignore the corresponding stop trading orders, discussed in *Leigh*, ch. I.E.

In the Canadian provincial legislation in force today from Ontario westward the discretionary provision takes the following form:

> "The Director may in his discretion issue a receipt for any prospectus filed under this Part, unless it appears to the Director that...[then follows a list of six situations, two of them further subdivided into three subheads each]."[177]

From Québec eastward, the provisions take a variety of forms but all explicitly grant to an administrative authority a discretion to determine whether or not the securities in question may be sold to the public.[178] The basic question for any jurisdiction is the appropriate degree of permitted discretion. The answer may well depend on the articulation of standards and the availability of an appropriate review procedure where the discretion is exercised against a particular issue of securities. In Ontario Bill 98, the director is required to issue a receipt for the prospectus unless "it appears to him that it is not in the public interest so to do" but, if any of eight listed situations occur, he is required not to issue a receipt.[179] There are appeal provisions provided both to the full commission and from the commission to the Supreme Court.[180] But there is no articulation of the general public interest standard. Even in the eight listed situations there is considerable discretion.[181] These eight grounds are:

177 Ontario Securities Act, s. 61; Manitoba Securities Act, s. 61. The Alberta Securities Act, s. 61 is identical except the "Director may in his discretion direct the Registrar to issue...". British Columbia has only five listed situations. Saskatchewan specifically provides "in its absolute discretion".

178 The Quebec Securities Act, s. 50, reads:

> "The Commission, whenever it deems it expedient, may grant such permission subject to such conditions as it may impose."

The Newfoundland Securities Act, s. 18, the Nova Scotia Securities Act, s. 17 and the Prince Edward Island Securities Act, s. 11 provide:

> "If it appears to the Registrar that a [registration statement] is incomplete, inaccurate or unsatisfactory in any respect the Registrar may..."

The New Brunswick Securities Act, s. 17 provides:

> "If..., The Board finds [the documents]...provide a fair, just and equitable plan for the transaction of business, it may issue to the company a certificate..."

179 Ontario Bill 98, s. 62.

180 Ontario Bill 98, ss. 8, 9. In view of the *Hretchka* case, *supra* note 175, it is doubtful if an appeal would lie from the Ontario courts to the Supreme Court of Canada.

181 Baillie, *supra* note 91, at 220 discusses the whole area, pointing out how significant the discretionary powers are. While the OSC took the view that the discretion was only exerciseable in the listed circumstances, this seems contrary to the express wording of both the old and the new sections. In some recent decisions, the "residuary" discretion under the public interest clause has been expressly recognized; *see In re* Galaxy Gold Mines Ltd., [1975] OSC Bull. 57, 60 (February); *see* to the same effect the decision of the Quebec Securities Commission in Re Farmex Enterprises, 5 QSC Bull., No. 30 (decision No. 4288, July 30, 1974).

(1) The prospectus or accompanying documentation
 (a) fails to comply in any substantial respect with the statutory requirements;
 (b) contains information that is misleading, false or deceptive; or
 (c) contains a misrepresentation,
(2) An unconscionable consideration is or will be paid for property or promotional purposes,
(3) The proceeds of the proposed issue together with other resources of the issuer are insufficient to accomplish the purposes set out in the prospectus,
(4) Considering the financial position of the issuer and its insiders, the issuer cannot reasonably be expected to be financially responsible,
(5) Past conduct of the issuer or its insiders affords reasonable grounds for the belief that the business will not be conducted with integrity,
(6) Such escrow arrangements as the director requires have not been entered into,
(7) In the case of a prospectus of a finance company,
 (a) the plan of distribution is not acceptable;
 (b) the offered securities are not secured in the manner required in the regulations;
 (c) the issuer does not meet the financial and other requirements set forth in the regulations,
(8) Any expert's report or valuation has not been prepared by an expert acceptable to the director.

While the opinion content in these eight enumerated heads for rejection is apparent, it is difficult to quarrel with the concepts or to suggest more clearly defined criteria.[182] Because of this difficulty in reducing the discretion to a set of simple, acceptable rules, it is absolutely essential that the persons exercising the discretion be sufficiently able and experienced to merit the confidence of the securities industry.[183] Even then the residuary standard of "the public interest" is too broad. It is not even clear which portion of the "public" is to be considered. It is suggested that a residuary standard of "when the commission decides, after a hearing, that the protection of the investing public in Canada so requires" would be sufficiently wide.

In a federal system, the question arises of where the "blue sky" discretion should rest. In the United States, the federal legislation anticipated that a state "blue sky" regime would con-

182 *See* WINDFALL REPORT at 96; Emerson, *supra* note 67, at 413-16.
183 *See* PORTER REPORT at 345.

tinue.[184] But this has resulted in very unequal investor protection as between the various states due to differing legislative philosophies. Such a divergence of philosophy is perhaps less likely in Canada. But there are several cogent reasons why the "blue sky" jurisdiction, at least for issues sold in several provinces, should be at the federal level. The first and most obvious is to ensure uniform application of at least minimum standards, regardless of the province of origin of the issuer. The second reason has already been alluded to, namely the necessity of hiring capable administrators. It is doubtful if the provinces, particularly the smaller ones, should be asked to strain their limited financial resources in order to provide such a wealth of talent. It is equally dubious whether ten persons of that quality should be expended on a job that two or three could adequately cope with on a centralized basis. The third major reason for including a discretionary authority at the federal level is the flexibility then afforded to the provinces. If any province felt that an adequate job was being done at the federal level it could opt out of the field entirely while, if any province felt otherwise, it would be free to impose additional requirements.[185] With respect to purely intraprovincial issues, any province which chose to remain in the field should retain full "blue sky" powers over such issues and the federal administrator should not be involved. If any province did decide to opt out of the field entirely, the federal administrator should then exercise the discretionary authority.

If we assume a federal discretionary authority then appropriate rights of appeal should be provided for. It is suggested that the commission, not the director, would be the initial decision-maker under the residuary authority. The director, or his counterpart, would be the initial decision-maker under the enumerated heads. The appeal provisions set forth in the proposed Ontario statute would be suitable for adoption, substituting the Federal Court of Canada for the provincial courts, but there should be some system whereby really important matters could be appealed to the Supreme Court of Canada. In view of that court's power over its own docket, the appeal would be available only by leave of the court. But the possibility should be there.

In considering the application in practice of the exercise of the discretionary jurisdiction, the most frequent case where judg-

184 1 L. Loss, ch. 1B.

185 If the stock exchanges are permitted to engage in primary distributions at all, then another strong reason for a federal presence is present in order to promote uniformity between stock exchanges; *see* Special Report on the Rae Report, CCH Aust. Sec. L. Rep. 3 (July 18, 1974).

ments of that sort are required are in the "hot issue" market[186] and in speculative mining issues.[187] A considerable body of experience has been gained by the provincial securities commissions in the problems relating to mining issues and this expertise should be utilized. While the speculative mining issues are largely a gamble,[188] numerous regulations and policies have been introduced to ensure that the gamble is as fair as possible.[189] On the other hand little attention has been given to the "hot issue" problem, at least at the level of "blue sky" type regulation.[190] A "hot issue" is an offering of securities where the whetted demand exceeds the available supply with the result that a substantial premium develops quickly in the immediate aftermarket.[191] The most effective way to stop a fictitious whetting of demand may be to slow down the issue in order to give the facts a chance to catch up with the fancy. While we do not propose to go into this question in detail, it does seem appropriate to lodge a discretion in the federal commission specifically tailored for this situation.

Refusal to accept a prospectus has been used by the provincial securities commissions for years as a way to force issuers to conform to whatever policies the securities commissions wish to promulgate. Not only is the securities bar reluctant to challenge such a use of the administrative process[192] but the then Minister of Consumer and Commercial Relations in Ontario used this ruse as the basis for implementing a policy control over Mortgage and Real Estate Investment Trusts.[193] It is submitted that a direct rule-making power must be included in the statute if policy statements are to be issued in such a grand manner. Hiding behind a "blue sky" discretion is entirely inappropriate. This is not to deny that certain segments of the securities industry need a much more detailed regulatory base than other segments, but such direct regulation should be dealt with separately from the

186 *See* Prifti, *The Hot Issue*, 24 Bus. Law. 311 (1968).

187 *See* Ontario Securities Commission, Study of the Financing of Mining Exploration and Development Companies (1968) (Beatty Report).

188 *Cf.* Windfall Report.

189 *See* National Policy No. 2, August 1974, 2 CCH Can. Sec. L. Rep. ¶ 54-839; National Policy No. 22, April 1971, 2 CCH Can. Sec. L. Rep. ¶ 54-859; OSC Policy No. 3-02, April 1, 1976, *as amended*, 2 CCH Can. Sec. L. Rep. ¶ 54-896; OSC Policy No. 3-03, April 5, 1971 *as amended*, 2 CCH Can. Sec. L. Rep. ¶ 54-897.

190 There has been some regulation of the brokerage fraternity in the United States; *see* CCH NASD Manual ¶ 2151.06.

191 Sowards & Mofsky, *The "Hot Issue": Possible Hidden Causes*, 45 St. John's L. Rev. 802 (1971).

192 *See* Lockwood, *Procedure in Cross-Country Prospectus Clearance and Regulation by Policy Statement*, in Law Society of Upper Canada, Special Lectures: Corporate and Securities Law 111, 119 (1972). In some situations, the technique has beneficial results but its indiscriminate use is an abuse of the administrative process.

193 [1972] OSC Bull. 181 (September).

general "blue sky" discretion.[194] Indeed in some cases, regulation by an authority other than the securities commission is indicated.[195] If such be the case, it is essential that the regulated industry be subject to only one master or at least that it not be subjected to conflicting requirements. It should also be mentioned that it is totally inappropriate to have some enterprises within a regulated segment subjected to more onerous requirements because they are obliged to file a prospectus every year (such as open-end mutual funds) while others within the same segment (such as closed-end funds) are subjected to less stringent regulation.

A final point that should be raised in the "blue sky" area is the role of the stock exchanges. It is evident that if primary distributions through the stock exchanges are preserved,[196] then the stock exchanges are in a position to impose their own form of "blue sky" regulation. Even without primary distributions over the exchange, the refusal of a listing application is an additional form of direct regulation. While it is not the purpose of this paper to examine the interrelation of the stock exchanges and the commission, we do note that it would be inappropriate to have less regulation on a primary distribution over the stock exchange.

Chapter V
Current Canadian Position

> Writing in 1964, Ontario Chief Justice Dana Porter said: "One of the principal objectives of some of the administrators and practically all the brokers, dealers and corporation lawyers is uniformity of [securities] legislation across Canada. Some faltering progress is being made...."[197]

Twelve years later, the elusive goal of uniformity appears to be still some way off although considerable progress has been made.[198] Accordingly, in describing the current Canadian position, we will attempt to cover the 1975 legislation by subject matter rather

194 An obvious example is the mutual fund industry and the authors have already made a detailed study in this area, which has not yet been acted on; *see* MUTUAL FUND PROPOSALS.

195 For example, with insurance companies in Canada, particularly when one considers the older constitutional law decisions and the existing administrative structure now in place.

196 As they are in Ontario Bill 98, s. 74(1)(b).

197 PORTER REPORT at 345.

198 One can hardly fault slow action by the provinces when juxtaposed to inaction at the federal level. One might hope that the provinces would pursue the uniformity issue

than to explain the provincial systems *seriatim.* As the Ontario system has been adopted in all the western provinces[199] and there is less uniformity in the east, Ontario will be used as the bench mark.

A. PROSPECTUS FILING REQUIREMENTS

The natural starting point is prospectus filing requirements, as the prospectus has been the fullest disclosure document required by the statutes since 1844. Subsection 35(1) of the Ontario Securities Act provides:

> "No person or company shall trade in a security either on his own account or on behalf of any other person or company where such trade would be in the course of distribution to the public of such security until there have been filed with the commission both a preliminary prospectus and a prospectus in respect of the offering of such security and receipts therefor obtained from the director."[200]

To understand this subsection one must be cognizant of the statutory definitions of "trade", "security" and "distribution to the public" because none of them is in accordance with normal English usage. "Trade" includes a negotiation, solicitation or any attempt to sell a security. "Security" includes, as well as what most people think of as a security, *inter alia,* a natural gas lease. "Distribution to the public" includes all primary and secondary distributions of securities to the public which have not been previously so distrib-

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more vigorously rather than embark on substantial revisions to the existing system, whose major weakness is its lack of uniformity.

199 This is not a new phenomenon. In 1964, Alberta, Saskatchewan and British Columbia had copied the Ontario legislation; *see* PORTER REPORT at 345.

200 Alberta Securities Act, s. 35, Saskatchewan Securities Act, s. 42 and Manitoba Securities Act, s. 35 are substantially identical, although Saskatchewan and Manitoba still use the old words "primary distribution to the public" which are slightly differently defined than the words "distribution to the public". This difference will be ignored. The British Columbia statute does not require a preliminary prospectus at all although B.C. Policy No. 3-03, April 5, 1971, 2 CCH FED. SEC. L. REP. ¶ 29-953, outlines a procedure for obtaining receipts for a preliminary prospectus on a "national issue". It has been a hallmark of the administration of securities regulation in Canada to attempt to make up through allegedly uniform policy statements for the lack of legislative uniformity. In fact, all the provinces now accept preliminary prospectuses although there is no provision for them in the east at all. This has been accomplished through cooperation between administrators who publish "National Policy Statements". The "national issue" requirements are set out in National Policy No. 1. A valuable table telling one what to file and where, is set out in Lockwood, *supra* note 192, at 125. Quebec has the most extra documents to file with the prospectus while Prince Edward Island and Newfoundland, not unexpectedly, have the least.

uted and also includes sales from persons whose total holdings materially affect control, whether or not the securities have been previously distributed to the public and whether or not the securities are of a class that has anything to do with control. Thus the requirement of filing a preliminary and final prospectus is much wider than an initial reading of the section might suggest. There are two important limitations; the distribution must be "to the public" and there are a host of exemptions. We will leave both of these limitations on when disclosure is required until we have sketched out the extent of the required disclosures.

The Ontario Securities Regulations[201] set forth in detail the requirements for prospectuses of prospective issuers,[202] while the statute itself sets out a requirement for full, true and plain disclosure.[203] At the end of each form is a requirement to "give particulars of any other material facts relating to the securities proposed to be offered". The use of the word "other" may be unfortunate as it suggests that all the enumerated items are "material" which in fact is not always the case. This catchall clause together with the statutory requirement for fullness gives another discretionary power to the commissions which often results in negotiations with the issuer before a prospectus will be accepted.[204] The relegation to the regulations or, better still, to commission rulings specifically authorized by statute, of the required content for whatever disclosure document is to be delivered to prospective purchasers is essential, especially in a federal statute, if flexibility is to be maintained.[205] The present provincial statutory provisions requiring "full" disclosure, which are carried forward into the proposed provincial legislation,[206] deny the commission the flexibility to permit delivery of a terse and simple document in place of the detailed prospectus, unless the terse and simple document contains "full" disclosure.[207] This is particularly unfortunate as the

201 Ontario Securities Regulations, pt. II and forms 13-18.

202 These regulations cover the items suggested in the KIMBER REPORT and in the PORTER REPORT.

203 Ontario Securities Act, s. 41.

204 Lockwood, *supra* note 192.

205 In the United States, the SEC has a rule-making power so the prospectus forms, for example, can be changed at any time. This is also the proposed system in the ALI FEDERAL SECURITIES CODE, Reporter's Revision of Tent. Drafts Nos. 1-3, s. 403. It is difficult to see the advantage of involving the Governor in Council, especially if provisions similar to those in the Administrative Procedure Act were adopted; *see* Baillie, *Securities Regulation in the Seventies*, in 2 STUDIES IN CANADIAN COMPANY LAW, *supra* note 67, at 343, 356.

206 Ontario Bill 98, s. 57.

207 This would perhaps make it impossible to institute a regime of differential disclosure or a summary prospectus such as was recommended in the CANADIAN MUTUAL FUND REPORT and carried forward in the MUTUAL FUND PROPOSALS.

prospectus, even in its current "narrative" form, is hardly a model of readability or of effective communication.[208]

There are three legends or certificates now required to be inserted on every prospectus – the issuer's certificate[209] that the prospectus constitutes full, true and plain disclosure, the underwriter's certificate[210] to the same effect, except that it is restricted by a "knowledge, information and belief" clause, and a legend disclaiming[211] any merit investigation by the securities commissions involved.[212] The substance of these assertions could be made statutory, with the result that the statements themselves could be omitted from each copy of the prospectus. It is difficult to see how the present repetition adds to purposeful disclosure. If it is meant, in the case of certificates, to bring home the statutory obligations to those signing prospectuses then the filing with the commission of one signed certificate should be adequate without the certificate being duplicated on each copy of the prospectus. The prospectus would contain a short statement of the statutory rights available to a purchaser including the liability of the issuer and the underwriter. In the case of the legend, it is often not true because the commission, within its "blue sky" function, does pass on at least some of the merits. The legend is derived from SEC practice where there is no "blue sky" provision. We would recommend that the certificates be omitted in any new statute and that the legend be modified or abandoned.

In addition to filing both the preliminary prospectus and the final prospectus with the commission, the statute requires that a copy of the final prospectus be delivered to each purchaser not later than midnight on the second day after an agreement of purchase and sale is entered into.[213] There is an important exception to this delivery requirement where the prospectus has been delivered to a person "who is acting as agent of or who thereafter commences to act as agent of the purchaser". This exception comes into play on certain primary distributions through the stock exchanges when the broker through whom a purchaser orders securities acts as agent for the purchaser and not as a principal in selling the securities. Thus if the underwriter or issuer on a primary distribution through the stock exchange, or on a best efforts

208 This problem of effective disclosure has been commented upon *supra* and will be a recurring theme in this paper.

209 Ontario Securities Act, s. 52.

210 *Id.* s. 53.

211 National Policy Statement No. 13, April 1971, 2 CCH Can. Sec. L. Rep. ¶ 54-850.

212 It appears from Ontario Bill 98, ss. 59 and 60 that the certificates at least will continue to be required.

213 Ontario Securities Act, s. 64. The statute does not use the term "final" prospectus but it is used in practice to differentiate it from the preliminary prospectus.

underwriting, blankets all members of the stock exchange with prospectuses, the purchasers from brokers who are not directly part of the selling group never need to receive the document.[214] In fact the exception is of limited use to the larger brokerage firms because most of them who act as agents for the purchasers are selling as principals, for business reasons. Only a scattered few brokers, representing a very small minority of the purchasers, are able to use the exemption in any given issue and they would be precluded from participating in the offering if the exception did not exist. Thus, while the exemption seems illogical in theory, we believe that it works in practice and is necessary so long as distributions over the stock exchange are permitted, a point we comment on later.

The preliminary prospectus, commonly called a red herring in the United States because of a useful legend in red type on the front page warning the reader that it is only a preliminary prospectus,[215] might better be called a dead herring in Canada.[216] The purpose of the preliminary prospectus was to permit prospective purchasers to study the merits of the securities to be issued and to permit underwriters to test the market.[217] Thus, during the "waiting period" of at least ten days (which is often longer in practice) between the time when the preliminary prospectus is filed and the time when the final prospectus is accepted the public was to judge the merits of the issue through the ready availability of the preliminary prospectus. However, there is no requirement in the present statutes that the preliminary prospectus be made available to anyone.[218] In fact it receives very limited distribution, partly because of the onerous requirement to keep a record of every person to whom a preliminary prospectus is sent and to send every such person every amendment to the prospectus.[219] Under the proposed new Ontario legislation, any prospective purchaser who asks for one, whether solicited or not, must be sent a copy of the

214 The pre-1967 Act had a similar exemption for cases where delivery was made to an agent of the purchaser, but applicable to all distributions, not only to those made through a stock exchange; *see* Baillie, *supra* note 91, at 180. This peculiar exemption has been carried along in Ontario Bill 98, s. 72(5).

215 The legend was proposed by the KIMBER REPORT ¶ 5.28(c) and is included in the Ontario Securities Act, s. 39.

216 There is no requirement for a preliminary prospectus from Québec eastward or in British Columbia.

217 KIMBER REPORT at 46.

218 Unless a person is sent an advertisement, in which case he must be advised of the address from which a preliminary prospectus is available, or if a prospective purchaser who was solicited by the underwriter indicates an intention to buy.

219 The requirement of keeping a record of the distribution of the preliminary prospectus was criticized by Baillie, *supra* note 91, at 192. This criticism was ignored in 1967 and the same concept is carried forward in Ontario Bill 98, s. 58(2).

preliminary prospectus.[220] One wonders how effective this new provision will be in achieving a wide distribution of the preliminary prospectus[221] to an appreciative audience. If it is effectively disseminated one wonders whether the list of recipients is worth keeping. If the concept of a preliminary prospectus is to be retained more extensive changes in its applications are necessary than those made in the proposed new Ontario legislation. Perhaps the preliminary prospectus could be eliminated or replaced with a signed draft prospectus which becomes part of the public record until the receipt for the final prospectus is received.

As the prospectus is an unwieldy document, it is interesting to note the provisions respecting advertisements and other materials with which the prospective investor may be bombarded. Under the present Ontario statute any printed or written material may be distributed unless prohibited by the regulations. The regulations contain no such prohibition. Under the proposed Ontario legislation this position remains unchanged after receipt of the final prospectus but is reversed during the waiting period.[222] It would seem that some regulations should be considered to limit inappropriate advertising during both periods. Such limitations are better contained in the regulations or rules established under the statute than in the statute itself.[223]

Before leaving the prospectus filing requirements, we wish to comment briefly on the extension of the concept of "distribution" contained in the proposed Ontario statute, which concept replaces "distribution to the public" under the present law. Essentially Ontario Bill 98 would establish a "closed" system in which securities may be sold within a sophisticated group without any prospectus requirements but once they pass out of this group a prospectus

220 Ontario Bill 98, s. 67.

221 It will be recalled that a disclosure provision in the Dominion Companies Act requiring directors to report their trades to the shareholders' meeting, but only if requested by the shareholders, was completely ineffective due to lack of requests; *see* note 90 *supra*.

222 Ontario Securities Act, s. 57; Ontario Bill 98, ss. 66(2), 70. The draft regulations under Ontario Bill 98 had no provisions either, so distribution of anything, except the preliminary prospectus, would be prohibited during the waiting period.

223 It may be worth noting that, in our opinion, the responsibilities of the federal Parliament are now so numerous that it is unrealistic to expect expeditious amendments to statutes other than the Income Tax Act. Accordingly, we tend to favour more regulations or rules but, in so doing, we wish to stress that we think it essential that any proposed changes be widely circulated and adequate time for comments afforded before such regulations or rules become effective. There are many examples of ill conceived rules that might never have been foisted upon the securities industry if proper consideration had preceded promulgation. On the other hand, when advance circulation has been attempted, there is often virtually no feedback from the securities industry. But the industry cannot complain if the opportunity for comment is presented.

must be filed, subject to a number of exemptions. The new provision defines a "distribution" to include:

(1) A trade in securities of an issuer which have not previously been issued. Thus any new issue, whether or not the public is involved and whether or not there is a distribution in the usual sense of that word, must find a specific exemption or be caught by the prospectus requirement unless a relieving order from the commission is obtained under section 75. This considerably widens the ambit of the situations where prospectuses are required and will result in more applications for exemption orders. These applications now consume an inordinate amount of time for the lawyers employed by the commission. To add to this burden may be a heavy price to pay for the gain derived.

(2) A trade by an issuer in previously issued securities which have been redeemed or purchased by or donated to the issuer. This is a logical extension of the primary issue concept in some respects but it will hamper the flexibility of market involvement by the issuer. It seems peculiar that the purchaser of a redeemed preference share should be entitled to a full prospectus whereas he is entitled to nothing if he happens to buy the same share from a director of the issuer.

(3) A trade out of the securities held by a person whose ownership of securities in the corporation materially affects control of the corporation. While this provision is not new, it is still unclear why a substantial shareholder cannot sell some non-voting debt obligations of the issuer which he happens to own, at least in small amounts.

(4) A trade in securities previously issued through an exemption under subsection 73(1) that is not made in compliance with certain other subsections of section 73. This attempts to tighten the "closed" circle to ensure that all securities will have prospectuses filed with respect to them before they can reach the marketplace. But it is peculiar that the requirement for a previously issued security is restricted to subsection 73(1) thereby precluding resale of securities without a prospectus that have been issued through, for example, an exempting order under section 75. This may lead to even more applications than heretofore for section 75 exempting orders on resales.[224]

224 The usual s. 59 order, which is the comparable section in the present Ontario Act, is a "two step" order which requires the purchaser to seek another exempting order on resale. But there are many exceptions to this general rule and the exceptions should increase under the proposed statute, *i.e.* the number of application where a "two step" order would be unnecessary should increase.

We will come back to these concepts from another vantage point when we discuss exemptions.

B. CONTINUOUS DISCLOSURE

While the prospectus has been the most important disclosure document in Canada to date the focus in the disclosure literature since 1966 has been on "continuous disclosure". The basic idea behind this concept is to have available at all times, for public inspection, up-to-date information on all corporations with issued securities that trade in the market. Then the investor, whether on a primary issue or on a secondary market transaction, can obtain reliable information about his prospective investment. In his famous article, *"Truth in Securities" Revisited,*[225] Milton Cohen, who had been the director of the SEC Special Study,[226] suggested that the primary focus in securities regulation should be on continuous disclosure, and that new issue disclosure should be coordinated with such continuous disclosure but should not be free standing in its own right.[227] This remarkable article was followed by the *Wheat Report*[228] of 1969, which also recommended more emphasis on a revised and expanded continuing disclosure system. Since the *Wheat Report,* there have been extensive revisions to the disclosure requirements in the United States. Meanwhile in Canada, a new wave of reports[229] burst forth in the securities area after the 1967 statute was enacted, which reports gave rise to a series of minor statutory changes, major policy changes and major draft legislation in Ontario, which draft legislation is now in its fourth incarnation.[230]

225 Cohen, *"Truth in Securities" Revisited,* 79 HARV. L. REV. 1340 (1966).

226 SEC, *supra* note 115.

227 Cohen attributed the emphasis on primary issues to be a result of the fact that the 1933 Act preceded the 1934 Act. But the 1844 Act preceded both by a fair margin.

228 *See* WHEAT REPORT.

229 These include the REPORT OF THE ROYAL COMMISSION ON ATLANTIC ACCEPTANCE (1969) (Hughes Report); INTERIM REPORT OF THE SELECT COMMITTEE ON COMPANY LAW (1967) (Ontario, Lawrence Report); REPORT OF THE COMMITTEE TO STUDY THE REQUIREMENTS AND SOURCES OF CAPITAL AND THE IMPLICATIONS OF NON-RESIDENT CAPITAL FOR THE CANADIAN SECURITIES INDUSTRY (1970) (Moore Report); OSC, REPORT OF THE SECURITIES INDUSTRY OWNERSHIP COMMITTEE (1972); CANADIAN MUTUAL FUND REPORT (196a); STUDY ON THE SECURITIES INDUSTRY IN QUEBEC (1972) (Bouchard Report); ONTARIO SECURITIES COMMISSION DISCLOSURE REPORT (1970).

230 It started off in 1972 as Ontario Bill 154 which is commented on extensively by Emerson, *supra* note 67. It reappeared in June 1974, after many briefs had been submitted and considered, as Ontario Bill 75. It was introduced again as Ontario Bill 98 in May 1975. It died on the order paper when the 1975 election was called. It was reintroduced in the fall of 1976. It is understood that the Ontario Bill has been discussed with administrators in each province. One might logically predict a uniform statute, but logic is not grist for the securities regulation mill.

Essentially the 1966 Ontario statute brought in an expanded form of continuing disclosure requirements: periodic financial reporting; mandatory proxy solicitation with accompanying information circulars; monthly reporting by insiders of trades in the securities of issuers and requirements relating to the content and dissemination of takeover bid offers.[231] The thrust of the statute was really directed at filling the long-standing gap in the application of disclosure policy between the new issue market and the trading market.[232] But the 1966 Act only included in its ambit for continuous disclosure, issuers which were traded on the Toronto Stock Exchange or which had filed a prospectus relating to equity securities with the Ontario Securities Commission after May 1, 1967.[233] This evidently left out several important enterprises, a problem which would be partly remedied under Ontario Bill 98.

The major pieces of continuing corporate disclosure under the 1966 Act were the financial reports and the information circulars, both of which had to be sent to shareholders but only the financial reports had to be filed with the commission. Accordingly there was a gap on the commission's records if a single repository of all corporate information regarding a given corporation was the goal.[234] Since 1970 the commission records have been even less complete for not all "timely disclosure" announcements need be filed there. The policy of timely disclosure[235] does however amount to a continuing disclosure of important events in the ongoing saga of a business enterprise which is not restricted just to companies that have filed prospectuses or are posted for trading on a stock exchange.

Under Ontario Bill 98, a new concept is introduced, namely, a "reporting issuer". This defined term includes any enterprise whose securities are or have been posted for trading on the Toronto Stock Exchange; any enterprise which is an Ontario corporation that is offering its securities to the public; any enterprise which

231 For further details, *see* Creber, *Take-over Bids, Insider Trading and Proxy Requirements*, LAW SOCIETY OF UPPER CANADA, SPECIAL LECTURES: DEVELOPMENTS IN COMPANY LAW 235 (1968); Bray, *Financial Disclosure and Accounting Practice*, *id.* at 251.

232 Emerson, *supra* note 67.

233 Ontario Securities Act, s. 118. Even then, banks were excluded.

234 That gap was not very important in the usual case as there is very little information in the information circular. It is important, however, when major corporate changes are being considered.

235 Uniform Act Policy 2-12, December 6, 1971, 2 CCH CAN. SEC. L. REP. ¶ 54-882. It should be noted that there are "National Policy Statements" which apply in eight of the ten provinces (Nova Scotia and Newfoundland remaining aloof), there are "Uniform Act Policies" for Ontario westward, and there are just plain Policy Statements on a province-by-province basis. There is much more unwritten policy than written policy.

has filed a prospectus with the OSC after Bill 98 becomes law, and any enterprise which had filed an equity share prospectus with the OSC since May 1, 1967.[236] Every reporting issuer is required to issue and file with the commission a press release disclosing forthwith the nature of any material change.[237] In addition the reporting issuer must file all information circulars and both annual and semi-annual financial statements with the commission.[238] The hope was that there would be a central repository where there would become available, in readily identifiable and accessible form, substantially the equivalent of a current prospectus of every reporting issuer.[239] This will take an enormous amount of time to accomplish or never occur because there are no requirements in Ontario Bill 98 that an initial overall disclosure be made or that compilation of the various bits of information be undertaken periodically. It might also be noted that, as the annual audited financial statements can be 140 days[240] stale when filed and the interim unaudited statements can be sixty days old, the information is far from current.

So far as corporate disclosure is concerned, the new proposed Ontario system is really the old system with a few new labels. The system in the *ALI Federal Securities Code* proposed in the United States is much more extensive. There the threshold is 300 holders of securities together with $1 million of total assets. Once past that threshold every enterprise must register as an issuer with the SEC. This amounts to filing the same documentation as would be filed on a distribution of securities to the public.[241] Once registered a registrant must file, send to security holders, keep a record of and publish whatever reports the commission requires "to keep reasonably current the information and documentation contained in the registration or to keep investors reasonably informed with respect to the registrant".[242] The status of a registered issuer may be terminated once the number of holders of all its securities drops below one hundred.[243]

236 Ontario Bill 98, s. 1(1)35. Under s. 84, a reporting issuer whose shareholders have dwindled to less than 15 can apply to be "deemed to have ceased to be a reporting issuer".
237 Ontario Bill 98, s. 76(1); there are secrecy provisions if the information may be detrimental to the interests of the reporting issuer.
238 Ontario Bill 98, ss. 78(1), 79(1), 82(1).
239 Cohen, *supra* note 225, at 1406. Ontario changed "continuous registrant" to "reporting issuer".
240 It is not clear why the auditors in Canada are so slow; the SEC only allows 90 days.
241 ALI Federal Securities Code, Tent. Draft No. 1, s. 403, provides that "a registration statement shall contain whatever information, financial statements, material contracts and other documents the commission specifies by rule".
242 *Id.* s. 601.
243 *Id.* s. 405.

The *Ontario Securities Commission Disclosure Report* would have adopted a similar system for Ontario and such a system was proposed in Ontario Bill 154.[244] But apparently the reactions in the briefs submitted[245] convinced the provincial authorities to modify the system. The result is an unsatisfactory hodgepodge for companies that are not required to file an initial document before becoming a reporting issuer. Even more importantly, the concept of permitting an issuer, who was a reporting issuer, to use an offering circular rather than a full-blown prospectus on any new issue has been abandoned.[246]

C. EXEMPTIONS FROM PROSPECTUS REQUIREMENTS

Under any system which utilizes the prospectus as the basic disclosure document, it becomes most important to know when that document must be used. If the focus is on investor protection with respect to the securities then to be issued, there are many exemptions which are reasonable. If the system includes adequate continuous disclosure requirements, many more exemptions could be tolerated or at least the requirements for the offering circular made less onerous for companies that are "continuously disclosing". By imposing the full prospectus provision the existing provincial law requires a complicated set of exemptions.[247] The legislature has recognized two separate categories of appropriate exceptions, those where the security is of such a nature as to be beyond reproach and those where the potential investor is thought capable of protecting himself. In addition, there is the very important category of trades which are not a "distribution to the public", which is an exclusion by definition rather than through an exemption.

This concept of the "public" in one way or another has been essential to a system relying on a prospectus. It is recognized that there is no utility in forcing a private company with only family shareholders to prepare mammoth disclosure documents. The information requirement becomes important when potential investors without information are approached with a view to soliciting

244 *See* Emerson, *supra* note 67, at 439.

245 There were numerous briefs submitted and most commented on the "cornerstone prospectus" idea, which was Ontario's suggestion for an initial document. The draft regulations setting out the contents of this document were poorly drafted and ill-considered. The result was that most briefs suggested amendments of one form or another.

246 This again is part of the proposed ALI FEDERAL SECURITIES CODE, Reporter's Revision of Tent. Drafts Nos. 1-3, s. 501.

247 The best writing in this area is Dey, *Exemptions under the Securities Act*, in LAW SOCIETY OF UPPER CANADA, *supra* note 192, at 127.

their capital. The appeal for capital from outsiders should be the trigger for significant disclosure. On the other hand, under an issuer registration system the concept of "public" is really replaced by a threshold. Thus under the proposed system in the United States, if the company does not have 300 security holders, it need not become a registered issuer. Once the arbitrary level has been reached, reporting is required regardless of the amount of securities-related activity of the issuer, until the issuer is deregistered.

The basic trigger for prospectus requirements and therefore disclosure requirements under the Ontario statute is the concept of a "distribution to the public". On one end of the spectrum of possibilities one could say that a "public" distribution only arises if there is a general invitation to all members of a community.[248] On the other end one could say that a distribution arises every time one newcomer is approached, if the issuer would approach another newcomer if the first approach were unsuccessful.[249] The more difficult cases arise when a particular class, such as the security holders, are singled out for special attention that will not be accorded others.[250] In such a case it is not clear that the public is involved, regardless of the extent to which the investor may be uninformed. To date the Canadian cases indicate that there must be an offer generally and not just to friends or associates or persons having common bonds of interest or association. But the numbers do not matter much once it is a general offer past such a delineable group.[251]

The position in the United States is quite different perhaps in part due to the difference in the exempting sections. There is a specific exemption for "transactions by an issuer not involving any public offering". But there are not the myriads of other little exemptions found in the Canadian legislation. In the important *Ralston Purina*[252] case, the court articulated a "need to know" standard which has been quoted ever since. In that case the

248 This was the view taken by the U.K. courts in Shorto v. Colwill, 26 T.L.R. 55 (Ch. 1909); Sleigh v. Glasgow and Transvaal Options, 6 Sess. Cas. (5th ser.) 120 (H.L. 1904); *but see* R. v. Piepgrass, 29 W.W.R. 218 (Alta. C.A. 1959) (*per* MacDonald, J.A.).

249 This is a view sometimes ascribed by authors to Viscount Sumner as a result of the decision in Nash v. Lynde, [1929] A.C. 158 (H.L.); *see* Dey, *supra* note 247, at 135. In fact, the situation in Nash involved several people so the remark is *obiter* at best. When read in context it makes sense. Lord Sumner is talking of approaching complete strangers, telling them the prearranged story and then collecting the money. If this occurs, then the offer is to the public even if the first gullible prospect takes up the whole offer. But there must have been a number of prospects in view.

250 *See* Government Securities Ltd. v. Christopher, [1956] 1 All E.R. 490 (Ch.).

251 *See* R. v. Piepgrass, *supra* note 248; R. v. Empire Dock Ltd., 55 B.C.R. 34 (Cty. Ct. 1948); R. v. McKillop, [1972] 1 O.R. 164 (Prov'l Ct.).

252 346 U.S. 119 (1953).

offering was to employees of the issuer but since there was a "chow loader" amongst the offerees, who had a "need to know", the public offering exception was denied. The *Ontario Securities Commission Disclosure Report* suggested that the "need to know" test should be adopted in Canada,[253] and the method proposed to accomplish the purpose was to eliminate the concept of the "public" entirely.[254] Then a more direct focus could be made in the exemptions on the concept of the necessary knowledge of the investors. A discretion in the commission to grant an exemption on the basis that the prospective purchaser did not need prospectus disclosure or that the trades would not be against the public interest, rounded out the picture. The theory is both simple and appealing so long as the exempting rules can be drawn sufficiently wide that the residual discretion in the commission is seldom necessary. If, however, the exemptions are not wide enough a prodigious amount of unnecessary adjudicative procedure will result. If the exemptions are too wide they will cover cases for which exemption is inappropriate.

Before examining the exemptions under the proposed provincial legislation, we will first look at the specific exemptions provided under the current legislation which complete the picture of when a prospectus is or is not now required. As we noted earlier, there are two genera of exemptions, one related to the type of transaction involved and one related to the type of security involved. It is easiest to deal first with exemptions based on types of securities as the issues are somewhat less complicated. These securities exemptions subdivide into exemptions based on the status of the issuer and exemptions based on the security being issued. The important exemptions based on issuer status are:

(1) Any debt obligation of or guaranteed by a government of any country or any political division thereof.[255] This is much wider than the corresponding exemption in the United States which requires the equivalent of a prospectus for foreign government issues.[256] It is difficult to see why no protection is afforded Canadian investors on foreign issues and we recommend that the exemption be narrowed accordingly.
(2) Any debt obligation of municipal corporations in Canada.[257] While historically municipal bonds have not always been attractive, it is likely the case today that intervention by a

253 *See* Ontario Securities Commission Disclosure Report ¶ 1.26.
254 *Id.* ¶ 3.15.
255 Ontario Securities Act, s. 19(2)1(a).
256 *See e.g.* ALI Federal Securities Code, Reporter's Revision of Tent. Drafts Nos. 1-3, pt. III.
257 Ontario Securities Act, s. 19(2)1(b).

senior level of government would save the bondholders. It is doubtful if any change in this exemption would be feasible politically even if it were necessary for investor protection, which we doubt.

(3) Any debt obligation of a Canadian bank, loan company or trust company.[258] It is not at all clear why an investor in debt obligations of the major financial intermediaries is in any lesser need of protection than his confrere who invests in bonds of other large industrial companies. On the other hand, the financial intermediaries are already regulated directly. If such regulation ensured adequate investor information there would be no need for duplication under a securities regulation statute. To our knowledge no such investor information is required at all, not even to the extent of telling a prospective purchaser of subordinated debt the amount of existing debt load ahead of him. This seems regrettable. The same principle applies with respect to guaranteed investment certificates of trust companies, which are also exempt under the current statute.[259]

(4) Securities issued by charitable, fraternal or recreational organizations where no part of the net earnings enure to the benefit of the security holders.[260]

(5) Securities issued by cooperatives.[261]

(6) Shares of a credit union.[262]

(7) Securities of a private company issued by the company if the

258 *Id.* s. 19(2)1(c). The International Bank for Reconstruction and Development is included under s. 19(2)1(d) if the debt is payable in U.S. or Canadian currency. This rider of currency of payment appears very narrow.

259 Ontario Securities Act, s 19(2)2. Under Ontario Bill 98, there is an exemption for variable insurance contracts which guarantee that at least three-quarters of the premiums paid to the date of termination will be returned. This is simply an affirmation in the statute of what the present policy is. It is our understanding that the insurance companies do not show any reserve to cover this three-quarters premium liability - it is so low as to be irrelevant. Thus, the securities commissions, after some hesitation, have decided not to require disclosure with respect to variable insurance contracts; *see* Re Variable Equity Insurance Contracts, [1969] OSC Bull. 179 (November) and [1970] OSC Bull. 128 (September).

260 Ontario Securities Act, s. 19(2)6. This exemption is important for golf clubs and social clubs. Usually charities do not have any securities outstanding. We know of no problems which have arisen as a result of this exemption.

261 Ontario Securities Act, s. 19(2)7. A relatively new statute in Ontario, the Cooperative Corporations Act, S.O. 1973, c. 101, provides in s. 34 that before the issue of any securities by the cooperative, an offering statement must be filed with the Minister and a receipt obtained. The standard of disclosure in s. 35 is "full, true and plain disclosure of all material facts relating to the securities proposed to be issued". This is an example of an industry which is being directly regulated and it is therefore appropriate that it be excluded from substantially identical requirements under the Securities Act.

262 Ontario Securities Act, s. 19(2)8. Again there is special legislation under The Credit Union Act, R.S.O. 1970, c. 96 dealing with these institutions.

securities are not offered for sale to the public. This exemption depends on the definition of "private company", which definition provides that the instrument of incorporation must (a) restrict the right to transfer shares, (b) limit the number of shareholders to fifty persons and (c) prohibit any invitation to the public to subscribe for its securities. It is presumably because only the instrument of incorporation must prohibit the public sale under the definition that the exemption repeats this prohibition on a factual basis. The reason for the exemption is apparent: one does not wish to have family businesses or close corporations clogging the administrative apparatus or wasting time with unnecessary disclosure. Yet the concept of a "private company" is being abandoned in "modern" Canadian corporate statutes.[263] The attempt to preserve for securities regulation purposes what is becoming an endangered species in the corporate world, highlights the difficulty inherent in the concept that required disclosure is appropriate only where public investors are involved. In the *Mutual Fund Proposals* we recommended that the statute not apply to a mutual fund of which the issued securities are beneficially owned by fewer than fifty persons.[264] We believe this is an acceptable posture for securities regulation generally. Thus so long as the total number of beneficial owners of securities of the entity stays at less than fifty, no prospectus-type disclosure need be made.[265]

(8) Finally there are three exemptions for initial mining development work. One is the sale of securities by a prospector to finance a prospecting expedition. The second is the sale by a prospector or the syndicate of securities of a prospecting syndicate where the syndicate agreement has been filed under the act.[266] The third is securities issued by mining companies in exchange for mining claims.[267] As all these arrangements relate to a particular industry it would seem sensible to treat them outside of the main stream of securities regulation. To the extent they would not be covered by some minimum number of security holders rule, as suggested

263 *See* Canada Business Corporations Act; Ontario Business Corporations Act.

264 2 MUTUAL FUND PROPOSALS, s. 2.01(2)(b).

265 We would note that this posture would make it unnecessary to have a separate exemption for prospecting syndicates or for investment clubs as proposed in Ontario Bill 98, ss. 35(2)5, 35(2)13. Obviously, the question of whether 25, 50 or 100 is an appropriate number is an open one.

266 Section 34 of the Ontario act relates to the terms and filing provisions of syndicate agreements. The exemption only applies if the director issues a receipt for the syndicate agreement.

267 These three exemptions are in ss. 19(2)10, 11, 12, 12a.

above, then direct regulation would seem appropriate if any separate exemption is to be provided.

Each of these eight categories of exemptions for securities based on issuer considerations is carried forward into the proposed Ontario legislation[268] together with additional exemptions for investment clubs and for securities issued by trust companies in respect of pooled accounts or accounts maintained to service registered retirement savings plans. The retirement plan exemption fits into the general category of securities regulated more directly under other legislation[269] while the investment club, being limited to fifty shareholders, is within the "private" principle we have previously suggested. Thus there are really four categories of exemptions based on the securities issuer:

(1) securities issued by governments (which we would restrict to Canadian governments);
(2) securities issued by private institutions;
(3) securities issued by not-for-profit organizations;
(4) securities issued by issuers regulated under other statutes.[270]

The security exemptions based on the type of security form a much shorter but equally important list. There are really only three of these, namely, "short-term" paper in denominations of $50,000 or above, mortgages sold by a person registered under the Mortgage Brokers Act and securities evidencing debts due under conditional sales contracts if such securities are not offered for sale to the public.[271] All of these exemptions are carried forward into Ontario Bill 98 and all seem to be appropriate considering the practical restrictions which we believe to exist in the marketplace for such securities. It does seem strange in the short-term exemption to place a $50,000 limit and a twelve-month term limit in the

268 For some reason which is not immediately apparent the exemption for securities issued for mining claims is deleted. This seems strange as the exemption only applies if there is an acceptable escrow agreement. This escrow agreement should be able to deal effectively with the secondary market problems.

269 In this case, by the Ontario Pension Benefits Act, R.S.O. 1970, c. 342.

270 In the ALI FEDERAL SECURITIES CODE, Reporter's Revision of Tent. Drafts Nos. 1-3, at 43-46, the Reporter makes mention of various plans introduced under the INTERNAL REVENUE CODE. The Reporter points out that these plans vary from time to time and are more appropriately covered by exempting regulations or rules than by direct statutory exemption. The same comment appears apposite in Canada where Registered Home Ownership Savings Plans are the latest but unlikely to be the last in a series of tax relief schemes. Viewed in this light, the reference to Registered Retirement Savings Plans in Ontario Bill 98 is unfortunate.

271 These exemptions are found in Ontario Securities Act, s. 19(2)4, 5, 6. The inclusion of the phrase "not offered for sale to the public" is redundant with the s. 35 concept of only requiring a prospectus if there is a public distribution. But the exemption would be important if the concept of "to the public" were abandoned. Thus, the exemption is continued in Ontario Bill 98 although it is there restricted to sales to persons other than individuals under s. 35(2)8.

statute itself. Both limits could be included in the regulations so variations could be introduced without the necessity of statutory amendment. While there is a general clause to allow any type of security to be exempted by regulation, only two exemptions have in fact been introduced by regulation.[272] We assume that a regulatory power granted at the federal level would be exercised more frequently.

Of equal significance to the securities exemptions are the trading exemptions.[273] By far the most important of these exemptions are:

(1) a trade where the purchaser is a bank, trust company, insurance company or other person recognized by the commission as an exempt purchaser (there is a long list of these, particularly pension funds) if the purchaser purchases as principal for investment only and not with a view to resale;[274]

(2) a trade where the purchaser is a person, other than an individual, or company who purchases for investment only and not with a view to resale, where the aggregate acquisition cost to such purchaser is not less than $97,000.[275]

Both these exemptions require an investment intent and the only real difference is that there is no minimum figure for institutional purchasers. This is important for trust companies who purchase for accounts fully managed by them where the purchases are often less than $97,000. These purchases, while really not by the trust company as principal are treated as such under the statute.[276] These two exemptions together with the general inap-

272 These are the regulations relating to the conversion of convertible securities pursuant to a right contained in them and the regulations relating to puts and calls written by others. The convertible securities regulations were likely unnecessary but their existence now causes problems as it suggests that the conversion of one security is the trading of another security.

273 We will not treat as an exemption for disclosure purposes the provisions for primary distributions over the stock exchange where a statement of material facts is required; *see* Ontario Securities Act, s. 58(2)(b). In practice, the statement of material facts has become almost the same as a prospectus and the problem is one of dissemination of disclosed information rather than an exemption from disclosure.

274 Ontario Securities Act, ss. 58(1)(a), 19(1)3. The vendor is required to file a Form 11 certified by the purchaser at the time of sale; *see* Ontario Securities Regulations, s. 11(1). The purchaser is required to file a form 12 at the time of resale. In this way, the Commission could check what resales do in fact take place. It is not known what action, if any, has been taken as a result of institutions filing forms 11 and 12 where it appears that securities have been resold in such a way to question that the requirement of investment intent has been met.

275 Ontario Securities Act, ss. 58(1)(b), 19(3). The comments in note 274 *supra* apply to this exemption as well. *See* Dey, *supra* note 247, at 144.

276 Ontario Securities Act, s. 58(1a). For years, the trust companies simply gave a total figure on "private placements" and broke the accounts out later. This subsection, introduced in 1971, merely legitimated what was common practice anyway.

plicability of section 35 to anything that is not a distribution to the public, form the base for the "private placement" exemption. A "private placement" is the most important new issue exemption and we will deal with it much more fully in our suggestions for new Canadian approaches.

There is a pair of trading exemptions where dealers are purchasing for their own account, whether as an underwriter or not.[277] These two exemptions are based on the realities of the structure of the issuing markets in Canada plus an appreciation of the sophistication of the brokerage houses.

Another important set of exemptions is the exemptions based on a "no-sale" theory.[278] Pursuant to that concept the exchange of securities by existing securityholders is not like a new issue but is like a replacement. Thus securities received pursuant to a statutory amalgamation or other like procedure[279] or pursuant to a takeover bid[280] are exempt from prospectus requirements. A short extension of this principle brings in trades to promoters of the issuer,[281] trades to employees,[282] issuance of rights[283] and stock dividends[284] to existing securityholders. The only other trading exemptions are for the purchase by way of private agreement with fewer than fifteen shareholders and for an exchange of assets in excess of $100,000 where the securities are acquired with investment intent. These last two exemptions are really little loophole fillers in the private placement area rather than extensions of the no-sale theory.

The above list of trading exemptions deals with situations where there would be a first "distribution to the public" of the securities involved. Similar exemptions on primary distributions exist under the proposed Ontario legislation. But we must not forget secondary distributions or secondary trading. It will be recalled that under the definition of "distribution to the public" there is included the concept of a "secondary-primary" when a person in a position to materially affect control sells securities. Yet there is an acknowledged need to let the insider sell some securi-

277 Ontario Securities Act, ss. 58(1)(d), (c) coupled with s. 19(1)6.

278 *See* 1 L. Loss at 518.

279 *See* the Ontario Securities Act, ss. 19(1) 9, 19(1)8(ii).

280 *See id.* s. 19(1)9(c). Of course, there is a requirement for substantially similar disclosure through the takeover bid circular; *see id.* s. 91.

281 *Id.* s. 19(1)9(c).

282 *Id.* s. 19(1)10. Note this exemption reverses the *Ralston* result discussed *supra*, so far as the facts of that case as opposed to the principle in it are concerned.

283 Ontario Securities Act, s. 19(1)8(iii). Rights issues require some minimal documentation to be filed with the commission.

284 *Id.* s. 19(1)8(i).

ties at some time, which necessitates a "fur coat" exemption.[285] With this in mind an isolated trade exception, when the securities are sold across the stock exchange, is specifically provided.[286] Unfortunately the present exemption does not limit the size of the isolated transaction with the result that several public distributions have been effected through this exemption by first using the isolated purchaser exemption to sell to a friendly institution which can then unload to the public without worrying about any requirements of "investment intent".

Of course ordinary secondary transactions do not need to depend on a specific exemption if section 35 is not applicable in any event, that is, if there is no "distribution to the public". Before 1971 the applicability of section 35 was limited to "primary distribution to the public" which was defined to include distributions to the public of "securities issued by a company and not previously distributed". In 1971 this definition was changed to "clarify the meaning"[287] by adding on the words "to the public" at the end so that the definition now read "securities issued by a company and not previously distributed to the public". These additional words have caused some confusion. Take, for example, the not uncommon situation of a private placement to ten exempt institutions. Would the resale by such institutions trigger prospectus requirements? Before 1971 many lawyers argued that the securities in question had been "previously distributed". But it is more difficult to say that the securities have been "previously distributed to the public". The commission takes the view that the resale is exempt on the ground that any sale to any institution is a sale to the public or one would not need the exemption in the first place. But this is a tortured interpretation of the statute.[288] Accordingly the question of required disclosure on secondary trading is very difficult in many cases. It is fair to say that in practice, there is little or no prospectus type disclosure on the resale of securities initially issued as a private placement.

The proposed Ontario system is completely different in its approach to secondary trading exemptions. Borrowing heavily from the United States but still lacking the concept of registered securities, the proposed statute attempts to create a wall around private placements in such a way that the first escape triggers

285 *See* Dey, *supra* note 247, at 172.

286 Ontario Securities Act, s. 58(2)(c). One can always apply under s. 59 for a commission order and these are fairly common in this situation; *see* OSC Policy No. 3-18, June 14, 1973 *as amended*, 2 CCH CAN. SEC. L. REP. ¶ 54-912, at pt. III.

287 ONTARIO SECURITIES COMMISSION DISCLOSURE REPORT at 45.

288 *See* Baillie, *supra* note 205; *see also* Dey, *supra* note 247, at 142–44; Meech, *Prospectus*

prospectus requirements unless the issuer becomes a reporting issuer. Subsection 54(2) contemplates that any issuer can become a reporting issuer at any time by filing a prospectus and preliminary prospectus. Thus where the initial placement is with an exempt institution, any resale of that security would constitute a distribution unless:

(1) the original issuer becomes a reporting issuer and was not in default of any requirement of the act;[289]
(2) no unusual effort is made to condition the market;
(3) a report is filed within ten days with the commission;
(4) the securities have been held by the initial purchaser for at least six months and in some cases up to eighteen months[290] before resale.

The proposed bill also introduces an important new category of trades which are treated as private placements, namely: trades where not more than twenty-five purchasers are involved,[291] the purchasers are seeking the securities themselves rather than being sought after and each purchaser either is an experienced investor, has an experienced investor acting for him or has access to detailed information respecting the issuer.[292] A resale by the sophisticated purchaser without a prospectus is predicated on the same set of criteria described above for the standard form of private placement.

The other exemptions proposed in Bill 98 are essentially the same as those under the current legislation with minor changes which could be amended before passage. Accordingly we do not elaborate on them in detail at this juncture. One change has been to move "puts" and "calls" into an exempt category in the statute itself.[293] This may prove to be somewhat premature as we would be inclined to the view that the system of the option market is still in a state of flux.[294]

Before leaving the current set of disclosure requirements

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and Registration Requirements, in LAW SOCIETY OF UPPER CANADA, *supra* note 231, at 211, 224.

289 Ontario Bill 98, s. 73(4)(a). How the vendor will know whether the issuer is up-to-date is clarified, *id.* s. 133 coupled with ss. 73(8), (10).

290 The 18-month holding period is for unlisted securities that do not fit within the "legal for life" categories.

291 There can be as many as 50 offerees.

292 The concept is very similar to the concept of a "limited offering" under ALI FEDERAL SECURITIES CODE, Reporter's Revision of Tent. Drafts Nos. 1-3, s. 227(b).

293 It was recently added as an exempt category in Ontario Securities Regulations, s. 86.

294 An option exchange has been operating in Chicago for some time now and it has revolutionized the "puts and calls" system in that country. Such a change may well occur in Canada as well.

triggered by the issue of additional securities into the hands of the public, we believe we should refer somewhat more specifically to the distributions carried out on the Toronto Stock Exchange. These distributions require a Statement of Material Facts to be filed which complies with the regulations and forms under the Securities Act. While this document is very similar to a prospectus it tends to be somewhat easier to prepare, is processed confidentially by the commission[295] and carries no requirement of a waiting period or preliminary prospectus. There are essentially two types[296] of offerings now permitted, the first of which is fixed price pre-market offerings. In these offerings a book is maintained on the exchange floor from 9:00 to 9:30 a.m. by the offeror's agent. Up to 25% of the offered securities, in the discretion of the stock exchange, must be publicly available but the rest can be reserved for clients of the member doing the offering.[297] This type of offering can be used for distributions of control block stock and a similar procedure has been used (under a different exemption) in some takeover bid situations. Obviously it has the appearance of undue haste and its continued existence is under attack. The other type of exchange offering is an open market distribution pursuant to which shares are sold by the issuer at the prevailing market price from time to time during normal trading hours.[298]

Finally we must allude to other disclosures required under the securities acts which we have virtually ignored as they are more fully discussed elsewhere. Within this group comes insider trading reporting, takeover bid circulars, directors' circulars and proxy forms. Each of these has important elements of disclosure within it but each can be logically severed from the general discussion of an appropriate federal regulatory pattern.

Chapter VI
Appropriate Canadian Federal Regulatory Pattern

A. ASSUMPTIONS AND OBJECTIVES

Having briefly reviewed the current situation in the Canadian provinces and the reasons that support a disclosure system as an integral part of securities regulation, we now wish to set forth our

295 *See* Apple, *Financing through the Toronto Stock Exchange*, in LAW SOCIETY OF UPPER CANADA, *supra* note 192, at 225, 232.
296 *See* Dey, *supra* note 247, at 172.
297 *See* Apple, *supra* note 295, at 240-41.
298 *Id.* at 249. *See* Statement of Policy Regarding Primary Distribution through the Facilities of the Toronto Stock Exchange under the Provisions of the Securities Act.

suggestions for the disclosure requirements which we believe would be appropriate in a Canada Securities Act. As our instructions require, in formulating these suggestions we have been cognizant of the existing Canadian legislative pattern but we have deviated from that pattern where we believe it can be improved. We stress, however, that none of the proposed changes is of sufficient importance to justify its implementation by the federal government while the provincial statutes remain in force in their present terms. If a federal decision to enter the area of securities regulation results in the creation of another layer of regulation, the resultant inconvenience will be vastly increased if the additional layer of regulation is inconsistent with, or even significantly different from, the existing requirements of the provincial governments.

Disclosure requirements of securities regulation cannot be formulated independently of other aspects of the regulatory pattern. We have therefore found it necessary to make a number of assumptions as to the context in which our proposals would be reflected. The following list of assumptions conforms in most respects with existing provincial requirements and therefore does not imply any conclusion as to the appropriate ambit of federal requirements. Our proposals would, we believe, be workable in a regulatory milieu which is consistent with the assumptions, regardless of the allocation between provincial and federal responsibility in that milieu.

The following are our assumptions as to the regulatory milieu in which our proposals would be reflected:

(1) That any remedies provided in the statute for investor protection will not be dependent on the investor receiving or reading any required document except, in the case of some remedies, in a negative sense. For example, if a prospectus is required at the time of initial issue, then the investor will be deemed, as under present law, to have relied on it whether or not he read it. On the other hand, non-receipt of a required document may entitle the investor to a continuing right of rescission.

(2) That brokers will continue to be licensed, their qualifications will be kept under continuing review to ensure their adequacy and the present rules, such as the "know-your-client" rules, will continue to apply.

(3) That all stock exchanges in Canada will continue to be self-regulatory bodies but will be subject to regulation by the

Canada Securities Commission[299] which regulation could extend to imposing positive duties on the exchanges.

(4) That other self-regulatory bodies, such as the Investment Dealers Association of Canada, will be subject to commission regulation that could include the imposition of positive obligations.

(5) That debt securities will not become generally listed or posted for trading on the stock exchanges or on any other centralized facility but that stock exchanges or another central facility will continue to provide the principal (or even the exclusive) secondary market for equity securities. Further, individuals will continue to be significant direct holders of equity securities, not being altogether replaced by financial intermediaries, and will have access through their brokers to the secondary trading market.

(6) That the commission will have a very wide rule-making power,[300] will be adequately staffed both quantitatively and qualitatively[301] and will be established as an expert body whose independence will be respected by the government within reasonable limits.

(7) Financial intermediaries, including banks, insurance companies, trust companies and mutual funds will be subject to more direct forms of regulation. Accordingly, no specific disclosure provisions tailored to such institutions need be made in our proposed legislation.

In addition to the above assumptions we have also assumed that there are no constitutional limitations which would restrict the federal government in demanding disclosure from any commer-

299 Throughout the paper, we speak of a Canada Securities Commission as though it were an existing fact. We realize that legislation without a commission at all would be possible. We only use the "commission" as a shorthand to represent the responsible regulatory authority, whether federal or provincial.

300 As Professor Loss said in his remarks to the American Law Institute when he introduced the Federal Securities Code Project:

> "Whatever we do, we certainly cannot diminish overall the Commission's rule-making power. One cannot live in this field without a great deal of administrative rule-making power."

Loss, *The American Law Institute's Federal Securities Code Project*, 25 Bus. Law. 27, 32 (1969). The rule-making authority should not however extend to substantive regulatory power over segments of the industry as is now the case with respect to mutual funds and real estate investment trusts.

301 We do not wish to be misinterpreted as saying that the provincial commissions are not now adequately staffed when such a statement has not been documented. We wish to recall the opinion to this effect in the Porter Report, and to add a caution based on our own experience with other federal regulatory agencies. The traditions of excellence reputed to exist in the civil service in both the United Kingdom and Australia and the high esteem in which the staff of the SEC is held in the United

cial enterprise, regardless of where it is incorporated or where it does business, if the enterprise wishes to avail itself of any of the facilities of the Canadian capital markets.[302]

While we have endeavoured in the formulation of the suggestions to maintain neutrality as to the allocation of responsibility between the federal and provincial governments, we have not found it desirable altogether to ignore this important question. We feel that the federal system should be sufficiently complete in itself that any province, if it so desires, could opt out of the securities regulation field entirely and still be satisfied that investors within the province were reasonably protected. As a corollary of this position it seems to us essential to have a "blue sky" provision in the federal statute, since the provinces have come to assume and accept the desirability of such a provision and since there are strong arguments for the availability of some review provision that goes beyond disclosure. Further, we have attempted to shape our suggestions so that a province could retain an independent "blue sky" discretion while relying on Ottawa to exercise the bulk of responsibilities for securities regulation.[303]

As the assumptions indicate, we do not envisage radical changes in the system of securities regulation that has developed through experience. Earlier in this report we refer to the school of thought which decries the disclosure system as useless and economically wasteful[303a] and indicate our belief that disclosure requirements have a valid public policy purpose and that without them government would be likely to extend its degree of direct involvement in economic regulation. Accordingly, we would retain the broad concepts of present disclosure law, with information being available both to primary and secondary market investors. Disclosure of an initial issue will remain more detailed however in view of the probable lack of prior knowledge concerning the

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States must be duplicated in the government agency in Canada given responsibility for the Canada Securities Act.

302 The constitutional questions are discussed in depth in *Anisman & Hogg.*

303 Loss, addressing himself to the same question in the United States said:

> "[P]erhaps we could leave the states to deal with the small, promotional offerings, the initial public offerings, and tell them to stop bothering, as many of them have stopped anyway, with A.T. & T. and General Motors and a lot in between. The state offices, by and large, are undermanned anyway, and if their attention could be devoted to the regulation of local offerings and local brokers and dealers and local fraud situations we might have much more effective overall protection than we do today, when there is a lot of unnecessary duplication at the federal and state level."

ALI Federal Securities Code, Tent. Draft No. 1, at xxxix. In Canada, if some provinces are to be permitted to opt out while some stay in, cooperation is even more important.

303a *See* articles cited in note 117 *supra.*

issuer and its securities within the industry generally. Periodic reporting both to shareholders and to the public generally will occur at least semi-annually. Special disclosure requirements for takeover bids and for insider trading will continue to be necessary. In addition, disclosure requirements for information that is not investor-oriented, will increase.

B. CONTINUOUS DISCLOSURE

1. *Reporting Issuers - Definitions*

In the *ALI Federal Securities Code*, in the 1974 Corporations and Securities Industry Act which was proposed in Australia and in the proposed Canadian provincial legislation, a continuous disclosure requirement is imposed on certain businesses. In the United States the mandatory trigger for continuous disclosure for an enterprise occurs where there are over 300 holders of its securities and its gross assets exceed $1 million.[304] Under the Australian draft legislation, every public company, which is defined to mean every company that is not a proprietary company, must report. Under the proposed Ontario legislation, every issuer that is listed on a stock exchange or that files a prospectus under the statute must become a "reporting issuer".[305] A reporting issuer in Ontario and a registrant in the United States must report and publish all material changes, substantially as they occur.[306] It seems evident that the legislative trend, which we support, is for widely-held companies to report regularly to the public and to maintain an up-to-date file with a central depository, namely the commission. The commission should be given the widest possible latitude to specify in published rules the types of reports required. We support also the Australian system that any disclosure filed with the commission should be automatically filed with all recognized stock exchanges. Requirements to this effect should be adopted in Canada when the exchanges have developed a system for communicating such information to exchange members, which system the exchanges should be encouraged to develop as quickly as possible. Conversely we believe that all documentation filed with the stock

304 Under ALI FEDERAL SECURITIES CODE, Reporter's Revision of Tent. Drafts Nos. 1-3, s. 401, the issuer then must file a registration statement, after which it becomes a "registrant".

305 Defined in Ontario Bill 98, s. 1(1)35.

306 Ontario Bill 98, s. 76; ALI FEDERAL SECURITIES CODE, Reporter's Revision of Tent. Drafts Nos. 1-3, s. 601. In Australia, the proposed Bill required every public company to file everything with the stock exchanges that is filed with the Commission; *see* Corporations and Securities Industry Bill, 1974, s. 48(3) (Commonwealth of Australia).

exchanges by any widely-held company should also be filed with the commission.

In order to carry out the policy of uniform access to relevant investor information, issuers should also be required to file with the commission copies of documents distributed to institutional investors and investment dealers for analytical purposes, although the rule to this effect should be carefully formulated to avoid public filing of private documents not within the policy objectives of the rule. What is desired is to have a current file of all material information concerning large public companies together with periodic reporting of a general nature and specific reporting of material developments available to the public at large.

The major question to be addressed here, so far as continuous disclosure is concerned, is what entities should be required to become "reporting issuers". In considering this question we have reviewed other current legislative proposals. Ontario Bill 98 proposes four categories of reporting issuers:

(1) an issuer who has issued voting securities after May 1, 1967, in respect of which a prospectus or securities exchange takeover bid circular was filed with the Ontario Securities Commission;
(2) an issuer that files a prospectus or securities exchange takeover bid circular after the act comes into force, regardless of whether voting securities are involved;
(3) an issuer, any of whose securities have been, at any time after the act comes into force, listed and posted for trading on the Toronto Stock Exchange;
(4) all companies incorporated in Ontario that are offering their securities to the public.[307]

Under the proposed *ALI Federal Securities Code* there would be two categories of registrant:

(1) a company with total assets of at least $1 million and 300 holders of its securities;
(2) any company that is required to file an offering statement, which is required whenever there is a non-exempt distribution of securities, either debt or equity.[308]

307 Ontario Bill 98, s. 1(1)35. The extension for Ontario companies in the fourth line effectively catches all Ontario companies that have ever filed a prospectus in Ontario. If the corporation has less than 15 security holders it can apply to the commission for relief; *see* Ontario Business Corporations Act, s. 1(9); Ontario Bill 98, s. 84. "Voting security" is defined to be a security other than a debt security carrying voting rights at the time; *id.* s. 1(1)4.

308 ALI FEDERAL SECURITIES CODE, Reporter's Revision of Tent. Drafts Nos. 1-3, ss. 401, 501. There is a complicated provision where a secondary distributor in effect forces a company to become a registrant against its wishes. The company can, under limited circumstances, buy out the would-be distributor. Both Ontario Bill 98 and the code provide for voluntary registration, a concept we support only if the

Thus both Ontario Bill 98 and the *ALI Federal Securities Code* extend the coverage of corporations subject to the continuous disclosure regime to companies with no public equity holders. The *ALI Federal Securities Code* is consistent as it provides for a registrant to send "to every record holder of its securities" whatever reports the commission requires by rule "to keep investors reasonably informed with respect to the registrant". The comments to this section in the first draft show that the reporter intends the annual report to be the "central device for continual disclosure" and intends it to be sent to debt holders as well as to equity holders. There is no requirement in Ontario Bill 98 for an annual report, in the sense of anything other than financial statements,[309] to be prepared at all nor is there a requirement for anything to be sent to security holders generally. There is a requirement to send an information circular with proxies to voting security holders in certain cases.[310] We accept that the focus in Canada is still on reports to shareholders and we believe it should remain there as it is shareholders who have been the promoters of expanded disclosure.[311]

We propose that every enterprise with over 300 public holders of equity securities should be a reporting issuer. We would define an equity security to mean a share in a company or similar security as well as any security convertible, with or without consideration, into such a security or carrying a warrant or right to subscribe to such a security or any such warrant or right.[312] We would exclude from the term "public holders" any directors, officers or holders of 10% or more of the class of securities involved, together with their spouses, lineal ascendants and descendants. While we recognize that it is theoretically possible to have 300 holders of debentures convertible into common shares without any common shares in the hands of the public, we do not believe that it is usually an acceptable type of security to have in the hands of the public. There will no doubt be peculiar cases where the formula suggested would not work and the commission should have power to exempt any corporation from the reporting issuer requirement on the application of

commission first gives its approval. We believe the advantages of reporting issuer status are only appropriate if the corporation involved is one that financial analysts are likely to follow.

309 Ontario Bill 98, s. 79.

310 *Id.* s. 85.

311 The promoters of expanded disclosure in the United States have also been shareholders; *see* Blumberg, *supra* note 123; Medical Committee for Human Rights v. SEC, 432 F.2d 659 (D.C. Cir. 1970). In Canada, the statutes now encourage shareholder proposals; *see* Canada Business Corporations Act, s. 131.

312 This definition is taken from ALI FEDERAL SECURITIES CODE, Reporter's Revision of Tent. Drafts Nos. 1-3, s. 232.

either the enterprise involved or the stock exchange on which the listing is being requested. The commission might, for example, exercise this exemption power for large professional corporations which are essentially partnerships, or for corporations which have attained the over-300 level through inheritances from an initial, small group of shareholders or other events beyond the control of the corporation. Similarly, the commission should have the power to require any company which has over 300 holders of its debt securities to become a reporting issuer; we doubt that frequent exercise of this power will be necessary, but it will put the commission in a position to ensure adequate information is available to holders of widely distributed debt securities if necessary.

A comment is appropriate here as to the operation of secondary markets in equity securities – a topic that goes beyond disclosure but has important implications as to disclosure. Currently, the bulk of dollar value of equity trading in the Canadian secondary markets appears to be conducted through the stock exchanges, but a significant volume of trading occurs off the exchanges. This principally comprises trading in unlisted securities; but there has been some development of an over-the-counter market in listed securities. In our view, it is preferable for secondary markets to be carried on through an exchange or other central facility; this contributes to availability of anti-manipulative techniques and controls, adds to public information about the markets, and contributes to depth and liquidity. We have considered whether to recommend a requirement that any corporation with over 300 equity security-holders be required to obtain an exchange listing, but have concluded that such a requirement might not currently be appropriate in Canada for technological[313] and regulatory[314] reasons.

This does not preclude mandatory listing as a desirable policy objective, and we recommend that this objective be sought. We note that in England there is effectively no over-the-counter market and that in the United States major initiatives are in progress with a view to the elimination of the over-the-counter market and its replacement by a combined central marketplace. Similar initiatives could, we believe, be pursued in Canada and would contribute to the effective operation of the securities markets from many standpoints in addition to disclosure. We believe that this should be a principal objective of regulatory authorities,

313 The technological difficulties, and proposed innovations to overcome them, are set forth in *Cleland*.

314 Currently, the stock exchanges have considerable regulatory authority over listed companies. Mandatory listing would mean that at least one important aspect of this authority - the power to delist - would be assumed by the commission.

although the ultimate implementation of such a major change ought not to be carried out without legislation.

The proposals above contain no equivalent to the $1 million gross asset limitation set out in the proposed *ALI Federal Securities Code* in the United States. We believe that valuation problems are too difficult to warrant the insertion of what might prove to be an irrelevant standard. There are very few companies with over 300 public shareholders which have less than $1 million in gross assets except the speculative mining organizations. It would not be appropriate to exempt those organizations from any of the reporting provisions unless a separate set of regulations is tailored to their needs. There will be the unusual case, of course, of corporations with over 300 public shareholders where reporting issuer status would be unduly onerous, but this could be handled under the general power of the commission to exempt, recommended above.

We also believe that any organization should be entitled to apply to register as a reporting issuer but such registration should be at the discretion of the commission if the threshold levels are not met. This is not the position adopted in the United States draft code or in Ontario Bill 98. Under Bill 98 the would-be reporting issuer has a right to so become upon filing a prospectus. The justification for the special treatment of reporting issuers in the application of prospectus filing and other disclosure requirements is the assumption that they are followed by analysts on a continuous basis. As noted below, we are concerned that this assumption may not always be justified even where the 300 shareholders requirement is satisfied. To provide the reporting issuer status to corporations whose shares are less widely distributed would detract further from the validity of the assumption. We would therefore recommend that the Bill 98 proposal be varied by permitting a corporation with less than 300 shareholders to become a reporting issuer only with commission consent. Correspondingly, the commission should have power to deny the status to a corporation with more than 300 shareholders, a power it should exercise if satisfied that the corporation is not followed by analysts or is abusing its special privileges.

A few additional comments are in order as to the scope of application of the obligation to register as a reporting issuer. Since the requirement would be applicable only to issuers with over 300 holders of their equity securities, we do not believe that many major exemptions should be provided. Some special provision may be necessary after technological and regulatory difficulties are resolved so that equity securities of all reporting issuers can be required to be listed for trading in the secondary marketplace; for

example, once the number of equity holders or the distribution patterns of the stock of an issuer falls below the minimum standards at which listing is feasible, it might be necessary to end the listing requirement but reporting should not end until the commission is satisfied that there is no longer a sufficient public interest to justify continuous reporting. In so deciding the commission would take into account not only the question of whether there were debt security holders whose interests still required reporting[315] but also whether other statutory policies indicated that public availability of information was desirable.[316]

The only exemptions from reporting issuer status that we would foresee as not needing commission approval would be:

(1) Enterprises such as mutual insurance companies where the policyholders in effect own the company. To require these companies to list on a stock exchange would not be feasible. The authorities in charge of insurance companies should however ensure that adequate public reporting is maintained.

(2) Enterprises which are directly regulated if, but only if, an adequate disclosure policy is enforced by the directly regulating authority and to register under the Canada Securities Act would be largely an exercise in duplication. We would not except any general category of enterprise from this requirement.

(3) Not-for-profit corporations, such as social clubs, charitable organizations, etc.

Obviously a foreign entity, whose securities were not traded on Canadian stock exchanges, could not be expected to become a reporting issuer unless its securities were offered for sale in Canada. Even then a foreign entity should not be required to become a reporting issuer if similar disclosure provisions are complied with in its home jurisdiction and a copy of the information filed abroad is forwarded to the commission.

2. *Disclosure Requirements for Reporting Issuers*

The next question to be considered is what documents should be required to be filed by a reporting issuer, both initially and on a continuous basis. A spectrum of possibilities is available. We recommend above that public corporations be required to file with regulatory authorities copies of their annual and interim reports, press releases, and similar documents. At one end of the spectrum,

315 As in the OSC decision *In re* Toronto-Dominion Centre Ltd., *supra* note 160.

316 *See* Canada Business Corporations Act, s. 154(1)(b), which requires financial reporting by all businesses with assets over $5 million or gross revenues over $10 million.

this might be the only continuous disclosure requirement imposed on reporting issuers. At the other end of the spectrum, they might in addition be required to maintain at all times a prospectus standard of disclosure. Ontario Bill 154 – one of the ancestors of Bill 98 – originally adopted something akin to the latter approach with the "cornerstone prospectus". After many protests, this was abandoned in Bill 98 although the responsible draftsmen protested that they had not intended to go as far in Bill 154 as the protestors assumed. In the absence of draft regulations, it is not clear where on the spectrum of alternatives Bill 98 would place the Ontario requirements.

We have concluded against recommending either end of the spectrum. While filing of annual and interim reports, press releases and other documents will be a valuable contribution, it will not alone justify special privileges being accorded to reporting issuers. On the other hand, continuous maintenance of a prospectus standard of disclosure would be unnecessary and might well be impossible. Even if the legislation were to state clearly that confidential information need not be disclosed unless it "leaks" – a statement that seems essential if confidential corporate transactions are not to be prematurely disclosed – the complexity and frequency of the decisions faced by those responsible for the continuous updating would often be mind-boggling. Further, practical experience indicates that the production of a document which satisfies prospectus standards even at a particular time in connection with a particular issue requires a major joint effort of the issuer, the underwriter, their respective legal counsel, and the auditors of the issuer. A requirement for continuous adherence to this level of disclosure would either bring the law into disrepute or impose unwarranted expense on issuers.

We have concluded that our recommendation should adopt a position along the spectrum which reconciles workability with public access. A number of items would be specified as to which information would be required and updated on a continuous basis. These items would include a description of outstanding securities and basic financial and other information as to the issuer, producing a result somewhat like an expanded version of the Financial Post card service now available. The information to be set out should also include projections, and perhaps the time has come to have financial statements prepared in accordance with inflation accounting as well as in the standard format; a recommendation which should not be implemented without adequate consultation with the accounting profession.[317] Generally we believe the regis-

317 The U.K. is far ahead of Canada in this field. Accounting Standards Steering

tration statement should contain soft data useful to sophisticated investment analysts.[318] We believe that the Investment Dealers Association should be requested to assist the commission in developing a registration statement that is useful to financial analysts. Indeed we would encourage that organization to make periodic recommendations for desirable changes, if any, in the registration data so it would be more useful for analysts. We believe that positive accounting rules to permit comparisons on an industry-wide basis are likely necessary.[319]

The commission would perform a "blue sky" function at the time of registration of any reporting issuer not listed on a stock exchange.[320] For presently listed companies, it would be extremely onerous to check through the material filed before permitting registration when the statute is first promulgated. Accordingly, for example, all entities which have been reporting issuers for at least twelve months under the Ontario system or any other system of comparable extent could be given an automatic registration upon filing the basic document, which basic document could be reviewed at the earlier of the next new-issue prospectus filing by the company or when the commission found it desirable or possible to undertake a review.

We envisage the registration data to be kept in some sort of binder so pages could be updated regularly and previous pages removed, although the previous pages should be kept available for examination for a period of, say, six years. Once the stock exchanges have developed adequate dissemination techniques to assure accessibility of the data to exchange members, copies would be sent to all the recognized stock exchanges and perhaps to major

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Committee, Statement of Standard Accounting Practice No. 7 (May 1974) urged all companies listed on the London Stock Exchange to supplement their annual accounts with a general-index-adjusted balance sheet and statement of profit; *see* Morley, *Inflation Adjusted Profit As a Basis for Taxation*, CANADIAN TAX FOUNDATION, 1974 CONFERENCE REPORT 482 (1974).

318 Another type of disclosure that seems to us to be desirable but requires further consideration is disclosure by financial institutions of their portfolio investments and portfolio transactions as now required in the United States; *see* Securities Exchange Act of 1934, s. 13(f). It is beyond the scope of this paper to delve extensively into the detailed definitions required to specify what must be reported. We make no comment on discretionary accounts such as trusts, managed by financial intermediaries.

319 *See* Kripke, *supra* note 128.

320 It would, of course, be necessary for the commission to recognize that "blue sky" has a different connotation here than in the context of a new issue of securities. With a new issue, requirements can be made and the issue can even be rejected without severe detriment, except perhaps to the issuer. Similar requirements imposed as to outstanding securities would be very different, and the "blue sky" review of an already public issuer should not reject that issuer from reporting issuer status except in a flagrant situation.

libraries. They would be open to public inspection at any time. We would envisage that the stock exchanges and the Investment Dealers Association might arrange for a microfiche or computer system whereby the pages could be dialed into brokers' offices as required by salesmen or analysts. Disclosure to a few repositories would be the duty of the enterprise, availability would be the duty of the repositories, public dissemination would be up to the brokers and the media.

The major document we envisage being required for reporting to the general public by reporting issuers is the annual report, to be sent to all equity holders at least twenty-one days before the annual meeting of the company and within one hundred days after the close of the fiscal year.[321] The proposed Ontario legislation, carrying on the previous practice, leaves the requirement of dissemination to shareholders for the incorporating statutes.[322] While these statutes do require dissemination of annual financial statements, our suggested annual report would be a more extensive document. Just as the data in the registration statement, which would be regularly updated, is directed to analysts, we believe the annual report should be directed to the informed layman, however "mythical". The contents of the report will develop over time. Naturally, some form of comparative financial data will be included. We question however the utility to shareholders of the detailed financial statements now presented. We would support the inclusion of a five-year financial history. In addition to the required information, which should be presented in digestible form, the issuer should have the right to include other information as it sees fit, subject to the usual rules about misrepresentations and half truths. It should be possible to include in the document what is presently required in the information circular[323] so no separate document need be prepared.[324] The proxy itself could be enclosed or attached.

We have considered the question of preclearance of the mandatory parts of the annual report. We are concerned by the fact that Professor L. Loss, who is the leading authority in the field, puts so much emphasis on the preclearance aspect as essential to a properly functioning system.[325] In our view, preclearance would be a mammoth job for the commission. While we hesitate to dis-

321 Ontario Bill 98, s. 79, allows 140 days for the filing of annual financial statements. This seems to us to be a long time. The usual period in the United States is 90 days.

322 For a survey of the requirements as of 1968, *see* Bray, *supra* note 231.

323 Ontario Bill 98, s. 87.

324 We assume the provincial securities commissions would exercise their discretion to permit such an arrangement, which seems to be contemplated under Ontario Bill 98, s. 89(2).

325 *See* ALI FEDERAL SECURITIES CODE, Tent. Draft No. 1, at 120-21.

agree with Professor Loss we believe that no requirement for preclearance should be built into the statute itself but provision should be made so that the regulations could require preclearance if that turns out to be necessary in practice. Thus we support the concept of certain data being included, which could be changed by the commission under its rule-making authority, but without commission review. We would be reluctant to see very much "soft" data required in annual reports at least initially. What is appropriate for sophisticated analysts may well be inappropriate for general distribution to shareholders. It is difficult to present such data properly without getting into confusing detail.

The last major area of continuous disclosure would be timely disclosure, with its ramifications of publicity and confidentiality. We agree with the suggestion in Ontario Bill 98 that most timely disclosure, if it is material and is not simply an updating of existing information, should be the subject of a news release. It is suggested that every press release filed with the commission contain a list of the newspaper chains or individual papers and of other news media to which the release was sent. This would allow the commission to ascertain whether nonpublication of an important press release was attributable to limited dissemination by the issuer.

The above remarks concerning timely disclosure are predicated on the assumption that issuers will be subject to a requirement to issue a news release for any material development. This again raises the knotty question of confidential information. It is clear to us that issuers should not be required to make premature disclosure of potential developments, even though material,[326] except that regulatory authorities should have power to require the disclosure if the information "leaks". The question is what requirement, if any, should be imposed to deal with a material but confidential development affecting a reporting issuer. Under Ontario Bill 98, a full press release would be required, which would be delivered to the commission with written reasons for nondisclosure. These reasons would be renewed every ten days if the issuer continues to regard the information as confidential. In our judgment, this requirement goes beyond what is justified by the problem involved; the arsenal of weapons available against improper nondisclosure should be adequate without the addition of such a major innovation. Further, we feel that acceptance by the commission of the responsibility involved in the Bill 98 proposal could have serious consequences for it. However some technique is needed to enable regulatory authorities to maintain a market watch on

326 Loss endorses the withholding of information for legitimate corporate reasons; *see* 6 L. Loss at 3596.

trading while confidential information is pending, and we therefore recommend that issuers be obligated to notify the commission when such information exists, without providing details except when requested by a senior officer of the commission. If such a request was made, the commission should not have authority to release the information unilaterally.[327]

In summary, then, continuous disclosure requirements for reporting issuers would have three key elements: continuous updating of a filed document setting out required basic information about the corporation, inclusion in the annual report of certain information, and timely disclosure of material developments. Further, all relevant documents, including, as noted above, information sheets and similar material prepared for institutional investors and investment analysts, should be filed with the commission to ensure continuous public availability of a file containing all relevant information released by the issuer. Taken together, and combined with effective commission supervision, we have concluded that these requirements are sufficient to justify the exemptions described below that would be available for securities of reporting issuers from full application of the prospectus requirements. However, it is important that the exemptive pattern is predicated on the assumption that reporting issuers will be followed by analysts and that the commission should be prepared to exercise the various powers available to it to deal with situations where it concludes that the exemptions are being abused by corporations of which that is not true.

3. *Disclosure Requirements for Non-Reporting Issuers*

It is apparent that the continuous disclosure obligations upon non-reporting issuers need be substantially less onerous than those upon reporting issuers; this follows because the range of corporations included in the category is so wide as to make general rules inappropriate, and because adequate protection to deal with most situations is provided by general corporate law and by the prospectus requirements proposed below. However, this category of corporation is too important to be ignored in the formulation of continuous disclosure requirements.

We consider it important that the rules imposing penalties and creating civil liabilities for false or inadequate disclosure should rest as heavily on non-reporting as on reporting issuers. In the United States, the vast accumulation of case law under Rule

327 The remedies for improper use of confidential information are discussed in *Leigh* and in *Yontef.*

10b-5 has done much to avoid fraudulent or deceptive practices affecting small corporations. While we do not concur with the scope of some of the remedies granted under that rule,[328] their principle seems to us appropriate and we believe (although the topic is not squarely within the scope of this paper) that the Canadian law in this area should be expanded.

Reference is made above to reliance on corporate law to ensure at least a basic minimum of information for the security holders of the non-reporting corporation. Requirements of Canadian corporate statutes as to disclosure are disparate, and those of foreign jurisdictions whose corporations may from time to time sell securities in Canada are even more so. It might well be appropriate to include in Canadian securities law provisions enabling the commission to require a non-reporting issuer to adhere to disclosure standards at least as extensive as those of the major Canadian corporate statutes.

In some cases, the commission should have even wider authority. Of necessity, the rules we propose embody precise numbers; more vague rules would create confusion and add to the administrative burden. The difficulty with rules embodying precise numbers is, of course, that persons wishing to avoid their application might be able to "plan around" them – for example, by making a public distribution to 299 purchasers. To avoid such abuses, we believe that the commission should have the power, where satisfied that a corporation was abusing its non-reporting status, to require compliance by it with the full continuous disclosure obligations of reporting issuers. This could be done with or without giving to the corporation concerned the status of a reporting issuer.

Except for the discretion in the commission to so require, we would not propose to have any general continuous disclosure requirements for non-reporting issuers. The commission would not be a repository of information for such corporations. They would not be required to file annual reports, information circulars or insider trading reports. We would stress that such entities have fewer than 300 public shareholders and hence their shares are not traded in the marketplace regularly. It is disclosure for the purpose of informed secondary trading that is the investor protection aspect of continuous disclosure. Where no substantial secondary trading exists the need for continuous disclosure to protect investors cannot be demonstrated.

328 Recent cases in the United States Supreme Court suggest that substantial limitations will be imposed on the previously broad scope of Rule 10b-5; *see* Ernst and Ernst v. Hochfelder, 98 S. Ct. 1375 (1976).

C. PROSPECTUS DISCLOSURE

From the standpoint of investor protection, which is the touchstone of securities regulation, the arguments in favour of full and complete disclosure in respect of securities offered to the public on an initial distribution apply equally in respect of outstanding securities that are publicly traded in the secondary market.[329] However, the cost of prospectus-type disclosure, as that has evolved in Canada today, is such that it cannot rationally be required in the average small transaction which occurs daily on the stock exchanges. Even an abbreviated form of required disclosure would be impractical for such transactions. It might be possible to have every seller in the secondary market required to make a statement, to which liability could attach, that he has no knowledge of any material change which has occurred in the affairs of the issuer of the securities which has not been generally disclosed.[330] But that is not disclosure at all, although its utility in certain circumstances is not to be denigrated.[331]

It is possible to suggest that a spectrum of disclosure documents be used on secondary trades with a complete, prospectus-type document being reserved for new issues and large distributions of stock not previously held by the public. While the cost justification of such a spectrum is apparent, it is not clear what type of simple disclosure document would be appropriate on significant but smaller secondary trades. Indeed the amount of securities or their source may be less relevant than the ready availability of reliable information concerning the issuer and the securities involved. Thus our focus here is on the availability of information as well as on the source and size of the contemplated trade.

Under the Ontario proposals, a prospectus is required, unless an appropriate exemption exists, anytime there is a trade in a security which would be a "distribution".[332] A distribution occurs

329 Emerson, *supra* note 67, at 419.

330 The wording is taken from Ontario Bill 98, s. 73(7), which appears to be taken from the tag end of forms 144 and 237 under the Securities Act of 1933. It is interesting to note that in the United States, Form 144 relates only to material adverse information generally disclosed while Form 237 relates to any material information (whether or not adverse) disclosed to the buyers. The proposed Ontario legislation seems to catch both concepts. *See also* ALI FEDERAL SECURITIES CODE, Tent. Draft No. 1, s. 509 and comments, *id.* at 102-03.

331 Indeed, we would favour its inclusion in the statute in some situations where disclosure is impractical.

332 Ontario Bill 98, s. 54. The word "prospectus" is not a word of fixed significance from a disclosure point of view. The practice in both the United States and Canada involves the use of various forms of prospectus depending on the issuer, the type of security involved and even the amount of securities to be sold.

whenever the issuer sells[333] a security, whenever a sale comes from the holdings of a person whose total holdings materially affect control and whenever a security previously sold through a trading exemption is not resold pursuant to the statutory scheme. While a prospectus requirement is sensible in many of the situations encompassed under this scheme, there are also included cases in which a prospectus requirement seems inappropriate. Modern corporate statutes permit issuers to repurchase issued securities[334] and in some cases require repurchases at the option of the holder.[335] It seems odd that the issuer cannot resell such shares on the market, even in insignificant quantities, without filing a prospectus[336] while an insider who was not in a control position could freely sell the same number of shares with no disclosure at all. Similarly it makes little sense to say that if a person happens to control a company he cannot sell even a minor amount of non-voting securities without prospectus disclosure, except in some exigencies, whereas if the person does not control he can sell millions of dollars of stock without any disclosure.[337] Again in the same spirit, it seems harsh to require an employee who acquired stock pursuant to a stock option plan which is an exempt trade[338] to file a prospectus before he resells his ten shares if his employer is in default under the statute.

The proposed *ALI Federal Securities Code* in the United States has a different formulation, again based on the definition of a "distribution". Essentially a distribution in the *Loss Code* is any sale of a security except a "limited offering" or a "trading transaction". A limited offering is a sale to not more than thirty-five investors, excluding institutional investors from the count, which does not fan out within a three-year period[339] of the initial sale to more than thirty-five investors, again excluding institutions. Thus, so long as the group remains smaller than thirty-five during

333 Sell is used here to include "issue" as well as sales of previously issued shares. There is an English decision, Re V.G.M. Holdings Ltd., [1942] 1 All E. R. 244 (C.A.), which suggests that an issue may not be a "sale" but this is a rather silly distinction which is not in accord with the U.S. cases such as Ruckle v. Roto-American Corp., 339 F.2d 24 (2d Cir. 1964), nor with the reasoning in J.M.P.M. Ltd. v. Danforth Fabrics Ltd., [1969] 1 O.R. 785 (H.C.); *see also* ALI FEDERAL SECURITIES CODE, Tent. Draft No. 1, at 48.

334 *See e.g.* Canada Business Corporations Act, s. 32.

335 *See id.* s. 168 coupled with s. 184 for one example.

336 The issuer could use the exemption in Ontario Bill 98, s. 74(1)(b), if it filed a statement of material facts.

337 Loss, *The American Law Institute's Federal Securities Code Project*, in ALI FEDERAL SECURITIES CODE, Tent. Draft No. 1, at xxix, xxxvi.

338 Ontario Bill 98, s. 73(1)(l).

339 The period is one year for reporting issuers; *see* ALI FEDERAL SECURITIES CODE, Reporter's Revision of Tent. Drafts Nos. 1-3, s. 227(b)(2).

the three-year period there is no distribution. A trading transaction is one effected through a dealer by a seller other than the issuer where the security was not acquired pursuant to a limited offering and the total trading transactions of the seller do not exceed some maximum volume which the commission can specify by rule.[340] The definition of "distribution" groups together both primary and secondary transactions in both proposals. For purposes of analysis it may be better to separate primary from secondary distribution. So far as primary distributions are concerned, the proposed Ontario legislation has an exemption for an "isolated trade" by the issuer for its own account. But this vague standard is not as easy to apply as a bright-line test if one can be satisfactorily fashioned. We would prefer the issuer, if he is a reporting issuer, to have an exemption more like the trading transaction exception in the *Loss Code.*[341] Ontario Bill 98 also contains an exemption which is a quasi parallel to the limited offering concept of the *ALI Code,* but only applies where there are less than twenty-five sophisticated purchasers from an issuer.[342] Why this exemption should not extend to secondary distributions by a controlling person is not clear. While we like the sophisticated purchaser concept as an investor protection device, we would think the number of purchasers could be broadly expanded if only sophisticated purchasers are involved and no restriction on the source of the securities is necessary.

Accordingly our basic suggestion on primary distributions is to require a prospectus but to have two broad exemptions – one for sophisticated purchasers and one which allows the issuer, if he be a reporting issuer, to dispose of not more than a set volume of securities over a given time period, the numbers to be specified in the rules. For non-reporting issuers we would suggest an exemption similar to the limited offering exemption of the *ALI Federal Securities Code,* with the same limit of thirty-five purchasers within a three-year period. While this compromises the investor protection approach to some extent, there must be a balance struck between complete disclosure to an investor and the ability of a small enterprise to develop an expanding base of security holders. It would be inappropriate for Canada to take a more restrictive stand that would discourage the growth of small domestic produc-

340 *Id.* s. 227.

341 While the trading transaction specifically excludes the issuer in the definition sections of the ALI FEDERAL SECURITIES CODE, there is provision for the commission to waive the rule in favour of the issuer and this is contemplated by Loss; *see* ALI FEDERAL SECURITIES CODE, Tent. Draft No. 1, at 22.

342 *See* Ontario Bill 98, s. 73(1)(m). The holding period on resale is effectively imposed under *id.* s. 73(4).

ers. On the other hand a wide distribution of even a fairly small amount of shares calls more clearly for some disclosure, which disclosure will be available through continuous disclosure in the case of reporting issuers. It is therefore appropriate to have a narrower exemption for non-reporting issuers.

In so far as secondary issues are concerned the problem is exacerbated by the fact that, until now, no restrictions have been placed on the right of institutional purchasers to later sell their portfolio investments into the marketplace without filing a prospectus no matter how many shares are involved. Before the provincial statutes required an investment intent to justify exempting institutional purchasers, institutions sometimes bought large amounts of shares for which no prospectus was ever filed and promptly distributed them to the public. This obvious loophole is no longer available but the same problem exists so far as investor protection for the purchaser is concerned if any institution or individual can split up a large block of stock in the market on the basis of an exemption on original issue or on the basis that there was a prospectus at the time of original issue. The purchasers of the pieces of the large block are entitled to receive no disclosure at all under the present provincial system and, in many cases, will receive no disclosure document under the proposed provincial system. We seriously question whether such a system is adequate.

Thus on large secondary distributions, whether emanating from a control block or any other large block, we believe that a current prospectus should be required at the time of sale. However, we recognize that this recommendation would be foolish in the extreme if it seriously impacted on institutional investment. Institutional investors are a necessary part of most issues where small individual investors are involved. Without the institutions it would be impracticable to market the issues initially. If the obligation to file a current prospectus on a resale of a large quantity of stock purchased by institutions would have a material adverse impact on institutional investment then this recommendation should not be implemented and other methods of investor protection should be canvassed. We doubt that institutions, in practice, often exceed a resale volume that would not be covered by the trading transaction exemption suggested above for reporting issuers. But it could well be that the institutions would demand unacceptable covenants from the issuers as a result of the difficulty that might arise if a resale requiring a prospectus were subsequently desired by the institution. It is in that sense that we are worried that institutional investment might be adversely affected by our recommendation and we therefore would suggest that its

enactment be deferred until the government is assured that there will be no significant negative results.

In addition to the trading transaction exemption on secondary distributions, we would again recommend a limited offering exemption for non-reporting issuers and a sophisticated purchaser exemption. The sophisticated purchaser for the purpose of both the primary and secondary distribution exemptions would include institutional purchasers, purchasers of over $100,000 blocks[343] and investors who by net worth and investment experience or by virtue of consultation with or advice from a registered investment dealer are able to properly evaluate the prospective investment on the basis of information supplied by the seller.[344] While it seems hardly necessary in theory to put a limit on the number of such purchasers of any one distribution we believe an overall limit of say one hundred purchasers should be established in order to prevent truly public distributions with everyone buying through an investment adviser. While one hundred is obviously arbitrary it reflects our view that numbers such as twenty-five are unnecessarily restrictive.

We also believe that the commission should have the right to demand that the issuer file a prospectus and that registered dealers distribute it on all sales when heavy secondary trading occurs in the marketplace even if no single seller is required to file a prospectus under the proposals previously set forth. We are aware that this is an extraordinary remedy and should only be used in extraordinary circumstances. The prospectus would not carry the same liability as a new issue prospectus in the sense of a rescission remedy nor could it be expected to contain information of a confidential nature. On a new issue the issuer can choose the timing of the issue to avoid the necessity of confidential disclosure but such would not be true on a prospectus filed as envisaged hereunder. The issuer has little or no control over market activity in many cases. On the other hand, the concept of investor protection demands that investors be supplied with up-to-date information if a highly unusual amount of trading is taking place. At present the provincial commission can only issue a cease trading order in cases of unusual trading which order may not be an appropriate remedy as it precludes trading by the portfolio investor who bought on the assumption that he could sell his investment at any time. Often a cease trading order is put on temporarily until a material change is disclosed by a press release and we would

343 The standard provincial number is $97,000, introduced in 1967 apparently to take care of a slight discount on $100,000 purchasers. If $100,000 blocks are very frequent in actual marketing practice we would retain the $97,000 limit.

344 The wording could be copied from Ontario Bill 98, s. 73(1)(m).

envisage that such a procedure would be adequate in most cases. However the commission should have the power to demand a prospectus if genuinely necessary for investor protection under the circumstances and we so recommend.

Assuming that a prospectus is necessary for a secondary distribution the present provincial system of requiring the issuer to provide the information should be adopted[345] although it should be made clear that, in the case of one major seller, the seller should bear the reasonable costs of the issuer in getting the information together and should have the same liability as an underwriter for incorrect statements and completeness, *i.e.*, liability if he has knowledge of any inaccuracies. Because we would not require an issuer to become a reporting issuer at the time of any issue requiring a prospectus (as Ontario Bill 98 requires) we can avoid the difficult question of the propriety of forcing reporting issuer status upon an unwilling issuer with relatively few securityholders. We believe the avoidance of that problem is an important argument against reporting issuer status without 300 shareholders. The problem is ignored in Ontario Bill 98 while the solution adopted in the proposed *ALI Federal Securities Code* is cumbersome at best.[346]

As we have stressed repeatedly throughout this paper we believe the commission should have a broad exempting authority. In this area the authority would extend to waiving the prospectus requirements anytime it believed that to do so would be in the public interest.

When a prospectus is required we have stated above that we do not see the merit in retaining on a compulsory basis the present preliminary prospectus requirements. Indeed only four provinces currently have provisions for preliminary prospectuses in their legislation and British Columbia conspicuously avoided it when its current statute was enacted. In the United States where the concept first developed, the proposed *ALI Federal Securities Code* has backed away from a mandatory preliminary prospectus although there is provision for the issuer to utilize one on a voluntary basis.[347] We do not think the system has worked in Canada and we think it is time it was scrapped. On additional issues by reporting issuers there is no reason to have a "waiting period" as our scheme would envisage a constant assessment of the issuer by analysts in

345 *See id.* s. 65.

346 *See* ALI FEDERAL SECURITIES CODE, Tent. Draft No. 1, at 83-87.

347 *Id.* s. 504(b). The voluntary basis is designed to solve the "California problem" of getting prospectuses to the West Coast from the eastern financial centres; *see id.* at 90. It is interesting to note that British Columbia is the one "Uniform Act" province without a preliminary prospectus.

the case of most large firms and detailed scrutiny of the prospectus by the commission in default of such assessment. On first issues we see the commission as having a much more serious "blue sky" function, which in part replaces the functions of the waiting period. In any event, there will be presentations on new issues by the underwriter to the banking or selling groups and it is these dealers who effectively disseminate information during the waiting period. We believe that little or no solicitation of the public presently takes place until immediately before the underwriting agreement is signed, which occurs at the end of the waiting period, so the waiting period is likely useless for business reasons anyway. If the brokers know their clients sufficiently well to anticipate what information the client should require before purchasing securities, this will be more effective than having lists of people to whom preliminary prospectuses and amendments might be sent. Disclosure of even the most pessimistic type[348] has proved no deterrent to the sale of rotten eggs, particularly when a hot issue market exists.[349] In short, the concept of a preliminary prospectus as a mandatory document to be sent to prospective purchasers during the waiting period is not sufficiently useful to justify its retention. We would however favour the requirement of filing a draft prospectus, signed by the chief executive officer and chief financial officer of the corporation, which draft would form part of the public record until the receipt for the final prospectus was obtained. The draft should be filed concurrently with or prior to any approaches to institutional investors.

Turning to the contents of the prospectus we believe that the amount of material can and should vary with the stature of the issuer and the type of securities involved. Thus a $50 million secured debt issue of a major Canadian industrial corporation with a debt equity ratio of less than unity should not call for the same prospectus disclosure as a first issue of shares by a newcomer on the industrial scene. The available information from the reporting issuer files will be adequate for analysis of everything except current undisclosed information and the details of the proposed issue itself. While we do not wish to suggest reliance on debt equity

348 The most amusing pessimism, which the commission felt was a put-on and refused to accept, said, *inter alia*:

> "The present directors do not foresee the possibility of the corporation ever being in a position to pay any dividends or having any assets of determinable value. The continued existence of the corporation is questionable. Bankruptcy may result at any time."

Holmes v. Cary, 234 F. Supp. 23 (N.D. Ga. 1964).

349 *See* Panel, *New Approaches to Disclosure in Registered Security Offerings*, 28 Bus. Law. 505 (1973), for trends on how to disclose in a hot issue market; and *see* particularly the remarks of Mr. Grienenberger, *id.* at 518.

ratios or other bright-line tests to determine which issues need less disclosure we do believe that on debt issues of reporting issuers, a summary prospectus would be adequate except in unusual cases. The same type of disclosure would be adequate on further issues of shares by reporting companies so long as the further issue did not dramatically increase the number of outstanding securities. We also believe that the commission should not review these blue chip filings at all, leaving the civil liability sanctions as sufficient deterrent to incorrect statements.[350]

On the other hand we believe that a set of guidelines should be developed below which even reporting issuers would have to prepare the equivalent of a full prospectus with a prospectus summary at the front,[351] unless the commission agrees to waive the full prospectus requirement, on new issues within the guidelines. These prospectuses would be vetted by the commission in much the same way as prospectuses are today, with a limited "blue sky" emphasis. For secondary distributions of reporting issuers which require prospectuses under our suggestions, we also believe commission vetting is appropriate initially to check that suitable disclosure is being made, including, in the case of sales by insiders, a statement of the reasons why the seller is selling.

On public offerings of securities of non-reporting issuers we believe a prospectus is appropriate although again we see no reason for the commission to vet it extensively on debt issues where the equity base is adequate. Where the issue is a new stock, however, in the sense that it has never been offered before to the public, or is a debt security with only a marginal cushion, a full prospectus is in order with a very strict "blue sky" vetting by the commission. While we do not believe that a legend should appear on the face page assuring the investor that such a vetting has occurred we do believe that the commission should recognize that investors do, in fact, assume that the commission has thoroughly investigated the merits of new security issues. We believe the commission should act accordingly although we do not wish by this suggestion to cut down new issues dramatically as we believe new ideas brought out by new entrants in a market are stimulating to the whole economy.[352] We believe the commission staff should spend its time helping the originators disclose their facts in a way that is meaningful to the public and also in making sure that the

350 *See* the interesting comments of Marsh, *id.* at 531 where he suggests that commission intervention has made prospectus writing a joint effort which has produced an abortion.

351 A prospectus summary is not to be confused with a summary prospectus.

352 Dynamic competition is the usual phrase in economic literature and is championed by J. SCHUMPETER, *supra* note 118.

scheme moves money into the enterprise as opposed to into the hands of the promoters.

On the content of prospectuses generally, we accept the criticism of Judge Weinstein when he said:

> "In at least some instances, what has developed in lieu of the open disclosure envisioned...is a literary art form calculated to communicate as little of the essential information as possible while exuding an air of total candor. Masters of this medium utilize turgid prose to enshroud the occasional critical revelation in a morass of dull and – to all but the sophisticates – useless financial and historical data."[353]

We realize we are simply joining a chorus when we recommend that clarity of communication in a narrative style must be a continuing goal. So far, prospectuses written by lawyers and vetted by administrative officers have proved to be difficult to read. How to turn lawyers into artists is beyond our competence.

Finally we would recommend that soft data be included in prospectuses if at all on a permissive rather than a mandatory basis. Examples might include plans, expectations and financial projections which have always been a part of the modern prospectus disclosure in England and have been permitted for several years now in the United States. On the other hand we would favour the compulsory inclusion of different financial reporting techniques on a comparative basis – *e.g.*, what would inflation accounting do to the profit picture – if such disclosure can be accomplished in a meaningful way. We also support bar charts or graphs for five-year projections as long as one is careful not to allow the picture so formed to be distorted by the use of unrealistic scales or similar devices.

Before leaving this section we wish to comment on the scheme of protection for the little investor buying from another little investor where no prospectus is required. In most cases we believe the seller is as ignorant of salient facts as the buyer although we would favour a requirement of a "no knowledge of any undisclosed material facts" report to the commission by any insider buying or selling at any time. The chief protection for the little investor buying from another little investor would be through his broker. We envisage that the broker, where he questions the suitability of any particular investment for any particular client (which questioning the broker should be encouraged to do under the "know-your-client" rules) should encourage him to reconsider his decision

353 Feit v. Leasco Data Processing Equipment Corp., 332 F. Supp. 544, 565 (E.D.N.Y. 1971).

relatively quickly so the transaction can be unwound in the marketplace, with relatively little loss, if necessary.

D. EXEMPTIONS

While we have already set forth our basic plan for exemptions in the continuous disclosure and prospectus disclosure sections, we believe we should review the existing[354] and proposed exemptions under the Ontario legislation as well as the major existing exemptions in the United States and the proposed exemptions in the *ALI Federal Securities Code*[355] to indicate how they differ from our proposals or where they fit under our proposals. It is not necessary to discuss the exemptions from reporting issuer status as these have been covered above. Accordingly we will concentrate on exemptions from the prospectus requirements. We will deal first with the trading exemptions and then with the exemptions based on the type of security issued.

Perhaps the most important exemption from initial issue disclosure under the present provincial laws is the sophisticated purchaser exemption which is sometimes lumped in with the private placement exemption[356] although logically the two are quite separate. The reason for exempting the sophisticate is either that he has no need for the information because he already knows it or he has the market power and the expertise to get what information he wants. It would be a waste of money therefore to impose disclosure requirements, so far as investor protection is concerned, as the purchaser is well able to protect himself. Under the present Ontario statute this exemption is in two parts: the purchaser who is exempted because of his status as a financial intermediary[357] – namely, banks, insurance companies and trust companies, persons acting on behalf of governments, dealers[358] and institutions[359]

354 The existing exemptions are the subject of an excellent article by Dey, *supra* note 247, to which the reader is referred for more complete information.

355 It will be recalled that the ALI FEDERAL SECURITIES CODE, Tent. Draft No. 1, does not define a "limited offering" or a "trading transaction" as an exemption but rather as an exception within the definition. As these concepts have been stressed earlier in the paper, they need not be repeated here.

356 Dey, *supra* note 247, calls the $97,000 exemption the private placement exemption and this is the popular name for it. But there is no "private" concept in the exemption. Nor is the placement of debt securities with several insurance companies necessarily a "private" placement. The reason for the exemption in both cases is a belief that the purchaser can fend for himself. In this sense, he is a "sophisticated purchaser".

357 Ontario Securities Act, s. 19(1)3.

358 The dealer exemption is in s. 58(1)(d) of the Ontario Securities Act and in s. 73(1)(n) of Ontario Bill 98.

359 The section as presently worded does not permit the commission to recognize an

recognized by the commission as exempt purchasers – and purchasers other than individuals, whose aggregate acquisition cost is not less than $97,000.[360] Any number of such purchasers may buy securities without triggering the prospectus requirements. These two types of sophisticated purchaser exemptions are carried forward substantially unamended in Ontario Bill 98.[361] Both the statute and the bill provide that a trust company will be deemed to be acting as principal when it trades as a trustee for fully managed accounts but apparently this would not be so for banks or other institutions[362]

There is an institutional investor exemption in the *ALI Federal Securities Code* as well but there is no $100,000 purchaser exemption.

We agree with the Ontario exemptions in this area, except for the proposed limitation that only trust companies can trade for managed accounts, as we believe the institutions and the larger purchasers are able to look after themselves. These would be covered in our proposals by the sophisticated purchaser exemption.

The second major exemption concept is that only public offerings of securities should require prospectus disclosure. This is accomplished under the present provincial statutes by limiting the scope of the substantive requirements rather than by utilizing the exempting sections. But there is also an exemption provided for trades in a security of a company in connection with an offer to purchase shares by way of private agreement with fewer than fifteen shareholders or an offer to purchase all the shares in a private company.[363]

The proposed Ontario legislation abandons this pattern entirely. There is no limitation of the scope of the disclosure requirements to public distributions. Instead all primary and secondary primary offerings are subject to prospectus disclosure unless an

individual, however sophisticated, as an exempt purchaser. While this is theoretically difficult to justify it probably is irrelevant in practice.

360 Ontario Securities Act, s. 19(3). The theory which Dey suggests to explain why individuals are excluded from this exemption, namely, that organizing into a corporation or partnership shows some degree of sophistication, is somewhat less than convincing.

361 Except that the restriction to persons other than individuals in the $97,000 exemption has been dropped; *see* Ontario Bill 98, ss. 73(1)(a), (c).

362 Loss says that it is implicit that banks and insurance companies are institutional investors when buying for accounts under their management; *see* ALI FEDERAL SECURITIES CODE, Tent. Draft No. 1, at 29.

363 Ontario Securities Act, s. 19(1)9a. Complementing this is the security exemption in s. 19(2)9 for securities of a private company issue by the private company "if the securities are not offered for sale to the public".

exemption is available. The major exemption of a private offering nature is one which is limited to twenty-five sophisticated investors[364] in situations where there has been no market grooming. This concept is adopted in part from the *ALI Federal Securities Code* but there is no restriction in the code that the investors be informed. It will be recalled that, under the proposed *ALI Code*, the "limited offering" exception was one which did not fan out to more than thirty-five people in under one year, for reporting issuers, and three years for other issuers. The proposed Ontario exemption only allows twenty-five beneficial owners as a result of this procedure over the life of the issuer. Presumably the "beneficial owners" in Ontario would not include subsequent transferees of the securities or the exemption would be very narrow indeed and hard to keep track of, although this is not clear in the statutory language. If it does include transferees then there is always the question of whether the securities transferred derived from the exempt sale or were from other securities acquired in the market by the vendor.[365] It would appear to make more sense to follow the proposed U.S. pattern in this particular case. It is also unnecessary to confine the number of offerees as contrasted with purchasers and we recommend that this concept not be followed in any federal legislation.[366] We do agree with the idea of not permitting general advertising to the public.[367]

The most troubling concept in the proposed Ontario private placement exemption is the requirement that the purchaser be a sophisticated investor, although we approve of this requirement as the basis for a separate exemption. We think that the Ontario proposal is confusing the "need to know" concept with the private placement concept.[368] A private placement is not subject to disclosure requirements because there is no public interest and not because of any need to know criterion. Thus sales of shares in a private company can be made to the most uninformed because there is no public interest. Why should there be a distinction on initial private distributions of other than private companies? Of course resales from this type of placement will need to be circumscribed and this has been recommended in both Ontario Bill 98 and the *ALI Federal Securities Code*. While it is attractive to say that only the sophisticated may buy, it is unrealistic with respect to

364 Ontario Bill 98, s. 73(1)(m).

365 *See* ALI FEDERAL SECURITIES CODE, Tent. Draft No. 1, s. 227(b)(8), which specifically covers this question.

366 *See id.* at 16.

367 *See* Ontario Bill 98, s. 73(1)(m)(iii); ALI FEDERAL SECURITIES CODE, Tent. Draft No. 1, s. 502(b).

368 The idea of having a naive offeree with an informed adviser was first suggested in Note, *Revising the Private Placement Exemption*, 82 YALE L.J. 1512 (1973).

small ventures where the purchasers are often direct participants. To force all such ventures into the "private company" definition, particularly when that definition is being abandoned for corporate law purposes, is unnecessary. The proposed Ontario system allows anyone who wishes to sell to fifty persons to do so by utilizing a legal form called a private company, while stoutly maintaining an investor protection stance for other forms of enterprise. To allow form to govern substance in this manner is regrettable.

We believe that there are two obvious alternatives to meet this problem. The first is to allow a limited sale to say thirty-five persons, excluding institutions, regardless of sophistication. This is the *ALI Federal Securities Code* formulation. The second is to allow only the most circumscribed private offering – to direct participants in the business, their spouses, lineal ascendants and descendants. We believe the first option is the more appropriate. The private placement exemption would make it unnecessary to have several of the additional trade exemptions for the issuer proposed in Ontario Bill 98. Thus an isolated trade exemption[369] would be unnecessary, an exemption for purchasing assets in exchange for shares would be unnecessary,[370] an exemption for an exempt takeover bid would be unnecessary[371] and an exemption for a trade by the issuer to its promoters would be unnecessary.[372] Thus we recommend an exemption for sales on primary issues to less than thirty-five purchasers, in accordance with the scheme set out in the *ALI Federal Securities Code* for "limited offerings".

The sophisticated purchaser exemptions together with the private placement exemption form the major distributive exceptions from prospectus requirements on primary distributions. The securities placed under these exemptions have, by definition, never been distributed to the general public. The question becomes then whether a secondary distribution of such securities should trigger some sort of disclosure requirement? This problem has been of central concern to the reforms recently suggested in

369 Ontario Bill 98, s. 73(1)(b).

370 *Id.* s. 73(1)(j), which is carried over from s. 19(1)9b of the current statute. *See* Dey, *supra* note 247, at 160, where he points out that this asset exemption as presently worded is really aligned to the $97,000 rule.

371 Ontario Bill 98, s. 73(1)(i) which is carried over from Ontario Securities Act, s. 19(1)9a. *See* Dey, *supra* note 247, at 160, for a note on the problems with the wording under the present statute which Ontario Bill 98 remedies.

372 Ontario Securities Act, s. 19(1)9c. The exemption was only added in 1971 and, as is pointed out by Dey, *supra* note 247, at 162, was likely unnecessary so far as prospectuses were concerned because a sale to a promoter is not a sale to the public.

both the United States and Canada. In the United States the Securities Act of 1933 only required a prospectus if the purchaser purchased a security from an issuer with a view to its subsequent distribution. This was interpreted to mean that the purchaser had to have an investment intent at the time of purchase,[373] a concept carried over into the current Ontario legislation.[374] This has proved a difficult concept to deal with in both jurisdictions and has been eliminated in both the *ALI Federal Securities Code* and Ontario Bill 98. Under the proposed *ALI Code* there is no necessary prospectus or disclosure requirement if the purchaser in a limited offering holds the securities for one year in the case of a reporting issuer or three years in any other case.[375] But all secondary distributions in excess of a fixed amount by one seller (initially set at $100,000) are subject to at least a distribution statement and, in the case of securities of non-reporting issuers, a full prospectus is required. Thus the code does provide for disclosure if a large block is subsequently distributed of a company about which there is no information publicly available. Ontario Bill 98 adopts a somewhat different pattern. It requires a prospectus on the sale of even one share of a non-reporting issuer which is derived from a private placement or sophisticated purchaser placement.[376] For reporting issuers, holding periods of between six months and eighteen months, depending on whether the securities are legal for life, are mandatory if prospectus-type disclosure is to be avoided. After that, so long as the seller has not groomed the market, there is no requirement for any disclosure; not even a distribution statement on the dispersion of a large block. While we believe that this legislation goes a long way in the right direction we are also of the view that it may not be adequate when a large block is distributed publicly, even two years after it was originally issued, depending on the depth of the market for outstanding securities of the same class.[377] We also believe that some minimal trading of non-reporting issuers may be appropriate without full prospectus disclosure. Yet some compromises are obviously required. As a result of a search for bright-line tests in this area, the Securities and Ex-

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Strangely enough, this exemption has been dropped in Ontario Bill 98 so a sale to a promoter is presumably a trigger for a prospectus under that legislation.

373 *See* Wheat Report at 160.

374 *See* Ontario Securities Act, s. 58(1)(a); Ontario Securities Regulations, s. 11 and form 11; Dey, *supra* note 247, at 147.

375 The trading transaction is not available to the purchaser in a limited offering; *see* ALI Federal Securities Code, Reporter's Revision of Tent. Drafts Nos. 1-3, s. 227(c)(1)(B).

376 Ontario Bill 98, s. 73(4).

377 If the market has no depth, grooming will be essential before sale so a prospectus would be required.

change Commission adopted Rule 144[378] under the current U.S. legislation. Essentially the rule has five separate components before a resale may be made without prospectus disclosure, which components, together with our comments, are as follows:

(1) There must be adequate current information publicly available with respect to the issuer of the securities being sold.[379] This criterion is satisfied under Ontario Bill 98 by requiring the issuer to be a reporting issuer, a condition which we believe is too onerous for sales to a small number of purchasers on secondary distributions of securities of non-reporting issuers.

(2) The securities have been held by the seller for an adequate period prior to resale.[380] This requirement was introduced in the United States to deal with the theory, developed as a result of the wording of the statute, that all distributions had to be the subject of a prospectus and one only lost the status of being part of a distribution if one held the securities for an adequate amount of time.[381] The concept has little to do with investor protection and, for disclosure purposes at least, should be ignored entirely. Accordingly we would not recommend any holding periods whether the securities are legal for life or not,[382] in view of the quantity restrictions which are imposed.

(3) There are limits on the amount of securities which can be sold.[383] Essentially the limits are that 1% of the outstanding securities of the class being offered or a number equal to the

378 SEC, Securities Act of 1933 Release No. 5223, January 11, 1972, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,487, *amended by* SEC, Securities Act of 1933 Release No. 5452, February 11, 1974, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,633. The basic idea was to change the area of the law from "theology to arithmetic"; *see* Panel Discussion, *Developments in Private Placements, Distributions of Restricted Securities; Rule 144*, 28 BUS. LAW. 483 (1973)(F.M. Wheat). The phrase comes from an address by SEC chairman William Casey, *PLI, SEC Seminar* (February 1972). Rule 144 is still in its early phase and has been amended several times; *see* Castruccio & Tischler, *Developments in Federal Securities Regulation*, 31 BUS. LAW. 1855, 1859 (1976).

379 *See* Rissman, *Rule 144: Manner of Sale and Availability of Public Information*, 67 NW. U.L. REV. 124 (1972).

380 *See* Flanagin, *The Rule 144 Holding Period*, 67 NW. U.L. REV. 87 (1972).

381 *See* Sommer, *Considerations Leading to the Adoption of Rule 144*, 67 NW. U.L. REV. 65 (1972).

382 We would point out that the "legal for life" requirement can be avoided (*see* TDRI prospectus of September 20, 1972). This does not mean that such securities are not more solid on the average than other securities. But solidity, without more, is not an acceptable basis for excluding disclosure requirements although it is an acceptable basis for precluding detailed commission review of the disclosure document.

383 Snyder, *Securities Regulation Rule 144 - From Lawyers to Mathematicians*, 40 TENN. L. REV. 399, 419 (1973); Wander, *Limitations on the Amount of Securities That Can Be Sold in Compliance with Rule 144*, 67 NW. U.L. REV. 111 (1972).

average weekly volume of sales of such securities on all exchanges for the four weeks prior to the placing of the sell order, whichever is the lesser, can be sold by any one private purchaser in a six-month period.[384] This is a "leakage" formula designed to allow a purchaser to dispose of securities where there is no undue disturbance of the trading markets.[385] It limits securities which can be sold without a prospectus to those bearing a reasonable relationship to the conditions existing in the trading market. It has little to do with disclosure to investors but is a compromise which we support as it is impracticable to force prospectus-type disclosure when only small amounts of securities are being sold. The actual numbers should be left to commission rule. Even for reporting issuers we do believe that, contrary to the proposed provisions in Ontario Bill 98, some number limitations should be retained in secondary distributions of this type.[386]

(4) The transactions must be completed in "broker transactions"[387] and the seller must not solicit any order to buy.[388] The prohibition on grooming the market seems particularly appropriate where no disclosure is to be provided and we would tentatively recommend its inclusion although we believe it should be the subject of continuing review. If our recommendation that reporting issuer securities be listed on a stock exchange becomes effective, it virtually assures that the transaction must be done through a broker.[389] For non-

384 There are aggregating provisions to cover spouses and family. In addition, for "affiliates" all sales are added in the six-month period whether or not acquired on a limited offering basis. For a good basic checklist *see* Levenson, *The SEC Approach to Rule 144*, 67 Nw. U.L. Rev. 164 (1972). In 1975, NASDAQ was added as an exchange for the purposes of number calculations under the rule. This was a relaxation for some issuers but a restriction for others as the test is on a "lesser of" basis.

385 A similar policy is used in Ontario on s. 59 applications where the commission only allows a resale in accordance with "orderly marketing" policies of the Toronto Stock Exchange; *see* OSC, Policy No. 3-18, *supra* note 286. The Toronto Stock Exchange requirements are decided on a case by case basis on the basis of the trading volume of the particular security involved and the likelihood that the shares affected by the order will be resold quickly. *See also* the discussion by Dey, *supra* note 247, at 172-73, of the "fur coat" exemption under s. 58(2)(c) of the present Ontario Securities Act. While this provision has been deleted, it should be stressed that s. 73(7) of Ontario Bill 98 allows a person who has a controlling position to sell all his securities without any restrictions if certain filings are made and the issuer is a reporting issuer.

386 Which would be consistent with the trading transaction exemption in ALI Federal Securities Code, Reporter's Revision of Tent. Drafts Nos. 1-3, s. 227(c)(1)(F).

387 This is also required under OSC, Policy No. 3-18, *supra* note 286.

388 *See* Miller & Setzer, *The SEC's New Rule 144*, 27 Bus. Law. 1047 (1972). The same idea of not creating a demand is found in Ontario Bill 98, s. 73(5)(c).

389 The only other likely agent would be a bank and Ontario Bill 98 would make them register unless they in turn act through a broker; *see* Ontario Bill 98, s. 35(1)10(b).

reporting issuers the broker assures a screen which should help to protect the purchaser. Thus we would support the broker requirement with respect to sales of securities of both reporting and non-reporting issuers.

(5) There are filing formalities to ensure that the central registry is kept up-to-date on what has been sold.[390] This is obviously a necessary requirement if any control is to remain over such resales at all.[391]

In short, our proposed resale exemption is wider than that proposed in Ontario Bill 98 but similar to the *ALI Federal Securities Code* although we believe the holding period is irrelevant so long as the numbers of purchasers or securities involved are limited on the resale. On the other hand, no length of holding period substitutes for adequate disclosure on the wide distribution of a large block of securities. It should be noted that this trading transaction exemption will only apply to reporting issuers as there will be no substantial market to allow a numbers test for non-reporting issuers.

Somewhat similar to the institutional or sophisticated purchaser concept but constituting an entirely different set of exemptions under provincial statutes are those which recognize certain classes of purchasers as in a special category so far as a given issuer is concerned. One such exemption, historically recognized in Canada but not in the United States,[392] is for a sale by an employer to employees of securities of the employer.[393] *The Ontario Securities Commission Disclosure Report* justified the continuation of the exemption on the basis that it is "desirable that employees should be readily permitted to invest in the company in which they are employed".[394] Certainly we would be loathe to see stock option or stock purchase plans disappear as a result of over-zealous regulation. But it would not be appropriate to place a substantial new offering entirely with employees. Such an occurrence is probably only theoretically possible in so far as stock option plans are concerned in view of the limits of the number of shares which can be under option pursuant to stock exchange rules. We believe that the employee exemption should be limited to some specific percentage of outstanding securities for situations other than stock option or stock purchase plans.

390 *See* Applebaum, *The Rule 144 Pattern - An Overview*, 67 Nw. U.L. Rev. 76 (1972); Bloomenthal, *Rule 144, the SEC, and Restricted Securities*, 49 Den. L.J. 301 (1973); *see also* Bialkin, *Rule 144 Amendments*, 8 Rev. Sec. Reg. 939 (April 26, 1974).

391 Reporting is also required under Ontario Bill 98, s. 73(4)(c).

392 *See* Dey, *supra* note 247, at 142, 162.

393 Ontario Securities Act, ss. 58(1)(c), 19(1)10. The exemption is limited to trades that are not induced by an expectation of employment.

394 Ontario Securities Commission Disclosure Report at 108. The exemption is carried forward in Ontario Bill 98, s. 73(1)(l).

The second group of exemptions for issuer placements to a specified group under current provincial legislation is the three exemptions for placements to existing shareholders, namely, stock dividends, securities issued on reorganizations and rights offerings.[395] These exemptions have been carried forward into Ontario Bill 98[396] substantially unamended. We know of very few problems[397] which have resulted as a consequence of these exemptions and we would recommend their retention as the number of times they are useful in reducing unnecessary regulatory activity far outweighs the problems they create.

Under the SEC statutes, there is an exemption from the registration requirements, for "transactions by an issuer not involving any public offering",[398] which was intended to allow issuers to avoid the substantial burdens of registration when the public was not involved. But the standards were vague and the risk of error, with possible attendant liability, has increased dramatically as the courts have become stricter over the years.[399] The SEC has tried to formulate various exemptions, none of which has met with much popular acclaim.[400] The current one is Rule 146 adopted in 1974.[401] The most significant concepts in the rule are that the purchasers must have access to the same kind of information that registration would disclose and they must have the ability to fend for themselves.[402] Thus this U.S. rule is really confined to the sophisticated purchaser whom we have discussed above.[403] The rule is replaced by the limited offering exemption in the *ALI Federal Securities Code* and we are proposing a similar exemption. It will allow some flexibility not only on sales of securities of

395 Ontario Securities Act, ss. 58(1)(c), 19(1)(8); Dey, *supra* note 247, at 153-58.

396 Ontario Bill 98, s. 73(1)(f).

397 *See In re* Panacea Mining & Exploration Ltd., [1971] OSC Bull. 156, 163 (October) for one situation which may indicate that problems can develop. In fact, in Ontario, the OSC has been insisting that any material change since the last notice to shareholders be communicated *before* a rights offering may be proceeded with. This has been a very salutary requirement.

398 Securities Act of 1933, s. 4(2).

399 *See* Patton, *Private Offerings: A Proposal for Administrative Action in Arizona*, 15 Ariz. L. Rev. 1 (1973).

400 *See, e.g., Rule 146 - Safe Harbor or Dry Dock for Private Placements*, 256 BNA Sec. Reg. & L. Rep., June 12, 1974, at B-1, where it is stated that "the route to that harbor is shallow and treacherous and the harbor itself is swept by dangerous currents".

401 Originally proposed in 1972, it was revised and republished in 1973 and adopted in 1974 pursuant to SEC, Securities Act of 1933 Release No. 5487, April 23, 1974, 4 SEC Docket 154 (No. 5, 1974); *see* Castruccio & Tischler, *supra* note 378, for details of changes in 1975.

402 *See* Wander & Shervitz, *Rule 146 Adopted*, 7 Rev. Sec. Reg. 911 (June 5, 1974). The "fend for themselves" test can be satisfied through our "offeree representative" who is a qualified adviser.

403 *See* Note, *The Private Offering: Rule 146 and Offeree Sophistication*, 25 Maine L. Rev. 295 (1973).

reporting issuers but also on both primary and secondary sales of non-reporting issuers.

While the United States does not have a general employee exemption, it does have exemptions for exchanges with shareholders in judicially or administratively approved transactions, on the exercise of conversion rights and for non-conversion exchanges.[404] There is also a proposed exemption in the *ALI Federal Securities Code*, not restricted to issuers, for all offerings under $100,000.[405] This latter exemption is, in our view, inconsistent with a comprehensive disclosure system although we realize that the cost of prospectus-type disclosure makes small offerings prohibitively expensive. Nevertheless, investor protection cannot be ignored and, if the public is to be solicited, some minimum standards should prevail on initial issues.[406] We would hope that a simplified form of prospectus could be developed on such offerings in an effort to cut the costs involved.

The third group of trading exemptions is really more related to marketing techniques than it is to any real exemption theory. Thus if the distribution goes down a chain from issuer to underwriter to banking group to selling group to customer, it would be useless to require a prospectus at each stage. What is desired is that the ultimate consumer be given a document he can understand and the investment analysts be given full information.[407] We have earlier commented that the satisfaction of prospectus requirements by delivery to an agent can be unsatisfactory and we adhere to that view. With that reservation we agree with a marketing exemption and we think the system proposed under Ontario Bill 98 is both simple and workable.[408]

Thus the major differences we suggest from the proposed Canadian provincial system for exemptions at the secondary distribution level are twofold. In the absence of market grooming, the proposed Ontario system never requires a prospectus if the issuer is a reporting issuer whereas we feel a prospectus should be required in the case of the public distribution of large blocks as

404 *See* ALI FEDERAL SECURITIES CODE, Tent. Draft No. 1, at 108-14.

405 *Id.* s. 511(d). It cannot be used on a secondary distribution of securities sold under a limited offering.

406 Loss foresees a higher figure than the $100,000 being used on primary issues subject to a regulation "A" short form prospectus; *see id.* at 107.

407 This is presently done in Ontario by a peculiar definition of underwriter, partly copied from U.S. statutes where the system is quite different, coupled with an exemption for trades to or among underwriters; *see* Ontario Securities Act, ss. 58(1)(c), 19(1)6, 1(1)25. *See* Dey, *supra* note 247, at 151. For the proposed U.S. scheme *see* ALI FEDERAL SECURITIES CODE, Reporter's Revision of Tent. Drafts Nos. 1-3, ss. 511(a), (b), (c), 512.

408 Ontario Bill 98, ss. 73(1)(o), 73(6).

discussed earlier.[409] We also believe that there must be some flexibility for the sale or resale of securities of non-reporting issuers. Contrary to Ontario Bill 98, we have suggested that an exemption based on the number of purchasers (up to thirty-five), regardless of sophistication, be permitted but only if the transactions are handled through licensed brokers and the number of shareholders does not fan out past thirty-five within three years of the sale or resale in question.

The proposed Ontario system also has an exemption for pledges of securities, held by persons whose holdings materially affect control, to secure a *bona fide* debt.[410] As we have no concept of control block distribution under our proposed system this exemption will not be necessary. A similar exemption for isolated trades out of a control block, which exists under the current provincial legislation,[411] can be ignored for the same reason.

Finally, so far as trading exemptions are concerned under Ontario law, there is an exemption for distributions of listed stock through the facilities of the Toronto Stock Exchange if a statement of material facts is accepted by the commission.[412] A statement of material facts is very similar to a prospectus in practice, although the sale price is not shown as it varies with the market.[413] From a disclosure point of view the real difference is in dissemination techniques. We do not believe that the disclosure is adequate if there is less dissemination than would occur with a prospectus. We doubt that adequate dissemination of information is likely to be possible in the hurly-burly of a busy day on the exchange[414] but we would note that investors seldom read prospectuses anyway and the deemed reliance provisions apply to statements of material facts. In practice the exemption has proved to be very useful and not abused. Accordingly we submit that this exemption, although theoretically objectionable, should remain unless, upon further study, it appears that the exception has negative factors of which we are not aware. Its central use has been for speculative mining companies[415] but it has been used

409 We have ignored in this paper the disclosure requirements of Ontario Bill 98, s. 73(5), because we feel the burden of such reporting should be on the issuer and should not be transferred to the reseller simply because of the desire to resell.

410 Ontario Bill 98, s. 73(e). Resales by the pledgee are subject to the same limitations as resales by the pledgor under s. 73(7).

411 Ontario Securities Act, s. 58(2)(c).

412 *Id.* s. 58(2)(b) which is carried forward into Ontario Bill 98, s. 74(1)(b). Québec has a similar exemption administratively invented; *see* 5 QSC Bull. No. 44 (November 5, 1974). *See* comments in text accompanying notes 213, 214 *supra.*

413 *See* Apple, *supra* note 295; Dey, *supra* note 247, at 171-72.

414 There is also the problem of divided regulation because of several stock exchanges; *see* Baillie, *supra* note 205, at 380.

415 *See* 3 R. Kingston, Ontario Corporation Manual 8276 (1978) ("Public Financing").

extensively in sales out of control blocks. We suggest that the "statement of material facts" be called a prospectus and that its ultimate delivery to each purchaser be required by the statute, although an interim delivery to the purchaser's agent should be maintained to permit the smaller brokers to participate in such distributions.

We have already dealt at some length with exemptions related to the type of security being sold. These are also discussed in Professor F. Iacobucci's paper in this volume, and we will not reconsider them here. One exemption which we have not covered and which has only recently been introduced in Canada is the exemption for puts and calls written by members of the stock exchange on securities listed on the exchanges.[416] A similar exemption was suggested in the first draft of the *ALI Federal Securities Code* but has now been watered down to allow the commission to withdraw the exemption.[417] An exemption is appropriate in our view only if the option market is directly regulated. Options are generally used by speculators trying to make a large profit at a low cost.[418] The risk to the unwary is considerable. If ever there was an area where trading should be confined strictly to informed investors the market in puts, calls, strips, straddles, spreads and straps is surely it, although we would support an exemption to allow the small investor to gamble a bit if he so desires. Securities regulation is not a morality code.

Chapter VII
Dissemination

The most complete disclosure is useless if it is hidden. Hiding can be done either by making the document unintelligible to the recipient or by not allowing it to reach any comprehending recipient. Seen in this light, the problem of dissemination can be seen as having two dimensions: (1) if the disclosure document talks with a confounding and confusion of tongues it is useless;[419] (2) if we are to have a sound capital market then the shareholders, brokers and financial experts must have access to full and reliable information.[420] Due in large part to technological breakthroughs in the compilation and dispensing of information through the use of

416 Ontario Securities Regulations, s. 86.

417 *See* ALI FEDERAL SSECURITES CODE, Reporter's Revision of Tent. Drafts Nos. 1-3, at 76.

418 *See* SEC, REPORT ON PUT AND CALL OPTIONS (1961).

419 A. BRILOFF, UNACCOUNTABLE ACCOUNTING (1972); O'Neal & Schwartzberg, *Financial Disclosure - A Tool for Public Analysis*, 6 TRANSNAT'L L.J. 1 (1974).

420 Re Castlereagh Securities, [1973] 1 N.S.W.R. 624 (Eq. Div.).

photography, computers and data-processing equipment that were unavailable one or two decades ago, the ready availability of corporate information is a reality.[421] Indeed the investor and the analyst may suffer from an informational overload,[422] sometimes purposefully supplied to hide pertinent information in the resulting morass. We believe that the purpose of a viable dissemination system is to provide recipients with as much as they need but not more than they can absorb.

Individual investors are, in large measure, financially well-to-do but unsophisticated members of society. Analysts, including those directing the portfolio investments of institutions, are sophisticated but not necessarily investors, at least for their own accounts. Thus we have the dichotomy of public disclosure, or at least public access to information, which is directed to two groups with divergent interests.[423] Insistence on uniform disclosure or disclosure documents of a type appropriate to 1844 when Gladstone introduced a general disclosure regime in England, is not necessarily consistent with current reality.[424] What is vitally needed is a separation of available disclosure for analysts through a central file or repository where all information, whether required by legislation or voluntarily divulged by an issuer, is open for inspection[425] and direct disclosure to shareholders and to the public of material information in a style acceptable to them. The latter objective is now served essentially by the annual report[426] although some commentators feel it will no longer serve the purpose if the SEC starts to dictate its contents.[427]

Our recommendation for reporting issuers would be to separate the two classes of recipients while at the same time having all information available. We will assume that the shareholders effectively include all interested members of the public so far as mandatory periodic disclosure is concerned. In fact, the cost of a single share is not high. Any interested person can buy one share and thus be sent annual and periodic reports, which reports we believe should be prepared at a relatively unsophisticated level. Such reports should be sent free of charge to all shareholders and copies

421 *See* WHEAT REPORT, ch. IX, for a discussion of the microfiche systems available in 1969 as an example of modern developments. Similar systems are presently available in Canada.

422 Knauss, *supra* note 83.

423 Duome, *The Two People Who Read Annual Reports*, [1974] INVESTMENT DEALERS DIGEST 14.

424 *See* Schneider, *Reform of the Federal Securities Laws*, 115 U. PA. L REV. 1023 (1967).

425 *See* SEC Proposes Firms Report to Agency Profit Forecasts Given to Analysts, The Wall Street Journal, April 29, 1975, at 2.

426 Sommer, *The Annual Report - A Prime Disclosure Document*, [1972] DUKE L.J. 1093, 1122.

427 Riggs, *Annual Shareholder Reports*, 7 REV. SEC. REG. 893 (August 14, 1974).

should be available at a minimal cost to any interested member of the public. The reports should include the disclosure requirements deemed necessary to show good corporate citizenship[428] as well as to give the reader some idea of the past performance of the enterprise over a fairly extended period, perhaps as much as five years. They should not be cluttered with voluminous financial statements or notes to financial statements. Auditors' reports should be designed to be explanatory, if they are included at all. The issuer should be free to include anything he desires in the various reports unless prohibited by commission rule. Compared with existing periodic reports, our recommendations would require less emphasis on formal financial statements.

Completing the publicly distributed material would be timely disclosure reports of material information which would be the subject of a press release but which would not be required to be sent to shareholders. Neither the periodic reports nor the timely disclosure releases would be checked by the commission although some civil liability should attach to misinformation or puffing contained in them. Soft data could only be included if consistent with rules adopted by the commission. Such a reporting framework would not have the information that a sophisticated investor or analyst would need but reference would be made to where that information was available.[429] Unlike the present system, the information distributed publicly by the issuer would not pretend to be useful for analysis because there would be little or no raw data.

For the interested investor, we believe that the central files at the securities commission and stock exchanges, which would eventually be on a microfiche or computer system, should be adequate. We see these files as being regularly updated and changes, which are not sufficiently material to justify a press release, would be available on a current basis. The central disclosure register would contain significant amounts of soft data. We see no need to burden the unsophisticated layman with data only the sophisticated can utilize effectively.[430]

We do believe that a broker who, in effect, solicits a client to purchase or sell a particular stock should be encouraged to send to

428 *See* Developing Trends in Company Law, address by H. Purdy Crawford, *ICSA Seminar* (June 18, 1975).

429 We recognize that this goes against the trend for including more sophisticated data in annual reports as suggested by several authorities in the United States; *see* Garrett, *The Role of Financial Public Relations*, [1974] INVESTMENT DEALERS DIG. ANN. REP. REV. 8; Gilbert, *The 10-K Report Now an Integral Part of Modern Reporting Standards*, *id.* at 18; Carlson, *Corporate Reporting - A Security Analyst's View*, FINANCIAL EXECUTIVE, May 1974, at 58; Cohen, *supra* note 141.

430 But the analyst clearly needs soft data such as value estimates, earnings projections, probable and potential minerals, *etc.*; *see* Kripke, *supra* note 128, at 637.

the client either the latest annual report of the issuer (where the client is purchasing) or photostats from the microfiche file that the broker feels the client could understand. An alternative might be to deliver a synopsis prepared by the broker.[431] We would recommend that the commission be given a discretion to require dissemination of such material by the broker where it believes there may be a problem of speculative trading and solicited orders.

Perhaps the most difficult question in dissemination techniques relates to the prospectus. If we concentrate on new issues, it is fair to say that the securities are often offered for sale before the prospectus has been received by the prospective purchasers. The *Wheat Report* and Ontario Bill 98 both support some effort to increase dissemination of information before the final prospectus is mailed. The *Wheat Report* details at some length the various attempts since 1933 to disseminate information to investors during the "waiting period", including "red herrings", "blue cards", "identifying statements" and "summary prospectuses". All of these attempts have failed. Until some new workable system is developed, we believe that the concept of mandatory dissemination of information during the waiting period should be abandoned. While retrospectuses are not as good as prospectuses in theory, they could be made more effective than they currently are. We believe that a more extended rescission period than presently exists, say, three or four days, might be feasible for purchasers of small amounts of the issue. For large purchasers or institutions there is no need for any rescission period as they are sophisticated purchasers and no prospectus would have been filed if the smaller investor had not been involved. A long rescission period would simply provide them with a free ride. But longer periods now exist in New York[432] and used to exist in Ontario[433] so they are not impossible for the brokerage community to live with. If the front page of the prospectus advised the purchaser of a three-day right of rescission for small investors and suggested he read the prospectus to see if he might like to exercise the right, the investor should be adequately protected without worrying about dissemination of information in the waiting period.

The prospectus should still be delivered to purchasers in accordance with existing practice. In the United States there is a "forty-day rule" which obliges dealers to send out a prospectus to all purchasers of securities of a reporting company that purchases

431 *See* WHEAT REPORT at 319.

432 *See id.* at 119.

433 *See* KIMBER REPORT.

within forty days of a new issue.[434] This system has been honoured mainly in the breach and is now being discarded.[435] But for new issues of non-reporting issuers there is a similar ninety-day rule which is being used now and the requirement will be strengthened under proposed legislation.[436] We recommend adoption of the ninety-day rule for initial issues by a previously non-reporting issuer.[437] We believe that a relatively small issue in a glamour industry needs far more dissemination of relevant information than an established public company.[438]

We have not canvassed the extra dissemination requirements on take-over bids or of insider trading reports, which are partly covered in other papers. We do wish to stress that such other disclosure requirements should be built into the system here proposed. Thus insider trading reports should not be published in some weekly or monthly bulletin but should be in the central file. On the other hand takeover bid circulars should be widely disseminated.

Chapter VIII
Summary of Recommendations

It is not necessary to restate all our recommendations in detail but we believe it may prove useful to have a summary of them readily available. We would stress again that the basic assumptions set out in chapter VI.A. have had a significant influence on the formulation of these proposals. In addition, all of our recommendations are qualified by our belief that compatibility with the existing provincial regulatory systems is essential. To the extent that any of the assumptions set out in chapter VI are incorrect, or if the provinces are unwilling to adjust their own legislation to ensure compatibility with the proposed system then the implementation of our proposals should be reconsidered.

A. CONTINUOUS DISCLOSURE

This would be required only of reporting issuers which would be defined to mean:

(1) A corporation with over 300 public holders of its equity securities, including as "equity securities" any security convertible

434 The rule only applies if the securities are derived from the new issue.

435 *See* WHEAT REPORT at 121.

436 *See id.* at 123; ALI FEDERAL SECURITIES CODE, Tent. Draft No. 1, ss. 511(b), (c).

437 The rescission rights usually connected with prospectus delivery in Canada should not apply to secondary trades during this 90-day period.

438 *See* Bromberg, *supra* note 142, at 1175.

into such a security or carrying a right to subscribe to such a security. Excluded from "public holders" would be any directors, officers or holders of more than 10% of any class of securities of the issuer involved together with their associates. Consideration should be given to requiring such corporations to list on a recognized stock exchange once the necessary facilities to accommodate such listing have been put in place and the regulatory difficulties satisfactorily resolved.

(2) A corporation which does not satisfy the tests under (1) above but which the commission permits to become a reporting issuer upon application of such corporation. The commission, in considering such application, would consider whether there was sufficient interest in the corporation to ensure that financial analysts would continue to follow it.

(3) A corporation with over 300 holders of its debt securities where the commission specifically required it to become a reporting issuer.

Excluded from reporting issuer status would be:

(1) charities, social clubs and similar not-for-profit institutions;

(2) regulated industries where the regulation assured comparable public disclosure of information as would be required under the federal securities legislation;

(3) mutual insurance companies or any similar institutions where there are no easily transferable interests;

(4) corporations exempted from reporting issuer requirements by the commission, after a hearing.

Generally, corporations which had been "reporting issuers" for over twelve months in Ontario, or other provinces having similar requirements, would automatically obtain status on filing the required documentation if they also satisfied the 300 public shareholders requirement. All other corporations would be screened by the commission before becoming reporting issuers. It would be the responsibility of the commission to ensure that the corporations voluntarily seeking to become reporting issuers were suitable to be granted reporting issuer status.

A reporting issuer would:

(1) File an initial registration statement with the commission and, once the stock exchanges had facilities to handle the information, with the stock exchanges and perhaps with the IDA. The contents of the registration statement would be set forth in rules promulgated by the commission and would permit the inclusion of a considerable amount of "soft data". This registration statement would be kept up-to-date at all times by the reporting issuer and would be available to the public.

(2) Regularly report to its shareholders, at least semi-annually and likely quarterly, in a narrative form. The commission rules would specify some required data but not extensive financial statements. The issuer would be free to include other data except data specifically prohibited by commission rules. The periodic reports would include any material information now contained in information circulars or like documents. The periodic reports would not be precleared with the commission.

(3) Disclose as soon as reasonably possible all material changes relating to the corporation through press releases. Where the issuer believed that material information was confidential a notice that confidential information existed would be filed with the commission but the information itself would not be filed. This would allow the commission to watch trading activity in the stock while preserving the confidentiality which is so essential to the issuer.

Reporting issuers would be the only entities whose shares could be widely traded in the secondary markets, except with the specific blessing of the commission. Generally speaking, reporting issuers would be allowed to sell new issues of securities pursuant to summary prospectuses as opposed to full prospectus disclosure.

B. PROSPECTUS DISCLOSURE

Prospectus disclosure of the type now common across Canada would continue to be required on all new issues of securities, not otherwise exempt, although the commission rules would provide for a summary prospectus for use by reporting issuers whose securities were regularly followed by financial analysts. The present requirement of a mandatory preliminary prospectus would be dropped. A slightly longer rescission period after receipt of the prospectus for small purchasers should be considered.

The contents of the prospectus would not be set forth in the statute at all but would be left entirely to commission rules. There would be no requirement for a certificate by the issuer or underwriter as to completeness in the publicly distributed copies of the prospectus nor would a legend indicating that the securities commission had not considered the merits of the offering be included. Different requirements for different types of issuers would be set forth in the rules. Soft data would generally be prohibited from disclosure in the prospectus.

The commission would have a discretion to reject a prospectus where it felt the securities offered were unsuitable for investment by the general public. The commission would be encouraged to concentrate on new issues by unknown entities and on issues

meriting special attention for other reasons, for example, because the issuer had a high debt equity ratio. The commission would not be expected to even check the prospectus of a well-established and stable reporting issuer unless it desired to do so.

In addition to requiring prospectuses on new issues by an issuer, a prospectus would be required on secondary issues, whether or not emanating from a control block, where the seller sold in excess of a stipulated amount of securities to the public. Before this proposal is implemented with respect to reporting issuers however the commission must be assured that it will have no material impact on institutional investors. If it is implemented, the stipulated amount should be related to the traded volume of the security, perhaps 1% of the average monthly traded volume over the past three months. This figure would be set by commission rule and the commission could relax the rule upon application in any particular case. Special provision might be made so that the commission could require a prospectus filing in other situations, for example, if the trading volume at any time increased dramatically in the securities of a particular issuer. However, care should be taken to avoid a compulsion to disclose confidential information when the issuer has no control over the timing of the filing, unless the information has already "leaked".

C. EXEMPTIONS FROM PROSPECTUS REQUIREMENTS

There should continue to be exemptions from prospectus requirements based on the status of the issuer but these should be confined to:

(1) Canadian government issues, including municipal bonds issued by municipalities in Canada and any other issues that the government has obligated itself to exempt under a treaty or international agreement;
(2) regulated industries where the disclosure demanded by the regulatory authority is equally as pervasive as that required under the federal securities legislation;
(3) not-for-profit corporations such as charities and social clubs;
(4) any issue where the total number of owners of equity securities of the issuer will be less than fifty after the issue has taken place.

The existing provincial exemptions based on the type of security being issued should be retained, namely:

(1) short-term debt sold in denominations in excess of $50,000 or whatever higher figure the commission designates by rule;
(2) mortgages sold by a registered mortgage broker, at least

until a trading market in mortgages becomes more widely established;
(3) conditional sales contracts not offered for sale to the public.

There should be whatever exemptions are necessary for trades between underwriters or between brokers so long as the ultimate purchaser on a public distribution receives the prospectus. The scope of this exemption must be kept under continuous review to ensure that it is neither so wide as to permit evasion of the prospectus delivery requirements nor so narrow as to hinder legitimate marketing practices.

There would be three major exemptions that would apply on both primary and secondary distributions:

(1) sales to up to one hundred sophisticated purchasers on any issue or distribution;
(2) sales limited to a determinate number of securities over a given time span, such number to be fixed by the commission but likely based on a percentage of the average traded volume; this exemption would only apply to reporting issuers;
(3) a distribution to less than thirty-five persons which did not fan out to more than thirty-five persons over a three-year period; this exemption would only apply to non-reporting issuers.

These exemptions would both be available to the issuer and to vendors in the secondary market. Sophisticated purchasers would include the financial institutions and persons purchasing in excess of $100,000 blocks.

Other more minor exemptions would include:

(1) sales to employees by an issuer, within limits as to total volume during any twelve-month period;
(2) sales to existing security holders through stock dividends, reorganizations and rights offerings;
(3) exchanges made as a result of asset acquisitions, amalgamations and share for share exchanges, subject to the takeover bid disclosure requirements.

Finally we would retain the exemption for sales made on the stock exchange where a statement of material facts is delivered to the purchaser, but the commission should have specific power to withdraw the exemption with respect to any issuer if it is being used to distribute large blocks to the public without adequate information reaching the investor.

D. DISSEMINATION

We have recommended that the periodic disclosure reports to shareholders form the basis of public disclosure in the general

sense. These reports would be supplemented by timely disclosure through press releases. These reports and releases would not be technical at all, would not be precleared by the commission and would permit the issuer to include data he believed to be relevant subject only to specific prohibitions.

For reporting issuers, a detailed registration statement, kept current by the issuer, would be available to analysts and other interested members of the public at the commission offices. The stock exchanges would be encouraged to develop a system so that copies of the registration statement filed with the exchanges would be available to exchange members by a microfiche or computer system. Until such a system is developed there is little point in requiring that copies be filed with the exchanges. Once such a system is developed brokers who solicit orders from clients should have an obligation to send to their clients such information as they think the client needs to assess his proposed investment. This would be an extension of the presently existing "know-your-client" rules. We believe it should be developed slowly so costly systems of little practical use are avoided.

Continuing Disclosure and Data Collection

Dleap S. Hall

September 1978

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Chapter I
Introduction

The economic role of government is to manage the economy, maintain a high level of employment, control inflation and promote economic growth. To meet this challenge, the government must have comprehensive information on business enterprises so that it can forecast trends, plan and predict the outcome of its programs. In the past – and indeed present – these information needs have been wanting. To fill the void, government often resorted to the establishment of commissions, such as the Royal Commission on Corporate Concentration and the Royal Commission on Government Organization, or to ad hoc committees such as the Interdepartmental Committee on Data Collection and Inspection Activities. However, neither Royal Commissions nor ad hoc committees can satisfy the continuing information needs of government, and as a result a substantial amount of data collection occurs on a regular basis in government departments. To improve the timeliness and quality of information, while at the same time reducing the burden on respondents, a rational approach must be sought to coordinate the gathering and dissemination of information, the sharing and transferring information among government departments and the eventual integration of databanks.

The views expressed in this paper are those of the author and do not necessarily reflect those of Consumer and Corporate Affairs Canada or its staff.

The continuous disclosure concept as outlined by Grover and Baillie in this volume[1] could provide the catalyst to bring the requirements of the private and public information disclosure systems into harmony with each other. Currently, the way in which the private sector prepares its financial statements and other corporate data is often different from the way in which government would like to have the data reported. There are, of course, exceptions, such as the returns filed under the Income Tax Act and filings by firms incorporated under the Canada Business Corporations Act. It could serve the interests of both the private sector and the government to have a common system for collection and dissemination of information.

Furthermore, a disclosure code should be established to make all material facts, subject to necessary exemptions, available in a common format. The Bank of America recently adopted a voluntary disclosure code which could be a model for the private sector. The objectives of the BankAmerica code are:

> "(1) to provide the men and women who manage BankAmerica with a continuing guide that keeps effective disclosure a principal objective of corporate policy;
> "(2) to facilitate disclosure of information that has been determined, not by the corporation but by its constituencies, to be useful and relevant in understanding and evaluating BankAmerica's activities;
> "(3) to encourage disclosure of information in ways which can be easily understood by all concerned;
> "(4) to give the public ready access, to the extent permitted by law, to information the corporation currently provides in its routine reporting to regulatory agencies;
> "(5) to define the limits of voluntary disclosure – that is, to respond to the public's question, 'why not?'."[2]

The government, for its part, must recognize that there are inefficiencies and waste in its information collection process which result in unnecessary duplication in forms and time pressures on those required to respond to them. Credibility of government information is especially open to challenge when its programs or decision-making are delayed by a lack of information or by misinformation. It is therefore necessary to reorganize and modernize the government's machinery for collecting and disseminating corporate information.

Following is a review of the government information collection process and how this process can be improved for the benefit

1 *See generally, Grover & Baillie, Disclosure.*

2 BankAmerica Corporation, *Voluntary Disclosure Code,* 95 Banking L.J. 4, 5 (1978).

of the public and private sectors, in the light of a continuous disclosure system developed under modern securities legislation.

Chapter II
Government Data Collection

There is an abundance of corporate information within the many federal government departments and agencies: large amounts of corporate data are deposited with regulatory departments to meet administrative requirements and smaller amounts are collected by surveys.

Difficulties derive not from the amount of information but from the lack of human communications skills to coordinate the collection process and to document, and ultimately interpret, the total inflow of information. In order to devise an adequate system, it is necessary to develop an inventory system to describe the type of information being collected and its availability, the collecting departments, frequency of collection and timeliness, confidentiality restraints, definitional standards and time frames. The absence of such a system continues to frustrate persons from whom information is required. The duplication of requests from many government departments results in unnecessary human and financial costs.

The absence of such an information system is the result of both the statutes authorizing the collection of information – for example, the Statistics Act[3] – and their administration. The statutes, in effect, often require duplicate facilities for the collection and storage even of tombstone data by specifying that the information is confidential and cannot be disclosed even to other government departments. Simultaneously, perhaps partly as a result, there has been a failure of government departments to coordinate their collection of information and thus ease the burden imposed on those supplying the data.

The Royal Commission on Government Organization, the Glassco Commission, in its report in 1962 confirmed the existence of the above problems and recommended measures to eliminate them. The Treasury Board responded to these recommendations and in 1966 promulgated a policy aimed at reducing the response burden and eliminating duplication.[4] The policy required all departments and agencies requesting information from more than ten respondents to provide the Chief Statistician of Canada with

3 Statistics Act, R.S.C. 1970, c. S-16, *as amended.*

4 *See* Management Improvement Policy, T.B. No. 659860 (September 8, 1966); M1-11-66 (September 12, 1966) (Treasury Board Circular Letter covering requests for information from more than ten respondents).

copies of the requests and all accompanying forms, schedules and questionnaires before the proposed survey date.[5]

However well intentioned, the policy was ineffective for basically the same reasons experienced in the United States under the Federal Reports Act of 1942.[6] That is, in many instances private firms or consultants were used to obtain the data.

There are approximately one hundred federal departments and agencies, not including autonomous operating units such as Air Canada and the Canadian National Railways, that collect data for administrative and regulatory purposes on a monthly, quarterly, semi-annual, annual and occasionally daily basis. There are about one million reporting firms in Canada, each of which could be simultaneously filing similar information with one or several administrative regulatory and/or statistical agencies, not including the information in their tax returns. Such duplicative requirements may create a formidable burden, especially for corporations which disclose similar data to provincial, municipal and other regulatory agencies such as securities commissions and stock exchanges.

We are concerned only with corporate data here, which is for the most part financial. There is minimal sharing and exchanging of data among government collectors. Furthermore, the material collected is not uniformly stored. It often remains on the original survey forms; some may be identified by a coding system peculiar to a particular branch or department and a small quantity may be put into machine-readable form. The government's lack of an efficient method and a proper facility for cataloguing and maintaining an inventory of corporate data often leads departments that are anxious to obtain information to collect the same data from essentially the same respondents. This embitters many corporations.

When corporations file data with government many of them believe it will be shared among departments; when they learn the contrary is true, they become dissatisfied and eventually antagonistic. Federal government collectors of information are often not sensitive to these feelings or even, on occasion, to their own data needs. As Professor Finagle[7] stated in his law of information:
(1) the information we have is not what we want;
(2) the information we want is not what we need;

5 *See id.*
6 *See* text accompanying and following note 8 *infra*.
7 Hunt, *Funds Position: Keystone in Financial Planning*, 53 HARV. BUS. REV. No. 3, 106-15 (1975).

(3) the information we need is not available.
And to use the words of Walt Kelly's comic-strip character, Pogo, "We have met the enemy and the enemy is us".

Data collected and compiled by special groups such as the Anti-Inflation Board and the Royal Commission on Corporate Concentration often lies dormant and/or is stored in the National Archives when the commission's mandate is completed. Special commissions leave a legacy of potentially meaningful data which is not incorporated into their reports and is therefore not available to anyone. It is unfortunate that the majority of specialists working on these commissions have never recommended a system which could be the nucleus of a government-wide data documentation centre for the continuous collection of needed information.

Chapter III
Means of Collection

Most data needs of government departments and agencies are met through their own administrative forms. Some information – on salaries, for example – is received from large employers on computer tapes. Most federal government departments have a surveillance system to ensure that all required data has been supplied and also to prod delinquent filers or to identify habitual violators who may be prosecuted.

Some surveys are used primarily to collect specific information for certain specified purposes. Once this data is used it is stored, and access to it is difficult. In 1966, in an effort to reduce the number of such surveys by government departments, Treasury Board invoked the rule of ten, mentioned above.[8] This rule stipulates that if more than ten respondents are to be surveyed, the form, purpose and type of data requested must be cleared by Statistics Canada, with Treasury Board being the final arbiter in the event of a disagreement.

The rule was based on one formulated by the United States Federal Paperwork Committee in 1942 under the Federal Report Act of 1942, the primary mechanism of the U.S. government for controlling its paper burden. However, the 1942 act was not completely effective because of structural and procedural flaws in the clearance process it had established, and the Commission on Federal Paperwork was set up to identify the defects and to recommend methods of rectifying them. One of the most important recommendations was that responsibility for coordinating the collection of information for program areas where several agen-

8 *See* materials in note 4 *supra*.

cies require similar information be assigned to a single "focal" agency. In 1974, therefore, the Office of Management and Budget and the General Accounting Office were given responsibility for reviewing and approving or rejecting proposed collection of information from the public by federal agencies.

In Canada, the effectiveness of the rule of ten was minimal because it was easily circumvented. Private agencies were hired to prepare the surveys or to undertake a broader project of which the survey formed an integral part. Departments were able to avoid the rule by characterizing the desired information as administrative rather than survey data. They succeeded in their efforts because of their autonomous nature and because no controlling or coordinating unit was established with the necessary enforcement powers. Statistics Canada, not having such authority, could only use persuasion. And while Treasury Board could restrict funds for departments not following established guidelines when the legislation defining a department's role gave it authority to collect the information, it was difficult to prevent it from carrying out its mandate. Until a unit with controlling, coordinating and disallowance powers is established, the effectiveness of present rules will continue to be limited.

Much of the data collected by governments and their agencies is classified as confidential by statutes such as the Statistics Act, by departmental policy or by a verbal undertaking given by the collecting authority to the effect that data on many industrial sectors is to be available only in aggregate form. This approach would be satisfactory if macroeconomic issues alone were involved. But there is also a substantial current need for microdata and more specifically for data on individual firms. Data in specific areas such as transfer pricing, profits by product lines and by operation, competition and concentration within an industry group are vital for policy development. And it is precisely this data that is not available to the public. Even though Canadians foot the collection bill, they can get little information about the specific activities of individual companies.

In order to obtain information on the actual operation of corporations subject to federal jurisdiction, the Canada Business Corporations Act recommends that such corporations indicate on the basis of the Standard Industrial Classification code[9] the industry sector in which their activities are conducted and identify sectors contributing 10% or more toward their profit in the same manner. This type of information is also required by the U.S.

9 Statistics Canada, Standard Industrial Classification Manual (Revised 1970) (Cat. No. 12-501, occasional publication).

Securities and Exchange Commission in its 10-K filings.[10] However, there has been little analysis to verify the accuracy of the information disclosed and no remedial actions have been taken in either country since the inception of the requirement.

The United States Federal Trade Commission, whose efforts in 1960 to collect refined corporate data by line of business failed, made a further effort to do so in 1974. As before, the issue was not resolved and went before the courts, with a ruling in favour of the FTC in 1978. The commission had given an undertaking that the data would not be divulged on an individual company basis and that access to the information would be limited to the staff of the Division of Financial Statistics.[11]

Chapter IV
Timeliness and Availability of Data

The collection, analysis and verification of data is a lengthy process which causes a delay in publication of from three months to three years. This makes the data of little current value. The publication in 1978 of information on intercorporate ownership compiled from data received as of 1975 under the Corporations and Labour Unions Returns Act (CALURA) while a valuable document is well out of date;[12] the rapidity of takeovers and mergers and the shifting of locations render the published data obsolete. A good deal of the delay is due to the verification that is conducted because of the statutory confidentiality provision.[13] In other cases, delays may be a result of the absence of material information which must be imputed, and care must be taken not to produce any inaccuracies or biases in the results. In fairness to the collectors, the delays are not entirely of their making: respondents' tardiness in transmitting the data is also a factor.

Rather than using precious time imputing missing data and checking statutory restrictions, government collectors should look at alternative, reliable sources of data. Similar data may be deposited under the disclosure provisions of the various securities commissions and stock exchanges or other private databanks such as the Financial Research Institute, Financial Post, Dun & Bradstreet or Canadian Business Service. Most information of this sort is in the public domain and is available without the usual govern-

10 Securities Exchange Act, 1934, ss. 13, 15(d) (annual filing).

11 *See, FTC's Authority on Business Data Upheld by Court,* The Wall Street Journal, July 11, 1978, at 3, col. 1.

12 Statistics Canada, Inter-Corporate Ownership (1978) (2 vols., Cat. No. 61-517, occasional publication).

13 Statistics Act, R.S.C. 1970, c. S-16, *as amended.*

ment confidentiality restrictions or delays. Furthermore, the data from these sources is more current, more complete and probably more accurate than that in government surveys because uniform data definitions are used and the reporting guidelines set out by the Canadian Institute of Chartered Accountants, the securities commissions, and the stock exchanges are followed. Information from these sources is filed by individual companies and thus provides a better basis for analysis and interpretation. More importantly, it is required on a continuing basis which ensures ready access; current revisions can be made.

During the past several years, there has been an increasing use by both the Canadian government and the private sector of the annual 10-K return which is filed with the Securities and Exchange Commission in Washington. Approximately 3,000 companies file these annual returns, among them about 150 Canadian corporations. A 10-K report contains full information on the nature of the filing corporation's business, its subsidiary companies, any important pending legal proceedings or contracts, as well as detailed annual financial statements. The information in the annual filing is supplemented by disclosures in the annual proxy statement and by quarterly and semi-annual filings and timely releases of important information. As a result, the Securities and Exchange Commission's files and even the 10-K report itself contain more information on filing corporations than is available elsewhere. Thus, Canadian corporations file more complete information in Washington than with any Canadian agency.

The ideal method of coordinating the collection of corporate information in Canada would be to harmonize the disclosure requirements of the corporate and securities laws with those under the Corporations and Labour Unions Returns Act.[14] This solution, even if imposed only by the federal government for its own purposes, would reduce the need for multiple filing of information as well as the cost of collection. However, proposed amendments to the act would remove most corporations now reporting from its coverage with the result that its effectiveness as a coordinating vehicle would be diminished.[15] In any event, all information disclosed under the act, other than tombstone data, is treated confidentially because the present form permits the use of tax data by respondents. In short, the potential of the Corporations and Labour Unions Returns Act as a vehicle for avoiding duplicate reporting has been negated by the confidential treatment of the

14 Corporations and Labour Unions Returns Act, R.S.C. 1970, c. C-31.

15 *See* Annual Return of Corporations, Sections A and B required under Corporations and Labour Unions Returns Act, pt. I.

information disclosed and will be further diminished by the proposed amendments to the act.

Chapter V
Duplication

Government departments have been criticized in Royal Commission reports[16] and by industry and industry spokesmen – such as the Committee of Independent Businessmen – about the duplication of data-gathering activities among departments. There are basically two types of duplication: for purposes of this paper they may be identified as *real* and *apparent*. Real duplication exists when two or more units within the same department or when two or more departments collect from the same respondent identical data for the same time frame using similar data definitions. Apparent duplication obtains for all other situations. Respondents do not distinguish between apparent and real duplication; they review requests for information on the basis of the cost and time necessary to provide it.

Nevertheless, there are some instances in which a case may be made for duplication. For example, both the Department of Industry, Trade and Commerce, and Statistics Canada collect information on "current capital expenditures"; the former requires the items as a bench mark or control figure within a space of time that is too short to permit Statistics Canada to make them available.

Other examples may be found in the area of labour statistics and mineral exploration. Several surveys, called "information on wages", and "the concept of wages", have varied with the collector. One survey requests gross wages, while another requests information on wages less specified deductions but including certain fringe benefits; yet another requests net wages. However, requests for confusingly similar data are likely to anger respondents. Moreover, the figures given to the various collectors probably come from the same source and are thus likely to be identical. In a 1977 article, W.H. Laughlin stated that a major form concerning exploration development and capital repair expenditures "is designed to accommodate twenty separate types of numerical data dealing solely with mineral exploration. Of these, only two are eventually published, partly because computation of the remainder is made meaningless by inconsistencies and omissions."[17]

16 *See e.g.* 3 Report of the Royal Commission on Government Organization 21-114 (Ottawa, 1962) (Supplying Services for Government: Report No. 12, Economic and Statistical Services and Report No. 13, Public Information Services).

17 Laughlin, *Exploration Activity Indicators Found Wanting*, The Northern Miner (Toronto), November 24, 1977, at D12.

There are also surveys that demand very refined data. These surveys, while not duplicative, impose a severe burden on the respondent. In some instances the respondent is unable to provide the data, and even if it were supplied, it would be of questionable value. The Computer Services Survey of Statistics Canada, for example, requires information available only from a highly sophisticated accounting system; in fact, each respondent is required to classify services of revenue by sixteen industry breakdowns.[18]

While demands for specific data items as outlined above may be legitimate from the surveyors' point of view, respondents may still regard them as duplication. A federal interdepartmental study in 1974 found that 188 surveys collected similar business data. If these demands could be integrated the required data might be made available to all.[19]

Continuing monthly and quarterly surveys should also be reviewed to see whether they continue to serve any purpose. It may be possible, for example, to reduce their frequency so that the monthly surveys might be taken on a quarterly basis and the quarterly ones only twice a year. Time series have been developed and analyses made by Statistics Canada to measure possible interruptions. At the same time, demands for more information are made. Experience in the United States indicates that demand has grown geometrically over the past two decades. It is estimated that it costs $43 billion a year for the collection and distribution of continuing survey data.[20] Comparable figures are not available for Canada, but the Glassco Commission report[21] estimated that about $20 million was spent in 1961 by the federal government to employ 3,000 persons to do statistical work and economic analysis, about two-thirds of which was incurred in respect of the statistical system.

If measures were taken by the federal government to implement the types of changes suggested in the preceding paragraph, they would go far toward assuaging businessmen who believe that the present requirements impose an unnecessary burden on them. The long-term benefits of such an attempt might lead to improvements in the quality of data received and thus to a more accurate and reliable reading of the health of the economy as well as resulting in cost savings for both the private and public sectors.

18 INTERDEPARTMENTAL COMMITTEE ON DATA COLLECTION, REPORT OF WORKING GROUP (Ottawa, 1973).

19 *See* app. B *infra* for table.

20 COMMISSION ON FEDERAL PAPERWORK, FINAL SUMMARY REPORT 5 (October 1977) (U.S. Government Printing Office).

21 3 REPORT OF THE ROYAL COMMISSION ON GOVERNMENT ORGANIZATION, *supra* note 16, at 21.

Chapter VI
The Business Register

Throughout this paper, reference is made to the creation of a mechanism that would facilitate coordination of data collection and standardize the varied forms of data collected. A computerized facility to collect, convert, store and retrieve data from a base with uniform entity classifications, data organizations and coding keys might provide such a mechanism. A facility of this kind could permit access to and distribution of accurate and timely information. The organization housing it could be called a business register, data clearinghouse or whatever; this writer prefers the former. The fundamental purpose of a business register is to have readily available a complete up-to-date list of corporations operating in Canada with their addresses, type of business, capitalization, subsidiaries and the names and nationalities of their officers and directors. Financial and other data could easily be added to such a file once it has been established.

Statistics Canada has been attempting to establish a business register for many years. In doing so, some insurmountable problems have arisen. For example, it is extremely difficult to develop an accurate list to keep the file of business establishments current. In addition, data cannot be obtained from the tax files of Revenue Canada. Although Revenue Canada at one point opened its files to Statistics Canada, it later withdrew the privilege because the latter shared data with Consumer and Corporate Affairs Canada, which was itself developing a comprehensive list of corporate names. As a result, the development of a business register by Statistics Canada has been delayed. The project is now being reviewed, however, because of the interest of a number of departments.

A business register should contain tombstone data on a universal basis and should also identify and standardize other data elements that are frequently required to be disclosed by business enterprises. This exercise would involve a number of steps, namely:

(1) a listing of all existing government surveys and their objects updated annually and including their data specifications;
(2) a scale indicating the reliability of the information in the various sets;
(3) a dictionary of uniform statistical concepts and data elements;
(4) classification of business firms in a uniform fashion in a system which takes into account parent-subsidiary and similar relationships;

(5) establishment of uniform concepts as to time frames and monetary or other quantitative measurements;
(6) development and utilization of uniform steps in collecting data;
(7) development and eventual use of uniform data-processing standards to facilitate data transfers;
(8) development of more uniform source document standards;
(9) establishment of confidentiality standards especially with respect to:
(a) the nature of data;
(b) the type of entity (individual, unincorporated business firms, corporation);
(c) the status of the user (private or public sector).

Given the need for a business register, the question of how to create one that can accomplish the desired goals remains. As long as the Statistics Act precludes the dissemination of detailed information, that is, microdata, Statistics Canada will be unable to perform all of the functions required of a business register. For example, information that is publicly available under the corporations and securities laws will not be disclosed in disaggregated form by Statistics Canada even when it has been received from a department that does disclose it. As a result, individual departments have developed their own information systems which they are reluctant to change.

In this context, the optimum solution would be establishment of a small coordinating agency responsible to Parliament through a Minister, presumably the Secretary of the Treasury Board, or to an independent review body. Such an agency could be empowered to transfer data-collection activities from one department to another in order to avoid duplication and to require transfer of the information collected to other users within the government. It would also diminish unnecessary effort by reviewing all surveys (and forms) and cancelling those that are unnecessary. And these functions would enable it to serve as a clearinghouse for information within the government.

A business register provides a basis for an efficient information system, especially if controlled by a coordinating agency like that suggested. Such a dual system will permit identification and analysis of the costs of gathering data and will also facilitate the use of alternative sources of information such as securities commissions and stock exchanges which already administer a system of continuous disclosure.[22] In addition, it will enable establishment and maintenance of an inventory of data that would provide a

22 *See generally, Grover & Baillie.*

basis for policy analysis of various kinds, while integrating existing databanks and reducing the costs of collection both to users and to those surveyed.

Chapter VII
Continuous Disclosure

The concept of continuous disclosure involves the availability of up-to-date information on corporations which have issued securities that are publicly traded.[23] The information that is filed and open to the public usually consists of annual and quarterly financial statements, all information circulars sent to shareholders and releases of timely information which may have an effect on the corporation. A system of continuous disclosure would go a long way toward improving the quality of information because of the generally accepted principles in accordance with which such information is prepared[24] and because of its timeliness. Such a system would also involve less cost to disclosing corporations.

A continuous disclosure system would not, alone, satisfy all government needs for information. Corporations and unincorporated business enterprises that have not issued securities to the public are not subject to the regular reporting requirements of corporation and securities laws, so that methods of obtaining information about them would have to exist alongside the more formal reporting system. However, such a system would complement the other methods and could result in a reduction of cost and enhancement of the general quality of information collected by the government by coordinating the information filed with securities commissions with that collected by other government agencies. The coordinating agency suggested above could establish mechanisms to accomplish these ends.

A coordinating agency could correlate not only the information collected by government agencies but also that gathered by private sources such as Dun & Bradstreet and the Financial Post and could store the data in machine-readable form permitting access through remote terminals by government officials, industry or academics. Special coding might be used to ensure that confidential information is available only to those entitled to it. Such a system would not only reduce duplication, but would also improve the quality and availability of corporate data and thus would both facilitate the development of government policy and

23 *See generally id.*
24 *See* CANADIAN INSTITUTE OF CHARTERED ACCOUNTANTS, HANDBOOK (1978).

further the aims of the continuous disclosure system for public issuers.[25]

Provincial governments, too, face similar problems in their collection of information. In fact, Québec has recognized the importance of a central registry of business firms and authorized the creation of the Fichier central des entreprises, a computerized system containing tombstone data such as the legal name of a firm carrying on business in Québec, the place and type of incorporation, location of head office, capitalization, nature and place of business and names and addresses of officers and directors. This data is updated annually from coded annual returns which are easily and efficiently fed into the computer, and inquiries to the Fichier central receive prompt responses. The Fichier central performs several types of service:

(1) it provides tombstone data by directly accessing the databank;[26]
(2) if such data is not available it directs the query to the department housing the data;
(3) it provides the source of the data to which the caller can direct his query.

Although there have been difficulties in establishing a similar system in the federal government, discussions on the feasibility of a centralized computer facility to house a business registry are continuing. It is somewhat discomfiting that better data than can be obtained in Canada on approximately 150 of the largest Canadian corporations is available from the Securities and Exchange Commission in Washington, D.C., and that the commission makes it available on microfiche, tape, or in hard copy.

The United States Federal Reserve Board uses data generated by the Securities and Exchange Commission for its quarterly report on the 200 largest manufacturing corporations which account for some 45% of sales, 60% of profits and 50% of all the assets of all U.S. corporations.

A federal body responsible for the supervision of the Canadian securities market would presumably collect information similar to that filed with the SEC. Such a body could, therefore, perform a similar function and provide an excellent source of micro-information on Canadian public issuers which could easily be integrated into a computerized facility for the storage and dissemination of business data.

25 *See generally id.*

26 Consumer and Corporate Affairs Canada has developed an information bank called CORBASE which performs the same functions.

Chapter VIII
Conclusion

Over the past several years, current information about the many segments of the Canadian economy – such as manufacturing, natural resources and ownership of the private sector – has been difficult to obtain. The difficulties arise from the incremental way in which the government information system developed; information was collected to meet the requirements of a specific program and not for overall government or business needs. No conscious attempt was made to coordinate data collection nor were there any efforts to reduce the burden on persons surveyed. The lack of coordination resulted in duplication of data collection, under-utilization of data collected, increased costs in human and financial terms and delays in processing and in disseminating data to the ultimate users.

The need to coordinate data collection activities is emphasized in a U.S. government report entitled *Federal Statistics*.[27] It is also essential, however, that the data thus collected be complete and accurate. To achieve accuracy, it is necessary to establish standardization in data reporting and collection. In the private sector, standards for financial reporting are set by the Canadian Institute of Chartered Accountants (CICA). No similar guidelines exist for the federal government's collectors of information. A government agency may therefore request data that is different from that normally prepared by a corporation. It would be beneficial if the government were to implement the guidelines adopted for business by the CICA. Once uniform reporting standards for both the private and public sectors have been adopted, coordination of the collection, processing and dissemination of information should follow. A centralized agency controlling one integrated information system is probably necessary to accomplish these ends. Theoretically, the powers necessary for such an agency to coordinate and integrate statistical activities are:[28]

(1) authority to transfer activities from one agency to another;
(2) power to authorize data transfers;
(3) forms control;
(4) guidelines and persuasion of outside task forces;
(5) audit of statistical activities.

To facilitate the exercise of these powers, the agency should compile a checklist of criteria for assessment of budget requests to begin or renew statistical activities that are subject to its approval.

27 PRESIDENT'S COMMISSION ON FEDERAL STATISTICS, REPORT: FEDERAL STATISTICS (1971).
28 *Id.*

It may also wish to initiate review by an independent board that will consider the collecting, handling and disclosure policies of agencies.

Appendix A
Federal Government Departments and Agencies Involved in the Collection of Data

Statistics Canada[a]

Main Collectors[b]

Agriculture Canada
Bank of Canada
Canada Employment and Immigration Commission
Department of Energy, Mines and Resources

Departments and Independent Regulatory Agencies[c]

Canada Employment and Immigration Commission
Canada Post
Canadian Radio-Television and Telecommunications Commission
Department of Communications
Consumer and Corporate Affairs Canada
Department of External Affairs
Department of Finance
Fisheries and Environment Canada
Department of Indian and Northern Affairs and Northern Development
Department of Justice

Air Canada (Transport Canada)
Atomic Energy of Canada Limited (Department of Energy, Mines and Resources)
Canada Council (Secretary of State Department)
Canadian Broadcasting Corporation (Secretary of State Department)
Canadian Dairy Commission (Agriculture Canada)
Canadian Grain Commission (Agriculture Canada)
Canadian National Railways (Transport Canada)
Canadian Transport Commission (Transport Canada)
Cape Breton Development Corporation (Department of Regional Economic Expansion)
Central Mortgage and Housing Corporation (Ministry of State for Urban Affairs)
Economic Council of Canada (Prime Minister)

a. Collects and provides statistical information on the Canadian Economy and Canadian Institutions. Collaborates with other federal departments and agencies, provincial and municipal governments and with businesses and individuals on the development of methodology on the production of new and expanded statistical information.
b. Each of these departments or agencies is responsible for the collection, analysis and publication of data in specific fields.
c. Both collect large amounts of statistical data as part of their administrative, regulatory and operating responsibilities. Both these groups provide statistical and other data to the Main Collectors, especially Statistics Canada. The difference between the middle and the lower groups is that the middle group comprises basically independent, operational and regulatory agencies. However, the CRTC (a regulatory agency) and UIC (an administrative agency) are incorporated with the lower group of departments and agencies because of their close relationship with the Main Collectors - especially Statistics Canada.

Department of Industry, Trade and Commerce	Labour Canada Health and Welfare Canada	Public Service Staff Relations Board
Ministry of the Solicitor General Ministry of State for Science and Technology Ministry of State for Urban Affairs	Department of National Defence Privy Council Office Public Works Canada Department of Regional Economic Expansion Revenue Canada	Secretary of State Department Supply and Services Canada Transport Canada Treasury Board Canada Veterans Affairs Department
National Energy Board (Department of Energy, Mines and Resources) National Film Board of Canada (Secretary of State Department) National Harbours Board (Transport Canada)	National Research Council of Canada (Ministry of State for Science and Technology) Northern Canada Power Commission (Department of Indian and Northern Affairs and Northern Development)	Northern Transportation Company Limited (Transport Canada) Public Service Commission (Secretary of State Department) Royal Canadian Mounted Police (Ministry of the Solicitor General) St. Lawrence Seaway Authority (Transport Canada)

As of September 1978

Appendix B
Matrix Showing Overlap in Data Collection in the Survey Areas of: Labour, Financial Statements and Capital Expenditures

Survey number	Number and type of reporting units[a]	Labour data				
		Employee count	Salaries and wages	Hours	Employee benefits	Further breakdown[b]
2	1,400 estab.	x	x			
3	250 estab.					
4	13 companies					
5	400 enterprises					
7	100 companies					
8	400 estab.	x	x			x
12	175 companies	x	x			
13	1,000 estab.					
14	75,000 estab.	x				x
16	552 estab.		x			
17	34 estab.		x		x	
19	500 estab.		x		x	
20	120 companies		x		x	
21	940 enterprises		x			
23	1,500 enterprises	x	x			
25	104 estab.	x	x			x
34	8,000 estab.	x				
36	700 estab.	x	x			x
37	708 estab.					
46	1,400 estab.					
47	200 estab.	x	x			
48	100 estab.	x	x			x

a. "Enterprise", "company" and "establishment" are as defined in the *Standard Industrial Classification Manual*, Statistics Canada, 1970, cat. no. 12-501.
b. Further breakdown of employee count, salaries and wages, hours and employee benefits.
c. Specific items which are part of profit and loss statement, balance sheet, source and application of funds.
d. Specific items which are part of construction, machinery, and equipment.
e. Further breakdown of construction, machinery, equipment and specific items.

Financial statements					Capital expenditure data				
Profit and loss statement	Balance sheet	Source and application of funds	Specific items[c]	Specific financial items	Construction	Machinery	Equipment	Specific items[d]	Further breakdown[e]
			x	x					
x									
				x					
					x	x	x		x
					x	x	x		x
x	x								
x				x					
	x								
x									
x				x					
x									
	x			x					
x									
				x	x		x		
				x					
x		x							
x				x	x				
				x					
			x						
			x						

		Labour data				
Survey number	Number and type of reporting units[a]	Em-ployee count	Sal-aries and wages	Hours	Em-ployee bene-fits	Fur-ther break-down[b]
49	2,800 estab.		x			x
50	112 companies	x	x			
51	2,800 estab.	x	x			x
52	25,000 estab.	x	x			
54	325,000 estab.	x	x	x		
55	25,000 estab.					
56	1,000 estab.	x				
57	150 estab.	x	x			
58	40 companies					
59	4,500 estab.					
60	150 companies					
61	1,900 estab.	x	x		x	
62	519 estab.					
63	39 estab.					
64	19,000 estab.					
65	11,000 companies					
66	550 enterprises					
67	12,000 estab.					
68	30 companies					
69	10,072 estab.					
70	650 companies		x			
71	companies[f]					
72	900 companies					
73	216 estab.					
74	12 estab.					
75	321 companies					
76	5,000 estab.		x			
78	1,450 estab.					
79	4,000 estab.	x	x			
80	20,000 estab.					
81	20,000 estab.					

f. Undefined number.

Financial statements					Capital expenditure data				
Profit and loss statement	Balance sheet	Source and application of funds	Specific items[c]	Specific financial items	Construction	Machinery	Equipment	Specific items[d]	Further breakdown[e]
				x					
			x						
x				x					
x									
x	x		x						
				x					
			x						
				x					
	x								
				x					
	x								
x			x						
			x						
			x						
			x						
			x						
			x						
			x						
			x						
			x						
			x						
			x						
			x						
		x	x						
			x						
			x						
			x						
x			x						
				x					
				x	x	x	x	x	
				x	x	x	x		x
				x	x	x	x		x

Survey number	Number and type of reporting units[a]	Labour data				
		Employee count	Salaries and wages	Hours	Employee benefits	Further breakdown[b]
82	20,000 estab.					
83	25,000 companies	x	x	x	x	x
84	1,400 companies					
85	9 companies	x	x			
86	271 enterprises	x	x		x	
87	280 enterprises	x	x		x	
88	82 estab.					
89	36 companies	x	x			
92	350 companies	x	x			x
93	549 companies	x	x			x
94	13 estab.	x	x			x
95	10,000 estab.		x			x
96	79 companies	x	x			
97	932 companies	x	x			x
98	10,000 estab.					
99	34 companies	x	x	x		x
100	24 companies	x	x			
104	12,575 estab.	x	x	x		
105	14,000 estab.		x	x	x	
106	51,900 estab.	x	x	x		x
107	6,500 estab.	x				
108	3,000 estab.	x				
109	26,000 estab.	x				
110	430,000 estab.	x				x
111	3,000 enterprises				x	
112	4,000 companies					
113A	250 companies					
113B	5,755 companies					
114	49 companies					
115	256 companies					
116	188 companies					
117	107 companies					
118	111 companies					

Financial statements					Capital expenditure data				
Profit and loss statement	Balance sheet	Source and application of funds	Specific items[c]	Specific financial items	Construction	Machinery	Equipment	Specific items[d]	Further breakdown[e]
				x	x	x	x		
x	x			x	x	x	x		
x	x			x					
x	x	x		x					
x	x	x		x					
x	x	x		x					
				x					
				x					
	x			x					
x	x	x		x					
x									
x	x								
x	x		x						
x	x	x		x					
				x					
x	x			x					
x				x					
	x								
				x					
x	x		x						
x			x						
				x					
	x			x					
				x					
			x						
				x					
				x					

		Labour data				
Survey number	Number and type of reporting units[a]	Employee count	Salaries and wages	Hours	Employee benefits	Further breakdown[b]
120	161 companies					
121	166 companies					
122	569 companies					
124	186 enterprises					
125	283 companies					
126	28 companies					
127	1,637 enterprises					
130	12 companies		x			
133	Establishments[f]	x	x	x		x
137	200 companies	x	x	x		
139	131 estab.	x	x			x
140	342 estab.	x	x			x
142	950 companies		x			x
168	1,300 companies		x			x
169	172 enterprises		x			
170	172 enterprises					x
171	60,000 estab.					
172	5,000 estab.	x	x		x	
173	3,000 companies					
174	223,000 estab.					
175	3,000 companies					
177	2,398 estab.	x	x	x	x	x
200	2,000 estab.	x		x		
201	40,000 estab.	x	x	x	x	x
202	30 companies					
204	1,716 enterprises	x	x			
206	36 companies					
207	5 co-ops.					
208	45 companies					
210	14 companies	x	x			
211	321 estab.					
212	410 estab.					
213	1,600 estab.		x		x	

Financial statements					Capital expenditure data				
Profit and loss statement	Balance sheet	Source and application of funds	Specific items[c]	Specific financial items	Construction	Machinery	Equipment	Specific items[d]	Further breakdown[e]
				x					
				x					
				x					
			x						
			x						
x	x		x						
				x					
			x		x	x	x		
x	x			x	x	x	x		
					x	x	x		
x	x			x					
			x						
x	x			x					
x	x			x					
		x		x					
x	x	x		x					
x	x				x	x	x		
x	x			x					
x									
x	x	x	x	x					
				x					
x	x			x					
x	x	x		x					
x	x	x		x					
x	x			x					
x	x			x	x				
x	x								
x	x	x		x					

		Labour data				
Survey number	Number and type of reporting units[a]	Employee count	Salaries and wages	Hours	Employee benefits	Further breakdown[b]
216	Companies[f]	x				x
219	50 enterprises					
221	180 companies					
222	375,000 estab.					
223	260,000 estab.					
224	112,000 estab.					
225	18,000 companies					
226	Companies[f]					
227	4,800 companies					
229	10,000 companies					
230	200 companies					
231	536,000 estab.	x				
232	40,000 estab.					
233	200 estab.					
234	3,800 companies					
235	14,785 companies					
237	12,000 companies					
238	65,000 estab.					
239	65,000 companies					
241	329 estab.					
242	550 estab.					
243	800 estab.					
245	75 companies					
247	457,511 estab.	x				x
249	60,000 estab.	x				x
259	162 companies	x				
260	600 estab.	x	x			x
261	600 government and companies	x				x
268	200 companies					
269	575 companies and establishments					
270A	328 companies					

Financial statements					Capital expenditure data				
Profit and loss statement	Balance sheet	Source and application of funds	Specific items[c]	Specific financial items	Construction	Machinery	Equipment	Specific items[d]	Further breakdown[e]
				x					
x	x	x		x					
x	x	x		x					
				x					
x			x						
x			x						
x	x			x					
	x			x					
x	x			x					
x	x			x					
x	x			x					
				x					
				x					
				x					
				x					
				x					
			x						
			x	x					
			x						
			x						
			x						
					x				
			x						
				x	x	x	x		x
				x					

Survey number	Number and type of reporting units[a]	Labour data: Employee count	Salaries and wages	Hours	Employee benefits	Further breakdown[b]
270B	328 companies					
275	42 industries and estab.					
278	1,000 companies					x
280	41,000 estab.	x	x	x	x	x
400	750 estab.	x	x		x	
401	150 estab.	x	x		x	
500	9 estab.					
501	104 estab.					
502	19 companies					
503	16 enterprises					
504	9 companies					
505	9 companies					
506	9 companies					
507	9 companies					
508	9 companies					
509	9 companies					
510	9 companies					
511	33 companies					
512	17 companies					
513	12 companies					
600	11 companies					
601	10 companies					
602	11 companies					
603	10 companies					
604	10 companies					
605	10 companies					
606	10 companies					
607	10 companies					
700	6,500 estab.					
702	12,000 estab.					
703	Companies[f]					
704	5,974 estab.					

Financial statements					Capital expenditure data				
Profit and loss statement	Balance sheet	Source and application of funds	Specific items[c]	Specific financial items	Construction	Machinery	Equipment	Specific items[d]	Further breakdown[e]
				x					
x	x	x		x					
x	x	x		x					
		x							
				x					
	x			x					
				x					
	x								
				x					
				x					
				x					
	x			x					
x				x					
	x			x					
	x			x					
				x					
	x			x					
	x								
x	x			x					
	x								
	x								
		x							
		x							
		x							
	x								
	x			x					
	x			x					
	x			x					
	x			x					

Survey number	Number and type of reporting units[a]	Labour data				
		Employee count	Salaries and wages	Hours	Employee benefits	Further breakdown[b]
706	5,974 estab.					
708	40 estab.					x
709	400 companies					x
710	165 estab.					
711	23,000 estab.					
712	23,000 estab.					
	Total of 188 surv.	54	56	12	16	33

Financial statements					Capital expenditure data				
Profit and loss statement	Balance sheet	Source and application of funds	Specific items[c]	Specific financial items	Construction	Machinery	Equipment	Specific items[d]	Further breakdown[e]
	x			x					
				x					
x	x			x					
				x					
58	62	20	40	98	16	12	13	1	5

Appendix C
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Securities Regulation: Problems in Relation to Sanctions

Leonard H. Leigh

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Chapter I
Introduction

This paper will, I fear, appear to be somewhat diverse in content. It is not a treatise, nor is it an article for a learned journal, but rather a working paper which is designed to raise policy issues for resolution prior to the preparation of legislation. It goes however beyond simple proposals for legislation as such, and discusses wider matters of contemporary interest and importance pertaining to the field generally. Thus, I have dealt with problems of sanctioning in their widest connotation, including both criminal sanctions and civil liability and aspects of matters allied to criminal and civil proceedings. It deals with investigations, and what might be considered as criminal intelligence or more broadly perhaps, the amassing of information about persons engaged in the securities business. Such matters as the possible oversight by a government body of self-regulatory agencies are also mentioned because they affect the way in which such agencies carry out their duties and the standard which they attain. This paper does not deal with self-regulatory agencies as such. That is the concern of other working papers. It does deal with cooperation between

I owe a debt to many of the other participants in the study and in particular to P. Anisman, former Director of Corporate Research, Consumer and Corporate Affairs Canada, and to Professor Warren Grover of Osgoode Hall Law School, York University.

various regulatory agencies and with other agencies generally involved in the field of criminal law and industry regulation.

Inevitably the paper lays stress on the U.S. Securities and Exchange Commission (SEC) practices. It also mentions in part the practices of the Ontario Securities Commission and other provincial commissions. The stress on matters American is attributable simply to the fact that the SEC is the largest and most sophisticated agency at work in this particular field.

No attempt has been made to cite all the available materials. My interest has been not in an exhaustive examination of all the possible case law and statute law available with a view to writing a treatise on the activities of one or more agencies, but rather to present a broad view of the types of sanctions and enforcement procedures used by regulatory agencies. My aim has been to ascertain what ideas and procedures we might find useful in Canada with or without any modification. Where, however, legal difficulties appear in Canada in relation to any part of the material, I have endeavoured to set out the relevant case and statute law in order to facilitate assessment of any recommendations contained herein.

Chapter II
Enforcement

A. THE EXISTING CRIMINAL CODE PROVISIONS (OUTLINE)

Certain types of offences related to securities are prohibited under Canada's Criminal Code. The provisions of the code and in particular the sections relating to false pretences, fraud and manipulation have been directed towards the grosser forms of fraudulent conduct. In addition, since the creation of regulatory commissions operating under statute, there have been a number of offences, contained in provincial securities legislation, directed toward the control of the securities industry in general. These go beyond fraud, ensuring that disclosure is made, that participants in the industry are adequately capitalized, that principals and salesmen observe standards of ethical conduct and that broker-dealers and other persons employing representatives supervise the activities of such persons. Breach of this latter group of standards may, typically, give rise to criminal prosecution, to intervention by civil process and to administrative sanctions. They contain matters of fundamental importance. Indeed, although in many cases breach of the rules laid down in the provincial acts cannot

firmly be attributed to fraud, the nonobservance of such rules is very often a first step in a fraudulent scheme. It is perhaps worth repeating the obvious point that persons can be damnified by overenthusiastic, albeit honestly made, representations as well as by schemes of fraud as such.

There appear to be at least three sets of problems relating to provisions prohibiting fraudulent conduct in the securities field. These are:

(1) Does the Criminal Code deal adequately with fraud?

While I do not deal with this question in this paper in detail, it seems appropriate to note that the ambit of the Criminal Code provisions on obtaining by fraud is extremely wide.[1] The relevant sections of the Criminal Code are:

False pretences. Section 320. This provision comprehends obtaining anything in respect of which theft may be committed or causing it to be delivered to another person, or obtaining credit by a false pretence or by fraud (a wider concept) or making a false statement in writing relating to the financial condition of himself or any person, firm or corporation with intent that it should be relied upon for the purpose of procuring, *inter alia*, the payment of money, the making of a loan, or the delivery of personal property.

Fraud affecting a public market. Section 338. This provision derived from the common law offence of conspiracy to cheat and defraud, penalizes (in subsection (1)) defrauding the public or an individual by any fraud, whether or not it is a false pretence, of any money, property, or valuable security. Subsection (2) is sufficiently important to warrant citation in full:

"(2) Every one who, by deceit, falsehood or other fraudulent means, whether or not it is a false pretence within the meaning of this Act, with intent to defraud, affects the public market price of stocks, shares, merchandise or anything that is offered for sale to the public, is guilty of an indictable offence and is liable to imprisonment for ten years."

Using the mails to defraud. Section 339. This penalizes use of the mails for the purpose of transmitting letters or circulars concerning schemes devised or intended to defraud the public or for the purpose of obtaining money under false pretences.

Fraudulent manipulation of stock exchange transactions. Section 340. This provision, derived from section 9(a) of the U.S.

1 For a detailed discussion *see* J. WILLIAMSON, SUPP., ch. 6.

Securities Exchange Act of 1934, was introduced into the Criminal Code in 1948.[2] It provides:

"Every one who, through the facility of a stock exchange, curb market or other market, with intent to create a false or misleading appearance of active public trading in a security or with intent to create a false or misleading appearance with respect to the market price of a security:

"(a) effects a transaction in the security that involves no change in the beneficial ownership thereof;

"(b) enters an order for the purchase of the security knowing that an order of substantially the same size at substantially the same time and at substantially the same price for the sale of the security has been or will be entered by or for the same or different persons, or

"(c) enters an order for the sale of the security, knowing that an order of substantially the same size at substantially the same time and at substantially the same price for the purchase of the security has been or will be entered by or for the same or different persons,

is guilty of an indictable offence and is liable to imprisonment for five years."

Gaming in stocks or merchandise. Section 341. This section penalizes gaming. It is intended to halt bucket shops in which the essence of the transaction is a bet upon whether commodities will rise or fall, under the guise of fictitious sales and purchases.[3]

Broker reducing stock by selling on his own account. Section 342. The essential thrust of this offence is to protect purchasers of shares on margin. It penalizes brokers who deal in shares on the margin for a customer and who, also dealing in such shares on their own account, reduce the amount of such shares in the hands of the broker or under his control in the ordinary course of business below the amount which the broker should be carrying for all customers.

False prospectus. Section 358. This section in fact goes beyond a prospectus as that term is commonly understood. It provides:

"(1) Every one who makes, circulates or publishes a prospectus, statement or account, whether written or oral, that he knows is false in a material particular, with intent:

2 *See* MARTIN'S CRIMINAL CODE, 1955 554 (J. Martin ed.).

3 Pearson v. Carpenter & Son, 35 S.C.R. 380 (1904); Beamish v. Richardson, 23 C.C.C. 394 (S.C.C. 1914); and *see* MARTIN'S CRIMINAL CODE, *supra* note 2, at 556-57.

"(a) to induce persons, whether ascertained or not, to become shareholders or partners in a company;
"(b) to deceive or defraud the members, shareholders or creditors, whether ascertained or not, of a company;
"(c) to induce any person to entrust or advance anything to a company, or
"(d) to enter into a security for the benefit of a company, is guilty of an indictable offence and is liable to imprisonment for ten years.
"(2) In this section, 'company' means a syndicate, body corporate or company, whether existing or proposed to be created."

Provincial legislation does not in general contain broad antifraud provisions. It is interesting that under the British Columbia statute a prohibition against insider trading is made a criminal offence.[4] Ontario Bill 20 also makes provision for this offence. It is proposed that contravention should be a summary conviction offence punishable in the case of a company with a fine of not more than $25,000 or in the case of an individual with a fine of $2,000 or to imprisonment for a term of not more than one year, or both.[5]

While this paper does not purport to deal with the substantive criminal law in detail, the difficulties to which the existing provisions have given rise render a few comments necessary on the following discussion of procedures and sanctions. The first and most obvious point is that the coverage achieved in the Criminal Code is wide. Virtually the only gap in the coverage provided by the Code relates to the obtaining of credit by fraudulent future forecasts which falls outside both the fraud and false pretence sections. This should certainly be put right and could be done by a minor legislative amendment to the definition of false pretence in order to make that definition cover representations concerning future conduct. In most securities cases, however, money or valuable security is obtained and therefore the fraud section readily applies.

The general fraud section, section 338, is a broad, functional provision which is not restricted to the technical definitions either of false pretence or of wash trading or other particularized forms of manipulation.[6] It applies both to stock and commodity markets. Mere nondisclosure of a material fact is not sufficient to convict. To deceive is defined as inducing someone to believe that a thing is true which is false and which the person practising the falsehood

4 British Columbia Securities Act, s. 111.
5 Ontario Bill 20, cls. 77, 121(1)(c).
6 R. v. Marquardt, 6 C.C.C. (2d) 372 (B.C.C.A. 1972); R. v. Knelson and Baran, 133 C.C.C. 210 (B.C.C.A. 1972).

knows to be false.[7] The test of manipulating a public market is said to be whether the activities were conducted not to stabilize the price of the securities involved, but rather to drive them up to a level disproportionate to their intrinsic value.[8] This test is of course impressionistic; it renders the provision one which can safely be employed only in very clear cases. The section has been employed in at least one insider trading case, *R. v. Littler*[9] where the accused obtained shares in a company from other shareholders by denying the truth of rumours of a lucrative takeover offer of which he later took advantage. Similarly, the false prospectus provisions have been given a broad and liberal construction.[10]

The most troublesome provision has been the anti-manipulation provision, section 340. It is not clear why prosecutions have been brought under this provision. As the essence of manipulation is fraud,[11] the general fraud section could, seemingly, be relied upon in any case. However, prosecutions brought under section 340 have encountered difficulties in proving intent to manipulate even where the existence of substantially matching orders could be shown. The difficulty is that stabilizing transactions for the purpose of effecting a block acquisition are lawful since matched orders are not unlawful *per se*.[12] There is also a potential problem in demonstrating matching. The difficulties posed by the section led a federal-provincial technical working group in 1966 to recommend redrafting section 340 and to suggest the enactment of a new section relating to the manipulation of an independent market.[13] There seems little doubt that, at least for a time, a lack of success in prosecutions brought under section 340 led to its nonuse.

(2) Have adequate sanctions been provided?

(3) Is the law being adequately enforced?

This can be taken to refer not only to whether proceedings are

7 R. v. Thornson, 39 C.R.N.S. 7 (Man. C.A. 1977); R. v. Brasso Datsun Ltd., 39 C.R.N.S. 1 (Alta. S.C. 1977).

8 McNaughton v. The Queen, 33 C.R.N.S. 279 (Qué. C.A. 1976); *see also* Klein, *Stabilizing Securities Prices*, 5 SEC. REG. L.J. 13 (1976).

9 65 D.L.R. (3d) 443, 467 (Qué. C.A. 1974); and *see* Johnston, Note, 2 CAN. BUS. L.J. 234 (1977).

10 Cox and Paton v. The Queen, [1963] 2 C.C.C. 148 (S.C.C.); R. v. Colucci, [1965] 4 C.C.C. 56 (Ont. C.A.); R. v. Scallen, 15 C.C.C. (2d) 441 (B.C.C.A. 1974).

11 Loomis, *Enforcement Problems Under the Federal Securities Laws*, in AMERICAN BAR ASSOCIATION, SELECTED ARTICLES ON FEDERAL SECURITIES LAW 177, 190 (H. Wander & W. Grienenberger eds. 1968).

12 I am indebted for some part of this discussion to J. Howard, Capital Market - Criminal Code (unpublished paper prepared for Canadian Bar Association Panel, August 23, 1974). *See* in particular R. v. Jay, [1965] 2 O.R. 471 (C.A.); R. v. Lampard, 4 D.L.R. (3d) 98 (S.C.C. 1969).

13 *See* J. Howard, *supra* note 12.

being initiated, but also to whether the courts are adequately punishing those offenders who are convicted.

In assessing the adequacy of enforcement procedures in this area, it must be borne in mind that the question which we face is wider than whether the legislation is being enforced in such a way as to minimize fraud in the purchase and sale of securities. There are further and other questions which confront us. Principal among these is the need for public confidence in the system of criminal justice. Public confidence in the administration of criminal justice should not be challenged by blatantly favourable practices conducted by white collar offenders. It may be the case, for example, that administrative sanctions will, in almost every instance, adequately deter persons from engaging in fraudulent or manipulative activities. Even if this were the case and it seems obvious enough that it is not, many persons might properly resent the fact that criminal proceedings were not taken against such persons while petty thieves were charged and convicted in a routine fashion in the criminal courts.

There are, however, general considerations which militate against simple reactions to the problem of enforcement. For example, the criminal law is a blunt instrument. It is a useful method where egregious cases of fraud are concerned provided that technical problems of the presentation and proof of cases can be overcome. To do so is often difficult; the line between impermissible manipulation and permissible stabilization can become so thin as virtually to be indistinct. In cases where fine discriminations must be made between permissible and impermissible conduct, proscriptions based upon fraud and the proof of fraud are often misplaced. Adherence to criminal provisions of this sort enforced either through the courts or administrative bodies results in inefficacious enforcement procedures or, as in the United States, the erosion of traditional *mens rea* concepts in order to maintain the integrity of the enforcement procedures.

The latter development has been very marked in securities regulation.[14] In effect, we need not only criminal sanctions directed towards clear frauds in securities regulation as in other regulatory areas, for example income tax, but also provisions and sanctions which relate to a host of reporting and similar requirements where we cannot afford the luxury of abstaining from enforcement until fraud can be shown. We need strict provisions enforced either through the lower criminal courts or administrative bodies. Where the legality of conduct involves fine discrimina-

14 James, *Culpability Predicates for Federal Securities Law Sanctions: The Present Law and the Proposed Federal Securities Code*, 12 HARV. J. LEGIS. 1, 1-62 (1974).

tions, intelligible technically to specialists and appropriate to the regulation of activities engaged in the industry, administrative controls are imperative.[15] Furthermore, in evaluating enforcement schemes we must look both at the totality of the problem and the totality of the response. It would, for example, be wrong to overlook the regulatory impact of noncriminal procedures, or *a priori* to ascribe their use simply to class favouritism. Crude attitudinizing is not helpful.

Subject to the above comments, crimes in relation to securities where the conduct involved is fundamentally fraudulent, ought, in my submission, to be dealt with in exactly the same way as any other crime of dishonesty. The normal decision in a clear fraud case would be to proceed by criminal prosecution. There are of course valid reasons for determining not to prosecute in particular cases. These are, in general, personal to the offender. Among them might be the stale character of offences, grave illness or senility on the part of the offender, the isolated nature of the occurrence and so on. In addition the sheer complexity of securities cases may require an agency to be somewhat selective in its prosecution policies.

The difficulties encountered in the enforcement of securities legislation are dealt with by Ogren.[16] He points out that in stock manipulation such activities are usually engaged in by a well-financed, sophisticated group of individuals including brokers, bankers and promoters who carefully arrange and conduct widespread purchases and sales of stock through nominees. In such a case the SEC will usually order an investigation only when the price of stock has collapsed and the investor has taken a loss. The SEC must then analyze buy/sell orders, it must trace bank accounts and financing arrangements. It is not unusual for a criminal reference by the SEC to the United States attorney's office to take place several years after the offence, when the witnesses have dispersed and the evidence is stale. Such cases can go on in the United States for several years after proceedings are instituted. Similar difficulties have been encountered in Canada under the anti-manipulation section of the Criminal Code.

We recognize that generally there can be no arbitrary divorce between enforcement policy and substantive law. The two clearly interact. Few enforcement authorities are prepared to waste time

15 *See e.g.* L. Loss, Proposals for Australian Companies and Securities Legislation: Comments from the American Experience (July 13, 1973) (Report tabled by Attorney-General of Australia in Senate, September 12, 1973), CCH AUST. SEC. L. REP., Special Report, September 20, 1973.

16 Ogren, *The Ineffectiveness of the Criminal Sanction on Fraud and Corruption Cases: Losing the Battle Against White-Collar Crime*, 11 AM. CRIM. L. REV. 959 (1973).

and money prosecuting persons under provisions which are practically unenforceable. Other factors which militate against a decision to prosecute are high costs, undermanned enforcement agencies, and perhaps deliberate policies of attempting to enlist the support of industry.[17] Of course some of these difficulties do not exist in Canada to the same extent that they exist in the United States. The difficulties encountered in the United States may have prevented the SEC from pursuing vigorously a policy of prosecuting in cases of fraud. The SEC annual reports however note a number of fraud prosecutions undertaken each year with, as far as we can determine, satisfactory results. Philip Loomis argues that the most significant shift in enforcement emphasis since 1959 has resulted from the increased willingness of United States' attorneys, particularly in New York and other large metropolitan areas, to undertake the complex task of investigating and prosecuting large complicated securities fraud cases. Providing necessary cooperation in this area has become a major part of the commission's enforcement effort.[18] However, it has been said by a former member of the commission that there is a failure to use the criminal provisions sufficiently in fraud cases and that this is one of the real shortcomings of securities law enforcement.[19] Problems of complexity must not be allowed to dominate the prosecution function.

There has been controversy over the best method of deterring so-called "economic" or "white-collar" crimes. The terms signify a rough description of the offence or the offender. They do not define constituent elements peculiar to any particular type of offence. Andenaes uses the term "economic crime" to denote crimes against governmental regulation of the economy and states that:[20]

> "Psychologically we can also put customs and tax evasion in this group, although logically these crimes belong in the fraud category."

Any temptation to do so in the realm of securities fraud should be resisted. That such temptations exist seems clear. The fraud employed in manipulating a market may lack the immediacy of

17 Seymour, *Social and Ethical Considerations in Assessing White Collar Crime*, 11 AM. CRIM. L. REV. 821 (1973) notes that the SEC has so few personnel that it can only audit the books of each mutual fund in New York once every 17 years.

18 J. Howard, *supra* note 12. SEC enforcement policy is also outlined in Matthews, *Criminal Prosecutions Under the Federal Securities Laws and Related Statutes: The Nature and Development of SEC Criminal Cases*, 39 GEO. WASH. L. REV. 901 (1971).

19 *See*, *Securities Enforcement: A Growth Industry - Cops Patrolling The White Collar Beat*, 397 BNA SEC. REG. & L. REP., June 6, 1977, at AA-1.

20 Andenaes, *General Prevention - Illusion or Reality*, 43 J. CRIM. L. CRIMINOLOGY & POLICE SCIENCE 179 (1952).

impact of, for example, the traditional false pretence in which a shopkeeper hands over goods in return for a worthless cheque. Because the mechanics of the offence may be little understood and its effects while widespread are not something with which the general public identifies, there may be a tendency to employ administrative measures. The use of noncriminal sanctions in relation to economic crimes is common in the United States and there is a considerable literature on the subject. We do not feel that the fraud offences should be denatured by the exclusive use of administrative sanctions. Serious fraud should be punished criminally. The considerations commonly advanced favouring administrative sanctions for economic offences really do not apply here. The conduct proscribed has traditionally been considered to be criminal. Laws against fraud are not novelties in business circles. The offences are clearly not minor.[21] Furthermore, we must now reckon with an organized crime element in the Canadian securities market. A British Columbia report concluded:[22]

> "The law enforcement agencies have estimated that approximately 20 to 30% of the mines and local junior industrial stocks listed on the Vancouver Stock Exchange are manipulated."

It is right to record that the Vancouver Stock Exchange has disputed the extent of manipulation, but not that there is manipulation in fact.[23] RCMP officers have concluded that stock frauds are an area into which organized criminals enter.[24] None of this need occasion surprise; the SEC has for some years been concerned by the problem, and the intervention of organized crime into such conceptually related areas as tax frauds has become a matter of note in Europe in recent years.[25]

We have already drawn attention to some of the obvious dangers. One tendency is to stay prosecution in the hope of enlisting the support of the industry. In this respect U.S. experience is not encouraging. The Sherman Act (on antitrust) is, for example, criminal in form. In a series of pioneering studies the late Professor Sutherland found a pattern of recidivistic infractions of the Act by

21 For general discussions of this issue, *see* Kadish, *Some Observations on the Use of Criminal Sanctions in Enforcing Economic Regulations*, 30 U. CHI. L. REV. 423 (1963); Ball & Friedman, *The Use of Criminal Sanctions in the Enforcement of Economic Legislation: A Sociological View*, 17 STAN. L. REV. 197 (1965).

22 CO-ORDINATED LAW ENFORCEMENT UNIT, INITIAL REPORT ON ORGANIZED CRIME IN BRITISH COLUMBIA (Dept. of the Attorney-General, 1974).

23 The Globe and Mail (Toronto), October 29, 1974, at B16, col. 1.

24 *Canada's Top Criminals Move into Big Time Fraud*, The Globe and Mail (Toronto), April 2, 1975.

25 *See* J. MACK, THE CRIME INDUSTRY (1975); J. COSSON, LES INDUSTRIELS DE LA FRAUDE FISCALE (rev. ed. 1974).

some seventy large corporations. He attributed such infractions in part to the use of noncriminal sanctions, which enabled the business institutions concerned to escape the stigma of criminality. As Sutherland states when speaking of crimes dealt with in Federal statutes pertaining to anti-trust and similar regulatory legislation:[26]

> "The violations of these laws are crimes...but they are treated as though they were not crimes, with the effect and probably the intention of eliminating the stigma of crimes."

Furthermore, no consistent policy was adopted with respect to the manner of proceeding against violators. Enforcement policy on antitrust has of course been inhibited by other factors, notably the notoriously vague content of the Sherman Act. In only a minority of cases, where clarity had been achieved by judicial decision, was the apt remedy thought to be in prosecution.[27] While Sutherland's study has been criticized as too loosely drawn for analytical purposes, it has considerable value, not least in noting the ambivalence with which offenders were regarded both by the courts and the public. It further stresses the problems which arise when enforcement policy is inconsistent.

Some of the enforcement problems which can arise are stressed by M. Clinard's study of the wartime black market operating in the United States. Many violations were felt by the Office of Price Administration (OPA) to be wilful, but in only a minority of cases was evidence found that was sufficient to lead to a criminal conviction. Most cases were not disposed of by prosecution. Only 6% of some 289,966 cases of violations were prosecuted. By the end of the war the OPA policy of cooperation with businessmen was found to be in ruins. Administrative measures did not suffice. While imprisonment was the sanction most feared by businessmen, it was seldom employed. Enforcement became ineffective.[28]

A further study by R. Lane throws light upon another aspect of the problem.[29] It has been asserted before the Ontario Securities Commission that violators were unaware of commission policies, though the policies in question had been promulgated in the commission's Bulletin.[30] Lane's findings cast some doubt upon the validity of such excuses. He concludes that most violations of regulatory offences are either wilful or the result of inadvertent

26 *See*, *Is "White Collar Crime" Crime?*, 10 AM. SOC. REV. 132, 136 (1945).
27 *See* Kramer, *Criminal Prosecution for Violation of the Sherman Act*, 48 GEO. L.J. 530 (1960).
28 *See* M. CLINARD, THE BLACK MARKET (1952).
29 *See* R. LANE, THE REGULATION OF BUSINESSMEN (1954).
30 [1961] OSC Bull. 1 (March).

misapplication of legal provisions. Violations resulting from ignorance of legal provision were less common. These findings have a bearing on policy, particularly where offences are on (if not over) the borderline of fraud. In the area of securities regulation we are dealing with a fairly closely knit community to the members of which commission policy must be familiar.

These considerations were also considered by judges of the U.S. Federal Courts in a Pilot Institute on Sentencing.[31] Among the topics discussed was sentencing of the income tax violator. Some of the matters referred to are clearly pertinent here. The first factor to which attention was drawn was a remarkable disparity of sentences. This is said to result from judges according different weight to some characteristics of the offenders, notably their previous good reputations in business and civic activities, though a recent study suggests that such variations were found in sentencing for a wide range of crimes.[32] The weight to be given to such considerations is disputed. We would agree with Judge Boldt who states:

> "The gifted and fortunate person has a high stake in our society and a special responsibility for setting standards of conduct and for providing an example of obedience to and compliance with the tax statutes as well as all other civil and criminal laws. The few of such individuals who deliberately breach their duty hardly are deserving of more lenient treatment than those not so talented and less favoured in education, position and wealth.[32a]

We would further agree with Judge Boldt and Judge McIlvaine that initially the primary purpose of sentencing in tax matters must be deterrence. We consider that this is also true in the area of securities fraud. We recognize that in securities fraud, the professional swindler is likely to be involved. The judges distinguished between situational offenders who, for example, succumb to temptation and embezzle and the aggressive person who considers himself to be a sharp promoter rather than a criminal. We do not think that this latter type of offender should be afforded the luxury of such a rationalization. Furthermore, the U.S. federal judges regard this latter type of offender as a poor rehabilitation

31 *See* 26 F.R.D. 264 (1960).

32 A. Partridge & W. Eldridge, The Second Circuit Sentencing Study (Federal Judicial Centre 1974).

32a 26 F.R.D. at 268.

risk.[33] The view was also expressed that lenient treatment for "white-collar" offenders may lead to public disrespect for the law.

There is another pertinent analogy from the tax field. Judge Boldt points out that the system is really one of self-enforcement based on expected integrity in compliance from the majority of tax payers and states:

> "That system could easily and quickly collapse if its basic assumptions failed and fraud by individuals in their self-assessment of tax liability occurred in any substantial frequency.[33a]

The same considerations pertain to the securities field. An attempt has been made to cause the industry to police itself within a broad framework of control.[34] Unless the available sanctions are used in cases clearly warranting their application, self-regulation could break down. If offenders were subject to adequate sanctions, the industry might well feel it to its advantage to subsidize more heavily its institutional means of control. And the institutions concerned would have a greater ability and incentive to police the activities of persons therein engaged more rigorously. This in turn could alleviate the burdens facing regulatory agencies, enabling them to reserve their energies for the more serious forms of conduct. It should also lead to a more consistent and thorough policing policy. The impact of the criminal law and of administrative enforcement should become more comprehensive and better understood, both generally and in the eyes of the industry. At present, for example, the criminal law appears (at any rate to the outsider) capricious in its incidence. Indeed, in the U.S. the SEC has been criticized for reliance upon consent decrees. It is alleged that while this may be effective in sparing the SEC inconvenience and expense, it engenders the belief among investors and others that villains go unpunished and the market is insufficiently policed.[35]

A policy of substantial reliance on administrative measures in

33 Though this view is certainly not unanimously held; *See* the remarks of Judge Carter in 26 F.R.D. at 356 and in particular his scepticism about deterrence. Again, we would emphasize that in securities fraud the impact of conviction will be felt by a relatively small segment of the community. Interestingly perhaps, the U.K. Parole Board takes a similar view of the unsuitability of parole to offenders whose livelihood is fraud. I am indebted to the late Lord Justice James and to Sir Louis Petch for information.

33a 26 F.R.D. at 268.

34 For discussion of the U.S. experience *see* Knauss, *A Reappraisal of the Role of Disclosure*, 62 MICH. L. REV. 589 (1964); Cary, *The Special Study of Securities Markets of the Securities and Exchange Commission*, 62 MICH. L. REV. 557, 566 (1964).

35 Sargent, *The SEC and the Individual Investor. Restoring His Confidence in the Market*, 60 VA. L. REV. 553 (1974); Editorial, *Aiming at Wrong Target*, The Commercial and Financial Chronicle, July 8, 1974, at 6, col. 1.

cases where egregious conduct falls squarely within the Criminal Code may lead to undesirable social consequences. The primary aim of the criminal law in the field of securities offences must be deterrence. Deterrence must be directed towards those active in the field. It does not depend entirely upon a Benthamite criminal weighing the formal penalty likely to be inflicted against the amount of money which he can be expected to gain. As Andenaes has pointed out, modern penal theory postulates deterrence as a general aspect of a system of social control. He states:

> "The idea is that punishment as a concrete expression of society's disapproval of an act helps to form and strengthen the public's moral code and thereby creates conscious and unconscious inhibitions against committing crime."[36]

Thus deterrence is not only a function of fear. It does, however, suggest that legal prohibitions have a long-term effect in strengthening and perhaps creating general moral inhibitions as well. For our purposes both aspects are of importance. Punishment, Andenaes states, may have a deterrent effect, a moralizing effect and may stimulate habitual law-abiding conduct. Of these functions, the latter two are of long-term importance.

If one adopts Andenaes' theory the possibility of undesirable consequences from overemphasis on purely administrative sanctions becomes evident. No small part of punishment lies in the stigma and publicity given to the offence. It is interesting that Canadian and American securities commissions make extensive use of publicity for sanctions of all sorts. Both as an information device and an aid to deterrence, the use of publicity would seem to be a commendable development. The offender loses status to the extent that society reprobates or can be made to reprobate the crime. One would expect this loss of status to reflect later in general inhibitions against such conduct. If securities offenders appear to receive preferential treatment, this valuable long-term effect may be substantially lost.[37] An ineffective system and a want of values and controls may lead to an exaggerated reaction in which exemplary sentences may be imposed in an attempt to recover lost ground. Furthermore, undue leniency could cause a public lack of confidence in enforcement agencies. Both the public and those active in the industry may derive the impression that

36 *See* Andenaes, *supra* note 20.

37 *See e.g.* Bosly, *Les frontières de la répression pénale en droit économique*, [1972-73] REVUE DE DROIT PÉNAL ET DE CRIMINOLOGIE 137; Matthews & Sullivan, *Criminal Liability for Violations of the Federal Securities Laws: The National Commission's Proposed Federal Criminal Code, S. 1 and S. 1400*, 11 AM. CRIM. L. REV. 883 (1973) argue for a clarification of prospectus fraud and false filing offences as felonies in order to emphasize the seriousness of such conduct.

fraudulent and manipulative practices are not strongly reprobated.[38] An unhealthy ambivalence in attitudes could result. Furthermore, as we have noticed, unhealthy stresses in the community could become evidence if other categories of offenders appeared to receive condign sentences.

Interestingly enough the tendency to overcompensate is found in some sociological writings. Thus Ogren in his article complains that whilst extensive fraud cases are in progress accused persons are likely to be free on bail during the entire process.[39] Such persons he suggests carry on business as usual for a number of profitable years. This may of course be so. But, it is surely not desirable that accused persons in complicated cases be held in custody during the entire period of investigation and trial. It would be intolerable in our system to have cases like *Matznetter* and *Stogmuller* where the accused persons spent years in an Austrian prison awaiting the bringing of their case to trial and the end of the pretrial investigations. These cases have justly been considered a blot on the record of the country concerned.[40] It is obviously desirable that securities fraud cases be treated as fraud cases. It is not desirable to overreact, subjecting securities or suspected securities offenders to treatment of an exemplary character. We must treat crimes as crimes. We must not allow honest indignation to distort the whole of the criminal justice system.

Similar concerns have been voiced about sentences imposed upon white-collar offenders in relation to fraud offences. Thus, for example, Seymour in a general survey of the topic contends that there is an unwelcome disparity in the sentencing of common criminals and white-collar criminals.[41] He refers to a sentencing study conducted in 1972 in the southern district of New York. That study indeed revealed that white-collar offenders, primarily white, received more lenient treatment than persons charged with common crimes, a group of offences largely committed by unemployed and undereducated persons. The latter (deprived) group is more likely to be sent to prison. In relation to securities matters prison was invariably awarded for the theft of securities, but for securities fraud offences 66% of convicted offenders went to prison and for a lesser term than the average common criminal. There were lighter sentences still for tax evasion.

Seymour from these findings argues that there is a need for a more evenhanded approach to sentencing; that the basic sen-

38 This concern is particularly stressed in Sargent, *supra* note 35.

39 Ogren, *supra* note 16.

40 12 Y.B. European Convention on Human Rights 364, 406 (1969); *see also* the case of Neumeister, 11 Y.B. European Convention on Human Rights 826 (1968).

41 *See, supra* note 17.

tencing structure employed by the United States' courts is unfair. Among his recommendations are: the collection of data on sentencing for circulation to the judges, annual sentencing institutes within the various circuits, annual conferences on sentences with a goal of seeking common policy and an emphasis on deterrence in white-collar crimes. He thus recommends fixed sentences to be served in institutions where the primary aim is custodial rather than rehabilitative. No parole should be allowed.

The general concern that underlies this sort of discussion may be applauded. No doubt some of the practical matters stressed in writings on white-collar crime can usefully be employed in enforcement. The deterrent value of prison terms in relation to white-collar offenders is now well documented. There is no reason why someone of an upper socio-economic level should be better treated than someone from the ghetto. There are, however, aspects of these arguments that bother me.

In the first place it is by no means clear that in the United States at any rate, sentences imposed upon securities offenders are unduly lenient. It is true that there are cases noted in the SEC annual reports at which one expresses surprise that a prison term was not awarded. Lenient sentences are also sometimes awarded in Canada. On the other hand, both in the United States and in Canada there are abundant examples of substantial prison terms being imposed for fraudulent and manipulative conduct. Recently, for example, we have seen forthright statements in Canadian and United States courts that white-collar offenders are not to be placed in a privileged position. In *R. v. Ocean Construction Supplies Ltd.*[42] a case of conspiracy to violate the Combines Investigation Act, the court held that fines in such cases ought to be high enough to convey a sense of shock. Prison sentences for manipulation have been handed down.[43] In a Québec decision, *R. v. Littler,* [44] prison terms of two years were imposed in a case of fraud contrary to section 338(1) of the Criminal Code where the accused, by misrepresenting his intentions and not disclosing to his vendor a more favourable offer for the vendor's shares was able to purchase at a low price and sell at a substantial profit.

In the United States there have been several examples of prison sentences imposed in cases of securities fraud.[45] When

42 18 C.P.R. (2d) 166 (B.C.C.A. 1974).

43 *E.g.* Nantel v. The Queen, 26 C.R.N.S. 359 (Que. C.A. 1973); R. v. Kirsh (Ont. H.C. 1977) (unreported decision of Haines, J.); and *see, Lawyer Sent to Jail for Fraud Conspiracy,* The Globe and Mail (Toronto), November 13, 1976.

44 65 D.L.R. (3d) 443, 467 (Qué. C.A. 1974).

45 *E.g.* the prison sentences handed down in the wake of the Equity Funding Affair; *see* The Wall Street Journal, April 15, 1975, at 22, col. 3 (Fred Levin); The Wall Street Journal, March 26, 1975, at 13, col. 1 (noting prison terms of up to eight years for the

counsel had the temerity to argue for a lenient sentence for his client, basing the argument upon a survey which showed that white-collar offenders generally obtained better treatment than ordinary thieves and burglars, the court, expressing the view that such a situation was scandalous, imposed a twenty-five year sentence for crimes of pledging stolen securities.[46] There are, it seems, occasions in which recourse to the "Brandeis brief" is at least unwise.

No doubt the courts sometimes err on the side of leniency in the area of securities fraud: but there does not appear to be any reason to think that the courts consistently treat offenders too leniently. There is, however, a body of informed opinion to the contrary emanating from persons now or formerly active in securities enforcement;[47] and one must recognize that the *SEC Annual Reports* may contain only the most prominent cases arising from year to year. In addition it is not altogether clear that the courts ought to view all cases of fraudulent and manipulative conduct as of the same gravity as cases of, for example, robbery. For some robbery cases may have involved substantial danger or even actual injury to the person of the victim. At any rate, before determining that the courts inevitably treat such offences leniently and arguing for further and exceptional measures, one ought to be sure that the crude figures do indeed represent a policy of favouritism or even an unconscious tendency in that direction.[48]

Even if there were a policy of favouritism or such a tendency, it is not clear to me that structural changes in the law are desirable.[49] The Criminal Code at present contains adequate maximum sentence provisions. It seems to me admirable that sentencing institutes should be held where the judges and others active in the field can discuss the problems involved in sentencing securities offenders. The notion of devising special sentences and special inhibitions on parole do not appeal to me. I would not in the least wish to argue against the position taken by some American

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president of the fund, five years to one vice-president, and up to two years for lesser officials); and a note of an even harsher sentence in, The Wall Street Journal, March 31, 1975, at 4, col. 3; and *see also* U.S. v. Sloan, 388 F. Supp. 1062 (S.D.N.Y. 1975); U.S. v. Ashdown, 509 F.2d 793 (5th Cir. 1975).

46 Browder v. U.S., 398 F. Supp. 1042 (D.C. Ore. 1975).

47 Sargent, *supra* note 35; Matthews & Sullivan, *supra* note 37; A. Sommer, *Sentencing,* 272 BNA SEC. REG. & L. REP., October 9, 1974, at A-12, arguing for more criminal prosecutions and judicial awareness of a need for substantial sentencing. There is a tendency to treat all white-collar offences as though they were a single entity; *see* Miller, *Respectability Helps if You're a Crook,* The Washington Post, July 7, 1974 at B1, B3. I doubt the validity of this approach.

48 I have argued these points more fully in L. LEIGH, POLITIQUE ET MESURES PÉNALS RELATIVES AUX INFRACTIONS ÉCONOMIQUES (Council of Europe 1976).

49 *See* for a similar view, Sommer, *supra* note 47.

judges.[50] There is evidence to suggest that deterrence can work in this area. The position against which I would argue is that the white-collar offender ought to be assimilated in treatment to, if not placed under more onerous restrictions than, other criminals in respect of other crimes, without examining whether indeed the emphasis upon long sentences in general is appropriate. And even if one is obliged to accept an emphasis on long sentences as applicable to all manner of men, we ought surely before proceeding to consider exemplary penalties to be sure that there is in fact differential treatment in favour of the securities offenders and if there is such treatment, that it is due to structural factors such as the limited maximum sentence which could be awarded under the relevant legislation. Above all, we should be clear in our search for equality what the needs of deterrence and law enforcement generally are. There is something surely to be said for the unconventional wisdom of the court in a U.S. antitrust case which holds that deterrence is only one end of punishment, that prison is the exception which must be justified and that it should be reserved for cases of clear fraud.[51] We would agree with the U.S. federal judges who, considering the prospect of imprisonment to be a very severe punishment to business offenders, suggest that what is required is a reasonable certainty of relatively mild punishment. There is evidence to suggest that the publicizing of the available criminal penalties may itself have an effect.[52] There are of course professional swindlers who ought to be proceeded against with severity. In general moderate terms of imprisonment together with administrative sanctions would, we hope, suffice. In some cases where a fraudulent scheme is intricate and carefully worked out, affecting substantial numbers of people and involving much money, the court will have to consider both the effect on the community and the deterrent value of the sentence.[53] We should recall, however, that criminologists and others question the desirability of long sentences.

There is now much scepticism concerning the reformative potential of prolonged imprisonment. It is no longer agreed that short sentences are ineffective as deterrent. One must, of course, balance humanitarian considerations with the needs of deter-

50 *See* text accompanying note 31 *supra*.

51 U.S. v. Alton Box Co., 2 Trade Cas. ¶61,190 (E.D. Ill. 1976); Note also the attempt in the United States to devise a suitable sentence which will deter without imposing custodial sentence; Renfrew, *The Paper Label Sentences: An Evaluation*, 86 YALE L.J. 590 (1977).

52 *See* N. WALKER, SENTENCING IN A RATIONAL SOCIETY 59 (1969).

53 For a general account, *see id.* c. 4.

rence, the protection of the public, general deterrence and a denunciation of the offence.[54] The balance need not tilt on the side of very long sentences.[55] The question whether fraud offenders should be paroled should rest with the parole board. It should not be absolutely excluded for deterrent reasons. Nor should we engage in scapegoating; we cannot assume that all persons who violate the securities laws necessarily approximate to the stereotype of the Benthamite criminal. Here, as elsewhere, individualization of punishment is possible within limits.[56] Above all, it would be unfortunate if a policy were adopted of attempting to remedy deficiencies in systematic enforcement by the occasional sporadic imposition of very long sentences.

1. *Administrative Offences*

Another group of offences are typically regarded as administrative in character, such as requirements for the registration of persons or of securities, or bookkeeping or capital rules applicable to broker-dealers. Breach of these rules is made criminal even though no intent to defraud the public has been proven. Yet, as these requirements stand at the centre of regulatory schemes, they cannot be treated as of minor importance. Some of them are of crucial significance and failure to enforce them may jeopardize the entire system. Under section 5 of the U.S. Securities Act of 1933, for example, criminal penalties are provided for wilful violations of the registration requirement. This is a serious offence which, while requiring a wilful violation, does not in fact require intent to defraud but requires simply intent to do or not to do what the statute requires. The provisions of this section are relied upon increasingly by government in order to combat illegal securities distributions.

The registration requirements appear to be one of the most significant pressure points in this area. Violations of the section are not treated as mere technical violations, but as serious breaches of the law. Matthews argues that these should be regarded as substantial violations.[57] The public disclosure required by the registration provisions of section 5 are the backbone of federal securities laws. Emphasizing the significance of these provisions, he

54 *See in general* R. CROSS, PUNISHMENT, PRISON AND THE PUBLIC 98-108 (1971).

55 For a Canadian expression of this view, albeit in a somewhat different context; *see* R. v. Gorman, [1971] 3 O.R. 364 (C.A.); R. v. Johnson, [1971] 3 O.R. 744 (C.A.).

56 *See e.g.* R. Hood, Tolerance and the Tariff, (1974) (NACRO Paper No. 11); R. VERNET, LES INTERDICTIONS PROFESSIONELLES 238-39 (1969); *cf. Department of Justice, Guidelines for Sentencing Recommendations under the Sherman Act*, 803 BNA ANTITRUST & TRADE REG. REP., March 1, 1977, at A-7.

57 Matthews & Sullivan, *supra* note 37.

states that in some cases when an "inside" witness is not available to testify to the formation of a fraudulent scheme, the SEC is able to prosecute large-scale fraudulent distributions of grossly over-priced securities only under section 5, where the government's burden of proof is usually limited to showing that the defendants acted wilfully, that an interstate public offering occurred, and that no registration statement was filed with the commission. In such cases, a section 5 violation cannot be viewed as merely a technical violation.

One of the principal defects which Matthews notes with certain U.S. law reform proposals is a failure to provide sufficiently stringent penalties for misfilings. Such practices should be considered as extremely serious offences. It is perhaps anticipating to suggest that the same point occurs or may occur in Canada. But there seems in fact little reason to doubt the central importance of prospectus or insider provisions. It may be thought desirable ultimately to make them strict-liability offences with a due diligence defence and provide for stringent fines and imprisonment in cases where the defence is not made out. In other words, it may ultimately appear unwise either to stipulate wilfulness as a necessary constituent element of the offence, or to avoid making provision for the imposition of criminal penalties, including imprisonment, where a due diligence defence is not made out by an accused person. There are stringent strict-liability crimes in the Canadian statute book, generally made subject to due diligence defences and this seems a suitable precedent upon which to act.[58]

The same strict-liability approach is advocated in respect of other serious violations of important regulatory provisions and obligations, such as, for example, the duty to supervise salesmen and others working for a registered person.[59] Again, the activities of such persons are crucial to the maintenance of an orderly market in securities. It will be recalled that one of the principal reasons why Investors Overseas Services (IOS) collapsed in Germany with disastrous consequences was a failure on the part of the company to regulate the practices of its salesmen and its sales managers. It is not necessary to outline in detail the sorts of abuses which took place. It is, however, appropriate to point out that where duties of supervision are commonly neglected, opportuni-

58 *E.g.* Canada Water Act, R.S.C. 1970 (1st Supp.), c. 5, s. 31; and *see* NATIONAL COMMISSION ON REFORM OF FEDERAL CRIMINAL LAWS, STUDY DRAFT OF A NEW FEDERAL CRIMINAL CODE, s. 404(4) (1970). The Canadian provisions are collected and discussed in Leigh, *The Criminal Liability of Corporations and Other Groups*, 9 OTTAWA L. REV. 247 (1977) (author's submission to the Law Reform Commission of Canada 1973).

59 The crucial significance of control systems is stressed by Hanson, *Focus on Fraud*, THE FINANCIAL EXECUTIVE, March 1975, at 4.

ties to defraud investors will be taken. This seems to be another area in which we ought to provide for adequate penalties. It is, of course, not necessary that a fine or imprisonment be imposed in every case of, for example, failure to supervise. Most cases can no doubt be dealt with administratively. Where, however, there appears to be an unexplained and serious neglect of supervisory responsibilities, criminal proceedings may well be thought appropriate.[60]

The structure which I advocate is precisely the same as that advocated in relation to registration offences. There ought to be strict liability in order to enforce an affirmative duty. There ought to be a due diligence defence. There ought to be the possibility of imprisonment in cases where the failure to supervise is egregious. Such cases would include those where management was, in fact, aware of circumstances which ought to have caused it to discharge its supervisory responsibilities. The case would be *a fortiori* where management simply decided to do nothing about a well-known problem.

Certainly there should be a maximum in such cases considerably in excess of the $500 fine or six months' imprisonment often stipulated in strict-liability cases. It is noteworthy that much recent legislation, for example dealing with marine pollution, employs strict-liability offences, due diligence defences, with, in theory at least, condign penalties. I would recommend, therefore, that provisions which are significant to the scheme of regulation, ought to be regarded as fundamental and a deterrent structure of potential penalties should be provided for. In respect of particularly serious infractions, this will, one hopes, prove to be a meaningful approach to the problem. As I have noted, it will not be necessary to proceed by criminal prosecution in every case of violation.[61]

In addition, we should provide for a judicially imposed disqualification on persons from acting in the securities industry or, so far as the constitutional powers of the Parliament of Canada extend, acting in the management of a company, where the person concerned has been persistently in default in complying with any of the reporting requirements of securities or company legislation. Power to apply for a disqualification should rest in the Minister of Consumer and Corporate Affairs. The Federal Court should have power to disqualify for a period of at least five years. The power could be exercised by the court either consequent upon conviction or upon the imposition of an administrative sanction by a commis-

60 For an example of such a case *see* C. RAW, B. PAGE & G. HODGSON, DO YOU SINCERELY WANT TO BE RICH? (1971).

61 The Quebec Securities Commission has already begun to act severely in such cases; *see*, *The Hard Cell*, The Financial Times (Toronto), May 30, 1977, at 31, col. 1.

sion. A similar provision now exists in section 28 of the U.K. Companies Act 1976.

2. *Defences*

A further problem concerns defences. We have argued for a due diligence defence in relation to regulatory offences. We suggest that in this connection provision should be made for a defence of reliance upon legal advice sought and tendered in good faith. At the moment U.S. courts hold that while reliance on an opinion by counsel may constitute a defence where crime requires specific intent, it affords no defence if only knowledge of the facts is required.[62] It should not be crucial to the defence that advice from a lawyer is wrong, unless indeed it is so obviously erroneous or so clearly based on an inaccurate appraisal of the facts as to permit the jury to speculate on the good faith of the accused.[63] On the other hand, reliance on the opinion of counsel ought not to constitute a defence where it is based upon assumptions which the accused person knew were erroneous either in whole or in part.[64] Such a provision applies under section 1517(b)(3) of the proposed *ALI Federal Securities Code*, but in an unduly laconic form, it being simply stated that:

> "(3) Advice of counsel is relevant but not conclusive in determining whether a person violates intentionally or recklessly..."

Apart from the rather skeletal character of this section, it is defective in not specifying whether it relates to mistake of fact or of law. It seems, however, that it must be the latter which is meant. The *ALI Code* does provide a "reasonable reliance" defence. The proposed Federal Criminal Code of the ALI, section 609, appears to be more restrictive, but this is not, I think, the case. Section 609 provides in part:

> "[A] person's good faith belief that conduct does not constitute a crime is an affirmative defence if he acted in reasonable reliance upon a statement of the law contained in:
> "(a) a statute or other enactment;
> "(b) a judicial decision, opinion, order or judgment;
> "(c) an administrative order or grant of permission; or
> "(d) an official interpretation of the public servant or body charged by law with responsibility for the interpre-

62 United States v. Hill, 298 F. Supp. 1221 (D. Conn. 1969); Kroll v. United States, 433 F.2d 1282 (5th Cir. 1970).

63 United States v. Crosby, 294 F.2d 928 (2d Cir. 1961).

64 United States v. Nardi, 330 F.2d 316 (2d Cir. 1964).

tation, administration or enforcement of the law defining the crime."

The notes to the section suggest that in most instances it would be unreasonable for a layman to fail to consult a lawyer and he would not act in good faith if he failed to make full disclosure to the lawyer of all relevant facts.

A section of this sort could be adopted with advantage.[65] The Federal Criminal Code form is, I think, superior. It would validate action taken in reliance on a statement from the commission, as well as on reliance on the advice of counsel.

A further provision that might be included is section 1517(c)(3) of the *ALI Federal Securities Code,* which provides that a person may not be sentenced to imprisonment for violation of a regulation or order that is not a violation of the code apart from the regulation or order if the court is satisfied that he was not aware of the rule or order. Indeed under some U.S. federal statutes it is provided that a person who does not know of the rule or order may not be convicted at all.[66] The difficulty with that formulation is that it might conduce to ignorance. Proof of lack of knowledge of the rule can only mean proof of ignorance of the substance of the rule; that the conduct was contrary to law.[67] If the rule reflects a statutory provision, ignorance is no limitation at all.

A provision about which I feel grave doubt is section 1517(b)(4) which provides that a person may not be sentenced to pay a fine in an amount that would prevent him from making restitution or reparation to his victims. The notes give no indication of the reasoning behind this proposal. The notes to section 3302 of the proposed new U.S. Federal Criminal Code, the drafting model, also do not explain the provision but they do indicate a bias against fines as having no rehabilitative value. This view is certainly not universally shared.[68] In any event, it is not clear how any such provision would work in practice. Would it require imprisonment in cases where even a modest fine would preclude reparation? Would imprisonment not deprive an accused of the ability to make restitution or reparation? Are we in danger of maximizing the use of custodial penalties? I fear these possibilities and would recommend against any such provision, notwithstanding its plausibility.

We conclude this section with a few further remarks on the thrust of enforcement efforts. J.C. Sargent, a former member of

65 *See further,* G. WILLIAMS, CRIMINAL LAW, THE GENERAL PART, s. 106 (1961); *see also* James, *supra* note 14.

66 ALI FEDERAL SECURITIES CODE, Tent. Draft No. 3, s. 1303, Comment (5)(a).

67 United States v. Willey, 291 F. Supp. 989 (S.D. Tex. 1968).

68 *See* N. WALKER, *supra* note 52, at 94-95, 109.

the SEC has, with others, voiced concern about certain enforcement practices.[69] One is a concentration upon administrative and civil remedies. The SEC is, in his view, inclined unduly to the use of consent decrees. The SEC favours this device because it saves resources. It assumes that such decrees have strong prophylactic effects. In Sargent's view the use of consent decrees may pose a threat to the efficacy and integrity of SEC enforcement procedures. The results may, he suggests, be:

> "(1) The SEC in many of its proceedings is never required to delve completely into the factual circumstances supporting its charges. It may, therefore, lack any realistic idea of what gave rise to the fraud, how it was perpetrated, or how it could have been anticipated, detected or prevented.
>
> "(2) Because of the economic pressures on many of those who are defendants in SEC proceedings, and because the sanction is generally minimal, many defendants will enter consent decrees as a matter of course even though they firmly believe they are innocent, or they are in fact innocent, of the SEC charges. The sanction, typically, is a short suspension of a broker's licence. It results in public censure of innocent persons.
>
> "(3) Because of the brevity of the procedure and the mildness of the ultimate sanction the consent decree does little to enhance the image of the SEC among members of the financial community. The SEC gets the reputation of administering only a mild slap on the wrist."

Sargent argues that the consent decree is successfully employed in minor cases, and, because it saves time and effort, is likely to induce the SEC to instigate more and more proceedings against relatively minor offenders which, he considers, creates a danger that the SEC will become obsessed with minutiae and will overlook major fraud cases. Thus, he argues, in the case of some larger frauds, the SEC failed to examine and verify material contracts. There was a failure to anticipate frauds which were signalled by rapid upsurges in corporate earnings per share in a short period, or by the anticipation of profits in the balance sheet giving rise to a false picture of liquidity. The implication is, he says, that the SEC is preoccupied with a multitude of minor infractions of the law. Such preoccupation will, it is suggested, alienate industry upon whose self-regulatory activities the scheme largely depends. Frivolous or unfair actions stimulate ill will.

69 Sargent, *supra* note 35; *see also Securities Enforcement: A Growth Industry - Cops Patrolling the White Collar Beat*, 397 BNA Sec. Reg. & L. Rep., April 6, 1977, at A-1.

A complaint is also levelled at courts which impose unduly light sentences in conspiracy to defraud cases. The validity of this latter point may be conceded. The rest of the reasoning will probably prove to be contentious.[70] It is no doubt true that a policy of concentrating on minutiae, allowing large frauds to escape attention, is bad. But has this happened? A further point must be recalled. So-called minor violations, such as breach of filing requirements, often go hand-in-hand with a fraudulent scheme. The enforcement of such rules may have a useful preventive effect. Nor is it necessarily the case, as we have noted, that a policy of seeking industry support by a nonprosecution policy, will stimulate industry to regulate itself. Undoubtedly there is a need for balance in prosecution policy and any Canadian commission will have to bear this in mind. I doubt that Sargent's propositions could be adopted as a guide to action without substantial qualifications.

B. CIVIL DAMAGE ACTIONS (GENERAL)

In the United States civil damage actions are regarded as a necessary means of enforcing the securities laws. Some such actions, in particular those dealing with misstatements in a prospectus, were expressly created by statute.[71] Others, such as actions for breach of section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, or section 14 of the Securities Exchange Act of 1934 dealing with proxy solicitations were developed judicially. Actions both individual and in some cases derivative were sustained on the broad footing that private enforcement of the legislation and rules provides a necessary supplement to commission action.[72] Both deterrence and compensation are recognized as appropriate purposes of the action. Indeed, actions under the Securities Act of 1933 are said to be primarily deterrent in character. But this substantial emphasis on deterrence has not induced American courts to award punitive damages for actions founded

70 It seems inconsistent with Matthews, *supra* note 18.

71 *E.g.* Securities Act of 1933, s. 11. There is a Canadian analogue under some of the corporation statutes of Canada and the provinces; *see e.g.* Canada Corporations Act, s. 79.

72 J.I. Case Co. v. Borak, 377 U.S. 426 (1964); Superintendent of Ins. of State of New York v. Bankers Life & Cas. Co., 404 U.S. 6 (1971); Kahan v. Rosenstiel, 427 F.2d 161 (3d Cir. 1970); Mariani, *Regulation of Fraud in Security Dealings*, 4 CUM.-SAM. L. REV. 94 (1973); note, *The Implication of a Private Cause of Action Under Title III of the Consumer Credit Protection Act*, 47 SO. CAL. L. REV. 383 (1974); de Vita, *Civil Liability for Margin Violations - The Effect of Section 7(f) and Regulation X*, 43 FORDHAM L. REV. 93 (1974).

Some actions are primarily brought for rescission and where damages are seldom available, as under the proxy rules; *see* Note, *Private Enforcement of Federal Proxy Rules*, 15 WM. & MARY L. REV. 286 (1973).

upon breach of the statute.[73] In part the reluctance to award punitive damages is attributable to the fear that such damages, especially when awarded in a class action, might prove too severe. In part it was felt also that these could cause a disharmony between different statutes in the same field since, under section 28(a) of the Securities Exchange Act of 1934, punitive damages are expressly forbidden,[74] while under the Securities Act of 1933 this is not the case.

We treat private damage actions in this section, but private actions are also brought to obtain other remedies, for example rescission, and these are dealt with later in this paper.

The question whether such actions are essential or desirable in Canada depends upon the exigencies of enforcement. The need for civil liability as an aid to enforcement was felt keenly in the United States. American courts were ready to imply causes of action where these are not expressly provided for in the legislation. Of recent years there has been increasing attention to ordinary principles of statutory construction. The United States Supreme Court has laid down certain guiding principles to determine when civil actions will be implied. These are:[75]

(1) the plaintiff must belong to a class for whose especial benefit the statute was enacted;
(2) whether there is any indication of a legislative intent to create or deny such a remedy;
(3) whether a private right of action would be consistent with the underlying purposes of the legislative scheme;
(4) whether the plaintiff's cause of action was one traditionally relegated to state law.

In some cases the provisions of a statute militate clearly against the creation of a civil right of action, in particular when the statute both creates a right and a limited remedy *uno flatu*.[76] The Supreme

73 Feit v. Leasco Data Processing Equipment Corp., 332 F. Supp. 544 (E.D.N.Y. 1971); Fratt v. Robinson, 203 F.2d 627 (9th Cir. 1953).

74 Globus v. Law Research Service Inc., 418 F.2d 1276 (2d Cir. 1969); and *see* Hirsch & Lewis, *Punitive Damage Awards Under the Federal Securities Acts*, 47 NOTRE DAME LAW, 72 (1971); *see generally* Painter, *Civil Liabilities and Administrative Sanctions Under the Securities Act of 1933 in* SELECTED ARTICLES IN FEDERAL SECURITIES LAW 257, *supra* note 11.

75 Cort v. Ash, 422 U.S. 66 (1975); *see also* Pitt, *An SEC Insider's View of the Utility of Private Litigation Under the Federal Securities Laws*, 5 SEC. REG. L.J. 3 (1976); Lowenfels, *Recent Supreme Court Decisions Under the Federal Securities Laws: The Pendulum Swings*, 65 GEO. L.J. 891 (1977); Note, *A New Rationale for Implying Rights of Action and Section 7 of the Securities Exchange Act of 1934*, [1975] WASH. U. L. REV. 1201.

76 *E.g.* National R.R. Passenger Corp. v. National Assoc. of R.R. Passengers, 414 U.S. 453 (1972); Comment, *Private Rights of Action Under Amtrak and Ash: Some Implications*, 123 U. PA. L. REV. 1392 (1975).

Court has evinced caution in recent years, remarking for example that implied actions under Rule 10b-5 are an oak which has grown from a mere acorn. There has been a fear that such actions will be used to obtain blackmailing settlements.[77]

In the event, the Court has taken refuge in strict constructions of provisions of the securities laws. It has refused a private right of action in respect of tender offers on the footing first, that the legislation already provided adequate remedies and second, that the aggrieved tender offeror was not a person for whose especial benefit the legislation was enacted.[78] Lower courts have begun to treat the issue whether a private right of action is a necessary adjunct of enforcement very cautiously.[79] U.S. courts are not at present inclined to ignore arguments about supposed legislative intents. They are not longer inclined to rely simply on their view of what public policy requires.[80]

In Canada there are extensive statutory provisions concerning civil damage actions, but these generally do not apply in the absence of privity. The contrast with the United States is striking. It is largely explicable in terms of procedural advantages which may accrue from suit in the U.S. federal courts. In the United States the prohibition against the use of deceptive devices and contrivances in the sale or in the purchase and sale of securities opened up a potentially wide ambit of liability which was quickly exploited. It became clear that matters formerly within the purview of state corporation laws alone, if at all, could be comprehended within the sweep of federal statutes and rules. The procedural and other advantages which accompany suit in the federal courts ensured that federal legislation would be resorted to in order to found private damage actions.[81]

The scope of American law is wide. In some respects the criteria and extent of liability are still unsettled. This is true of insider trading and actions under Rule 10b-5 generally where all matters pertaining to the conditions of liability for damages have not been authoritatively settled. For example, the Supreme Court has held that *scienter* in the sense of intent is required for civil

77 Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

78 Piper v. Chris-Craft Industries, Inc., 97 S. Ct. 926 (1977).

79 *E.g.* Reddington v. Touche Ross & Co., 428 F. Supp. 483 (S.D.N.Y. 1977); Imperial Supply Co. v. Northern Ohio Bank, 430 F. Supp. 339 (N.D. Ohio 1976).

80 Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970); an action brought to set aside a merger which allegedly violated s. 14(a) of the Securities Exchange Act of 1934; Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951); Fratt v. Robinson, *supra* note 73.

81 *See* Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946) in which the theories underlying the implied action were set out. *See also* Note, *New Civil Liabilities Under Securities and Exchange Act Rules*, 14 U. Chi. L. Rev. 471 (1971).

recovery of damages under section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.[82] It is not clear whether recklessness suffices, though the balance of authority indicates that it does.[83] Matters such as intent, reliance, materiality and causation form the staple of continuing judicial development. It is, for example, not clear whether in an action involving positive misrepresentation the plaintiff must show that he relied on the misrepresentation or whether materiality suffices.[84] The standard of materiality at any rate has been clarified to mean that the omitted fact would have been viewed by the reasonable investor as actually significant. It is not a mere matter whether it might have had an effect on him.[85] We do not propose to go further into U.S. substantive law. It suffices to point out that the existence of extensive anti-fraud provisions cast in terms of the effect or characteristics of conduct has given a tremendous impetus to development.

By contrast the situation in Canada is uncertain and extensions of liability have in general to be the creations of statute. Thus Ontario Bill 30 (the latest available reform measure) expressly specifies both criminal and civil liability for insider trading.[86] Both the civil cause of action and the available defences are specified. The provision would apply to insiders who purchase or sell securities of a reporting issuer and would seemingly apply only to the other party to the contract. The clause may be rather obscure.

It is not desired to compare the United States and Canadian systems at this stage. It is perhaps enough to say that our provisions are apparently relatively narrowly drawn and unlikely to benefit from the wider constructions given to their U.S. counterparts. In addition, however, U.S. courts and no doubt Canadian courts as well are likely to be wary of the great economic consequences of wide, implied, causes of action.[87] This concern as we

82 Ernst and Ernst v. Hochfelder, 425 U.S. 186 (1976).

83 Sanders v. John Nuveen & Co., [1977-1978 Transfer Binder] CCH FED. SEC. L. REP. ¶96,030 (7th Cir. 1977); Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033 (7th Cir. 1977); Wright v. The Heizer Corp., 560 F.2d 236 (7th Cir. 1977).

84 Materiality is enough in omissions; *see* Affiliated Ute Citizens of Utah v. United States, 92 S. Ct. 1456 (1972). As to misrepresentations, the issue is confused; Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975) suggests that materiality is enough in all cases but it is not clear whether this is correct. *See* PLI, SEVENTH ANNUAL INSTITUTE ON SECURITIES REGULATION (R. Mundheim, A. Fleischer Jr., B. Vandegrift eds. 1977) where the matter is extensively discussed.

85 T.S.C. Industries Inc. v. Northway Inc., 96 S. Ct. 2126 (1976).

86 Ontario Bill 30, cl. 77(1); on the duty of disclosure *see* Green v. Charterhouse Group Canada Ltd., 12 O.R. (2d) 280 (C.A. 1976).

87 Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975); *see* in a more expansive vein SEC v. Texas Gulf Sulphur Corp., 401 F.2d 833 (2d Cir. 1968); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith Inc., 495 F.2d 228 (2d Cir. 1974).

have seen underlies some of the recent United States Supreme Court decisions.

The difference in substantive law only partially explains the lack of civil actions in Canada. For, in some respects, American and Canadian statutes do appear to cover the same ground and the resulting civil actions which have developed in the United States disclose that even under a relatively narrow statutory regime there is room for supplementary civil actions.

1. *Traditional Civil Actions: Prospectuses*

Certain heads of liability are traditional both here and in the United States. The first of these is liability for a misleading prospectus.[88] Clause 129 of Ontario Bill 30, the most recent Canadian proposal, which is structurally similar to section 80 of the Canada Corporations Act, provides in part:

> "129. (1) Where a prospectus together with any amendment to the prospectus contains a misrepresentation, a purchaser who purchases a security offered thereby shall be deemed to have relied on such misrepresentation and has a right of action for rescission or damages against,
> "(a) the issuer or selling security holder;
> "(b) each underwriter of the securities who is required to sign the certificate required by section 60;
> "(c) every director of the issuer at the time the prospectus or the amendment to the prospectus was filed;
> "(d) every person or company whose consent has been filed pursuant to a requirement of the regulations but only with respect to statements or reports that have been made by them; and
> "(e) every person or company that signed the prospectus or the amendment to the prospectus other than the persons or companies included in clauses a to d.
> "(2) No person or company is liable under subsection 1 if he proves that the purchaser purchased the securities with knowledge of the misrepresentation."

The coverage thus achieved is similar to that contained in section 1403 of the *ALI Federal Securities Code.*

Clause 129 then proceeds to capitulate defences. It distinguishes between different classes of defendants. Thus subsections (3) and (4) provide:

> "(3) No person or company, other than the issuer or

88 Such provisions leave ultimately from the Directors Liability Act 1890, 53 & 54 Vict., c. 54.

selling security holder, is liable under subsection 1 if he proves,

"(a) that the prospectus or the amendment to the prospectus was filed without his knowledge or consent, and that, on becoming aware of its filing, he forthwith gave reasonable general notice that it was so filed;

"(b) that, after the issue of a receipt for the prospectus and before the purchase of the securities by such purchaser, on becoming aware of any misrepresentation in the prospectus or an amendment to the prospectus he withdrew his consent thereto and gave reasonable general notice of such withdrawal and the reason therefor;

"(c) that, with respect to any part of the prospectus or the amendment to the prospectus purporting to be made on the authority of an expert or purporting to be a copy of an extract of a report or evaluation of an expert, he had no reasonable grounds to believe and did not believe that there had been a misrepresentation or that such part of the prospectus or the amendment to the prospectus did not fairly represent the statement of the expert or was not a fair copy of the extract from the report or evaluation of the expert, or

"(d) that, with respect to any part of the prospectus or the amendment to the prospectus purporting to be made on his own authority as an expert or purporting to be a copy of an extract from his own report or evaluation as an expert, he had, after reasonable investigation, reasonable grounds to believe and did believe that there had been no misrepresentation or that such part of the prospectus or the amendment to the prospectus did not fairly represent his statement as an expert and on becoming aware of such use of his statement or report or evaluation he forthwith advised the Commission and gave reasonable general notice that such use had been made and that he would not be responsible for that part of the prospectus or the amendment to the prospectus.

"(4) No person or company, other than the issuer, is liable under subsection 1 if he proves that, with respect to any part of the prospectus or the amendment to the prospectus not purporting to be made on the authority of an expert and not purporting to be a copy of an extract of a report or evaluation of an expert, he had, after reasonable investigation, reasonable grounds to believe and did believe that there was no misrepresentation.

Subsection (5) then proceeds to specify that the standard of

reasonableness shall be that required of a prudent man in the circumstances of the case. Section 1403(g) of the *ALI Federal Securities Code* specifies with greater particularity the matters to be taken into account in determining reasonableness. It provides:

> "1403(g) *Standard of reasonableness.* In determining what constitutes reasonable investigation or care and reasonable ground for belief under section 1403(f)(3), the standard of reasonableness is that required of a prudent man under the circumstances, including with respect to a defendant other than the registrant (1) the type of registrant, (2) the type of defendant, (3) the office held when the defendant is an officer, (4) the presence or absence of another relationship to the registrant when the defendant is a director or proposed director, (5) reasonable reliance on officers, employees, and others whose duties should have given them knowledge of the particular facts (in the light of the functions and responsibilities of the particular defendant with respect to the registrant and the filing), (6) the type of underwriting arrangement, the role of the particular defendant as an underwriter, and the accessibility to information with respect to the registrant when the defendant is an underwriter, and (7) whether, with respect to a fact or document incorporated by reference, the particular defendant had any responsibility for the fact or document at the time of the filing from which it was incorporated."

It is submitted that the greater particularity of the American proposal is not in fact an advantage. The criteria in spite of their definite appearance are rather nebulous and I doubt the wisdom of giving greater currency to the doctrine that directors can reasonably rely on officers than it has already.

Damages are limited under subclause (5) of Ontario Bill 30 in respect of an underwriter by providing that no underwriter is liable for more than the total public offering price represented by the portion of the distribution underwritten by him. An identical provision appears as section 1403(h)(1)(C) of the *ALI Federal Securities Code.* In Ontario there is a provision that in no case shall damages exceed the price at which securities were offered to the public. The *ALI Federal Securities Code* contains a complex formula because it deals also with liability for misrepresentations in annual reports. The Securities Act of 1933 provides, as does the Bill that the amount recoverable shall not exceed the price at which the security was offered to the public.

Clause 130 of the Ontario Bill contains a right of action for rescission and damages in connection with misrepresentations in

a takeover bid circular. The structure of the section is essentially the same as that of the prospectus liability section. The action lies against the offeror, its directors at the relevant time and each person who signed a certificate in the circular. Liability in damages is also stipulated against every director or officer who signed a director's circular sent to the offerees of an offeree company. The structure of defences including withdrawal of consent, reasonable investigation and reasonable grounds for belief in the truth of the representation and the like, is the same as that of the prospectus section. The clause applies in favour of offences only and not in favour of a competing offeror.[89]

Clause 132 of Ontario Bill 30 provides for rescission and damages for a number of trading violations. Liability is provided in favour of the traders' purchaser or offeree. The provisions concerned are:

(1) section 54, trading without prospectus where a prospectus is required;
(2) section 66, concerning distribution in defiance of the waiting period restrictions;
(3) section 72, concerning the obligation to deliver a prospectus;
(4) section 73 (4), (5), (7), concerning restrictions to the exemption from prospectus provisions;
(5) section 95, concerning the form of a take-over bid circular and the requirement that it accompany a take-over bid.

This section finds its analogue in section 1402(a) of the *ALI Federal Securities Code*. By contrast, section 1402(b) of the *ALI Code* is wider in that it catches transactions in the impersonal market where these take place following specified violations of the formal requirements of the code.

2. *Insider Trading*

Civil actions for breaches of the insider trading provisions already exist in U.S. law and in Canada under the British Columbia Securities Act. The most recent Canadian proposal is found in clauses 77 and 130 of Ontario Bill 30. The Ontario Bill does not confer a right of action for manipulation as such. It makes provision in clause 77 forbidding any person or company from purchasing or selling the securities of a reporting issuer with knowledge of a material change in the affairs of such issuer that he or it knew or reasonably ought to have known had not been generally disclosed or from informing another person or company about such a

89 The result is the same as that in Piper v. Chris-Craft Industries Inc., *supra* note 78.

material change other than in the necessary course of business before it has been so disclosed. Section 128 then provides:

> "128. (1) Every person or company that sells or purchases the securities of a reporting issuer with knowledge of a material change with respect to such issuer that has not been generally disclosed is liable to compensate the purchaser or vendor of such securities for damages as a result of such trade unless,
>
> "(a) such person or company has reasonable grounds to believe that such material change has been generally disclosed; or
>
> "(b) such material change was known or ought reasonably to have been known to the purchaser or vendor.
>
> "(2) Any person or company who has access to information concerning the investment program of a mutual fund that is a reporting issuer and uses that information for his or its direct benefit or advantage to purchase or sell securities of an issuer for his or its account where the portfolio securities of the mutual fund include securities of that issuer is accountable to the mutual fund for any benefit or advantage received or receivable as a result of such purchase or sale.
>
> "(3) Every person or company referred to in subsection 1 that is also an insider of the reporting issuer, or an associate or affiliate of such insider, is, in addition to the liability imposed by subsection 1, accountable to such issuer for any benefit or advantage received or receivable by such insider or associate or affiliate."

It seems probable, as we have argued, that subclause 1 is restricted to privity situations. The provision speaks of compensating the purchaser or vendor of *such* securities, meaning thereby, it is submitted, securities actually purchased or sold by the insider in violation from or to the potential plaintiff. It does not purport to confer an action upon persons who can show only a temporal rather than a causal connection between dealing and loss. It is submitted, therefore, that the ban on insider trading in section 77 is wider than the right of action conferred by section 128(1). Subsection (3) enacts the rule developed by U.S. courts that the misuse of insider information by officers of a corporation constitutes a misappropriation of a corporate advantage for which the insider is liable on restitutionary principles.[90]

Two other interesting models of insider trading provisions may be referred to. The first is the U.K. Companies Bill of 1973

90 Diamond v. Oreamuno, 24 N.Y. 2d 494, 248 N.E. 2d 910 (1969).

which lapsed on the fall of the Heath government. It was a bill directed primarily towards penalizing insider trading by the criminal law but provided a civil cause of action. Clause 15(3) would have created a civil right of action where an insider with confidential information deals or procures another person to deal in securities to which confidential knowledge relates. The defendant would have been liable to compensate the plaintiff, the other party to the transaction, who was not in possession of the information for any loss sustained by that party by reason of any difference between the price at which the securities were dealt with and the likely price had that information been available. Again, the provision seems to have been intended to refer only to situations in which the parties were in privity, wider situations being left to the criminal law.

The *ALI Federal Securities Code*, section 1402, provides a right of action for insider trading where the defendant has sold or bought a security of an issuer if he knows a fact of special significance with respect to the issuer, unless he believes and has reasonable ground to believe that the fact is generally available, or, if the other party to the transaction or his agent is identified, that he believes and has reasonable ground to believe that that person knows it or that that person in fact knows it from the insider or otherwise. "Insider" is defined to include a broad range of persons, the issuer, its officers, those of subsidiaries, etc. Liability goes beyond the privity situation. Civil liability applies whether the transaction is or is not effected in the market.[91] In order to prevent huge awards of damages there is a prorationing provision in section 1409 and a limitation of damages provision in section 1402(2) which applies where transactions are effected in the market and limits the defendants damages by reference to the amount of securities which the defendant bought or sold. Thus, where in essence the case rests on "poisoning the market" the global total of damages is subject to an arbitrary upper limit in order to avoid colossal damage awards.

In a case where the parties have been brought into privity by a communication expressly and explicitly directed from one to the other the boundaries of liability are easy to determine and the compensatory purpose of the civil action can plainly be seen to be vindicated.[92] But in a case in which the transactions are market transactions, this is not always the case.

91 ALI Federal Securities Code, s. 1402(a), (b).

92 List v. Fashion Park Inc., 340 F.2d 427 (2d Cir. 1965), *cert. denied*, 328 U.S. 811 (1965). The scope of the action created by the Canada Corporations Act, s. 100.4 which reproduces the present Ontario s. 113, is altogether uncertain. It clearly provides for liability to the insider's corporation on restitutionary principles. *Qua* other persons, an insider who trades on the basis of confidential information is liable for

The difficulty arises both in cases of misrepresentation by affirmative false statement and in cases of misrepresentation by omission. If, for example, insiders trade on the basis of a positive misstatement in a press release, their liability in theory extends (provided that any other qualifying conditions such as intention or negligence are met) to every person who dealt during the period in which such release can be assumed to have affected the market. The extent of such liability is potentially enormous, for, if the basis of liability essentially rests in poisoning the market, the insider must be liable to everyone who traded therein and suffered loss whether or not he actually came into contact with the insider or actually read or otherwise became acquainted with the material false information. Historically, U.S. courts, mindful of the compensatory basis of civil liability and anxious to set some bounds to liability, have insisted that it be shown that the defendant's transgression caused the plaintiff's loss.

Other limitations to recovery have also been suggested, turning on the *scienter* necessary to found an action for damages as distinct from a SEC injunction proceeding.[93] The Supreme Court, relying on similar considerations, has norrowly construed the "in connection with" clause of Rule 10b-5.[94]

3. *Manipulation*

Similar considerations arise if it is considered appropriate to create a civil action for market manipulation. No such action presently exists in England or in Canada. The *ALI Federal Securities Code* does however propose to create one. It founds in part upon existing actions. Section 1408 refers to manipulation by representation or trading.[95] It confers an action for damages upon a person

any *direct* loss suffered by that person as a result of the transaction unless the information was known or ought reasonably to have been known to that person. Whether it was intended to import the wide jurisprudence under s. 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, is uncertain. In Green v. Charterhouse, *supra* note 86, which did not involve these wider issues, the court cautioned mildly against relying uncritically on U.S. precedents, noting that the words of the statute are to be applied according to their plain meaning.

93 SEC. v. Texas Gulf Sulphur, *supra* note 87; and *see* Ernst and Ernst v. Hochfelder, *supra* note 82.

94 Blue Chip Stamps v. Manor Drug Stores, *supra* note 87; Thomas v. Roblin Industries, 520 F.2d 1393 (3d Cir. 1975).

95 The section refers to ALI FEDERAL SECURITIES CODE, ss. 1308, 1309. Section 1308 prohibits manipulation by touting, wash sales and matched orders, manipulation by trading which means engaging in a series of transaction to affect share prices artificially, and buying during a distribution which refers to certain acts of buying by a secondary distributor or underwriter or other person who is participating or financially interested in a distribution. Essentially the culpable acts are buying for

who bought or sold a security of the class involved after the violation but only on proof that he bought or sold at a price affected by the violation if he bought or sold more than thirty days after the last act constituting the violation. In other words, if he buys after the expiration of the thirty-day period he must prove that his purchase price was affected by the violation. The defendant has a defence if he proves that the plaintiff bought or sold with knowledge of the violation. The measure of damages is reduced to the extent that the defendant proves that the violation did not cause the price differential. An upper limit to damages applies where the manipulation refers to buying during a distribution, or to a breach of the stabilization rules. By subsection (e) a person who violates the antimanipulation provisions noted above is liable to any person other than a buyer or seller of the security involved for any loss caused by the violation. This provision puts a burden of proof on the plaintiff who must prove the causal connection.

The justification for placing an arbitrary maximum upon damages for breaches of the buying during a distribution or stabilization rule provisions is their difficult and technical character.

4. *Other Possible Actions*

The *ALI Federal Securities Code* suggests an action based upon nonfraudulent breaches of regulatory requirements. Section 1401 deals with such liability and is divided into transactions not effected in the markets and transactions effected in the markets. Among the unlawful practices struck at are purchases or sales of securities for which an offering statement or prospectus is required and none is made available,[96] section 509(b) referring to distribution statements, etc. The relief afforded is rescission or damages. The section is said to be superior to existing law in that:

(1) market sales are covered adequately;
(2) a damages scheme is involved to limit the defendant's liability in market sales. This aspect has been mentioned in accordance with manipulation and insider trading;
(3) not every trivial breach of a regulatory requirement will found liability.

Provision is also made in section 1403 for actions based on false registration statements, offering statements, and reports. A plaintiff may bring an action if, in the case of an offering state-

oneself or for an account in which one is broadly interested beneficially. Section 1309 refers to contravention of commission regulations concerning stabilization.

96 *See id.* s. 503.

ment, he bought a security of a class covered thereby after its effectiveness. Section 1404 deals with other filings. Provision is made for reliance. Section 1403(e) confers a defence on a person who proves that the defendant bought or sold with knowledge of the misrepresentation, the fact or document omitted or not incorporated by reference, or a fact of special significance which should have been disclosed by reason of another provision of the code.[97] There is a defence of correction or lack of negligence. The defendant, by section 1403(d)(1) has a defence if he proves that the misrepresentation or omission was corrected by a later filing. This defence is not available against a plaintiff who dealt before the correction became generally known or who justifiably relied on the misrepresentation or omission. Reliance on an omission is proved by reliance on a particular filing or document, and reliance on either a misrepresentation or an omission may be proved without proof that the defendant read a particular filing or document. A defendant has a defence to an action based on a culpable failure to correct a report if he proves that he did not know and had no reason to believe that there was a culpable failure to correct.[98] Again, there is a limitation of damages provision in section 1403(3)(h).

The section deals with offering statements, registration statements and annual reports. The limitation provision seeks to ensure that greater potential liability will not be imposed for registration statements than for offering statements, since greater liability would, the reporter states, be illogical. He states there must also, given the availability of class actions, be some maximum to prevent the possibility of utterly disproportionate recoveries for material, but nevertheless insubstantial, lapses. It is not clear how a lapse could be both insubstantial and material. The problem is how to encourage the class action, facilitate its use by avoiding proof of causation and yet avoid destructive recoveries, some of which may in respect of some class members, be windfall benefits. The question whether arbitrary limits to recovery is the best way of tackling the problem is dealt with below. But at the risk of some discontinuity in exposition, the deterrent aspect of the private damage action must again be stressed.

97 *See id.* s. 1303(c); a fact is material if, broadly, in addition to being material it would be likely to be made generally available to affect the price of securities or if a reasonable person would attach special importance to it in making his decision.

98 Despite a misprint in ALI FEDERAL SECURITIES CODE, Reporter's Revision of Tent. Drafts Nos. 1-3 which refers to s. 1303(d), it seems clear that s. 1304(d) is meant.

5. *Actions Based upon Registrant's False Filings Generally*

Section 1404 of the *ALI Code* deals with other and residual cases including secondary distributions – unless the secondary distributor controls the issuer or underwriter in which case he will be liable under section 1408. Only the registrant (subject to section 1419 dealing with aiders and abettors) is liable under the section. The matters comprehended are: purchase or sale of a security of a registrant other than a security of a class covered by a contemporaneous registration statement; or in the case of a filing not comprehended within section 1403(a), the purchase or sale of a security of a registrant after the filing. The measure of damages is again limited. The section seeks to come to grips with the difficult question of open-ended liability either with respect to miscellaneous false filings or with respect to false press releases or other forms of publicity, for example a report to stockholders or a speech. Defences are provided; for example, proof by the defendant that the plaintiff bought or sold with knowledge of the deceptive act or misrepresentation, or where the plaintiff proves only a misrepresentation and the defendant proves that he did not believe and had no reason to believe that there was a misrepresentation (section 1402), or where, as in section 1403(d), there was a timely correction. The measure of damages is again limited as in section 1403(h) but in accordance with that section, not where there has been an intentional misrepresentation. The great strength of the section as revised by the Reporter lies in allowing a compensatory action broadly based on fault. The culpable state of mind is *scienter*, defined in section 296AA as a representation made knowingly or recklessly as to its falsity or knowing that it does not have the factual basis which it is implied that it has. Seemingly, liability for negligence *stricto sensu* is excluded by the formulation. Its weakness lies in imposing limits on individual compensation which can only be sustained on broad grounds of public policy.

6. *Actions Based upon False Distribution Statements*

Section 1405 of the code refers to certain contents of a distribution statement. The section renders the secondary distributor and every underwriter liable in the same way as a registrant and underwriter under clause 1403.

7. *Actions Based upon False Publicity*

Section 1406 applies to a violation of section 1304(c). That section makes it unlawful to make, etc., a representation in a press release if it is reasonably foreseeable that the deceptive act will induce other persons to buy, sell and hold securities. On proof of a violation by means of a misrepresentation known by the violator to be so, the violator will be liable to a person who bought or sold a security of the registrant after the violation. It is a defence to prove that the plaintiff bought or sold with knowledge. There is also a defence of prompt correction. Again, there is an upper limit to liability. Like section 1404 on which it is modelled this section insists on *scienter* as a prerequisite to liability. It is similar in imposing upper limits to recovery. Like the rest of the scheme this reflects a preference for the conservative views expressed in *Texas Gulf Sulphur* and fears of the huge recoveries possible in class actions.

8. *Churning*

Section 1410 applies to a broker or dealer who violates the churning section (section 1306) and renders him liable to the customer in an action to recover commissions or profits, any interest paid by the customer and whatever additional items of damages the court may allow; *e.g.*, taxes, income or capital appreciation and trading losses. The latter recovery was indeed allowed at common law in New York.[99] One would expect it to be allowed in Canada under general principles of agency. It could well appear in our legislation.

9. *Failure to Register on Demand*

Section 1411 refers to section 501(b) of the code, filing on demand by an issuer of offering and registration statements. In addition to requiring compliance, the court may award damages for any loss caused by the violation.

10. *Proxy Solicitations and Tender Requests*

Section 1412 refers to existing or apprehended violations of the proxy solicitation and takeover bid sections (sections 602, 603, 1301) but not where an action already lies under sections 1402–06. The court may enjoin violations, require compliance, enjoin the use

99 Pierce v. Richard Ellis & Co., 310 N.Y.S. 2d 266 (1970).

of proxies solicited or given in violation or the consummation of action authorized by their use, or set aside action so consummated, or award damages against a violator for any loss caused by his violation, or grant other appropriate relief, preliminary or final, including a combination of the types of relief specified in the section. In order for damages to be awarded, the plaintiff must prove his loss.[100] By subsection (c) added by the Reporter in the Revision volume a buyer or seller may not obtain damages under this section to the extent that he has an action under sections 1402–06 inclusive as a result of conduct actionable under this section. This provision is intended to avoid overlap. One who buys or sells in the market in reliance on false literature that violates one of the specified sections must sue under them.

11. *Liability for Short-Term Insider Trading*

Section 1413 of the code refers to section 604(a), dealing with insiders, 10% holders, etc. It is intended to be the successor to section 16 of the Securities Exchange Act of 1934. Its purpose is to prevent the unfair use of inside information. It accomplishes this purpose by conferring an action upon an issuer to recover profits from short-swing purchases and sales within a six-month period. Certain transactions of gift, pledge and loan are excepted. There is a provision against double liability. The commission has an exemptive authority. The dispute as the Reporter points out, concerns whether there should be an arbitrary liability of this character, especially given (in the United States) the broad anti-fraud jurisprudence under Rule 10b-5. In respect of the latter it has been argued that the rule has rendered obsolete the concept of automatic recapture of certain short-term profits of certain insiders. The Reporter advocates its retention on grounds of symbolic significance.[101] He notes also that the section strikes at the opportunity for abuse, especially where there is such opportunity in the event of a sale *after* insider status is achieved. One's initial reaction is to suggest that if this stringency is necessary on prophylactic or deterrent grounds, it should be retained. Mere symbolism is not, in my submission, enough. The provision against double liability which enables the recoverable profit to be reduced by damages, interests or costs paid to purchasers, etc., seems appropriate given that the section imposes liability without fault.

100 *See* ss. 1412(a), (b), (b)5 allowing damages for loss "caused" by his violation; the section codifies Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970); s. 1412(a)(1) codifies J.I. Case Co. v. Borak, 377 U.S. 426 (1964).

101 ALI Federal Securities Code, Tent. Draft No. 2 at 133 (1973).

12. *Credit Provisions*

Section 1414 refers to violations by lenders of regulations limiting the amount of permissible credit. I do no more than mention it here since the regulations have not as yet been drafted. There seems a clear rule under U.S. legislation that a customer has a private right of action against a person who unlawfully provides finance for him. The action is one of protecting the innocent "lamb" attracted to profits with low capital investment. One can see the deterrent purpose of the action without finding the prospect of customers suing lenders an attractive one, at any rate where the lender did not engage in high-pressure tactics. But if the thrust of the action is regulation, the private action to which the *in pari delicto* rule does not apply has its attractions.

a. *Breach of Fiduciary Duty*

Breach of fiduciary duty regarding investment companies founds an action which would include taking excessive compensation. It is buttressed by a SEC action created in part XV which will largely incorporate section 1415 of the *ALI Code* by reference. The action will attract injunctive relief under section 1515(b).

13. *Civil Actions Implied from Rules of Self-Regulatory Agencies*

United States courts have implied civil actions from breaches of the rules of self-regulatory agencies. The rule must be shown by the plaintiff to be of such a nature that its violation ought to give rise to a private cause of action.[102] In the *Buttrey* and *Bache* cases the Court of Appeals held that where the function of the rule is to protect the public so that the rule is not a mere matter of domestic housekeeping a civil action may lie. In *Buttrey* there was more than a mere violation of a rule; the violations amounted to conduct inconsistent with just and equitable principles of trade and were indeed said to be tantamount to fraud. Later cases, in the wake of *Cort v. Ash*, have enquired closely into whether the legislature intended an action, and evinced a reluctance to increase Federal Court jurisdiction, or to contemplate liability when massive damages may result.[103] In the *Bache* case it is said that the case for

102 Colonial Realty Corp. v. Bache & Co., 358 F.2d 178 (2d Cir. 1966), *cert. denied*, 385 U.S. 817 (1966); and *see* Piper, Jaffrey & Hopwood Inc. v. Lake, 399 F. Supp. 292 (S.D. Iowa 1975); Van Gemert v. Boeing Corp., 520 F.2d 1373 (2d Cir. 1975).

103 422 U.S. 66 (1975); and *see* Lang v. H. Hentz & Co., 418 F. Supp. 1376 (N.D. Tex. 1976); Utah State Univ. v. Bear Staines & Co., 549 F.2d 64 (10th Cir. 1977); Warren v. Bokum Resources Corp., 414 BNA SEC. REG. & L. REP., August 3, 1977 at A-1 (D.N.M.

implying a novel cause of action would be strongest when the rule imposes an explicit duty unknown to common law.[104] In such a situation, in the United States, the result would be both an extension of substantive law and of federal jurisdiction. Among the rules which, it is suggested, exist for the protection of the public, are rules restricting the pledge of customers' securities, forbidding affiliations with bucket shops, limiting the discretion which a member may have over a customer's account, and which prohibit excessive trading, manipulative practices and the circulation of rumours. There may well be further rules, instituted as a matter of good business practice, which bear this public connation though the tendency of the courts as we have noted is against such an extension.[105] It has been argued that once it has been shown that violation of the rule caused the loss and that the rule alleged to have been violated was for the protection of investors, liability should follow without any requirement of showing that the violation was tantamount to fraud.[106] It has indeed been intimated that a failure by a stock exchange to enforce its own rules may give rise to a civil action, particularly if it can be shown that the stock exchange's failure caused the plaintiff's loss and the appropriate standard of culpability can be proven against the exchange. Courts have said that an exchange is not under a duty to scrutinize every transaction but may be liable for losses occasioned by a general deficiency in the enforcement of its rules.[107] The fault requirement for liability has not yet been authoritatively determined.[108]

If it is desired to provide for actions founded on the breach of the rules of self-regulatory agencies, it would be preferable to do so expressly by statute. In the light of *Vapor Canada Ltd. v. MacDonald*[109] any such provision will have to be carefully drafted in order to display criteria which make it a necessary part of a regulatory scheme. We might therefore consider a provision like section 1416 of the *ALI Federal Securities Code*. That section provides that a person who violates a rule of a national securities exchange or of the NASD provided that it is a rule which comes

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1977); Zagari v. Dean Witter & Co., [1976-1977 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,777 (N.D. Cal. 1976).

104 *See also* Plunkett v. Dominick, 414 F. Supp. 885 (D. Conn. 1976).

105 *See* cases cited at note 102 *supra*.

106 Allen, *Liability Under the Securities Exchange Act for Violations of Stock Exchange Rules*, 25 BUS. LAW. 1493 (1970).

107 Pettit v. American Stock Exchange, 217 F. Supp. 21 (S.D.N.Y. 1963); Butterman v. Walston & Co., 387 F.2d 822 (7th Cir. 1967), *cert. denied*, 391 U.S. 913 (1968).

108 *See further* Swanburg, *Implied Civil Liability Arising from Violation of the Rules of the National Association of Securities Dealers*, 8 LOY. L.A.L. REV. 151 (1975).

109 7 N.R. 477 (S.C.C. 1976).

within the section, will be liable to any customer for a loss caused by the violation. Power is given to the SEC to determine whether the rule is to come within the section or be definitively excluded from it. If it is not excluded, the court may imply the action as a matter of federal common law. The enactment of a similar provision, limited by the criterion of a commission decision that it does come within the section would, it is submitted, meet the constitutional criteria and enable the commission to control the spread of litigation in the public interest.

14. *Implied Actions Generally*

A further provision worth considering is that of section 1417 of the *ALI Federal Securities Code* which enables a court to recognize a private action based on a violation of the provisions of the code. The section has the merit of specifying what considerations should govern the court in implying a cause of action. These are:

(1) that such an action not be inconsistent with the conditions or restrictions in any of the actions expressly created;
(2) that the provision be intended to protect the class of persons to which the plaintiff belongs against the kind of harm alleged;
(3) the plaintiff satisfies the court that under the circumstances the remedy sought and the deterrent effect of recognizing the action would not be disproportionate to the violation;
(4) in certain cases where potential liability is very wide; those which resemble the cases where the code proposes an upper limit to damages, a comparable limit is placed on damages.

The criteria are not dissimilar to those in *Cort v. Ash*[110] save that the court need not inquire whether the matter is analogous to matters dealt with by state law. In the interests of constitutional prudence it would be wise to specify as a negative criterion that an action in Canada should not be implied where the subject matter is adequately dealt with as a matter of provincial common law.

It is submitted that no constitutional impediment to the creation, or indeed the implication, of private rights of action in aid of securities regulation arises. This comment assumes, however, that securities regulation in its widest aspects is a topic competent to the Parliament of Canada. That issue forms the subject of a separate paper. *Prima facie*, however, Parliament could rely upon the general power in section 91 of the BNA Act 1867, the commerce power in section 91(2); and the criminal law power in section

110 422 U.S. 66 (1975).

91(27), the latter having been quite liberally construed since *Proprietary Articles Trade Association v. A.G. of Canada.*[111]

It has been suggested that constitutional difficulties arise. Professor Alexander writes:[112]

> "In a country of divided legislative jurisdiction like Canada, another factor influencing the courts in their pursuit of legislative intention is the constitutional difficulty of finding a Parliamentary intention to confer civil causes of action. Such an intention, if it were found to exist, would in most cases be unconstitutional; hence, the courts are unlikely to find such an intention when to do so would be to render the particular statute *ultra vires.*"

The argument is as unimpressive as the authority cited in its support. If Parliament were simply to create civil actions at random the legislation would be *ultra vires* either because the legislation would be in relation to property and civil rights, a field reserved to the provinces under section 92(13) of the BNA Act 1867, or because it could not be said to relate to any validating head of federal power.[113] But simply to focus on whether a civil action is created is to confuse subject matter and aspect. With isolated exceptions Canadian courts have considered that there is no constitutional impediment to the creation of civil actions in aid of otherwise valid federal legislation. The better view is that such actions are perfectly valid measures passed in aid of enforcement. They share the aspect of the legislation as a whole.[114]

A different and potentially difficult justification has been suggested concerning *implied* actions; namely, that these are a construct of provincial law; provincial common law rules concerning the implication of actions.[115] The former analysis is the simpler and more comprehensive, especially if implied actions are thought to derive from the dictates of public policy. I conclude that there is no constitutional impediment.

It is, one supposes, possible that the government might desire to leave the matter of civil liability largely, if not entirely, to judicial implication, at least in the first instance. Would this be a

111 [1931] A.C. 310 (P.C.); on the topic in general *see* Leigh, *The Criminal Law Power: A Study in Functional Concurrency*, 5 ALTA. L. REV. 237 (1967).

112 Alexander, *The Fate of Sterling Trusts v. Postma*, 2 OTTAWA L. REV. 441 (1968); and *see*, Transport Oil Ltd. v. Imperial Oil Ltd., [1935] O.R. 215 (C.A.); *but see also* Gordon v. Imperial Tobacco Sales Co., [1939] 2 D.L.R. 27 (Ont. H.C.); Wasney v. Jurazsky, [1933] 1 D.L.R. 616 (Man. C.A.) (*per* Trueman, J.A.).

113 Vapor Canada Ltd. v. MacDonald, *supra* note 109.

114 Direct Lumber Ltd. v. Western Plywood Ltd., [1962] S.C.R. 646, 650 (*per* Judson, J.); Floyd v. Edmonton City Dairy Ltd., [1935] 1 D.L.R. 754 (Alta. S.C.); Philco v. Thermionics Ltd., [1940] S.C.R. 501, 504.

115 Placatka v. Thompson [1941] 2 D.L.R. 320, 324 (Alta. C.A.) (*per* Ford, J.A.).

feasible option? There is doubt concerning under what circumstances Canadian courts will imply civil causes of action.[116] The precedents are discouraging.[117]

The topic of implied civil actions has been extensively discussed in academic writing. Professor J.G. Fleming states that save in exceptional cases, the imputation of a presumed legislative intent to confer a private right of action is a fiction. He writes: [117a]

> "In reality, an intent to give or deny an action for damages to the person injured has more often than not been ascribed to the legislature as a result of presumptions or by reference to policy considerations rather than the meaning of the instrument."

The U.S. theory that the civil action is not a true creature of statute is, he contends, intellectually more acceptable. Professor G. Williams by contrast argues that the American approach gives too free a hand to the judges, thereby confusing judicial and legislative functions. It would, he argues, be anachronistic to leave the creation of new areas of law or new classes of private rights to the hazards of litigation.[118] This is a very English point of view, acceptable no doubt in a unitary system and especially one enjoying cabinet government, but conceivably less acceptable in a federal system where, for political reasons, legislative power is not always pushed to its furthest extent. It is, nonetheless, a viewpoint which could well commend itself to Canadian courts which are likely to prove rather conservative in such matters.

It is, however, desirable to indicate what seem to be the conclusions which flow from adherence to statutory interpretation as the key to implied liability, and, as well, to suggest that the stock criticisms of U.S. developments are directed towards consequent evils which frequently do not exist in the rather exaggerated forms which commentators assume.

No doubt reliance upon statutory interpretation acts as a sheet anchor to judicial discretion. Narrowly applied, it would imply that the notion of statutes conferring rights of action lies along the boundaries of common law duties. That is, a court would be most likely to buttress its view of the policy of a statute by reference to whether the statute extended an area already partially protected at common law. But if a court can buttress that area by its view of the policy of a statute or, rather, of what the public

116 *See* P. ANISMAN at 314–18.

117 Ames v. Investo-Plan Ltd., 35 D.L.R. (3d) 613 (B.C.C.A. 1973).

117a J. FLEMING, THE LAW OF TORTS 122 (4th ed. 1971); *see*, for a strong judicial view, O'Connor v. S.P. Bray Ltd., 56 C.L.R. 464 (1936).

118 Williams, *The Effect of Penal Legislation in the Law of Tort*, 23 MOD. L. REV. 233 (1960).

interest requires, why should it not do so by reference to public policy where the duty is new and statutory? One could still have limiting principles of construction.

Part of the answer may derive from the consideration that English and Commonwealth judges in general do not care for social experiments at large. Liability, if it is to be imposed, is likely to be imposed strictly in terms of the statute without the aid of a mitigating discretion, the existence of which the judiciary might, and probably would, deny. Thus, Williams writes:[119]

> "Where the defendant is not under a duty of care at common law, the passing of a penal statute should not automatically be held to place him under a civil duty. The compelling reason is that liability in tort may be far more onerous than the criminal penalty specified in the statute. For one thing, the damages in tort may greatly exceed the penalty thought appropriate by the legislature. Again, the damages in tort follow inexorably from a decision of liability, whereas a criminal court has power to reduce or remit the penalty according to the degree of the defendant's wrong-doing."

These are substantial considerations. They are, as will be seen, given weight by Canadian courts. They do not, however, militate against policy considerations as founding liability. One can argue that Parliament, in imposing a relatively low fine, did not intend wide liability to flow from a breach of statute. One could argue *per contra* that a small fine was imposed simply because consequent civil liability would be great. And, in any event, English courts in some areas do impose civil liability simply in order to give legislation adequate teeth. The use of the constructive trust concept under section 54 of the United Kingdom Companies Acts dealing with the provision by a company of financial assistance for the purchase of its own shares is an example.[120] But it is clear that, adventurous though some U.S. courts may be, they create actions not in contradiction of the broad policies which the statute serves, but in aid of them. They do respect limitations which militate against the recognition of civil causes of action.[121] In addition some judges are inclined to adopt intermediate positions, for example, suggesting liability for damages for intentional rather than negligent infractions of a statute, while recognizing that for the purposes of other relief, *e.g.*, injunctive relief, negligent viola-

119 *Id.* at 256; *see also* J. FLEMING, *supra* note 117a, at 126.

120 Selangor United Rubber Estates v. Cradock (No. 3), [1968] 1 W.L.R. 1555 (Ch.).

121 *E.g.* National R.R. Passenger Corp. v. National Assoc. of R.R. Passengers, 414 U.S. 453 (1972); and *see* Comment, *supra* note 76.

tions should suffice.[122] It remains to be seen whether Canadian courts are apt to be more or less adventurous in imposing liability.

The criteria employed by U.S. courts in determining whether to imply a civil action have already been discussed.

A criterion universally invoked both in United States and Canada is whether the legislation is intended for the protection of a particular class of persons. This criterion is quite liberally invoked in Canada. Motor vehicle legislation often results in the implication of civil actions, both because it is seen as directed towards the protection of other road users and because such liability is akin to traditional liability in negligence for vehicles. Thus, in *Sterling Trusts Corp. v. Postma*,[123] Cartwright, J. held that the breach by the driver of a motor vehicle of a statutory provision which is designed for the protection of other users of the highway gives a right of action to a user of the highway who is injured as a direct result of that breach. The provision requiring red rear lights is of this character. The questions for the court are said to be whether the defendant committed a breach of the provision and whether such breach was an effective cause of the accident. Whether liability is absolute or can be defeated by showing that the condition occurred without negligence were questions reserved by Spence, J., but absolute liability seems to be suggested by the rest of the Court. This decision has of course been consistently followed by lower courts.[124] Similarly, in *Paulsen v. C.P.R.*[125] a majority of the Manitoba Court of Appeal found the fencing requirments of railway legislation to be intended both for the protection of people and to keep animals off the railway track. A similar characterization, in some cases perhaps surprisingly, appears in a number of cases involving breaches of muncipal regulations. A not unexpected instance was a failure by a contractor to observe the provisions of the Alberta Gas Installation Act in installing a domestic gas supply, as a result of which children of the family died and one parent became severely ill.[126] The object of the legislative provision was to provide as part of the scheme of the legislation the creation of rights enforceable by action for the benefit of individuals such as the Ostash family.

122 *See* SEC v. Texas Gulf Sulphur Co., 401 F. 2d 833 (1968) (*per* Friendly, J.). The comparative rigidity of English courts is discussed in J. FLEMING, *supra* note 117a, at 131 but it must be remembered that the courts are operating in quite a different constitutional milieu on these questions too.

123 Sterling Trust Corp. v. Postma, [1965] S.C.R. 324.

124 *E.g.* Blakney v. Leblanc, 2 N.B.R. (2d) 274 (C.A. 1970); Schofield v. Town of Oakville, [1968] 2 O.R. 409 (C.A.) (failure of a municipality to perform its statutory duty to repair a bridge).

125 43 W.W.R. 513 (Man. C.A. 1963).

126 Ostash v. Sonnenberg, 67 D.L.R. (2d) 311, 324 (Alta. C.A. 1968) (*per* Smith, C.J.).

Under certain legislation, for example, municipal zoning by-laws, the courts hold that the legislation renders a particular course of conduct imperative and a deviation from it punishable by penalty in the general interest of the public at large. In such cases, *prima facie*, an action for damages by a person injured by failure to perform the duty imposed does not lie.[127] The court in such cases is inclined to conclude that the remedies provided by the statute are intended to be the sole remedies available by way of guarantees to the public for the observance of the statutory duty, or by way of compensation to individuals who have suffered by reason of the nonperformance of that duty.[128] Inadequacy of the general penalty provided will not found the action.

Ordinarily, one would have little difficulty in concluding that much securities legislation came within the class described in the preceding paragraphs. One's doubts concern whether the fact that a single breach of the statute could engender multiple litigation almost limitless in extent is to be taken as a factor militating against private actions. The question arises as a result of *Direct Lumber Co. Ltd. v. Western Plywood Co. Ltd.*[129] in which Judson, J. in the Supreme Court expressly upheld the reasoning on this point of Johnson, J.A. in the court below. The case involved discriminatory trade practices, including the giving of discriminatory discounts, which were made criminal offences. Johnson, J.A. held that the matter depends on imputed legislative intent, that such intent will generally be found in cases involving industrial legislation and that the fact that a person is one whom the legislature intended to protect is not necessarily a determining factor in deciding whether or not a cause of action was intended. This emphasis certainly seems to contradict *Sterling Trusts Ltd. v. Postma.* On the issue of the scale of consequent litigation, a matter not dealt with in *Postma* at all, Johnson, J.A. states:[130]

> "In the case of a large concern doing business all across Canada which in violation of s. 412 gave a discount to one customer, it would follow that the company would be liable to all its customers who purchased at the higher price. It might be that such purchasers before as well as after the offence could sue. It is difficult to think that Parliament intended such consequences in addition to the penalty that the *Code* provides. It is more reasonable to assume that Parliament was intending to punish it by

127 Tompkins v. The Brockville Rink Co., 31 O.R. 124 (H.C. 1899).
128 Orpen v. Roberts, [1925] S.C.R. 364, 370 (*per* Duff, J.).
129 [1962] S.C.R. 646, *aff'g in part*, 32 D.L.R. (2d) 227 (Alta. C.A. 1962).
130 32 D.L.R. (2d) at 235.

making it a criminal offence to engage in unfair and restrictive trade practices and nothing more."

This concern about the extent of ultimate litigation appears in the municipal by-law cases as a factor against liability. It is not clear what weight courts will give to it; whether to accord it decisive significance or not. Hence the issue remains doubtful. Furthermore, there may well be difficulties of causation in some of these cases.

It should however be stressed that some implied liability does not involve this sort of problem. Where the vice alleged is a failure to observe statutory requirements in the operation of customers' accounts, multiple litigation would flow not from a single breach, but from a number of individual breaches. This sort of problem is, therefore, distinguishable. No one has ever doubted the wisdom of express statutory actions founded on misleading prospectuses, even though the eventual liability may be great. Not all civil actions for breach of a requirement such as that contained in Rule 10b-5 necessarily pose the problems to which Johnson, J.A. refers, and such rules are expressly designed for the protection of the public. But in some respects, where these dangers arise as where negligent press releases are concerned, U.S. courts are prepared to limit liability by reference to the culpability involved. The basic consideration is really economic; it cannot, as we have noted, seem logical from the point of view of the individual investor to allow liability where the loss arose from the defendant's intentional act or omission, but not where it derives from negligence. Would a Canadian court be flexible in this fashion or would it adopt an holistic approach, tending towards disallowing actions where application of the provisions would result in almost unlimited recovery; for example where the essence of the defendant's conduct lay in poisoning the market?

I conclude that the uncertainties concerning whether civil actions will be implied are such that it would be unwise to rely simply on the common law rules if it is desired to employ civil actions in aid. We cannot predict what attitude courts will adopt, nor is it altogether fair to ask them to solve basic policy problems which we have not faced. Hence I advocate a provision like that of section 1417 of the *ALI Federal Securities Code*, and I do not think that it would be wise to rely on common law implication.

15. *Rights of Action and Damages*

One of the principal fears associated with the creation of causes of action outside the privity situation is the very large amount of damages which may ultimately be awarded against the

defendant. These fears are exacerbated where, as in the United States, fairly liberal rules concerning class actions apply. The purposes of civil actions, especially where the cause of action relates to market manipulation, to the dissemination of false information which has an effect on dealings, and insider trading, are both compensatory and deterrent. In effect, the civil action is often employed as an adjunct to agency enforcement. Hence the consequence traditionally feared, the award of large damages, is the consequence which seems from a deterrent point of view most agreeable to the agency.

The consequence of liability in any case must, if traditional damages principles are employed, be computable strictly arithmetically. Unlike a criminal penalty which can be tailored to the circumstances of the accused, the quantum of damages cannot. There is therefore a risk of severe economic dislocation from the award of damages, at any rate where they are awarded against a large enterprise. Unless this difficulty can be overcome, there are bound to be doubts about the wisdom of extending civil actions into the areas above mentioned.

The alternatives appear to be these:

(1) not to create rights of action outside the privity situation; in effect to adopt provisions like those proposed for Ontario in Bill 30;

(2) to create wide rights of action but to limit the extent to which these can be vindicated by class actions. Such a limitation would enable persons who had suffered large damages to sue; it would however probably limit severely the occasions upon which such actions would be brought. But it would in theory permit recovery of substantial losses;

(3) to create wide rights of action with class actions in aid but to impose arbitrary upper limits to recovery. This enables the risk of economic dislocation to be minimized, but in theory may mean that a plaintiff whose loss is substantial gets much less recompense than he ought to receive according to accepted principles of private law;

(4) to create wide rights of action with class actions in aid, and without any limits whatsoever. This entails running the risk of large awards.

Which alternative is to be chosen depends upon the extent to which one wishes to stress the public aspects of the damage action; that is, its potential as a measure of deterrence. The U.S. experience indicates that agency enforcement is simply not sufficient to enforce the due observance of the securities laws. While therefore my personal preference would be to leave matters such as dealings in the markets where there has been a violation of requirements to

file documents such as distribution statements (*ALI Federal Securities Code*, sections 1401 and 509), or insider trading where persons have dealt generally in the market or trading where there has been manipulation of the market to criminal and administrative proceedings, I recognize that it may be unwise to do this from an enforcement point of view. Insider trading in particular may need to be redressed by a very wide action. Actions founded on false publicity may also need to be enforced by wide actions. I would therefore not adopt the Ontario solution, but I would submit that extensive civil actions should be restricted to areas where the problems are great and the U.S. experience at least suggests that civil actions are necessary as a deterrent measure; insider trading, false publicity, but not manipulation in general.

The dangers of pyrrhic awards are sufficiently great to convince one that alternative (4) should not be adopted. The choice is between the second and third alternatives. The second at least permits persons who have sustained large losses and who wish to sue to do so. It is however likely that few people will suffer sufficiently large losses individually to contemplate bringing complicated and protracted civil proceedings. If we are to stress deterrence, the third alternative, provided suitable limitations to damages can be found, seems appropriate. One must however recognize that without a contingency fee system and a tolerance of entrepreneurial attitudes by the bar, civil actions are unlikely to be weapons as frequently invoked as they are in the United States. We are likely to have to rely throughout on the commission as the primary source of enforcement whatever the text of the law.

The *ALI Federal Securities Code* endeavours to deal with the problem. Certain of the sections impose upper limits to damage awards. Section 1402(b) dealing with insider trading in the markets limits damages by providing that the measure specified is reduced to the extent that the defendant proves that the violation did not cause the loss (in effect a no causation defence) and limited also by the amount of securities that the *defendant* sold or bought. The actions in section 1403 concerning false registration statements, and section 1408 dealing with manipulation is subject to an upper limit of the greatest of $100,000 or 1% to a maximum of $1,000,000 of gross revenues in the defendant's last fiscal year before filing the action, and his profit on any sale of a security of the class before the facts constituting the violation became generally known.

Section 1409 of the *ALI Code* provides machinery for the prorationing of damages. The defendant notifies the court if there are multiple claims against him. These may then be stayed and consolidated. If the aggregate award of damages exceeds the

upper limits imposed by the sections creating the causes of action, these may then be awarded pro rata among plaintiffs in accordance with their claims.

The difficulty with this machinery is simply that a plaintiff who suffers large losses may be baulked of his recovery by machinery which enures to the benefit of claimants, some quite small, who may be before the court by reason only of extensive class action procedures. On the other hand there are, I submit, few cases in which this result is likely to occur. U.S. experience would suggest that effective civil actions are a necessary measure of deterrence.

16. *Class Actions*

It is not enough simply to create extensive damage actions. Means must be found to make these actions effective. Where losses, though large in the aggregate, are small individually, the machinery is apt to be underutilized. In practical terms, means must be found to aggregate claims and to make the pursuit of actions rewarding for litigants and, above all, for their lawyers. In the alternative the state could be empowered to bring proceedings. A further possibility is to facilitate both private actions and actions by the state.

A striking aspect of recent American development has been the development of the class action, which at times appeared almost cut off from its roots in private redress. It attained real significance as a regulatory device in the public interest. The first device with which this section deals is the class action. Consolidation procedures, etc., are well known. The impact of the class action and its shortcomings are of crucial significance, certainly in the enforcement of U.S. securities legislation and, as well, in the structure of the American Law Institute proposals. As one note states:[131]

> "The substantive law and procedure interact in many subtle ways in other areas of the law, but in the case of class actions brought under the Truth in Lending Act the union of substance and procedure has given birth to the prospect of damages which might financially cripple or destroy major credit institutions."

The potential impact of the class action on securities regulation is scarcely less profound.[132]

I propose to outline the United States Class Action Rule; to

131 Note, *Class Actions Under the Truth in Lending Act*, 83 YALE L.J. 1401 (1974).

132 *See e.g.* Kahan v. Rosenstiel, 424 F.2d 291 (3d Cir. 1970); Green v. Wolf Corp., 406 F.2d

discuss some of the hopes expressed for it, recent litigation which has curtailed these hopes, the difficulties which surround its use, and then to evaluate what use we might make of the device or any available alternatives.

The United States rule is discussed here, first, because it is the most highly developed rule that I have encountered and second, because it has been the subject of much creative judicial use and academic comment. Its Canadian and Commonwealth counterparts are, so far as I have been able to determine, primitive by comparison.[133] The basic scheme of the rule is followed in the proposed Uniform Class Actions Rule adopted by the National Conference of Commissioners on Uniform State Laws in 1976. Rule 23 provides in part:[134]

> "(a) *Prerequisites to a Class Action.* One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defences of the representative parties are typical of the claims or defences of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.
>
> "(b) *Class Actions Maintainable.* An action may be maintained as a class action if the prerequisites of subdivision (a) are satisfied; and in addition:
>
> "(1) the prosecution of separate actions by or against individual members of the class would create a risk of
>
> "(A) inconsistent or varying adjudications with respect to individual members of the class which would establish incompatible standards of conduct for the party opposing the class, or
>
> "(B) adjudications with respect to individual members of the class which would as a practical matter be dispositive of the interests of the other members not parties to the adjudications, or substantially impair or impede their ability to protect their interests; or
>
> "(2) the party opposing the class has acted or refused on grounds generally applicable to the class, thereby mak-

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291 (2d Cir. 1968); Note, *The Impact of Class Actions on Rule 10b-5*, 38 U. CHI. L. REV. 337 (1971).

133 For a Canadian source, *see* Panel, *Class Actions and Related Matters*, in CANADIAN BAR ASSOCIATION (ALBERTA BRANCH), SELECTED PROCEEDINGS 133 (P. Ketchum, Chairman 1973); *see also* N. WILLIAMS, CONSUMER CLASS ACTIONS (1974).

134 FED. R. CIV. P. 23 (1966).

> ing appropriate final injunctive relief or corresponding declaratory relief with respect to the class as a whole; or
> "(3) the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy. The matters pertinent to the findings include: (A) the interest of members of the class in individually controlling the prosecution or defence of separate actions; (B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; (C) the desirability or undesirability of concentrating the litigation of the claims as the particular forum; (D) the difficulties likely to be encountered in the management of a class action."

Further provisions of the rule provide for a determination by the court, conditional or final, whether the action is to be maintained as a class action. The court is to direct to the members of the class the best notice practicable under the circumstances including individual notice to all members who can be identified through reasonable effort. The following extract from subsection (c)(2) indicates the crucial significance of the notice provision:

> "The notice shall advise each member that (A) the court will exclude them from the class if he so requests by a specified date; (B) the judgment, whether favourable or not, will include all members who do not request exclusion; and (C) any member who does not request exclusion may, if he desires, enter an appearance through his counsel."

This reflects an "opting-out" requirement. Members who do not "opt out" of a class action will be bound by the judgment. This is so even though they may have remained entirely passive towards the action.

The rule further provides that where appropriate an action may be brought or maintained as a class action with respect to particular issues. A class may be divided into subclasses and each subclass treated as a class. The provisions of the rule are then to be construed and applied accordingly. Rule 23 has given an impetus to class actions.

Rule 23(b)(3) which applies to class actions for damages has undoubtedly proved to be controversial. On one hand it is thought that the class action is the only means of redressing infractions of, *inter alia*, securities legislation. On the other it is argued that the economic devastation that would follow upon an enormous recov-

ery indicates the folly of allowing huge actions to be brought in respect of claimants who would never have sued for their own small claims. In addition, it is argued that the class action lends itself with some frequency to blackmailing settlements.[135] Furthermore, it has been argued that if the thrust of the class action is deterrence, the appropriate response is to increase the applicable criminal penalty and not to rely on the class action, or to abandon the class action in favour of a governmental action.[136]

There seem to be several distinct problems. In particular, should the class action be viewed primarily as an instrument of public redress or should it sound primarily in private redress? There is in any event no absolute exclusivity here since an action seen as essentially for the benefit of private litigants may well serve an important public purpose as well. If the former is the desired result, what can the U.S. experience with class actions under Rule 23 teach us? Should we perhaps, in the light of that experience, seek another mode of public redress, leaving the class action as a useful but not revolutionary procedure in aid of private right? If the class action is to sound in private redress, is Rule 23, as interpreted, a suitable drafting model, or should amendments be made to it, or should it be disregarded altogether?

What has happened to class actions under Rule 23 throws, I think, some light on the first question. It may be true, as a recent U.S. Senate report suggests, that most class actions involve classes sufficiently small to render the actions manageable and to make individual notice to class members possible.[137] There have been some striking exceptions to that generalization. The courts were and are broadly sympathetic to the proposition that class actions are a necessary vehicle for the vindication of small federal claims.[138] The advent of very large class actions, however, posed problems both practical and doctrinal.

The idea of the class action essentially as an instrument of public redress was rapidly perceived and exploited by the legal profession. After 1966 when the present Rule 23 was introduced, class actions proliferated. The courts, faced with the necessity of interpreting the rule according to its terms, set something of a

135 Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

136 Staff of U.S. Senate Commerce Committee, 93d Cong., 2d Sess., Class Action Study (1974).

137 *Id.*

138 *See e.g.* Berland v. Mack, 48 F.R.D. 121 (S.D.N.Y. 1969); Kahan v. Rosenstiel, 424 F.2d 161 (3d Cir. 1970); Zahn v. Int'l Paper Co., 414 U.S. 291 (1973); Green v. Wolf Corp., 406 F.2d 291 (2d Cir. 1968); and *see* Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968); Note, *supra* note 132.

brake on such developments. In class actions, Rosenfeld remarks, the important factor[139]

> "[I]s that wrongdoers should be forced to return their illegally obtained profits and not that individual class members have a right to repayment."

From this premise, the inhibitions contained in Rule 23 indeed look irksome. The solution is either to treat these as mere technicalities, to be overborne by large and sympathetic interpretations, or, as the U.S. Senate committee recommends, to devise new machinery.[140]

The difficult procedural problems have centred around the requirements of manageability, notice, costs and standing. The question of whether the would-be class is sufficiently united in interest is less often troublesome.[141] Thus courts have held that where a common scheme of deception has been alleged, a common question exists even if the suit is based on otherwise unrelated nondisclosures or misrepresentations.[142] In an action complaining of the withholding of relevant information the existence of individual issues of reliance does not hinder the predominance of the common question; the actionability of the defendant's conduct.[143] Apart from those matters which derive from the wording of Rule 23 itself, the class action really requires that materiality be taken as proving a *prima facie* case of reliance. The rule in *Affiliated Ute* is not of course restricted to the class action, but it is necessary to make it effective. Proof of reliance also poses problems, essentially seen as aspects of manageability, on the distribution of any recovery including the matter of disposing of any unclaimed balance after notice of recovery to the class. It is in this

139 Rosenfeld, *The Impact of Class Actions on Corporate and Securities Law*, [1972] DUKE L.J. 1167.

140 STAFF OF U.S. SENATE COMMERCE COMMITTEE, *supra* note 136; and *see*, *Vanik Introduces Bills Aimed at Overcoming Restraints to Class Action Suits Posed by Eisen, Zahn Decisions*, 268 BNA SEC. REG. & L. REP., September 11, 1974, at A-18.

141 *See*, however, Winokur v. Bell, 58 F.R.D. 178, 41 U.S.L.W. 2259 (N.D. Ill. 1972) insisting on common representations under Rule 10b-5; La Mar v. H.B. Novelty & Loan Co., 489 F.2d 461 (9th Cir. 1973); and *see* the very permissive judgment allowing want of standing in the original class to be cured by the joinder of persons having standing, Haas v. Pittsburgh Nat'l Bank, 60 F.R.D. 604 (W.D. Pa. 1972); Re U.S. Financial Securities Litigation, [1977-1978 Transfer Binder] CCH FED. SEC. L. REP. ¶ 96,838 (S.D. Cal. 1974) (where different documents are relied on as the source of a misrepresentation, the misrepresentations must be the same or similar, or that the misrepresentations were part of a single manipulative scheme); *see also* Miller v. Central Chinchilla Group Inc., [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,077 (S.D. Iowa 1975) (class actions are inappropriate in the case of oral misrepresentations).

142 Simon v. Westinghouse Electric Corp., [1977-1978 Transfer Binder] CCH FED. SEC. L. REP. ¶ 96,094 (E.D. Pa. 1977).

143 Cameron v. E.M. Adams & Co., 547 F.2d 473 (9th Cir. 1977); Sargent v. Genesco, 75 F.R.D. 79 (M.D. Fla. 1977).

latter respect that advocates of the class action clearly desired it to move away from its traditional roots. Finally, and perhaps inevitably, it was alleged that the class action was being used as a means of coercing settlements.

Some courts are tolerant of manageability, even where large administrative tasks are involved. Class actions should not, it is said, be defeated because the defendant has taken so much from so many that the resulting actions become very complicated.[144] But the courts have also stated that Rule 23 is not intended to permit redress for all wrongs without limitations. Where, therefore, problems of notice and of the distribution of any recovery arose, courts invoked the notice and manageability bars to the rule. Actions on behalf of six million purchasers of gasoline at retail,[145] and all consumers of eggs in the United States,[146] were disallowed on these grounds. Other courts were willing to allow the action to proceed with a view to devising machinery for the allocation of recoveries at a later stage.[147] Plaintiffs' attorneys responded on two levels.[148] The first was to argue that the individual notice requirement was technical and should not therefore be so interpreted as to block meritorious litigation. The crux, according to this argument, is that if class actions are barred because the class is thought to be unmanageably large, the wrongdoer is enabled to benefit from his own wrong. The second response was the imaginative invention of the "fluid class" notion in order to solve the problem of distribution of recovery, a device necessitated by the fact that the membership of large classes is apt to change between the date of the wrong and the date of judgment. Persons were invited to submit claims against the judgment fund. Any residue would be applied *cy pres* by the court. In a drug antitrust case the monies were disbursed to state health care programmes. In *Eisen v. Carlisle and Jacquelin*[149] it was suggested by counsel that the recovery in an odd-lot differential case be applied by the wrongdoers on reducing the odd-lot differential in future. The result, Rosenfeld states, would be:[150]

> "Thus, the wrongdoers would surrender their illegal profits, and the defence of unmanageability would be by-passed. As a result the *class* of odd-lot buyers and

144 Appelton Electric Co. v. Advance-United Expressways, 494 F.2d 126 (7th Cir. 1974).
145 City of Philadelphia v. American Oil Co., 53 F.R.D. 45 (D.N.J. 1971).
146 United Egg Producers v. Bauer International Corp., 312 F. Supp. 319 (S.D.N.Y. 1970).
147 *In re* Co-ordinated Practical Proceedings in Antibiotic Anti-trust Actions, 333 F. Supp. 267 (S.D.N.Y. 1971).
148 Rosenfeld, *supra* note 139.
149 94 S. Ct. 2140 (1974).
150 Rosenfeld, *supra* note 139; and *see* Note, *supra* note 132.

> sellers would be made whole, although each of the individuals who overpaid because of the fixed price would not necessarily be compensated."

The emphasis quite clearly is on policing the market and sustaining standards generally, rather than on individual recovery. This impression is reinforced by the statement that:[151]

> "Attempting to ascertain and pay each class member his exact damages may not only be too burdensome for the court, but may also be an expense that would consume too great a portion of the recovery."

The suggestion was imaginative, but it was not warranted by the wording of Rule 23.

The device of a preliminary enquiry on the merits was also suggested as an answer to problems of manageability and costs.[152] Some courts were prepared to proceed thus; others insisted that the sole question before the court is whether the requirements of Rule 23 were met.[153] In a doubtful case, the action should be allowed to go forward as a class action.[154] Preliminary hearings were in some quarters thought to confer illusory advantages only, since in only rare cases could the court assume that the class would ultimately succeed. Nonetheless the defendant could be required to share some of the costs if the claim appeared meritorious.[155]

The impact of the class action also affected the elements of the action itself. This is particularly noticeable in relation to issues of reliance and causation. In *T.S.C. Industries Inc. v. Northway Inc.*[156] the Supreme Court holds that the test of materiality is whether the reasonable man would have attached importance to the fact misrepresented. The decision apparently alters the concept of materiality enunciated earlier in *Mills v. Electric Auto-Lite Co.* where the test is said to be whether the defect was of such a character that it might have been considered important, in that case to a reasonable shareholder who was deciding how to vote (in the light of a proxy statement).[157]

In 10b-5 actions the position is more confused. It is sometimes thought that *Affiliated Ute Citizens of Utah v. United States*[158] is an

151 Rosenfeld, *supra* note 139, at 1182.

152 Dolgow v. Anderson, 53 F.R.D. 664, 40 U.S.L.W. 2236 (E.D.N.Y. 1971); Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970).

153 Miller v. Mackey Int'l Inc., 452 F.2d 424 (5th Cir. 1971); Katz v. Carte Blanche Corp., 52 F.R.D. 510 (W.D. Pa. 1971).

154 Kahan v. Rosenstiel, 424 F.2d 161 (3d Cir. 1970).

155 Berland v. Mack, *supra* note 138.

156 96 S. Ct. 2126 (1976).

157 396 U.S. 375 (1970); *see further* Lowenfels, *supra* note 75; PLI, *supra* note 84.

158 92 S. Ct. 1456 (1972).

authority against there ever being an obligation on the part of the plaintiff to prove reliance in class actions.[159] This may overstate the effect of the case which seems to turn on nondisclosure by persons who placed themselves in a near fiduciary relationship to the plaintiffs.[160] Reliance must be shown in some individual suits.[161] Difficulties as we have seen arise concerning the extent to which materiality can be invoked in order to raise a *prima facie* presumption of reliance and causation.[162] Some courts and writers assume that it is proper for a court to deal with issues of reliance by deferring them to a later stage, but that reliance must at some point be proven.[163] Other courts conclude that at any rate, where the action depends upon an omission, a withholding of relevant information, the plaintiff need not prove reliance but only materiality.[164] Whether reliance will be required in the United States after *Blue Chip Stamps v. Manor Drug Stores*[165] in cases of affirmative misrepresentation is not clear.[166] What does seem to be clear is that to have different rules depending upon whether the matter is characterized as misrepresentation by omission or by positive misstatement is quite illogical. The *ALI Federal Securities Code* is inclined to solve the problem by reversing the onus of proof, giving a defendant a defence to the extent that he or it can prove nonreliance by the plaintiff or plaintiffs. This is likely to bear as hard on defendants as the contrary rule would bear on plaintiffs but it is, I submit, a practical necessity. Arguably, the ALI proposal is no more than a straightforward interpretation of *Affiliated Ute* and is certainly more workable than requiring proof of reliance in the first instance or in some cases at all.[167]

While U.S. courts evince no hostility towards class actions as such, some of the more adventurous constructions of Rule 23 have been struck down by the courts. Thus, a diversity suit seeking damages cannot be maintained as a class action under Rule

159 Dorfman v. First Boston Corp., 336 F. Supp. 1089 (E.D.P.A. 1972).

160 *See further* Ruder & Cross, *Limitations on Civil Liability Under Rule 10b-5*, [1972] DUKE L.J. 1125.

161 List v. Fashion Park Inc., 340 F.2d 457 (2d Cir. 1965), *cert. denied*, 382 U.S. 811 (1965).

162 Chris-Craft Indus. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir. 1972), *cert. denied*, 414 U.S. 910 (1973); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith Inc., *supra* note 87.

163 Ruder & Cross, *supra* note 160; Berland v. Mack, *supra* note 138; Green v. Wolf Corp., *supra* note 132; and *see* Note, *supra* note 132; Tucker v. Arthur Anderson & Co., 67 F.R.D. 468 (S.D.N.Y. 1975); Felderman v. Empire Fire and Marine Ins. Co., [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,822 (S.D.N.Y. 1974).

164 Cameron v. E.M. Adams & Co., [1976-1977 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,819 (9th Cir. 1977).

165 421 U.S. 723 (1975).

166 PLI, *supra* note 84.

167 *See further*, Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975).

23(b)(3) in the absence of a showing that each of the unnamed members of the class independently satisfies the jurisdictional amount requirements of the legislation even though each of the named plaintiffs met jurisdictional amount requirements.[168] This particular difficulty does not arise under the securities laws because jurisdiction is not founded on diversity.

More significant is the decision of the Supreme Court in *Eisen v. Carlisle & Jacquelin* upholding the notice requirement of Rule 23 and striking down the fluid class concept.[169] The case deals with alleged antitrust violations in connection with the purchase and sale of odd lots on the New York Stock Exchange in May and June 1966. The plaintiff's own loss was put at an estimated $70. The class, it ultimately transpired, consists of six million people of whom 2,250,000 could be easily identified. Members of the class resided in every state of the United States and in some foreign countries. The estimated total damages were $120 million. The plaintiff could not afford the expense of giving notice to all members of the class. The lower court directed the plaintiff to give actual notice to selected groupings of persons within the class, *e.g.*, to 2,000 or more class members who had ten or more transactions during the relevant period and 5,000 other class members selected at random from the 2,250,000 members who could be readily identified. On the question of who was initially to bear the costs, the lower court directed a brief preliminary hearing on the merits and then concluded that the defendants must bear 90% of all expenses. As many of the six million persons would never claim against the recovery, the balance was to be used for the benefit of all odd-lot traders by reducing the odd-lot differential in an amount determined by the court to be reasonable until the fund was depleted. This disposition was disapproved by the Court of Appeals and the Supreme Court.

The Supreme Court, addressing itself to the requirements of Rule 23, notes that under its terms the court must direct to class members the best notice practicable under the circumstances including individual notice to all members who can be identified through reasonable effort. Individual notice *must* therefore be sent to all class members whose names and addresses may be ascertained through reasonable effort. Arguments about the policy of class suits, or whether it is necessary to have individual notice in cases where individual recovery is so small that it is unlikely that individuals would sue, are irrelevant. The requirement of individual notice is not discretionary, but mandatory. The idea behind

168 Zahn v. Int'l Paper Co., 414 U.S. 291 (1973).
169 94 S. Ct. 2140 (1973), *aff'g*, 479 F.2d 1005 (2d Cir. 1970).

Rule 23 is to bind all class members who did not request exclusion from the suit. Justice Powell thus states:[170]

> "Accordingly, each class member who can be identified through reasonable effort must be notified that he may request exclusion from the action and thereby preserve his opportunity to press his claim separately or that he may remain in the class and perhaps participate in the management of the action. There is nothing in Rule 23 to suggest that the notice requirements can be tailored to fit the pocket books of particular plaintiffs."

The plaintiff must bear the costs of notice. The use of a preliminary hearing on the merits as an allocation device was rejected. It is unauthorized by the rule; it would allow a representative plaintiff to secure the benefits of a class action without first satisfying the requirements for it in that he could obtain a determination on the merits of the claims advanced on behalf of the class without any assurance that a class action could be maintained. The defendant could as a result suffer prejudice. The result is consistent with the general U.S. rule that when the parties are truly adversary the plaintiff must pay the costs of notice as part of the ordinary burden of financing his own suit. Justices Douglas, Brennan and Marshall, dissenting in part, would have remitted the action to see whether subclasses could be created, in whose name the action could proceed.

The Court of Appeals for the Second Circuit had also dealt with the "fluid recovery" procedure in cases where individual claims are of little consequence.[171] This part of the decision was not dealt with by the Supreme Court. The Court of Appeals concludes that the fluid recovery procedure is not authorized by Rule 23, is inadmissible as a solution to the manageability problems of class actions and wholly improper. The *in terrorem* effects of the innovations amount, it was alleged, to legalized blackmail, producing settlements in cases where the merits of the claim are doubtful. It is improbable that the Supreme Court would take a different view of the matter.[172]

Nonetheless, the Court of Appeals recognizes that real problems are posed by wrongs which give rise to large numbers of losses, few of which are large enough to render practicable individual actions for redress. There is a need for an adequate remedy.

170 94 S. Ct. at 2152 (*per* Powell, J.).
171 479 F.2d 1005 (2d Cir. 1973).
172 Blue Chip Stamps v. Manor Drug Stores Inc., *supra* note 135.

Rule 23 works well in cases where the class is not unduly large. But, as the Court states:[173]

> "It seems doubtful that further amendments to Rule 23 can be expected to be effective where there are millions of members of the class, without some infringement of constitutional requirements."

The Court therefore invites Congress to consider creating an agency to vindicate consumer rights. It draws attention to the injunction as a remedy more desirable than class actions for damages. It seems clear that the court, and indeed other courts as well, are troubled by blackmail settlements which are felt to benefit plaintiffs' attorneys primarily. The prospect of ruinous judments is also uncongenial.[174]

The United States Senate Commerce Committee has recently advocated new legislation to enable large classes of plaintiffs to recover small individual claims. It suggests that new class action legislation might prevent unjust enrichment of the defendant even when significant individual recovery among consumer class members is not possible. Rule 23, the committee notes, is designed to protect the interests of individual class members. It hinders class actions on behalf of large numbers of consumers with meritorious claims too small to support individual suits, thus frustrating other valid ends of consumer class actions such as the prevention of unjust enrichment and deterrence. The Committee advocates the use of the "fluid recovery" device and the *cy pres* doctrine in aid.

I propose to rehearse some of the committee's findings before evaluating proposals for reform. The principal sample employed by the committee was of cases in the District of Columbia. In addition, the committee considered a small sample from the country at large. The chief points appear to be:

(1) There has been a substantial increase in class actions since Rule 23 came into effect in 1966.
(2) The majority of class actions do not seek monetary relief.
(3) While some classes are very large, only 14% of actions had classes with more than 100,000 members; 25% had classes under 10,000 members.[175]
(4) Few defendants settle. Some 55% of cases were disposed of in favour of the defendant on a preliminary motion, the largest single bloc of which was for failure to state a claim. Few cases are frivolous. A very small proportion of cases went to trial,

173 479 F.2d at 1019; this latter phrase reflects the "Case and Controversy" clause of the United States Constitution.

174 *See* Blue Chip Stamps v. Manor Drug Stores, *supra* note 135.

175 It seems fair to conclude that classes in Canada would be much smaller.

but in the District of Columbia only 5% *of all* civil cases terminated were tried on the merits.

(5) Class actions in general do not take markedly longer from filing to disposition in the District Court than do civil actions in general. If, however, actions were not disposed of early in the litigation, problems concerning certification, notice and damage distribution did sometimes arise.

(6) Courts often considered the merits of class actions along with and in aid of a decision on the certification issue. Plaintiffs felt it essential to present a strong case on the merits as well as on the class issues before the certification issue arose, since they felt it unlikely that certification would be granted in a case in which the judge was not convinced that the plaintiff had a meritorious claim. (It will be interesting to see whether this will survive *Eisen.*)

(7) In general, individual notice was given to defendants. Classes were often small and manageable. In some cases it was difficult to show that all potential members were indeed notified. Some notices were for example returned because the addresses returned were inaccurate. Other forms of notice had then to be resorted to. The costs of other forms of notice were often no less expensive than the costs of giving individual notice.

(8) The costs of notice were not unduly high, except perhaps in very large actions. In no case did costs of notice exceed 5% of total recovery.

(9) Information concerning distribution of damages is limited, but the sample does show that problems of manageability and administrative costs were not overwhelming in most cases. In no instances were the problems of damage distribution insurmountable or class awards consumed by costs. Class size did however diminish substantially between the time of certification and the time of allocation of damages. Unclaimed amounts were sometimes left over. In some cases "fluid recovery" was used, in other cases the surplus was returned.

(10) Few individuals use the opt-out procedure under Rule 23. It does not, therefore, contribute substantially to the reduction of class sizes.

(11) It was suggested to the committee that attorneys frequently abused the class action by engaging in solicitation to create a class and by using it primarily as a vehicle to collect exorbitant fees. The committee doubted whether this was so. Few defendants' lawyers thought that class actions were being brought frivolously. It was thought that attorneys were unlikely to devote the amount of time and effort required in such actions unless the action seemed meritorious.

(12) The contingency fee is distrusted. It is thought to facilitate the recovery by attorneys of enormous fees. There was felt to be need for a system that prevents unreasonable awards, yet provides sufficient incentive for attorneys to bring meritorious suits. Only partial provision is made for this at present. The court must, under Rule 23, scrutinize attorneys' fees where a claim is being compromised or settled.

The study reaches some interesting conclusions. It considers that Rule 23 procedure is effective in the case of small classes but that, viewed from the standpoint of individual compensation, large classes with small individual claims are particularly apt to be unmanageable. Procedures ought however to be changed to give primacy to such other goals as deterrence and the prevention of unjust enrichment. Machinery should be devised to allow cases to proceed even though, because of problems of class size and manageability, the action could not proceed as under Rule 23. Flexibility is needed in dividing classes and subclasses, and in devising notification procedures. If compensation to individuals is not feasible, machinery should be devised for the exaction of a deterrent fund from the defendant. Such machinery is of course suggested in section 1409 of the *ALI Federal Securities Code*, discussed above. The study considers distribution *cy pres*, with the damage fund held open for long enough to allow claims against it. Even within the context of Rule 23, the opting-out device should be perpetuated.

There are two matters upon which further information is desirable. Are the figures for large class actions too low? Experience under the Truth in Lending Act suggests that this may be so.[176] Has Rule 23 had the effect of reducing class sizes; that is, is it reponsible for the finding that few class actions involve astronomical numbers of plaintiffs? What direct and oblique results can one assume would follow from adoption of the Senate Study recommendations? It cannot be said that the study probed this aspect of the matter closely.

I conclude that:

(1) We should facilitate class actions in Canada and adopt a class action rule similar in terms to Rule 23.

(2) We should not however follow the U.S. Senate Commerce Committee's suggestion to facilitate the use of the class action as an instrument of depriving defendants of unjust enrichment. Deterrence can be provided for in the normal class action or by criminal, injunctive or other proceedings.

(3) We ought to explore as an adjunct to the class action the

176 Note, *supra* note 131.

notion of an action brought by a government agency to vindicate private rights.

It is, I trust, unnecessary further to stress the advantages of Rule 23 as a mechanism for enforcing private rights. It combines claims, with a consequent saving of judicial time. It enables persons having some elements of common interest to finance expensive litigation. It enables persons who do not want to come into the class to opt out if they so wish. By using an opting-out device persons basically ill-informed, or ignorant of the ways in which their rights can be vindicated may be joined in the action. At the same time, the action can only be certified where the class action is a manageable and practical device. I see no reason to doubt the U.S. Senate Commerce Committee's assertion that the rule works well except in cases of a large number of small claims which, individually, would probably not be litigated otherwise. In most cases it will probably not be unduly difficult to ascertain the boundaries of the proposed class.[177] Rosenfeld notes that in the United States, class actions have been used most frequently under the proxy and anti-fraud provisions of the Securities Exchange Act of 1934 and the registration provisions of the Securities Act of 1933.[178] The action based on proxies is the simplest variety because each member of the class is identifiable; the alleged wrong took place at the same time for all class members, and damage to each and every member of the class can be measured in the same manner. Thus, the two principal problems, identification of class members and individual reliance, may not be present in a proxy fraud case. Registration statement violations are dealt with under section 11 of the Securities Act of 1933 which imposes liability upon persons responsible for a registration statement if the registration statement or prospectus contains an untrue statement of material fact or omits to state a material fact or omits to state a material fact required to be stated therein, or necessary to make the statements therein not misleading. The liability thus created is nearly absolute. There is no need to show how the alleged omission affected the judgment of each class member. It is said that the class action device provides the only practical way in which those who are damaged by a false registration statement can be repaid. Liability is potentially more open-ended than in a proxy case.

Actions founded on a breach of section 10b-5 can give rise to vexed problems of scale. According to Rosenfeld, in a typical Rule

177 Thus, in Shapiro v. Merrill Lynch, Pierce, Fenner & Smith Inc., *supra* note 87, the class was readily determined as comprising all purchasers who traded contemporaneously with the defendant's wrongdoing.

178 Rosenfeld, *supra* note 139.

10b-5 class action, a company's publicly issued earnings report is challenged as false and misleading. If the company's stock drops in value, any person who bought the security after the earnings statement was published may bring a class action on behalf of all other persons who bought the security after the publication date. Liability is sometimes not observed for several years. The class in whose name the action is brought may be huge. The scale of the action is not, he asserts, the true problem. The real problem:[179]

> "...is not the fact that the class is often very large and, in turn, difficult to identify and locate, but rather the fact that the merits of some section 10(b) actions are sometimes thought to be thin."

As an example he cites the *Texas Gulf Sulphur* case where the press release was drafted under great time pressure by nonlawyers for nonlawyers.

There is I think, an element of truth in this assertion. But, apart from merits, we need to determine what the leading feature is to be, deterrence or whether a compensable loss has occurred.

Consistent with the approach taken earlier in this paper, I do not advocate the adoption of a more restrictive class action rule than that afforded by Rule 23b. I do advocate the imposition of an upper limit to damages as suggested by the *ALI Federal Securities Code*. We do, I submit, need civil actions in aid of deterrence and this involves having effective machinery. In my submission we should introduce class action machinery along the lines of Rule 23b, but in areas where giant recoveries are to be anticipated, the dangers should be limited by a limitation of damages provision of the sort contained in the *ALI Federal Securities Code*. The provisions of the rule such as manageability and notice should be strictly enforced.

I doubt whether enforcing manageability requirements would kill the class action. Most classes, according to the U.S. Senate Commerce Committee are small enough to be manageable, and indeed, the existence of Rule 23 may induce counsel to consider carefully what the class is to be, how closely it should be defined, etc. Classes seem still to be numerous enough to make recovery worthwhile. Indeed, numbers alone do not necessarily render a class unmanageable. In *Eisen* the Court of Appeals thought that it did, but the Supreme Court did not endorse this aspect of the Court of Appeals' judgment. The question decided in *Eisen* is whether personal notice must be given.[180]

179 *Id.* at 1177.

180 This narrow construction of the case is adopted by several American commentators as well; *see e.g. Eisen IV: Don't Believe the Headlines*, 271 BNA SEC. REG. & L.

What the court in general must decide is whether the four criteria in Rule 23a are made out and in addition that common questions predominate and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy.[181] If there is a less disruptive means of doing so, it should be adopted. In a case where it is difficult to define a class closely, or where very large numbers of potential plaintiffs are involved, the test case may prove to be an acceptable alternative, with notice given to all other class members if liability is established. (If the defendant prevails, other class members may try again.)[182]

The point is that not one but several procedures are open for litigating the issue, and that even in the class action subclasses may be used. From the point of view of private recompense, Rule 23 machinery seems to work well. When one seeks to make the machinery work primarily in aid of public purposes such as deterrence or the denial of unjust enrichment, one risks incidental distortions of an undesirable character. One limits either the devices which can be adopted in aid of recovery or the limits of recovery which can be allowed. It would in my submission be preferable not to expand the device. It seems appropriate also to point out that the empirical data available concerning the class action is fragmentary. We know very little about the extent to which large recoveries may be anticipated or their economic effects, or the impact of large class suits on court schedules, and the like.

If it is desired to make extended provision for class actions, some of the obscurities of Rule 23 might be dealt with. For example, while it is settled that district courts cannot conduct preliminary trials on the merits with a view to determining whether actions should proceed as class actions, the issue continues to crop up in various ways. In particular, courts have experienced difficulties in determining whether common questions of law and fact both appear and predominate. These issues must be decided at an early stage. The rule seems to be that although the judge may have to speculate to some extent, his decision will not be interfered with provided that he has sufficient material before him to reach a

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REP., October 2, 1974, at B-1; *Eisen IV: Class Actions One Year Later*, 711 BNA ANTITRUST & TRADE REG. REP., April 29, 1975, at B-1; Scott, *Two Models of the Civil Process*, 27 STAN. L. REV. 937 (1975); *cf.* Dam, *Class Action Notice: Who Needs It?*, [1974] SUP. CT. REV. 97, who nonetheless believes that the decision will prove discouraging.

181 *See further* Kamm v. California City Development Co., 509 F.2d 205 (9th Cir. 1975).

182 *See generally* Katz v. Carte Blanche Corp., *supra* note 153.

(tentative) conclusion and bases his ruling on that material.[183] We might make explicit provision to this effect.

In my submission it is also imperative that we deal with the issue of materiality or reliance. Here I advocate that in the cause of action or in the class action rule we provide that a plaintiff in any action based on misrepresentation be required only to demonstrate materiality. The rule in *Blackie v. Barrack* should apply generally; its adoption is a practical necessity.[184] The safeguards are first, the ability of the defendant to prove nonreliance by the plaintiff, second, the upper limit to damages and, if the ALI draft is followed, the fact that there will not have been a breach of the code, in insider trading cases at least, where the defendant believes (on reasonable grounds) that a fact of special significance was generally known or known to an identified other party to the transaction. In short, liability under the ALI scheme for this proposal, would not be arbitrary and unfair.

The matter of costs also requires attention. In the absence of a contingency fee system the possibility of even a successful plaintiff not being awarded enough in costs to satisfy his legal expenses is likely to prove a considerable deterrent to anyone seeking to bring a class action. In a report to the Consumers' Association of Canada, Professor N. Williams concludes that two steps might be adopted:

(1) to adopt a special rule for class actions whereby the defendant would be ordered to pay costs to the plaintiff on a solicitor-client basis which would give the plaintiff a complete indemnity for his costs;

(2) to provide legal aid to the plaintiff for some of his costs, at least to the extent that the costs recovered from the defendant are inadequate to meet the costs the plaintiff must pay to his own lawyer.

Both suggestions are worthy of further exploration.[185]

Another procedural change might be the introduction of the contingency fee. This is probably an essential innovation if class actions are to be pursued aggressively enough to act both as a compensatory and deterrent device. But, as Professor K. Dam delicately notes, it raises the central policy issue of the role of the plaintiff's lawyer; what it is to be in the enforcement of regulatory legislation and how much entrepreneurial scope the lawyer is to have.[186] With the exception of Alberta, Canadian law societies

183 Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975).

184 *Id.*

185 N. Williams, *supra* note 133, at 36.

186 *See* Dam, *supra* note 180; Dam, *Class Actions: Efficiency, Compensation, Deterrence*, 4 J. Legal Stud. 47 (1975).

have been conservative in these matters. The contingency fee is unlikely to be unanimously adopted in Canada.

17. *Governmental Actions*

The question whether the broader public purposes of the class action might not be best achieved by vesting the right to bring civil actions on behalf of a class of consumers in a protective agency has been raised in a number of quarters, both here and in Europe, though in Europe the action does not lie in damages.[187] A first step has been proposed in this regard by Ontario.[188] In order to enforce a liability to a reporting issuer deriving from the misuse of inside information, or, in the case of a mutual fund, deriving from insider information pertaining to the fund, the High Court may on application permit a securityholder of the reporting issuer or the Ontario Securities Commission to bring action on behalf of the reporting issuer. In any case it must be shown either that the reporting issuer (or mutual fund) refused to bring an action within sixty days of a demand upon it to do so, or failed to prosecute it diligently. The costs may be ordered to be paid by the reporting issuer. In determining whether leave shall be given to bring or continue the action for the benefit of a reporting issuer, the judge shall have regard to the potential benefit to be derived from the action by the reporting issuer and the securityholders thereof and the cost involved in the prosecution of the action.[189] The purpose of the action is therefore plainly compensatory rather than deterrent. It is similar to section 37 of the United Kingdom Companies Act 1967 which enables the Department of Trade and Industry, following an investigator's report, to bring a civil action in the name and on behalf of a body corporate where it appears desirable to do so in the public interest, and to section 100.5 of the Canada Corporations Act. It overrides a decision by the controller not to sue and could certainly enure to the benefit of creditors. The repository of any recovery is conveniently indicated, the company, and the ultimate distribution will be to creditors and shareholders in proportion to their claims. The section, potentially useful, has no revolutionary significance. Nonetheless, it could prove to be a powerful regulatory device if rigorously used.

Elsewhere in the field of securities, what claims would be

187 Dam, *supra* note 180; Eisen v. Carlisle and Jacquelin, 479 F.2d 1005 (2d Cir. 1973) (*per* Medina, C.J.); on French law *see* de Poulpiquet, *Le droit de mettre en mouvement l'action publique; conséquence de l'action civile ou droit autonome*, REVUE DE SCIENCE CRIMINELLE ET DE DROIT PÉNAL COMPARÉ 37-57 (January-March 1975).

188 Ontario Bill 30, cl. 134.

189 *Id.* cl. 6.

pursued, whose interest is to be vindicated, and to whom ought recovery to go? The causes of action of which we speak may be incredibly diverse. For example, we could be speaking of dealers who cause loss by manipulating customers' accounts, or of issuers who file false prospectuses, or of insiders who intentionally or otherwise manipulate a market or who issue misleading statements at a time when their stocks are being traded.

So far as insider liabilities are thought to produce claims by the insiders' corporation the corporation is, as we have noted, a suitable repository for recovery. But in a situation in which it is desired to pursue individual claims in the insider situation the desirability of such machinery is less clear. For, on whose behalf would the claim be advanced, what quantum of damages would be appropriate, how would causation and loss be proven? The difficulties of inducing ordinary private persons to bring class actions would be surmounted, but one would not necessarily solve the potential difficulties implicit in the unregulated class action.

One solution might be to enable an agency to take over or commence civil litigation, subject to satisfying the court that the claimants whose rights it vindicates have requested such action and that it is in the public interest that the action be allowed to proceed. Provision could be made once the cause of action had been proven, for others to file claims, and for determination of the total recovery to be deferred long enough for claims to be filed and proven. This would involve claimants in proving that they fell within the class to which the judgment related, that they relied, and that they suffered loss. Proof could be facilitated by allowing proof by affidavit, subject to cross-examination by the defendant if desired. Very small claims would probably not be advanced because to do so would be somewhat time-consuming and the financial benefit, after costs of proof, exiguous. The defendant would ultimately pay only the sum due to claimants plus costs. There would be no residue for distribution *cy pres*. It is perhaps less likely, than under some proposals, to result in colossal damage awards of a severely disruptive character.

In determining whether the public interest dictates that the agency should be allowed to bring an action, the nature and extent of any alleged wrongdoing; the amount of recompense to individual plaintiffs, the dictates of deterrence and the availability of alternative machinery could all be taken into account. A court might well be able to conclude that the public interest did not warrant such an action. For example, where what was in issue was a press release drafted in haste and in innocence, it might be though that deterrence and the enforcement of standards of care did not require public intervention. At the same time a private

action on behalf of a person substantially damnified, or even a class, could proceed subject to the normal hazards of litigation such as proving that there really was a cause of action. The agency would initially be faced with a hurdle; that of demonstrating to the court that on balance it is in the public interest that it be allowed to bring a particular action.

Some heads of public interest have been mentioned; another might appear where numbers of economically deprived persons were mulcted of appreciable sums of money, or where persons manipulated a governmental scheme designed to protect a class of persons as in *Affiliated Ute*. As Dam notes, some machinery would have to be devised in cases where both governmental and private actions were in train, to deal with the problem of overlapping recoveries. We would also need a rule to deal with cases in which the same conduct attracted suits for damages on behalf of individuals and a suit by the insider's corporation based on restitutionary principles. We may have to consider limits to recoveries, priorities if any in the execution fund and the like.

A further and fundamental point arises. This paper discusses such matters as improved class action procedures and allied devices. Few if any provincial rules of court are very advanced in these areas. Normally, actions under federal statutes would fall within the concurrent jurisdiction of provincial Supreme Courts and the Federal Court of Canada. But as it may prove difficult to secure the desired unanimity in provincial rules concerning class action, it may be best to invest the Federal Court with exclusive original jurisdiction in civil matters arising under any federal securities code. Presumably, it would be possible to procure a suitable class action rule under the rules of the Federal Court, or make special provision for this in the statute itself. Inconvenience to litigants is minimized by section 15 of the Federal Court Act by which the court sits in any place in Canada. If we are to suggest substantial changes in modes of procedure, we will, I think, have to centralize jurisdiction. In addition, if we are to rely upon such matters as class actions it might be easier to secure greater consistency in the application of standards via one court than several.

C. INJUNCTIVE AND ANCILLARY RELIEF

There is an obvious need, under any regime of securities regulation, for a power to prevent individuals from carrying on unlawful activities, either at the particular time or in the future or both. Where the activity involved results in the collection of a fund from the public which is put at risk, or the exaction of an unlawful profit, or the obtaining of securities which may, by further dealing

in the course of trade deprive the victim of redress via rescission, there arises also a need for ancillary relief in order to preserve the *status quo* pending final relief. The SEC tackles these problems via the injunction, the utility of which goes far beyond its avowedly deterrent purpose. This is also a feature of section 1515 of the *ALI Federal Securities Code*. Those current provincial statutes modelled upon Ontario give the general powers to apply to the High Court for power directing compliance with the legislation, and powers to freeze assets, appoint receivers, managers, and trustees of property in the hands of broker-dealers.

In some respects the SEC and the provincial administrators achieve similar coverage. The sweep of U.S. law is greater which must be taken into account in evaluating the system. The greatest single advantage of the injunction procedure as it exists in the United States is its use as a prospective civil disability measure, which refers not only to the deprivation of a person from an entitlement to act as a broker-dealer, but also limits the range of activities in which corporate insiders can engage. Both branches are important. It must, however, be remembered that administrative proceedings can only be taken against registrants. For transgressions by others, civil and criminal proceedings must be resorted to.

Under our most modern provincial legislation, provision is not made for injunctive proceedings as such. The most recent proposals in Ontario Bill 30 clause 16 specify that assets may be frozen and a receivership application made under the following circumstances:

(1) When a provincial Commission is about to order an investigation under *e.g.*, clause 11 or 13 or during or after an investigation.[190]
(2) Where it is about to make or has made an order under clause 16(1)(a) that trading in securities of an issuer shall cease.
(3) Where under clause 16(1)(c) the commission is about to make or has made a direction, decision, order or ruling suspending or cancelling the registration of any person or company or affecting the right of any person or company to trade in securities.
(4) Where criminal proceedings or proceedings in respect of a contravention of the Securities Act or Regulations are about to be or have been instituted by any person or company, that in the opinion of the commission are connected with or arise

190 Seemingly, this means that no such order may be made while an investigation under s. 3 is being contemplated by the Minister. The omission was no doubt

out of any security or trade therein or out of any business conducted by such persons or company.

Given the existence of the required conditions, the commission may, it is proposed, in writing or by telegram, direct persons to hold funds or securities of the respondent, or to refrain from withdrawing them from any person having them on deposit, under control or for safekeeping, or to hold them in trust for an interim receiver or trustee.[191]

The commission may also by clauses 17(1) and (2), under the like circumstances, apply to a judge of the Supreme Court for the appointment of a receiver and manager and trustee of the property of such person or company. This jurisdiction may be exercised where the judge considers such an appointment to be in the best interests of the creditor or of the person or company whose assets are being affected. Provision is also made by clause 17(3) for a fifteen-day order which can be made by the judge upon an *ex parte* application by the commission. By clause 17(4) a receiver and manager so appointed shall have authority, if directed by the judge, to wind up or manage the business and affairs of the person or company. By clause 17(5) the order made may be enforced by contempt procedure if required. This is apt to invoke a wide aiders and abettors doctrine.[192] An order made under the section may be enforced in the same manner as any order or judgment of the Supreme Court and may be varied or discharged upon an application made by notice.

In addition, there is power under clause 125 of Ontario Bill 30 for a judge, on application by the commission, to direct by order any person or company which has failed to comply with or is violating any provision of the act or regulations, to comply with the act or regulations, or restraining him or it from violating such provision. The judge may make such order "or such other as the judge thinks fit". There is an appeal to the Court of Appeal.

Section 1515 of the U.S. *ALI Federal Securities Code*, which is essentially a consolidation of existing legislation, provides that the commission may bring an action to enjoin a violation or enforce compliance with the code. The grounds for issue are either that the defendant's past conduct indicates a reasonable likelihood of future violations or that the defendant is apparently engaged or is

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deliberate, because the commission cannot know that an order will issue. Note that the same structure of powers is contained in cls. 11 and 30 of Ontario Bill 30.

191 Clause 16(2) permits a person in receipt of such a direction to apply to the commission. Clause 16(4) permits notification to the appropriate official where proceedings are about to be taken in respect of mining claims or land.

192 *See* Ronson Products Ltd. v. Ronson Furniture Ltd., [1966] 2 W.L.R. 1157 (Ch.) and cases cited therein.

about to engage in unlawful practices.[193] Provision is made for the bringing of actions on behalf of investment companies, in particular against controllers for breach of fiduciary duty. A trustee of such company may be appointed by the court in any such action. The commission may bring an action to enjoin the consummation of a plan of reorganization of such company. Further provisions deal with the liquidation of unit investment trusts, and holding company reorganization. The commission may bring an action or intervene in any action in order to prevent indemnification or contribution not required or authorized by the code, *e.g.*, a contract which indemnified officers against liability occasioned by bad faith, misfeasance, gross negligence, or reckless disregard of the duties involved in the conduct of his office by the insider. Finally, in section 1515(i) there is a general provision for ancillary relief. The section provides in part:

> "In an action created by or based on a violation of the Code, whether or not brought by the Commission the court has the authority of a court of equity to grant appropriate ancillary or other relief, including an accounting, a receivership of the defendant or the defendant's assets, and restitution...."

The *SEC Annual Reports* note that injunctions are sought where a violation of the anti-fraud provisions is alleged, or there are alleged violations of the financial responsibility, net capital or bookkeeping requirements, or other investor protection requirements.[194] The relief sought in actions against broker-dealers includes an order to put in a receiver to freeze assets and to obtain an accounting. In the case of mutual fund corporations and broker-dealers a receiver may be sought in order to oust persons guilty of mismanagement, where investors' interests are likely to be impaired by their continuation in office.[195] Orders for rescission and requiring the disgorging of unlawful profits may be sought. While the SEC does not bring action on behalf of individuals, its own actions may serve to vindicate private rights.[196]

It must be remembered that American legislation, especially as it has been interpreted by the courts, penetrates deep into the interstices of corporation law. The securities laws, in particular section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 were not however intended to deal with ordinary corporate

193 ALI FEDERAL SECURITIES CODE, Tent. Draft No. 3, at 92-93.

194 SEC, 26TH ANNUAL REPORT 123-25 (1960); SEC, 35TH ANNUAL REPORT 125 (1969); SEC, 36TH ANNUAL REPORT 108 (1970); SEC, 37TH ANNUAL REPORT (1971).

195 SEC, 28TH ANNUAL REPORT 131 (1962); SEC, 38TH ANNUAL REPORT 118 (1972).

196 SEC, 38TH ANNUAL REPORT 118 (1972).

mismanagement.[197] Enforcement action there by a regulatory agency has a wide ambit. Furthermore, the ultimate sweep of the injunction, especially as coupled with ancillary relief of one form or another, has not been determined. The injunction against improper dealings in securities is well established. So too is the use of the injunction essentially as a warning measure, in the case of negligently misleading press releases, though here as will be seen some doctrinal edges are blurred.

The issue of such an injunction may conduce to greater care. In addition, it would be impercipient to overlook the result that successful injunctive proceedings before the Federal Courts could have in a private damage suit. Assuming that the ingredients of liability are settled, such a decree could well induce a settlement of the private litigation. The injunction action has been used, in the case of a public financing, to enjoin persons from violations of anti-fraud and prospectus filing requirements; to order the disgorging of proceeds, profits and income derived from the sale of the corporation's stock, to appoint a trustee to receive these funds and distribute them to defrauded public investors, and to freeze the corporation's assets until such time as the proceeds are transferred to the trustee.[197a]

The ability to restrain persons from committing acts which are of the same type as those which the respondent is found to have committed functions as a form of civil disability measure. This aspect, of disabling wrongdoers, appears also in *SEC v. Bowler*. This was an action based on breach of the anti-fraud provisions for an injunction and receivership. It was alleged that substantial nondisclosure, failure to register, plus intercorporate transfers and other abuses, had enabled corporations in a family group to appear in a more favourable light than they deserved. The respondents filed a plea of reorganization which the trial judge accepted. He granted the injunction but refused the receivership. On appeal, it was held that the trial judge erred in approving the reorganization and refusing the receivership. In part this determination was based on the consideration that the principal malefactor would still retain an active, if not decisive, part in the corporation's affairs. The court thus states:[198]

> "At most, his domination would be diluted for only a period of three years. Certainly, the limited injunction against improper security dealings would provide no brake against mismanagement, other than security deal-

197 SEC v. Manor Nursing Homes Inc., 458 F.2d 1082 (2d Cir. 1972).

197a *Id.*

198 427 F.2d 190, 197 (4th Cir. 1970).

ings in violation of the Securities Act 1933, after the expiration of that period."

The use of the injunction as a general civil disability measure is limited by the consideration that the injunction must be drafted with sufficient particularity to convey clearly to the person enjoined what precisely he may or may not do.[199] Injunctions cast too widely are subject to attack.

Ancillary remedies in the United States presently take one of three basic forms:

(1) remedying of past abuses;
(2) prevention of further fraud by requiring the adoption of special corporate procedures;
(3) the temporary appointment of special agents in cases of gross mismanagement requiring unusual control or the wholesale replacement of existing management.

Once the injunction power has been competently invoked, the court has power to award all equitable relief necessary in the circumstances, including, as in *SEC v. Texas Gulf Sulphur Inc.*,[200] a disgorging of insider profits. Through the device of consent decrees the SEC has gone even further, obtaining for example the appointment of receivers, limited receivers for disclosure purposes, the appointment of special auditors and masters, of special counsel, and an order for the election of new directors satisfactory to the SEC and to the court. One commentator states:[201]

> "In each instance, the result is the imposition of a quasi-governmental layer of authority which deprives incumbent management of its absolute control over the internal affairs of the corporation, although perhaps not totally displacing incumbent management with a court-appointed receiver."

The logic of such developments is clear. Receivership is a useful means of preserving companies from further harm. An order appointing directors enables vigorous management policies to be pursued.[202] It is, however, improbable that we would wish to venture so far into what has traditionally been thought of as corporate law, with the danger not merely of supplementing but of contradicting existing company law provisions. For example, one might well encounter provisions which required, on the removal of directors, an immediate appointment by the shareholders or by a provincial officer. There is a case for restraint here, espe-

199 Williams v. U.S., 402 F.2d 47 (2d Cir. 1967).

200 401 F.2d 883 (2d Cir. 1968).

201 Treadway, *SEC Enforcement Techniques: Expanding and Exotic Forms of Ancillary Relief*, 32 WASH. & LEE L. REV. 637, 652 (1975).

202 Note, *Equitable Remedies in Enforcement Actions*, 123 U. PA. L. REV. 1188 (1975).

cially as the provinces are unlikely to be quiescent concerning areas in which they have been closely associated.[203]

What matters must be proved in order to obtain an injunction? The mental element is important. The decision of the Supreme Court of the United States in *Ernst and Ernst v. Hochfelder*[204] that *scienter* is required for civil liability has led to a reassessment of the ingredients necessary to support an application for an injunction. One of the statutory criteria for an injunction is that there has been a violation of the securities laws. If a violation requires *scienter* in the sense of recklessness at least, it follows as a logical matter of statutory interpretation that an infraction which was at least reckless be proven in addition to proving that harm is likely in the future. Several U.S. cases interpret the requirement in this fashion.[205] Circuit courts of appeal and commentators are inclined to seek a way of circumventing the problem having regard to the remedial purposes of injunction procedure.[206] The better solution, as a matter of drafting, would, I submit, be to key the procedure to the phenomenon, that is, has manipulation for example occurred in fact? If so, and if there is danger of repetition, a matter to which *scienter* is plainly relevant, a court should be able to award an injunction together with such ancillary relief as appears necessary.

No court has held in terms that mere proof of a past violation is sufficient to found relief. It has been said that proof of illegal conduct in the past is suggestive of a propensity to commit future violations and that when once a previous violation has been proved the burden passes to the defendant to provide the court with some basis for believing that there will not be any repetition of the illegal conduct.[207] In similar vein, it has been held that mere proof of the cessation of illegal activity is not enough to prevent the court from granting an injunction.[208] The standard is, however,

203 Québec, for example, has and asserts such a power; *see*, *11-Firm Administrator Is Sought by QSC*, The Globe and Mail (Toronto), April 9, 1975, at B1, col. 3.

204 425 U.S. 185 (1976).

205 SEC v. Cenco, [1977-1978 Transfer Binder] CCH FED. SEC. L. REP. ¶ 96,133 (2d Cir. 1977); Arthur Lipper Corp. v. SEC, 551 F.2d 915 (2d Cir. 1976); SEC v. American Realty Trust, [1976-1977 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,913 (E.D. Va. 1977).

206 *E.g.* SEC v. World Radio Mission Inc., 544 F.2d 535 (1st Cir. 1976); SEC v. Bausch & Lomb Inc., 565 F.2d 8 (2d Cir. 1977); and *see* Berber & Franklin, *Scienter and Securities and Exchange Commission Rule 10b-5 Injunctive Actions: A Re-appraisal in Light of Hochfelder*, 51 N.Y.U. L. REV. 769 (1976); Harkelroad, *Requirements for Injunctive Actions Under the Federal Securities Laws*, 2 J. CORP. L. 481 (1977).

207 SEC v. Rega, [1975-1976 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,222 (S.D.N.Y. 1975); SEC v. Cooper, 402 F. Supp. 516 (S.D.N.Y. 1975).

208 SEC v. Management Dynamics, 515 F.2d 801 (2d Cir. 1975); SEC v. D'Onofrio

whether or not there is a reasonable likelihood that the violation will be repeated. It seems probable that courts, especially in the light of the decision of the Supreme Court in *Rondeau v. Mosinee Paper Corp.* will insist upon a showing that there is a likelihood of repetition and will not infer repetition simply from the fact of a prior breach, though that continues to be a persuasive circumstance.[209] In Ontario the court of appeal has held that where an injunction is sought in order to prevent a breach of statute, the usual criteria of balance of convenience and irreparability of apprehended damage are irrelevant.[210]

If it is desired to take powers requesting courts to grant ancillary relief, I conclude that we must specify plainly in the legislation which the requisites for liability are to be, avoiding a need to prove prior wilful breaches, and what powers we want. We certainly need powers to ban persons from acting in the securities industry, either as officers of issuers or as members of the exchanges or as dealing with the public as licensed dealers. We certainly need to determine what the conditions for injunctive or other relief are to be. It is noteworthy that both in the field of securities regulation and pollution one finds suggestions that proof of past violations should either found relief or at least give rise to a rebuttable presumption that relief is required.[211]

Ontario Bill 30 proposes that the issue of an order under clauses 16 and 17 of Act in some cases accompanies an order cancelling or suspending registration; in others it will be followed by proceedings giving rise to such an order. It is proposed that where clause 126 is invoked, a court order would not result in a final determination of the merits, but the commission might eventually determine to discipline a registrant or deny exemptions. The result as it would affect registrants is not dissimilar to that which is produced by the grant of an injunction in the United States. An injunction is cause for denial, suspension or rescission of the registration of any broker or dealer.[212] A self-regulatory association must by rule provide that a person enjoined shall not be admitted to or continued in membership of the association as a

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[1975-1976 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,201 (S.D.N.Y. 1975); CFTC v. J.S. Love Options Ltd., CCH COMM. FUT. L. REP. ¶ 20,198 (S.D.N.Y. 1976).

209 422 U.S. 49 (1975); and *see* SEC v. Penn Central Co., 425 F. Supp. 593 (E.D. Pa. 1976).

210 A.G. of Ontario v. Grabarchuk, 11 O.R. (2d) 607 (Div'l Ct. 1976).

211 *See* 302 BNA SEC. REG. & L. REP., May 14, 1975, at A-1 (recording the opposition of prominent members of the securities bar to the suggestion); *see also Burdens of Proof in Environment Litigation, Hearing Before the Sub-Committee on Environment of the Senate Committee on Commerce*, 93d Cong., 2d Sess. (November 19, 1974) (Serial No. 93-126) (on S. 1104 Amend. No. 1814).

212 Securities Exchange Act of 1934, s. 15(b)(5)(A).

broker-dealer without the approval of the commission.[213] In the case of nonmember registrants, the SEC has wide powers; the effect of an injunction can be the removal of directors from office in particular companies for substantial periods of time. It is possible for orders to go regulating their conduct in some respects over a period of time. There is a question of how far it is desired to enter the field of what is traditionally thought of as corporate law. But, in some respects, the power to intervene in management is essential. Mutual funds afford a ready example. It would be advantageous to have a general civil disability provision in such an area. An injunction proceeding which might help to ease the way for private litigants could prove useful, directed as it would necessarily be to particular wrongful acts performed in breach of the securities laws. This is one aspect in which the injunction is superior to existing provincial procedures. Another lies in the extent of ancillary relief which is available. The utility of this, the ability to order rescission, etc., depends ultimately on the structure of legislation which it is proposed that we adopt.

Most SEC injunction applications are dealt with on a consent basis. The order usually goes by consent and follows the kind requested in the prayer. The defendant usually declines to admit facts. The commission will not accept a consent where the facts are positively denied and, indeed, it seems unlikely that a court could make a consent order in such a case. It is pertinent to note that the practice of accepting consent decrees without any admission of facts detracts from the value of injunctive proceedings to prospective civil litigants. One advantage of settlement procedure is however, that a consent decree may be so drafted as to provide for restitution to defrauded customers.

As such an injunction can form the basis of disciplinary proceedings against a registrant, it is prejudicial to him. The danger of coercion can in part be met by judicial oversight of consent decrees.

Would injunction procedure at the behest of a centralized agency prove sufficiently expeditious? There is no reason why it should not. SEC regional offices do not encounter difficulty. Instructions, pleadings, etc., can go from the head office to the regions by telecopy. Orders can be obtained very quickly. There seems to be little reason to fear inhibiting delay.

Another aspect of the enforcement problem is trading in dubious securities by nonregistrants which is presently dealt with either by a general cease trading order[214] or by an order denying

213 *Id.* s. 15A(h)(4)(B) read with the provision in note 212 *supra*.
214 Ontario Securities Act, s. 143.

exemptions. The effect of the former order is similar to an injunction. It is interesting to note that in 1970 the Ontario commission announced its readiness to invoke stop trading procedures where, *inter alia*, persons traded on the basis of undisclosed insider information.[215] We thus begin to approach the U.S. position more closely. The effect of this latter procedure is to bring into motion the whole paraphernalia of regulation.[216] In either event breach is punishable. The matter could, if desired, be dealt with formally by injunction, or indeed by a combination of both procedures. What is needed is a procedure whereby trading in suspect securities can be forbidden on a continuing basis until the commission is satisfied that trading should be allowed. The great advantage of an injunction is that it attracts a wide aiding and abetting doctrine while the denial of exemptions affects only the person against whom it is made.[217] This weakness can be overcome by a general cease trading order buttressed by adequate criminal and administrative penalties.[218] The Quebec Securities Commission seems to make considerable use of this sort of device, preventing extensive lists of persons from trading in securities which are thought to have been manipulated. The order may go against all persons trading in the stock, or against certain persons only.[219]

Under clause 126 of Ontario Bill 30, the commission would be able to impose a cease trading order for such period as is specified in the order. It could do so notwithstanding that a company has complied with clause 76(3) and forwarded a continuous disclosure report. Except where the length of time required for a public hearing could be prejudicial to the public interest a cease trading order is not to be made until after a hearing has taken place.[220] A similar safeguard surrounds clause 127 granting the commission

215 *See* Notice, Timely Disclosure [1970] OSC Bull. 145, 146 (November).

216 *See e.g.* Re Mercantile Bank & Trust Co., [1973] OSC Bull. 173 (October); and *see* [1972] OSC Bull. 6 (January) in which it is noted that denial of exemptions is one way of inducing persons to file insider reports. Re Midgaul Ltd., [1970] OSC Bull. 91 (June) is a case in which a denial of exemption order was used in a case of suspected fraud.

217 Re West Plains Oil Resources Ltd., [1965] OSC Bull. 18 (November).

218 This particular area is replete with international problems and is covered in *Hebenton and Gibson*; and *see* Re Tipuani Gold Mines Ltd., [1974] OSC Bull. 35 (March); Re Chemalloy Minerals Ltd., [1974] OSC Bull. 60 (March).

219 *E.g.* Re Fort Norman Exploration Inc., 6 QSC Bull. No. 48 (decision 4970, December 1, 1970); *QSC No-Trading Edict New Blow for Sidney Rosen*, The Financial Post (Toronto), April 19, 1975, at 27, col. 1. There are a number of further examples. In the *Rosen* case, the order was coupled with a request for the appointment of an administrator for a number of public companies.

220 After an order has been imposed, the person subject to it bears the onus of showing cause why it should be revoked; *see* Re Panacea Mining and Exploration Ltd., [1971] OSC Bull. 156 (October); Re Rodney Gold Mines Ltd. [1972] OSC Bull. 159 (H.C. July); Re Canusa Holdings Ltd., [1971] OSC Bull. 173 (October).

the power to revoke exemptions. The precise purpose of the cease trading order is not specified in the legislation; whether it exists merely to force compliance with reporting requirements or for other purposes. I am informed that it is extensively used, even in situations where its invocation could be harmful to individual investors.[221] This is not a matter upon which this writer feels competent to deal further. It is perhaps worth noting that when the matter was raised before a committee of the Ontario legislature, H.S. Bray of the Ontario Securities Commission defended the practice as a nonpunitive means of stopping trading in a market affected by rumours until such time as accurate information could be released. He admitted that the order was used in cases of fraud, but these were few, of the order of six to ten *per annum.* The commission does not like using the power for this purpose but occasionally finds it necessary to do so.[222] The power does seem a useful one to have to deal with suspected manipulations, and one would expect a commission to have such a power, as indeed should the stock exchanges.

D. ADMINISTRATIVE SANCTIONS AGAINST BROKER-DEALERS

Securities legislation typically makes provision for the imposition of administrative sanctions. Such sanctions may be imposed either in conjunction with criminal or civil proceedings, or alone.

Under the Securities Exchange Act of 1934 as amended in 1964, the SEC has available to it a wide range of administrative sanctions which it may impose on broker-dealers and other persons. There is similar power under the Investment Advisers Act of 1940 as amended in 1970. These broad powers are incorporated in the *ALI Federal Securities Code.* The SEC may deny a broker-dealer's application for registration. The SEC may impose sanctions upon registered broker-dealers ranging from censure to suspension or revocation of registration and it may suspend or terminate a broker-dealer's membership in the NASD. In addition, it may suspend or bar any person from association with a broker-dealer, or censure him. This is an additional power inserted in 1964. Before that date such persons could only be named as a cause of a broker-dealer's violation. A similar range of powers exists under Canadian legislation.[223]

Generally the SEC may, under section 15(b) of the Securities Exchange Act of 1934 as amended, impose sanctions only if, after

221 I am indebted to Prof. Warren Grover for information on the point.

222 LEG. ONT. DEB., 29th Leg., 5th Sess. No. S-29, at 843-54 (1975).

223 *E.g.* Ontario Bill 30, cls. 19-32 which generally reproduce provision in the Ontario Securities Act.

notice and opportunity for hearing, it finds: (1) the accused wilfully violated or aided and abetted violations of any provision of the Securities Acts or rules thereunder, or is subject to certain disqualifications such as a conviction or injunction relating to certain types of offence and, (2) that a particular sanction is in the public interest. The hearing requirement features in Canadian legislation as well. Often matters are dealt with without hearings where the accused waives his rights to a hearing and submits an offer of settlement. In 1971, 264 administrative proceedings were taken against broker-dealers and investment advisers.

Proceedings may also cover the adequacy of disclosure in a registration statement or in reports filed with the SEC. Such cases may lead to an order suspending effectiveness of a registration statement or directing compliance with reporting requirements.[224] The SEC also has the power similarly to suspend trading where the public interest so requires. The SEC tries to gear sanctions in both contested and settlement cases to the circumstances of the case. It may limit the sanction to a particular branch office of a broker-dealer rather than the entire firm, or prohibit only certain kinds of activity by the broker-dealer rather than the entire firm, or prohibit only certain kinds of activity by the broker-dealer during a period of suspension, or only prohibit an individual engaging in supervisory activities.

The SEC does not take disciplinary action in every violation. It does, however, proceed promptly if the violation appears to be wilful and the public interest is best served by formal action against the broker-dealer. Similarly the SEC does not impose formal sanctions in every case in which proceedings are taken. This abstention is found especially in cases of failure of supervision where the firm adopts suitable internal controls to reduce the risks of any recurrence of injury to investors of the type found and where a further sanction against the firm would harm innocent people. The same comment is true of OSC practice.[225] In the case of some technical violations such as unwitting breach of the net capital rules, the commission gives the violators an opportunity to comply. Failure to do so results in the imposition of formal sanctions.[226] The SEC has in the past required as a condition of staying sanctions that the firm dissociate itself from the members of the executive committee found to be at fault either permanently or for a period of time during which such members do not receive any pecuniary benefits from the firm.

224 SEC, 38TH ANNUAL REPORT 70 (1972).

225 *E.g.* Re Davidson, [1972] OSC Bull. 7 (January); Re United Inv. Sec. Ltd., [1972] OSC Bull. 20 (February).

226 SEC, 26TH ANNUAL REPORT 105 (1960); SEC, 27TH ANNUAL REPORT 81 (1961).

The *SEC Annual Report* for 1972 notes that the commission will impose formal disciplinary sanctions where:

(1) there has been a wilful violation of the provisions of or a rule made under the Securities Acts; or
(2) a failure to supervise in a reasonable manner another person who committed a violation;
(3) where a respondent has been convicted for, or enjoined from, certain types of misconduct;
(4) where there is inadequate disclosure in a registration statement or report filed with the commission.[227]

In the latter case the commission may suspend the effectiveness of a registration statement or direct compliance with registration requirements. The *ALI Federal Securities Code*, section 1505 contains similar provisions. The list thus extends beyond fraud to incompetence. The commission, like its Canadian counterparts, also has the power summarily to suspend trading in a security when the public interest so requires.

Some aspects of SEC practice have become well settled. Wilful violation of the antimanipulation provisions generally merits expulsion. This, in the light of such cases as *Cady, Roberts & Co.*, helps to put real teeth in the insider rules.[228] The administrative response to *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith*[229] which preceded the judicial decision and in which the firm entered a stipulation of settlement and accepted discipline makes it clear that broker-dealers cannot utilize inside information for their own benefit or for that of their clients. Practices which would be considered blatant violations of the rules merit revocation. Such, for example, are the sale of unregistered control shares, that is, distribution without a prospectus, and the filing of false and misleading statements;[230] the use of high pressure tactics and statements, in particular the use of unfounded financial forecasts;[231] and failures of supervision resulting in fraud.[232]

227 SEC, 38TH ANNUAL REPORT 72 (1972); *PLI Securities Law Institute*, 7 REV. SEC. REG. 820, 825 ff. (1974) notes that in 1967-69, SEC discipline cases against broker-dealers in fraud cases produced 48% expulsions and 52% suspensions. In nonfraud cases, 16% were expelled and 84% suspended. There seemed to be a bias in favour of New York Stock Exchange members and broker-dealers. One suspects that the figures are crude and need further analysis.

228 *See* Daum & Phillips, *The Implications of Cady, Roberts*, 17 BUS. LAW 939 (1962); Jacobs, *The Impact of Securities Exchange Act Rule 10b-5 on Broker-Dealers*, 57 CORNELL L.J. 869 (1972).

229 *See* note 171 *supra*.

230 *See* the material cited in note 227 *supra*.

231 SEC, 30TH ANNUAL REPORT 67 (1964); SEC, 31ST ANNUAL REPORT 65 (1965); SEC, 32D ANNUAL REPORT 60 (1966); SEC, 33D ANNUAL REPORT 78 (1967).

232 Re Shearson, Hammill & Co., reported in SEC, 32D ANNUAL REPORT 58 (1966); Re Collins Securities Corp., SEC, Securities Exchange Act of 1974 Release No. 11766,

The use of high pressure tactics is particularly deprecated by all securities agencies because it is inconsistent with the obligation of a broker-dealer to know his client.[233] It is generally considered to be very improper to recommend securities which do not meet the needs of a customer who has informed the broker-dealer of them.[234] Churning is also a cause for revocation.[235] So also are wilful violations of the net capital rule which is seen as a substantial rather than a mere technical provision.[236] The same comment applies to violation of the registration requirement provisions. Breach of these is serious and a ground for revocation.[237]

The same emphasis (apart from the matter of insider trading) is also evident from the OSC Bulletins. Default in supervision,[238] failure to consider clients' interests, including overloading and high pressure sales methods;[239] participation in the distribution of unregistered securities and failure to deliver proper confirmations;[240] the conduct of a "classic" pooling operation designed to result in an artificial scarcity;[241] failure to meet filing requirements;[242] failure to meet conditions of registration and net capital and contingency fund participation (in the case of a mutual fund);[243] improper dealing with a client's account for the broker-dealer's own purposes;[244] failure to meet net capital requirements;[245] unauthorized trading by Ontario registrants into other

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October 23, 1975, [1975-1976 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,327 where, however, it is pointed out that the principal will not be liable if he reasonably delegates a function and neither knows nor has reason to know that the delegate is not properly performing his function; Re John R. Brick, SEC, Securities Exchange Act of 1934 Release No. 11763, October 24, 1975, 8 SEC Docket 248.

233 There are a number of cases of this sort in British Columbia. *See e.g.* Re Ginetti, B.C. Corp. and Financial Services Comm'n Weekly Summary, August 22, 1975, at 1; Re Groberman, B.C. Corp. and Financial Services Comm'n Weekly Summary, November 28, 1975, at 1.

234 SEC, 34TH ANNUAL REPORT 93 (1968).

235 SEC, 28TH ANNUAL REPORT 66 (1962); SEC, 36TH ANNUAL REPORT 102 (1970).

236 Blaise d'Antoni & Assoc. Inc. v. SEC, 289 F.2d 276 (5th Cir. 1961).

237 Financial Counsellors Inc. v. SEC, 339 F.2d 196 (2d Cir. 1964).

238 Re Davidson & Co., *supra* note 225; Re H.E. Smith Securities Ltd., [1970] OSC Bull. 166 (December); Re Martell Investment Co., [1969] OSC Bull. 123 (July); Re Robertson, Malone & Co., Ltd., [1968] OSC Bull. 254 (November).

239 Re Ramras, [1972] OSC Bull. 123 (June); Re McNairn, [1968] OSC Bull. 24 (February); Re McLarty, [1968] OSC Bull. 9 (January); Re Adelaide Securities Ltd., [1968] OSC Bull. 54 (March); Re Lusty, [1967] OSC Bull. 58 (October).

240 Re Glandfield & Co. Ltd., [1972] OSC Bull. 44 (April).

241 Re Hevenor & Co. Ltd., [1971] OSC Bull. 42 (April).

242 *See* Notice, Filings Under pt. XII of the Securities Act, [1970] OSC Bull. 79 (June).

243 Re Financial Planning Associates, [1970] OSC Bull. 119 (August).

244 Re Thomson, [1969] OSC Bull. 160 (September).

245 Re Ord, Wallington & Co. Ltd., [1968] OSC Bull. 109 (April) (in which case interim suspension may be used).

jurisdictions;[246] and, of course, deceptive and manipulative practice generally.

As in the United States, the OSC has been at pains to establish the proposition that registrants and salesmen owe a duty to give dispassionate and informed advice to the public.[247] Similar duties apply to a person who holds himself out as a securities adviser. He is not just a newspaper publisher. He represents himself as qualified to engage in the business of recommending purchase or sale of specific securities at opportune times. In order to give advice he must have relevant information and to give advice knowing that such is not available is improper conduct which can lead to the cancellation of registration.[248]

A rash of such cases occurred in 1966, of which the most celebrated is that of *Goldmack Securities Corp.*[249] It is evident from an examination of the OSC Bulletins that the thrust of the Commission's regulatory activities has gone beyond manipulation into a consistent enforcement of the duties of broker-dealers to the public via the "shingle theory", and to other matters such as duties of supervision and training and the like. The same remarks apply to the activities of the Québec and British Columbia commissions whose published reports testify eloquently to their endeavours to raise standards in the industry. The imposition of a duty to deal fairly with the public is of course essential. In *Do You Sincerely Want to Be Rich*[250] the authors note, not unexpectedly, that high pressure selling and salesman enthusiasm are the most important factors in the client's decision to purchase.

The SEC and the OSC exhibit certain similarities of approach. Thus, as we have noted, formal sanctions are not always imposed, especially where the offender has taken steps to rectify a situation which allowed an infraction to develop.[251] The SEC however appears to rely more extensively on offers of settlement in which restructuring proposals, or limited civil disability measures are advanced by the respondent. We deal with this below. Ontario commonly employs denial of exemptions as a means of terminating undesirable conduct. This in particular is used to control offerings with a foreign element, a topic which forms the substance of the Hebenton and Gibson paper in this volume.[252] As we

246 Re Canadian-American Securities Ltd., [1968] OSC Bull. 230 (October).
247 Re Rotenberg, [1967] OSC Bull. 28 (September).
248 Re Southern Brokerage & Holding Co. Inc., [1967] OSC Bull. 4 (Ont. C.A. June).
249 Re Goldmack Securities Corp., [1966] OSC Bull. 14 (January).
250 C. Raw, B. Page & G. Hodgson, *supra* note 60, at 222.
251 Re United Investment Securities Ltd., [1972] OSC Bull. 20 (January).
252 *See* Re Chemalloy Minerals Ltd., [1974] OSC Bull. 60 (March); Re Belgium Standard Ltd., [1973] OSC Bull. 94 (July); Re Mercantile Bank & Trust Co. Ltd., [1973] OSC Bull. 173 (October); R. v. Goss, [1969] OSC Bull 44 Prov. Ct. April).

have noted orders banning trading in a security are also used, and may be coupled with a denial of exemptions.[253] Denial of exemption procedure is also invoked where it is thought that a fraud is in progress. The burden of proof on such a hearing is simply that the evidence supporting the inference of fraud be clear and convincing.[254]

The SEC and OSC have similar powers over registrants. The SEC seems less accommodating than the OSC, readier to revoke registration while the OSC, from the evidence of its bulletin, is prepared in many cases to suspend registration of principals and salesmen, either with or without conditions, or simply to administer a reprimand. In particular, where the OSC considers that an infraction is attributable to a saleman's ignorance, it often suspends him until he has passed the Canadian Securities Course.[255] An order for suspension may be coupled with an obligation on the respondent's firm to make periodic reports concerning his conduct after the period of suspension has elapsed.[256] Where, however, a salesman has a history of breach of the rules and casual indifference to his duties and obligations as a securities salesman and a bad employment record, his registration may well be cancelled.[257]

A striking apparent difference between the SEC and the OSC lies in the use of the reprimand. This is seldom imposed as a sole sanction by the SEC, but is sometimes so used by the OSC, in particular when remedial steps have been taken.[258] Similarly, the OSC seems readier to use relatively brief periods of suspension against broker-dealers than does the SEC, which appears to be more stringent in its approach. Comparisons would be invidious. One consideration should, however, be recalled. If administrative proceedings are to be used in preference to criminal proceedings in some cases where the latter could be invoked, it may be difficult to justify apparently lenient sanctions to a public imbued with the notion that white-collar offenders are, in general, treated preferentially. In other words, our interest is not solely in whether the industry is being efficiently regulated; we must concern ourselves with wider issues of social justice as well.

A further aspect of the employment of administrative remedies is the availability of remedial sanctions. Thus, the SEC in some cases may impose a remedial sanction; for example, the exclusion

253 Re Panacea Mining & Exploration Ltd., *supra* note 220; Re Canusa Holdings Ltd., *supra* note 220.

254 Re Midgaul Investment Ltd., *supra* note 216.

255 *E.g.* Re Webb, [1972] OSC Bull. 220 (October); Re Glandfield & Co. Ltd., *supra* note 240.

256 Re McNally, [1970] OSC Bull. 108 (July).

257 Re Forsythe, [1972] OSC Bull. 167 (August).

258 *E.g.* Re United Investment Services Ltd., *supra* note 251.

of a person from the securities business for a time coupled with the requirements that thereafter employment be in a nonsupervisory capacity. The courts have held in *Buck v. SEC*[259] that remedial penalties cannot be imposed as a deterrent and therefore the SEC must have evidence indicating that there is a possibility that the accused will commit further illegal or fraudulent acts before remedial penalties can be resorted to. It is not clear how substantial an impediment this is.

Apart from the use of remedial penalties, flexibility is also achieved by structuring remedial stipulations into offers of settlement accepted by the SEC. A form of restitution to the public is a not uncommon stipulation. Obligations can be imposed on clearing firms to make inquiries and take prompt steps to terminate any participation in activity which violates the securities laws. The SEC may limit the sanction to a particular branch office of a broker-dealer rather than to the entire firm, or prohibit only certain kinds of activity by the broker-dealer during a period of suspension, or only prohibit an individual from engaging in supervisory activities. In some cases, where a broker-dealer changes management and individuals associated with the infraction are barred by the SEC from association with a broker-dealer or investment adviser, a quite substantial infraction may be visited with a suspension only.[260] The OSC also employs remedial sanctions. The criminal process cannot, as yet, be used in this flexible manner.

There is one aspect of all this about which I feel uneasy. Settlements do, it is true, reflect a great deal of flexibility; it is possible that they could contain stipulations not directly authorized by the legislation. This imports a potential element of coercion against which there is no very obvious safeguard. It would be naive to assume that the SEC does not, in some measure, dictate the form of settlement which is submitted to it. Elbows are occasionally jogged by the SEC's regional office which may supply a form of settlement, approved in a previous case, in blank. It is true that a respondent can submit whatever form of settlement he or it desires. The respondent has the right to carry any offer of settlement up to the commission itself. It is reviewed regionally and at headquarters. Revisions may be suggested. A recommendation to accept or reject goes from the staff to the commission. Usually a respondent who is advised that the regional office or headquarters disapproves the settlement will withdraw it and rework the offer. There is much careful review before the settle-

259 413 F.2d 832 (6th Cir. 1969).
260 SEC, 38TH ANNUAL REPORT 70–71 (1972).

ment reaches the commission itself.[261] But the respondent's right to carry the matter forward if he wishes does not entirely dispel the aura of coercion which may be present. It would be impossible to do so, in any system which permits settlements.[262] The settlement is too useful a device to be eschewed entirely. It might be preferable to deal in the legislation with the matters which might form part of an administrative sanction or a settlement. Thus, for example, the legislation could deal explicitly with the temporary suspension of officers, their deprivation of emoluments, etc.; the discharge of guilty employees, and limit the terms of agreed settlements to variations on these approved themes. Section 1507 of the *ALI Federal Securities Code* affords a reasonably explicit drafting model, but it does not state what conditions may accompany a conditional suspension, or conditional bar from being an associate. The ALI is content to leave this area to further development; to leave the growth of restitution practices to evolution within a general form of words. I do not like this degree of latitude. A statutory power to carry offers of settlement to any regulatory commission which, as we have noted, reflects SEC practice, is, I submit, useful as a statement declaratory of the rights of the parties. Provision might also be made for ultimate judicial approval of the terms of any settlement and for ensuring its voluntary character.

There should be provision for appeal from any order made by any proposed commission in administrative proceedings. The commission should be under a duty to give reasons for its decision as the SEC now is.[263] Clause 9 of Ontario Bill 30 contains provisions which might well be taken as a model. It confers a right of appeal from a decision of the commission to the Supreme Court, save where the commission's decision is under clause 75 (an order exempting from registration of a prospectus). The secretary shall certify to the court the initial decision, the decision of the commission on review and the reasons therefor, the record of the proceedings before the commission, and all written submissions to the commission or other material that is relevant to the commission. The court may direct the commission to make such decision or do such other act as the commission is empowered to do under the act

261 I am indebted to the Seattle office of the SEC for much of this information.

262 The obvious analogue is the practice of plea bargaining which is generally viewed with reservation in England, Canada and the Commonwealth; *see* the authorities collected and noted by the author in [1969] ANN. SURVEY COMMONWEALTH L. 223; [1970] ANN. SURVEY COMMONWEALTH L. 173-74; and J. BALDWIN & J. MCCONVILLE, NEGOTIATED JUSTICE (1977).

263 Beck v. SEC, 413 F.2d 832 (6th Cir. 1969).

or regulations and as the court considers proper. By subclause (6), a very useful provision:

> "(6) Notwithstanding an order of the court, on an appeal, the Commission may make any further decision upon new material or where there is a significant change in the circumstances, and every such decision is subject to this section."

Subclause (6) sets an intelligent and intelligible limit to the possible invocation of *res judicata.* The adoption of such a provision does not mean that a court would interfere readily with sentence. There would undoubtedly be a limiting principle, that the court would not intervene except in cases of gross error. As was said in *Armstrong, Jones & Co. v. SEC*:[264]

> "Unless a gross abuse of discretion on the part of the Commission is shown, the Commission's determination of the sanctions necessary to protect the public interest will not be disturbed."

There is a danger either that a regulatory body will become too severe, or, on the other hand, will relate too closely to the regulated industry and attempt to secure cooperation through leniency. Such policies may be adhered to even when it is inappropriate to do so. It would be useful to have an independent check via the Federal Court. The *ALI Federal Securities Code,* section 1514 makes provision for judicial review. It includes a power in the review court to permit the introduction of additional evidence. Nonetheless, section 1514(h) reflects the same bias as this proposal, stating,

> "(h) *Substantial evidence rule.* The findings of the Commission as to the facts, if supported by substantial evidence, are conclusive."

Under section 28(1) of the Canadian Federal Court Act (1970) a similar result would be produced; the Court of Appeal could determine on review whether the inferior court or tribunal's finding of fact was open on the material before it.[265]

E. STOP ORDERS

Stop orders may be used to stop trading in any security when it appears that an offering or distribution statement contains a

264 421 F.2d 359 (6th Cir. 1970); and *see* Berko v. SEC, 316 F.2d 137 (2d Cir. 1963).

265 *Per* Thurlow, J. in Re State of Wisconsin and Armstrong, 32 D.L.R. (3d) 265 (F.C.T. 1973); and R. DUSSAULT, 2 TRAITÉ DE DROIT ADMINISTRATIF, CANADIEN ET QUÉBECOIS 1321-23 (1974). *See also* the decision of the British Columbia Securities Commission in Re Ponderosa Industries Ltd., B.C. Corp. and Financial Services Comm'n Weekly Summary, September 12, 1975, at 1.

misrepresentation or omits a material fact or document required to be included. In the United States the SEC, under section 8(d) and 8(e) of the Securities Act of 1933, may issue a stop order suspending the effectiveness of any registration statement. The commission may make an examination in any case in order to determine whether such an order should issue. The commission or any officer or officers designated by it has access to, and may demand the production of, books and papers. It may administer oaths and affirmations to, and examine the issuer, underwriter or other person in respect of any matter relevant to the examination. There is also a general power of investigation under section 20(a) of the Securities Act of 1933. The *ALI Federal Securities Code* perpetuates the power to make stop orders in section 1506(d). It improves on the Securities Act by making it clear that a stop order must be expressly vacated by the commission in order to cease to have effect.

In Canada, most provincial acts also make provision for the use of stop orders. Clause 71(1) of Ontario Bill 30, which would amend the present act, would give the commission power to order that all primary distribution of securities to which a filed prospectus relates, shall cease. The usual provisions relating to hearings and temporary *ex parte* orders is made in subclause (2). Jurisdiction to make such an order depends upon the commission forming the view that any of the circumstances mentioned in clause 62(2) appear. These include: failure to comply with filing requirements, the presence of deceptive, false or misleading forecasts, concealment of material fact, the giving of unconscionable consideration for promotional services or property, and that the proceeds from sale of securities plus the other resources available to the company are insufficient to accomplish the purposes set out in the prospectus.[266]

The commission has interpreted its powers broadly. In particular it has issued a stop order when circumstances indicated that a company's operations deviated substantially from development plans specified in the prospectus,[267] or was acquiring very speculative securities not contemplated in the prospectus,[268] or was incurring large debts after having stated in the prospectus that no

266 The Commission has sought to maintain some control after promotion by requiring reports on the disbursement of funds as a condition of releasing shares from escrow; *see* for a recent example, Re Riley's Datashare Int'l Ltd., [1974] OSC Bull. 65 (March).

267 Re Kenilworth Mines, [1965] OSC Bull. 7 (July-August); Re Great Divide Explorations Ltd., [1965] OSC Bull. 10 (July-August).

268 Re Victoria Algoma Mineral Co. Ltd., [1966] OSC Bull. 5 (June).

indebtedness would be created or assumed.[269] It would now, however, seem more appropriate to deal with this problem by a general cease trading order of the sort discussed above. Such an order could also be used in the case of trading on the exchange if the exchange declined to act.

Chapter III
Investigations[270]

Securities regulation, like company law, bankruptcy law, and income tax law, is an area in which extensive investigative powers are conferred upon the government agencies active in regulating the field. There are a number of reasons for conferring investigative power. First and foremost unless facts relating to complicated cases of fraud are unearthed, the principals responsible for unlawful conduct may well be able to continue their illegal activities virtually unchecked. Securities fraud transactions are frequently complicated. Nominees are often used. The truth is difficult to ascertain. The fraud under investigation may continue or further frauds occur unless the full facts are uncovered. Somewhat the same considerations apply in respect of company law and bankruptcy law where fraudulent or incompetent directors may continue to mismanage companies unless and until sufficient information is found to put a stop to their conduct. In the case of the income tax acts there is the further consideration that the amount due to the state may only be discoverable as a result of investigative proceedings. In all of these areas the conferment of extensive investigative powers is commonplace.

Investigative powers, unless hedged about with special restrictions, can be used for enabling civil recovery of amounts obtained from the public as a result of fraudulent or improper schemes. They can be used as a means of obtaining facts necessary to warrant the imposition of administrative sanctions upon issuers, broker-dealers or both. Investigations can also be used as a means of acquiring facts which will later be employed against the persons under investigation in the criminal courts. Their significance should not be assessed from the number of recorded civil, criminal, and administrative proceedings which their use provokes. Informal dispositions may also owe much to their invocation. Thus, one seventh of all formal investigations closed informally by the SEC without formal disciplinary action during 1974

269 Re Medallion Mines Ltd., [1965] OSC Bull. 12 (September).

270 I am particularly indebted to the SEC and its Seattle office and to Messrs. J. Bookey

involved confessions of misconduct and offers of settlement including guarantees of good conduct during the future. In each of these cases the conduct was not thought serious enough to warrant formal disciplinary action. Other cases informally closed were remitted to state agencies. Some were closed for lack of evidence. There is no doubt that the investigation is one of the strongest weapons in the enforcement armoury.

The potentially onerous consequences of an investigation give rise to a concern that individuals' civil rights be protected. It is undoubtedly necessary that investigative schemes give wide jurisdiction and wide powers to the persons conducting the investigation. Undoubtedly there must also be some due process safeguards favouring individuals under investigation. This would remain true even if it were not possible to use the evidence obtained as the result of an investigation in a subsequent criminal case. The civil consequences of investigations can be extremely onerous. There is therefore a case for allowing certain basic safeguards such as the right to explain, the right to be informed of the case made by other witnesses in the inquiry and conceivably a right to counsel.

The case may be thought to be strong where criminal prosecution can follow an investigation, utilizing materials obtained as a result of the investigation, and the case becomes stronger still under statutes which permit whatever the person under investigation has said on oath to be used against him at a subsequent criminal trial. Indeed a tendency can be discerned to try to limit the use which can be made of materials ascertained as a result of investigations. Some statutes limit the use in evidence of matters related by an investigatee under oath. This is certainly true of section 114.3 of the Canada Corporations Act. It is not true of the Income Tax Act, nor is it true of such foreign legislation as the U.K. Companies Acts 1948–67. These matters are dealt with further in a later part of this paper.

The jurisdiction to examine persons and documents to be conferred upon the person conducting the investigation should be broad. It is undesirable to draft legislation with undue particularity since too much particularity, by inviting applications for judicial review based on want of jurisdiction, may prove inhibiting to investigations.[271]

The jurisdictional section employed by the *ALI Federal Securities Code*, section 1505(a), which does not differ materially from

and L. Emory for information. *See also* Merrifield , *Investigations by the Securities and Exchange Commission*, 32 BUS. LAW. 1583 (1977).

271 There is in any event a general tendency to refuse interlocutory challenges to investigation procedures.

other U.S. enactments, simply provides that, "the Commission may investigate to determine whether any person has violated, is violating, or is about to violate this Code". The only limitation which this wording suggests is that a violation must at least be apprehended. Under section 1505(b), the so-called quasi-legislative provision, the commission may investigate to aid in the prescribing of rules or in obtaining information to serve as a basis for recommending further legislation.

The form of wording employed in Ontario Bill 30, clauses 11 and 13, which bears an affinity to the provisions of the Canada Corporations Act, 1970, is similar. Investigations could be commenced either by the commission under clause 11, or by the Minister under clause 13. The commission under clause 11(1) is empowered to commence an investigation where, upon a statement made under oath, it appears probable that any person or company has contravened the Securities Act or regulations or has committed an offence under the Criminal Code in connection with a trade in securities. This takes care of the case in which a violation is at least apprehended. In addition, however, the commission may, by clause 11(2), by order appoint any person to make such investigation as it deems expedient for the due administration of the act, or into any matter relating to a trade in securities and in such order shall determine and prescribe the scope of the investigation. This power is not expressed to require an allegation on oath or probable cause. Seemingly, subclause (2) is intended to permit investigations into trades and securities which do not necessarily disclose the infractions of the act, regulations or the Criminal Code but which appear to raise questions of general importance concerning securities trading.

This wide grant of power, including the power to conduct a public inquiry, appears to be desirable. The *ALI Federal Securities Code* in United States which builds upon the existing federal statutes in the field contains ample powers, as indeed do provincial acts in Canada, to require the attendance of witnesses and the production of books and papers once an investigation has been formally instituted. However, as will be seen, in many cases investigations are instituted informally and pursued for some time before it is decided to ask for formal powers. The reasons for this are the undesirability of harming companies, subjecting individuals to onerous consequences before it is clear that a real case for investigation exists and harming investors in general. This sort of preinvestigation or preliminary investigation technique is used not only by the SEC but by other regulatory agencies. We therefore think that an additional power in aid of investigation might be borrowed with advantage from the U.K. Companies Act 1967.

In an attempt to obtain a greater use of the investigation provisions in the Companies Act 1948 the United Kingdom Parliament enacted Section 109 of the Companies Act 1967 to enable the Department of Trade and Industry to obtain books and papers from companies without making a formal order of investigation with all the detriment to the company that might ensue. The section therefore allows the department to require the company, at such time and place as might be specified by the directions, to produce such books and papers as may be so specified or, if it thinks there is good reason to do so, to authorize any officer of theirs, on producing (if required to do so) evidence of his authority, to require any such body as aforesaid to produce to him forthwith any books or papers which the officer may specify. The power includes a power to take copies of or extracts from books and papers, to require a person in possession of them or employed by the body in possession of them, to provide an explanation of any of them, and if the books and papers are not produced to require the person who was required to produce them to state to the best of his knowledge and belief where they are. It is made an offence to fail to comply with any such requirement. This particular power is buttressed by section 110 which contains a power to enter and search premises with a warrant where there are reasonable grounds for suspecting that there are on any premises any books or papers of which production has been required by virtue of section 109 and which were not produced in compliance with that section.

The U.S. Law Institute draft would give power to require the production at any time of any of the records required to be kept by section 1503(b)(1) of that draft. It does not however seem to be a general preinvestigation power. The power in the Restrictive Trade Practices Commission acting under section 114(1) of the Canada Corporations Act 1970 is also not quite what is advocated herein. It does enable an investigation to begin without publicity. The hearings can be held *in camera* if necessary. It is not however an informal procedure of the sort contemplated here and it is unlikely that the news that a full inquiry is in progress could be kept confidential for long.

The need for preinvestigation powers corresponds to what appears to be the universal practice concerning complicated investigations of this character. Since the conferment of such powers in the United Kingdom, the Department of Trade and Industry reports a considerably greater use of investigative power than formerly.[272] In the United States, the SEC almost invariably be-

272 *See further* Fraser, *Administrative Powers of Investigation into Companies*, 34

gins investigations informally, in order to avoid prejudice to persons against whom no real evidence may ultimately be found.[273]

The manner in which SEC investigations are conducted is interesting. The source of suspicion may be a newspaper, a competing dealer, etc. The investigation may result from a market surveillance report showing unusual trading activity in a security. Investor complaints are another effective source. Stock exchanges, NASD, state and Canadian securities agencies are further such sources. So too are periodic inspections.[274] Very often the information is inconclusive.

A regional office (and investigations are conducted through regional offices) is often unable initially to take a view about the merits of a complaint and so proceeds informally. If the complaint appears to be substantial a file is opened. A computer search is undertaken for names. The computer printout gives details of the individual's involvement in the securities market. It is in fact a picture of his total involvement; it is not limited to disciplinary records and the like but includes filings, his status in other issues, and so on. The search often turns up much dross, but often much very useful information as well. The technique is said to be particularly useful where the existence of organized crime is suspected.

Once a file is opened, the regional office is committed to head office for the investigation. Headquarters and the regional office keep mirror files of proceedings. Sources of evidence are separately docketed. When an investigation is docketed the regional office takes charge. Quarterly reports are filed at headquarters. Cases are investigated by investigators and attorneys, often working as a team. Investigators report to the attorney who may advise them of further details to look for, issues to clarify and the like.

Subpoena powers where required are granted by the commission itself. These are sometimes not needed because broker-dealers are obliged by statute to have, and to make available, their records to the SEC at any time. The same observation applies to investment companies and to mutual funds. The *ALI Federal Securities Code* also, in section 1505(e) makes provision for subpoenas. Some entities such as banks and issuers can only be reached through subpoena.

The power to subpoena witnesses and documents is, in the United States as elsewhere, an incident for the formal process of

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MOD. L. REV. 260 (1971); *see* DEPT. OF TRADE AND INDUSTRY, COMPANIES IN 1974, table II (U.K. 1974).

273 SEC, 37TH ANNUAL REPORT 103 (1971).

274 Ferrara, *SEC Division of Trading and Markets: Detection, Investigation and Enforcement of Selected Practices that Impair Investor Confidence in the Capital Markets*, 16 HOW. L.J. 950 (1971).

investigation. It is a power to administer oaths and affirmations, subpoena witnesses, compel their attendance, take evidence and require the production of books, papers or correspondence or other records relevant to the inquiry. The power may or may not include a power to freeze assets and control the affairs of the person under investigation.

Civil liberties problems arise in connection with investigations. The difficulty is that the investigation is seen as an inquisitorial rather than as an adversarial procedure.[275] The result is that even where investigatees are accompanied and advised by lawyers, they are not in general informed of what the investigators have discovered, nor are they given the right to attend and cross-examine other witnesses before the investigation. Professor L. Loss[276] notes that counsel may only advise his client on the question of self-incrimination and object to questions as outside the scope of the inquiry.

The direct protection given to investigatees also varies. In Canada under the Income Tax Act a person under investigation must answer upon oath, whether or not the answer would incriminate him, and the same appears to be true under the provincial securities acts. Under section 109(5) of the U.K. Companies Act 1967 a statement made by an investigatee pursuant to a demand from the Department of Trade and Industry may be used in evidence against him. Under section 114(3) of the Canada Corporations Act, answers given on an investigation may be accorded protection; if the investigatee claims protection, the answer may only be used against him in a subsequent proceeding for perjury stemming from the particular answer. In the United States, in order to procure answers to incriminating questions, an indemnity against prosecution must be offered the investigatee. Otherwise the constitutional protection against self-incrimination may be claimed.

But even the most favourable regime involves potential risk to the investigatee.[277] While an investigation may not of itself determine rights, it can certainly be gravely prejudicial. The resulting prejudice is often perfectly justified. A balance must be struck between the need for thorough and expeditious inquiries, and the interest of the individual in dispelling groundless suspicion arising from information or assertions at an early stage.

275 Re Pergamon Press Ltd., [1970] 3 All E.R. 535, 539 (C.A.) (*per* Lord Denning, M.R.); Norwest Holst Ltd. v. Dept. of Trade, [1978] 3 All E.R. 280.

276 3 L. Loss at 1954.

277 *See* Fuller, *Symposium on Federal Civil and Criminal Income Tax Fraud Investigations: Law and Order v. The Constitution*, 2 HOFSTRA L. REV. 130, 134 (1974); Merrifield, *supra* note 270.

Some of the matters referred to can be instituted or remedied by administrative procedures if it seems desirable to do so. Others can only be dealt with by legislation. The discussion which follows is based upon issues disclosed in the theoretical writing, largely though not exclusively American, and from discussions with the SEC.

The first question raised in connection with current U.S. practice is whether there is sufficient control over the commencement of investigations. For our purposes the question becomes one of what controls ought to exist and how they should be administered. We should note that when head office action is required, for example when formal subpoena powers are sought, the regional office must justify the request and the commission review is substantial. Head office review of the case is thought by the region to be a useful device, very often effecting a clarification of the case. The commission reviews subpoena powers every six months to determine whether they should be kept alive. At some stage there will be a further review and a recommendation for injunction and/or administrative proceedings. The impression which I derived was of an agency which took pains to ascertain the merits of investigations before according extensive formal powers upon investigators.

It has, however, been argued that institutional review is patchy. The commission has powers to reject a request, ask for more information before making a decision or issue an order initiating an investigation. This process, while not objectionable in theory has become, it is alleged, a rubber stamp. Lowenfels asserts:[278]

> "If a staff member feels strongly enough to recommend an investigation, the Commission is inclined to concur. As a rule, the staff member who recommended the investigation is then given the power to try to prove his case. He becomes in effect a prosecuting attorney with great powers to examine the investigatee's files, issue subpoenas and depose witnesses. And he has the full power of the United States Government behind him."

There is no magic answer to this sort of problem. Institutional review procedures of a reasonable character exist in the SEC. It would be possible to vest review powers in the courts rather than the agency, thereby attaining a formal separation between the initiating and reviewing body. It is possible that a court, with less expertise than a commission, would conduct a less searching re-

278 Lowenfels, *Securities and Exchange Commission Investigations: The Need for Reform*, 45 St. John's L. Rev. 575 (1971).

view. If an application for review were publicized as a result of its being made in court or chambers, the investigatee might suffer avoidable prejudice. The functional separation of powers which now exists in the SEC would seem apt to minimize this sort of difficulty. I would suggest that powers to initiate investigations should be placed in a commission, with institutional review procedures specified by regulation. This would also conform to the pattern found in section 114 of the Canada Corporations Act. The commencement of investigations would not be subject to judicial review; some aspects of investigations procedure would however be so subject. Commencement would be subject to internal review and provision should be made, as in the United States, for periodical review by senior personnel of investigations in progress.

There have also been complaints that investigations are unduly prolonged, and that sometimes they become a general fishing expedition.[279] I did not derive this impression from the SEC. The SEC is aware that avoidable delay is bad for the investigatee because the financial community will not deal with a broker-dealer while he is under investigation. He is therefore in limbo. Accordingly, the SEC proceeds as expeditiously as possible.

In part, this problem can be dealt with by internal procedures. There seems no reason why unwarranted delay could not be dealt with also via judicial review. It might be advisable to consider whether, in any fasciculus of provisions dealing with investigations, we should not make provision for judicial review where the complaint is that the inquiry is not proceeding sufficiently expeditiously. I would certainly recommend that we do so.

It is not so easy to deal with the problem of the "fishing expedition". The jurisdiction section which I advocate is wide. Presumably, excess of jurisdiction would in any event continue to attract judicial review. But it would not be easy for a court to rule on the question whether the investigators were exceeding their jurisdiction. Unhappily, any narrower formulation could be put to an harassing purpose by investigatees. I would, therefore, with some reluctance, recommend against more restrictive conditions of jurisdiction. Accepting this recommendation entails the consequence that the practical utility of judicial review will be minimized.

We ought however, to consider whether there ought not to be an internal procedure for redress: that is, a section to which complaints of abuse of power might go, and which would be required to review the case with a view to determining whether complaints were justified. Such procedure could work more rapidly

279 *Id.*

than judicial review. The section's review procedure would not provide the complainant with an oral hearing. He would be apprised of the section's decision. It would entail undue delay if the section were obliged to give full reasons for its determination. A summary might however be provided either at the time of decision or later.

This suggestion differs from that of Lowenfels who suggests that each investigation should be assigned to a specific independent supervisor for his oversight. The supervisor could rule on whether information sought by the investigator should be disclosed, subpoenas issued, and the like. The proposal seeks to protect the investigatee by a separation of roles. The suggestion again is worth considering. It is not unlike an examining magistrate procedure. The supervisor is, one supposes, expected to stand neutral. It is labour-intensive in that the supervisor must keep abreast of the investigation at all times. It is not clear whether the supervisor's functions are to be decisional only or whether he is intended essentially to direct investigations. The former seems to be intended. It might be a time-consuming procedure since, at each stage when the investigator desires to take a significant step, the supervisor would have to review the file to determine whether it was justified, whether or not there had been any complaint. If the supervisor's caseload were heavy, there is a danger that either decisions would be delayed or review would become a purely formal process. The procedure would in my submission be too cumbersome to be worth adopting.

Other problems concern the conduct of the investigation itself. Investigatees are generally accorded the right to counsel while giving evidence before the investigator. Certainly this is so under section 114(13) of the Canada Corporations Act and clause 11(5) of Ontario Bill 30. Investigations are potentially so prejudicial that such rights must continue to be given.

Should investigatees have the power to object to the issue by the investigator of a summons to a third party, or to cross-examine other witnesses before the inquiry? I would return a negative answer to both. As to the former, it is the investigator's duty to obtain the fullest possible information. He therefore should have considerable latitude. Complaints of harassment and abuse of power could be dealt with by the review section, the creation of which is advocated herein. The general right of cross-examination is a feature of tribunals of inquiry, but, generally, not of administrative investigations where speed is required if civil or criminal proceedings are to follow. Furthermore, there will be a later stage, if prejudicial matter is discovered, at which the investigatee can make his defence. This affords some justification for restricting

the investigatee's participation. Tribunals of inquiry on the other hand are not always followed by judicial proceedings and no legal forum for dispelling prejudice which arises from them exists. There is therefore a very strong case for full participation by persons likely to be affected by the findings.[280]

Should the investigatee have power to refute the investigator's findings before these are formally submitted to the commission in any case where prejudicial action may be taken upon them? Again, the interests of speed and the consideration that another forum for defence will be provided militate against reopening the inquiry to enable a detailed refutation to be made. However, there is, I think, much more to be said for instituting a procedure whereby the investigatee will be furnished with a draft report and afforded an opportunity to comment on it before it goes forward. A limited provision of this sort appears in section 1505(d)(2) of the U.S. *ALI Federal Securities Code*, but only where the person under investigation may be the subject of adverse publicity. This is too narrow. Both the report and the investigatee's comments should go to the commission for review and action. In the event that the commission feels that the investigatee had raised a point of substance with which the investigator has not dealt adequately, the matter can be remitted back for further investigation.

Should we provide for a privilege against self-incrimination and if so in a modified or absolute form? If a full privilege is accorded it will be necessary to guarantee immunity from prosecution to witnesses before the inquiry if incriminating answers are to be obtained. The SEC made the point to me that the problem with granting such immunities to witnesses or providing that the witness' testimony shall not be used against him criminally is that it is often difficult to know who will eventually be a prime target. One might unwittingly grant immunity to a person who later is discovered to be a prime malefactor. It would in any event seem possible to elicit the truth without frequent recourse to the practice.

The real choice is between providing that where a witness claims a privilege against an incriminating question such answer shall not be used against him criminally save on a prosecution for perjury, and, on the other hand, compelling answers to such questions by statute, the answers to be capable of use in later criminal proceedings. Two questions at least are raised by these points. The first relates to fairness; what safeguards should witnesses have and why? The second, related question, is what purpose do we wish the inquiry to serve? Is it exclusively intended for administrative

280 Lord Salmon, Tribunals of Inquiry 14 (1967).

and civil uses, or is it used and intended to be used as an aid to criminal discovery?

I assume for the moment that investigations can properly serve both administrative and criminal discovery functions. I admit to a bias in favour of compelling answers by statute. The investigatee is entitled to be dealt with decently and expeditiously and he should certainly have the opportunity of dispelling any erroneous inferences which arise from his evidence. The same is true of other witnesses. The milieu is not that of a police station in which an ingenue is faced with a menacing and unfamiliar situation, often without benefit of counsel. He is certainly not entitled to be shielded from the consequences of his own wrongdoing and the prosecution should be entitled to use any weapons which come fairly into their hand.

In fact, however, I doubt whether it will make much practical difference which alternative is chosen. In the United States the invocation of the privilege against self-incrimination is thought often to be of little use, and an individual such as a broker-dealer who asserts the privilege can suffer disastrous consequences to his business. In any event most broker-dealer cases can, it is said, be proven without the oral testimony of the principal respondents. Thus one recent work states,[281]

> "I do not know of a single case in which the assertion of the privilege had any of the salutary benefits that juridical philosophers talk about. I can think of a number of cases where the assertion of the privilege stimulated successful prosecution with devastating personal results. I therefore recommend to you that you reject this as an instrument of advocacy."

In Canada, even if the customary protection is accorded, the investigatee may still be prejudiced by discovery of facts as a result of his testimony, or the uncovering of further witnesses. In addition, seizure of records may disclose the existence of documents which will prove helpful in the event of a future prosecution. Witnesses whose answers incriminate others will have afforded a hostage on oath which the prosecution can use in proceedings against the other. It is in this respect that our procedure of partial protection in respect of incriminating answers could prove useful, and this advantage may appear even more pertinent if the case is not a broker-dealer case, but one having wider or other connotations. In effect the prosecution, or in civil proceedings the agency,

281 Gould, *Due Process and the Securities Laws*, in PLI, NEW TRENDS AND SPECIAL PROBLEMS UNDER THE SECURITIES LAWS 367 (A. Sommer chairman, H. Enberg ed. 1970).

will have available from a number of persons what amounts to depositions on oath. The agency will know who to call, and what they can prove, and the transcript of investigation should afford a serviceable club.

It will be obvious from the preceding remarks that I see investigations as a forum for discovering facts which will not only assist in providing information tending to the better regulation of the securities markets, but also as a device for obtaining information which will later be put to use in civil, criminal and administrative proceedings arising from the particular case. Investigative provisions under provincial securities enactments can certainly be so used. There is no doubt of the difficulties which beset the prosecution of securities and related cases under even the most favourable regime for the prosecution.

In the United States the propriety of all this has been questioned.[282] It is said, in connection with income tax investigations, to be unfair to issue an investigative summons to gather evidence for a criminal prosecution. The purpose of such summons is to garner information in order to assess civil tax liability. The SEC apparently takes the view that civil discovery should not be used in aid of criminal process. If a criminal matter is discovered, civil suit is sometimes not persisted in; instead criminal proceedings are initiated.

This "proper purpose" doctrine may or may not be accepted. It is certainly difficult to apply in practice. U.S. courts hold that an Internal Revenue Service summons may be issued in aid of an investigation if it is issued in good faith and prior to the commencement of a criminal prosecution. This formulation is seen as a way of protecting against the possibility that a recommendation for criminal prosecution may be purposely delayed in order to afford the Internal Revenue Service (IRS) the use of the summons power to obtain evidence for the prosecution. The requirement is difficult to police for, apparently, current court cases uniformly hold that a summons issued for the proper purpose of assessing civil tax liability will not be voided simply because the information obtained may also have been used as evidence for a future criminal prosecution. In cases where prosecution has not been launched at time of issue of the summons, it may be difficult to show improper purpose. The difficulties are compounded by a general intertwining of the civil and criminal aspects of an income tax investigation, and it is submitted that the same difficulty is likely to appear in securities fraud cases.[283]

282 *See* Fuller, *supra* note 277; and *see* Donaldson v. United States, 400 U.S. 517 (1971).
283 SEC v. United Brands Co., [1975-1976 Transfer Binder] CCH FED. SEC. L. REP. ¶95,357 (S.D.N.Y. 1975).

I doubt whether a "proper purpose" limitation is desirable under securities legislation, let alone the Income Tax Act. No single clear purpose appears from existing legislation which is general in terms. Nor, in any event, do I think that a "proper purpose" doctrine can be applied by the courts with consistent results. I would suggest that the interests of regulation be given primacy and that involves the use of investigation as both a civil and criminal discovery device.

Chapter IV
Supervision of Self-Regulatory Agencies

In the United States as in Canada enforcement agencies rely extensively on self-regulatory agencies to police the field. In the United States, the National Association of Securities Dealers (NASD) is the only recognized body. In Canada broker-dealer associations and the Investment Dealers Association of Canada (IDA) are active. In Ontario and other Canadian provinces the securities commissions have direct power to suspend, expel, or revoke the licences of principals and salesmen, whether or not they belong to a self-regulatory agency, and can direct that as a condition of continued registration they undertake such courses as the Canadian Securities Course. In the United States, the Securities and Exchange Commission (SEC) functions primarily as a review body in the case of NASD members. It has of course direct original jurisdiction over SEC-only (SECO) registrants.

The jurisdiction which a federal body should have and the terms on which it should have it depends upon several factors. Among these are the size of the agency, the number and qualifications of personnel whom it can deploy to deal with disciplinary matters and its geographical distribution. A further and vitally important factor relates to the self-regulatory bodies themselves: how many are there, how efficiently are they operated, how do they discharge their functions, and is it, ultimately, reasonable to rely upon them as primary enforcement agencies?

The following paragraphs contain a summary account of the SEC's powers in relation to self-regulatory bodies because it provides an example of a "review" structure over discipline and related matters in the industry. It should not be thought however that the SEC's functions are purely repressive. Under the Securities Reform Act of 1975, for example, the SEC is obliged to ensure that self-regulatory agencies provide a fair procedure for diciplinary action, the denial of membership, the barring of any individual from being associated with a member, and the prohibition or limitation of any person with respect to requested access of-

fered by the organization or any member thereof. Notice of any final action by an agency which prejudicially affects any person must be filed with the SEC, and the SEC may of its own motion review any disciplinary action by a self-regulatory agency. The SEC also has the power to determine the scope of self-regulatory activity. By new sections 6(b)(5) and 15A(b)(6) of the Securities Exchange Act of 1934 it may require the rules of such organization to be designed to prevent fraudulent and manipulative practices, to promote safeguards against unreasonable rates, and in general to protect investors and the public interest. It thus has a general monitoring function.[284]

In Canada the Ontario Securities Commission has by section 140 of the Ontario Securities Act wide powers over the stock exchanges including review powers on appeal, but a less impressive range of powers over the Ontario division of the Investment Dealers Association of Canada or the Broker-Dealers' Association of Ontario. The latter bodies are less significant in Canada than is the NASD in the United States.

The SEC has the responsibility of supervising self-regulatory organizations dealing with broker-dealers who are not members of exchanges. Only the NASD fulfills this role at present. The SEC has the power to oversee the NASD's rules and can disapprove them. It has the power to abrogate any NASD rule if necessary or appropriate in order to attain the purposes of the act. The SEC did so in one case noted in the *1972 Annual Report* on the basis that the NASD rule was *ultra vires* the enabling act.[285]

The SEC also has the power to inspect NASD activities. In 1972 it was pleased to record that it had been granted extra funds to enable it to do so. It examines, on a sample basis, members of self-regulatory bodies to determine if they are complying with the securities laws. It also can examine a member of a self-regulatory body directly and at the same time review the examination report and working paper of that body in order to determine whether its examination program is thorough and effective. In addition, and in practice, the commission also normally reviews in advance of publication general policy statements, directives, and interpretations proposed to be issued by the association's board of governors, pursuant to its powers to administer and interpret NASD rules.

The SEC conducts periodic inspections of NASD activity. In 1971, the NASD offices in Boston and New York were inspected and a review was taken of the New York district office's programs

284 For an account of the United States amendments *see* Securities Reform Act of 1975, CCH FED. SEC. L. REP. (1975) (extra edition, No. 589) which contains also a useful section of committee reports.

285 SEC, 38TH ANNUAL REPORT 54 (1972).

and procedures with respect to the monitoring of the financial and operating conditions of NASD member firms. The structure of examinations and investigations thus appears to be similar to that which obtains in the case of the national stock exchanges. The SEC is informed of all NASD disciplinary actions. The NASD may impose on a member sanctions of expulsion, suspension, fine or censure. Where the violator is an individual, his registration as a representative may be suspended or revoked, he may be suspended or barred from being associated with any member, and he may be fined or censured. The NASD has in the past imposed apart from expulsion, substantial fines upon some of its membership. Censure is rarely imposed alone.[286] It is usually a secondary penalty where a more severe penalty was also imposed.

The SEC has the power of review over disciplinary action by the NASD. The SEC must sustain NASD action unless it finds that the penalties imposed are excessive or oppressive in which case it must cancel or reduce them. In the past, the SEC has drawn attention to the fact that it can only reduce penalties. It has suggested that it ought in a proper case to have the power to increase them.[287] Upon an application for review by the SEC the penalty imposed by the NASD is automatically stayed pending SEC review unless the SEC otherwise orders after notice of opportunity for hearing. A federal agency should also have power to call in a file with a view to imposing heavier penalties, or to review self-regulatory agency procedures, or perhaps to require a self-regulatory agency to proceed to invoke disciplinary measures. The SEC possesses power to remove officers and directors of self-regulatory agencies for failure, *inter alia*, to enforce compliance with the statutes and regulations or rules of the society.[288]

In most cases, the SEC upholds NASD disciplinary action. Thus the *1972 Annual Report* notes that where NASD exams were leaked and used by a firm in preparing its trainees, the revocation or expulsion of the firm would not be judged excessive or oppressive unless the most extraordinary mitigating facts were shown.[289] In another case, noted in 1965, the SEC did reverse an NASD decision against a firm which failed to complete a stock purchase contract where the firm believed in good faith that the transaction was part of a manipulative and fraudulent scheme. This was held by the SEC not to be unethical or dishonour-

286 SEC, 36TH ANNUAL REPORT 123 (1970).
287 SEC, 33D ANNUAL REPORT 88-89 (1967).
288 Securities Exchange Act of 1934, s. 19(h)(4), *as amended by* Securities Reform Act of 1975.
289 SEC, 38TH ANNUAL REPORT 56 (1972).

able.[290] The SEC concluded that under these circumstances the firm's action does not violate an NASD rule requiring the observance of high standards of commercial honour and just and equitable principles of trade. But the refusal to settle was only justifiable because the firm involved acted in good faith and fearing that the person with whom it was dealing was attempting to manipulate the market.

In each year there are a number of cases in which either NASD action is set aside or the penalties imposed by the NASD are reduced. In most cases, however, the NASD action is sustained and in general there is a tradition of supporting NASD disciplinary action. Attempts by the NASD in particular to devise and enforce a duty on employers to supervise employees have thus been loyally and effectively seconded by the SEC. This is precisely the pattern which one would expect to find.

The SEC also has jurisdiction over some aspects of NASD membership. Under section 15A(b)(4) of the Securities Exchange Act of 1934 and the NASD by-laws, no broker-dealer may be admitted to or continue in NASD membership without SEC approval if he has been suspended or expelled from membership in the NASD or a national securities exchange, if he is barred or suspended from association with a broker or dealer, member of the NASD or an exchange; his registration as a broker-dealer has been denied, suspended or revoked; he has been found to be a cause of certain sanctions imposed upon a broker-dealer by the SEC, NASD or an exchange; or he has associated with him any person subject to one of the above disqualifications. Any of these findings thus act as a prospective civil disability measure.[291]

The SEC has power under section 15(b)(4) of the Securities Exchange Act of 1934 to approve or direct admission to or continuance in NASD membership notwithstanding that the person is disqualified from membership under that section or under an effective NASD rule adopted under that section or under section 15A(b)(3). The procedure is for the member or applicant to initiate the matter. The NASD may then, at its discretion, file an application on behalf of the applicant with the SEC. If the NASD refuses to sponsor an application, the applicant may apply directly to the SEC for an order directing the NASD to admit or continue him in membership. In any event, the final decision is that of the SEC as ultimate guardian of the integrity of the markets. In one case noted in the *1963 Annual Report* an application from a firm for continuation of membership was denied where the firm intended

290 SEC, 31ST ANNUAL REPORT 72 (1965).
291 SEC, 34TH ANNUAL REPORT 97 (1968).

to admit as an employee the father of a principal in the firm who it was difficult to believe would be effectively supervised.[292]

Ontario has initiated follow-up procedures to ensure that complaints from the public regarding members of self-regulatory bodies are dealt with. This procedure is worth emulating.

Chapter V
Cooperation with Other Securities Agencies

For several years there has been an emphasis upon cooperation among the various regulatory agencies. This development is noted in detail in the *SEC Annual Reports*. Cooperation takes a number of forms. One is a comprehensive exchange of information concerning mutual enforcement problems and possible securities violations. Information is exchanged with foreign agencies.[293] Indeed, there is a considerable record of cooperation with Canadian securities administrators.[294]

The SEC refers some matters to state and local authorities for action where a matter appears to be confined largely to one state or local area and it appears that the matter will be dealt with promptly and effectively there. Examples might be a prosecution or proceedings for an injunction. The SEC frequently provides manpower assistance to state authorities in the development of securities cases.[295] The provision of assistance to United States attorneys has already been noted. State authorities are notified of important investigations being carried on in their state.

SEC regional offices have taken steps to improve the coordination of inspections and other activities with state securities administrators and with the NASD in areas where their respective jurisdictions overlap. The SEC and state authorities have conducted joint inspections, a practice which has made the entire inspection program more effective.[296]

The SEC has initiated a program of cooperative regional enforcement conferences at its regional offices. Its personnel meet with personnel from state securities agencies, post office inspectors, federal, state and local prosecutors and local representatives of self-regulatory agencies. In 1972 one session was opened to

292 SEC, 29TH ANNUAL REPORT 70 (1963).

293 Thus Belgium, as a result of material supplied by the SEC, declined to allow Investors Overseas Services (IOS) to trade there; *see* C. RAW, B. PAGE & C. HODGSON, *supra* note 60, at 272.

294 *See e.g.* SEC, 35TH ANNUAL REPORT 122 (1969); SEC, 34TH ANNUAL REPORT (1968) also contains an account.

295 For a full account, *see* SEC, 37TH ANNUAL REPORT 133 (1971).

296 *Id.* SEC, 36TH ANNUAL REPORT 126 (1970).

representatives from the industry with beneficial results. The conferences are designed,[297]

> "[T]o promote the exchange of information concerning regional enforcement problems, the development of methods of increasing cooperation and communication, and the elimination of needless effort and waste of man-power and other resources in the regulation of the securities market."

This is a step which we could emulate.

The SEC also holds an annual enforcement training program. It is attended by SEC personnel, persons from other federal and state agencies, and from other countries. In 1972, seven Canadian representatives attended. The *1972 Annual Report* notes,[298]

> "The program seeks to impart an understanding of how the securities markets operate, explain applicable rules, suggest desirable investigative procedures, indicate how available enforcement remedies can best be utilized and provide guidance in connection with the trial of securities cases."

I assume that this is a facility which we will ultimately emulate and of which we could in the interim take full advantage.

Chapter VI
Intelligence

A. STORING AND EXCHANGE OF INFORMATION

The SEC maintains a Securities Violation Section for storing and exchange of information. In acquiring information it is assisted by state and Canadian agencies. The section acts as a clearing house for information regarding enforcement action in securities matters taken by state and Canadian authorities, by other governmental and self-regulatory agencies and by the SEC. In 1969 for example information was received from several states and Canada on 104 criminal actions, 49 injunction actions, 169 cease and desist orders and 104 other administrative orders such as denials, supervisions and revocations of registration of issuers, broker-dealers and salesmen. It also received information from the U.S. Department of Agriculture concerning administrative action taken against future commission merchants and floor brokers under the Commodity Exchanges Act.[299] The data in the section files consti-

297 SEC, 36TH ANNUAL REPORT 127 (1970).
298 SEC, 38TH ANNUAL REPORT 89 (1972).
299 *See* SEC, 35TH ANNUAL REPORT 90 (1969).

tutes a valuable tool for screening applicants for registration as securities or commodities brokers or dealers, as well as applicants for loans from certain agencies.

The SEC publishes a periodical bulletin which is sent to contributing agencies and other enforcement and regulatory agencies. The bulletin contains current information which is a matter of public record regarding the institution and disposition of remedial and enforcement proceedings including proceedings initiated by the NASD.[300]

Other bodies have pertinent information. The OSC, for example, contacts Interpol for data on the criminal record, if any, of persons seeking registration as broker-dealers or salesmen.[301] The OSC has, it may be noted, informed all registrants under the Securities Act that violation of the securities laws of any jurisdiction is prejudicial to the public interest and affects fitness for continued registration in Ontario.[302]

The material in the Securities Violations Section files goes beyond criminal convictions and proven securities violations. In addition, as we have noted, the SEC has a data bank index of the names of persons who have been named in formal filings with the SEC, have been a party to a proceeding, or have been involved in an investigation.[303] Computer name searches are run on prospective securities salesmen and others whose names are submitted by the stock exchanges, NASD and state securities commissions.[304]

In addition, the SEC maintains and publicizes a Foreign Restricted list which comprises the names of foreign companies whose securities the SEC has reason to believe recently have been, or currently are, being offered in the United States in violation of the registration requirements of the Securities Act. Broker-dealers will not, in general, touch such companies, but promoters illegally offer such securities directly to investors in the United States, either personally or by mail. Originally the list was known as the Canadian restricted list. It is a matter of satisfaction to note that Canadian companies are much less prominently featured in it today.

300 SEC, 29TH ANNUAL REPORT 133 (1963).

301 Re Thomas, [1972] OSC Bull. 118 (June). Interpol does not, however, concern itself in practice with so-called "economic crimes". *See* Feraud & Schlanitz, *La coopération policière internationale*, [1976] REVUE INTERNATIONALE DE DROIT PÉNAL 475-98.

302 [1968] OSC Bull. 17 (February).

303 SEC, 36TH ANNUAL REPORT 94-95 (1970).

304 SEC, 33D ANNUAL REPORT 74 (1967).

B. MARKET SURVEILLANCE[305]

The SEC conducts a market surveillance program to identify possible manipulative activities. This is coordinated with the stock-watching operations of the New York, American and regional exchanges. The staff maintains a continuous ticker tape watch of transactions on the New York and American Stock Exchanges and monitors the sales and quotation sheets of regional exchanges in order to detect any unusual or unexplained price variations on market activity. If any of these sources reveals possible violations the market surveillance staff conducts a preliminary inquiry into the matter. The inquiry generally begins with the identification of brokerage firms which were active in the security. The staff may communicate with principals or registered representatives of these firms, with customers, or with officials of the issuer involved to determine the reasons for the activity or price change in the securities in question and whether violations have occurred. The Ontario Securities Commission relies not on its own monitors, but upon close liaison with the Toronto Stock Exchange. This cooperation has obviously proved fruitful.

The SEC has also developed an over-the-counter surveillance program involving the use of automated equipment to provide more efficient and comprehensive surveillance of stock quotations distributed by the National Quotation Bureau and the NASD's automated NASDAQ service. Automated equipment is programed to identify, among other things, unlisted securities whose price movement or dealer interest varies beyond specified limits in a preestablished time period. This data, combined with other available information, is collated and analyzed to select those securities whose activity indicates the need for further inquiry or referral to the commission's enforcement staff.

The market surveillance branch considers that it has primary responsibility for surveillance in the over-the-counter market, as it maintains the only automated surveillance program.

C. INVESTOR COMPLAINTS

Investor complaints are another effective tool. In 1971 there were 17,000 complaints from the public against broker-dealers. These are carefully analyzed by a special staff unit within the Division of Trading and Markets. In 1971, approximately 80% of

305 SEC, 37TH ANNUAL REPORT 102 (1971); contains a full account; *see also* Ferrara, *supra* note 274.

complaints involved back office problems such as the failure of firms to deliver securities or funds promptly and the alleged improper handling of accounts. The SEC cannot arbitrate in private disputes, but a complaint may lead to a referral as described below.

If it becomes apparent from SEC scrutiny that there has been a violation of the securities laws the complainant is referred to the appropriate enforcement officials at the SEC. The SEC may in turn refer the subject matter of the complaint to the appropriate stock exchange if a listed security is involved, or to the NASD if the security is traded over-the-counter, to enable the self-regulating agencies to take internal administrative action. Ferrara concludes:[306]

> "Thus, it may be seen that analysis of investor or consumer complaints may be used as a vehicle for not only detecting problems that affect capital markets generally, but also providing information as to houses experiencing particularized (*sic*) problems."

A recent noteworthy development is the SEC proposal to establish a clearing system for information on lost, stolen and counterfeit securities. Securities firms, exchanges and dealers will have, if the proposal is accepted, to report missing, stolen or counterfeit securities. They will also have to notify the SEC in case of recovery of any such securities. This follows a rule adopted in 1974 requiring all persons handling securities to be fingerprinted.[307]

A further technique, worth emulating, is the systematic use of publicity to alert the public to the dangers of fraudulent schemes. This typically includes information concerning the type of fraud concerned and the methods employed.[308]

Chapter VII
Organized Crime

In 1969 and 1970 the SEC indicated that it was taking special steps to deal with the problem of organized crime. Close liaison

306 Ferrara, *supra* note 274, at 961.

307 *See SEC Proposes System to Amass Information on Stolen Securities*, The Wall Street Journal, January 22, 1976; Rowen, *Securities Acts Amendments of 1975*, 8 Rev. Sec. Reg. 889 (1975).

308 Fraudulent Practices in Connection with Oil and Gas Fractional Interests, SEC, Securities Exchange Act of 1934 Release No. 11992, January 8, 1976 [1975-1976 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 80,355.

with the U.S. Department of Justice was announced, with staff members placed in strike forces. The *Annual Report* announced:[309]

> "This unit acts as a 'backup' unit to the various strike forces and is an enforcement unit investigating certain securities violations in which persons with organized crime associations are believed to be involved."

Organized crime is thought to complicate matters by threatening witnesses, destroying documents, using nominees and foreign bank accounts, and working through foreign affiliates. The SEC in 1972 noted that nonetheless, enforcement agencies had had some notable successes. No doubt the RCMP and others will wish to consider whether a federal agency should seek an involvement in this area, and, if so, what form it might take. The question of foreign involvement, treaties of assistance and the like, falls outside this paper.

309 SEC, 36TH ANNUAL REPORT 123 (1970).

Insider Trading

Marvin Yontef

May 1978

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Chapter I
Introduction

Company law and securities regulation statutes in Canada[1] deal extensively with insider trading which "is generally used to denote purchases or sales of securities of a company effected by or on behalf of a person whose relationship is such that he is likely to have access to relevant material information concerning the company not known to the general public".[2] The legislation is based on the generally held view that "[while] it is not improper for an insider to buy or sell securities in his own company...it is improper for an insider to use confidential information acquired by him by virtue of his position as an insider to make profits by trading in the securities of his company".[3] This view from the *Kimber Report* was

This paper was completed in the fall of 1977 and early winter of 1978, with the result that the information provided herein is primarily as of fall, 1977. As it is difficult for a practising lawyer to keep apprised of developments in the many jurisdictions referred to herein, the writer expresses his gratitude for the time permitted for even this limited coverage by the firm with which he was associated when the paper was undertaken and the firm of which he is now a member. Of the many who assisted in searching out materials and preparing drafts and footnotes, a special debt is owed to Carolyn Rosenstein who typed many "final" drafts. The usual disclaimer for the personal views expressed and responsibility for errors applies.

1 *See e.g.* Canada Business Corporations Act; British Columbia Securities Act; British Columbia Companies Act, S.B.C. 1973, c. 18, *as amended*; Ontario Securities Act.

2 KIMBER REPORT ¶ 2.01.

3 *Id.* ¶ 2.02. This is not, however, a unanimously held view. *See e.g. contra* H. MANNE,

the impetus for legislative controls in Ontario in 1966[4] and thereafter in most Canadian jurisdictions.[5]

The legislative controls over insider trading in Canada, both in the provinces and federally, are virtually identical in principle. Insiders are required to report on their ownership of and transactions in securities of their companies. Liabilities may be imposed upon insiders when they have made use of confidential information for their own benefit or advantage. While there are slight variations of detail in the legislation, no Canadian jurisdiction has departed significantly from this legislative approach.

The purposes of this paper are fourfold. The first is to describe and analyze Canadian legislation on insider trading. The second is to compare the Canadian regulatory positions with those of selected foreign jurisdictions. The third is to consider the legal issues raised by insider trading and to evaluate the legislation to control it. The fourth is to explore improvements to the current regulatory system. The overall question to be considered is the role for federal regulation on insider trading.

Recently, legislators have joined the commentators in Canada[6] who have written on the subject of insider trading by recom-

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INSIDER TRADING AND THE STOCK MARKET, ch. 1 (1966) where the author discusses the basis for regulation of insider trading.

4 Ontario Securities Act, pt. XI [hereinafter cited as the Ontario Act].

5 At present, all jurisdictions in Canada regulate insider trading by statute except New Brunswick, Nova Scotia, Prince Edward Island, Newfoundland and the Northwest and Yukon Territories. For more detailed legislative background in this area, *see*, *Anisman* at 173.

6 On the subject of insider trading generally, *see* J. WILLIAMSON, SUPP. at 351; F. IACOBUCCI, M. PILKINGTON, J. PRITCHARD, CANADIAN BUSINESS CORPORATIONS 341 (1977); D. JOHNSTON at 275; P. ANISMAN at 115, *Anisman* 151; Cranston, Comment, [1974] U. TORONTO FAC. L. REV. 175; Crawford *Insider Trading*, 8 CAN. B.J. 400 (1965); Creber, *Takeover Bids, Insider Trading and Proxy Requirements*, in LAW SOCIETY OF UPPER CANADA, SPECIAL LECTURES: DEVELOPMENTS IN COMPANY LAW 235 (1968); Davies, *Canadian and American Attitudes on Insider Trading*, 25 U. TORONTO L.J. 215 (1975); Downs, *Bill 125 and Insider Trading*, 9 WESTERN ONT. L. REV. 91 (1970); Hretzay, *Market Morality: A Developmental Analysis of Insider Trading Legislation in Manitoba*, 6 MAN. L.J. 257 (1975); Johnston, *Insider Trading Liability; A Comparison of U.S. and Ontario Legislation*, [1968] OSC Bull. 199 (September); Johnston, Comment, 51 CAN. B. REV. 676 (1973); Johnston, Comment, 2 CAN. BUS. L.J. 234 (1977); Johnston, *Insider Trading Liability Legislation - Green v. Charterhouse Group Canada Ltd.*, 15 WESTERN ONT. L. REV. 239 (1977); Kimber, *A Second Look at Insider Trading*, in ISAAC PITBLADO LECTURES, THE LAW CATCHES UP: RECENT LEGISLATIVE CHANGES 89 (1969); Lewtas, *Directors', Officers and Insiders' Liability*, in LAW SOCIETY OF UPPER CANADA, SPECIAL LECTURES: CORPORATE AND SECURITIES LAW 183 (1972); Magnusson, *Insider Trading: The Basis of Liability* 1 QUEEN'S L.J. 53 (1968); Mullin, *Insider Transactions*, in ISAAC PITBLADO LECTURES, COMPANY LAW 235 (1965); Pryde, *Canada Corporations Act and Insider Trading*, 12 CAN. B.J. 125 (1969); Rothman, *Insider Trading, Proxy Solicitation and Takeover Bids under the Canada Corporations Act*, 17 MCGILL L.J. 521 (1971); Williamson, *Takeover Bids and Insider Trading*, 28 BUS. Q. 47; Wortsman, *The Insider: A Survey in Corporate Disclosure*, 25 U. TORONTO FAC. L. REV. 55 (1967).

mending and adopting changes in the law. Proposals and new laws which significantly expand liabilities for insider trading contribute to making comment in this area difficult. The Canada Business Corporations Act (hereinafter the CBCA),[7] which applies to newly incorporated federal companies and existing federal companies which have elected to continue thereunder,[8] contains markedly different controls than does the Canada Corporations Act (hereinafter the Canada Act).[9] Similarly, recent attempts to amend securities legislation in Ontario[10] have suggested departures from existing provisions. As a result, the comments herein are directed at existing legislation but they will also assume that proposals for change will eventually appear in legislation, substantially in the same form as published to date.

Chapter II
Insider Reporting

A. INTRODUCTION

There are several reasons for imposing a reporting obligation upon insiders of a company. An insider's report may serve as evidence for purposes of subsequent legal proceedings in that a regulatory body or a party seeking to impose insider trading liabilities will have access to the reports of an insider's transactions. The fact that an insider must report and the act of reporting itself may have salutary effects since the insider discloses and publicizes his trades in the company's securities.[11] Public reporting furnishes the market with the insider's assessment of his company's securities and the information in those reports may affect the market's evaluation of the securities.[12] Insider report-

7 Canada Business Corporations Act [hereinafter cited as CBCA].

8 *Id.* ss. 3, 261.

9 *Compare* pt. X of the CBCA *with* ss. 100-100.6 of the Canada Corporations Act [hereinafter cited as the Canada Act].

10 *See* particularly Ontario Bill 30, pt. XX, for proposed regulation of "Insider Trading and Self-Dealing" and pt. XXII relating to "Civil Liability"; *see also* Bray, *Ontario's Proposed Securities Act: An Overview, Its Purpose and Policy Premises,* [1975] OSC Bull. 235 (October); Dey, *Securities Reform in Ontario: The Securities Act, 1975,* 1 CAN. BUS. L.J. 20 (1975).

11 1 BUSINESS CORPORATIONS PROPOSALS ¶¶ 254, 256; *see also* L. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 62 (R. Abrams ed. 1967), *quoted in, Anisman* at 181 n. 188.

12 *See* in this regard [1967] OSC Bull. 9 (June) from which the following observation appears:

> "Clearly the purpose of the legislation is to bring to the attention of the public the view that those in a position to know most about a company's affairs take of the company's shares at the particular prices at which they are trading."

ing, therefore, constitutes the material disclosure for purposes of potential liability but it may have greater impact by virtue of its effects on the insider and others in the market.

Notwithstanding that insider reporting is meant to perform these several independent functions, it has neither been as fashionable an area for comment as the insider liabilities issue, nor has there been a great deal of consideration of the reporting issues *per se.*[13] There are several significant questions raised by the legislative provisions imposing insider reporting obligations and, in view of the dearth of reported cases on insider trading liabilities and the considerations generally in bringing insider trading actions which are outlined below, the reporting obligations may be seen to constitute the only substantive regulation of insider trading in Canada. It is, therefore, critical that the reporting obligations be responsive to the purposes for which they are imposed.

B. COMPANIES IN WHICH REPORTING OBLIGATION IMPOSED

Insider reporting applies in companies whose securities are widely held. The Securities Act of each of the "uniform act provinces"[14] imposes obligations on insiders of a company which has voting securities outstanding in respect of which a prospectus or document of similar import has been filed with the provincial securities commission.[15] The Quebec Securities Act, the Canada Act and the Ontario Bill 30 base their application on whether *any* securities are outstanding in respect of which a prospectus or document of similar import has been filed with the applicable regulatory body.[16] The CBCA refers to any securities outstanding from a "distribution to the public".[17] Therefore, the concept of widely-held securities as it relates to insider reporting varies in that, in the uniform act provinces, application of the statutes results from a theory of widely-held equity securities whereas the remaining jurisdictions base application of the legislation on a concept of widely-held securities of any type.

Insiders of a company which has shares listed or posted for trading on a stock exchange are subjected to insider reporting

13 Indeed, note that Bray, *supra* note 10, does not mention insider reporting as an issue of sufficient import to require significant reform in the first major revision of securities regulation in Ontario in over 10 years.

14 "Uniform act provinces" refers to Ontario, Manitoba, Saskatchewan, Alberta and British Columbia.

15 *See e.g.* Ontario Act, s. 109(1)(b) and note specific reference to date of filing the prospectus; *but see also* Ontario Bill 30, s. 1(1)(36), where a broader class of companies would be involved under the definition of "reporting issuer".

16 *See e.g.* Canada Act, s. 100(1).

17 CBCA, s. 121(1); *see* definition of "distributing corporation".

obligations. In the uniform act provinces and Québec, the exchange must be one recognized by the local securities commission.[18] In the Canada Act,[19] listing on any stock exchange in Canada gives rise to insider reporting obligations. Application of the reporting obligation by virtue of listing on a stock exchange is another way of demonstrating a concern with widely-held companies so that, for example, an exchange listing of non-voting securities in one of the uniform act provinces will give rise to reporting requirements notwithstanding that there has been no distribution of equity shares.[20]

Insiders of relatively widely-held companies may not be subject to insider reporting obligations. Provincially incorporated companies which have not distributed equity shares publicly and do not have a class of securities listed on a stock exchange do not involve their insiders in reporting obligations. Insiders of any foreign company whose securities are widely held but which were neither distributed pursuant to a prospectus as contemplated by the statutes nor listed on a Canadian stock exchange are exempt.[21] Companies which have issued what are ultimately widely-held exempt securities, such as short-term promissory notes, will not occasion reporting obligations for their insiders.[22] Canadian regulation envisages either an initial distribution to the public or a continuing stock exchange listing which, while applying to most widely-held companies, does not cover all.

It may be noted that securities regulation statutes and corporations law containing insider reporting obligations are somewhat different in application. Corporations statutes such as the Canada Act and the Ontario Business Corporations Act apply to companies incorporated under those statutes.[23] Securities regulation statutes apply irrespective of jurisdiction of incorporation and contain exemptions if reporting is made under the province's corporations law.[24] In practice, securities commissions are respon-

18 *See e.g.* materials in note 15 *supra.*

19 Canada Act, s. 100(1), "public company".

20 This is a material consideration in Canada where a significant number of issuers have participating preferred shares listed on an exchange while the common (voting or "equity") shares are closely-held. Another consideration is the "posting" for trading whereby an exchange, without receiving application for listing, may "post" securities, which are widely traded locally, on the exchange for trading.

21 Since few widely traded U.S. companies are "posted" for trading on Canadian exchanges, Canadian holders of U.S. securities receive no insider reporting protections from Canadian securities laws.

22 Debt obligations of, for example, Canadian affiliates of foreign banks in Canada are universally "exempt". The fact that these securities are widely held does not give rise to inside reporting.

23 Canada Act, s. 2; Ontario Business Corporations Act, s. 2.

24 *See e.g.* Ontario Act, ss. 109(b), 101(a)(iii). Note also that Canadian chartered banks are not "corporations" giving rise to insider reporting.

sible for all provincial insider reporting and the federal corporations branch administers insider reporting as part of its duties under the general corporations law.

By way of comparison, United States federal regulation imposing insider reporting obligations shares the same concern of Canadian regulation in the application to widely-held companies. Under section 16(a) of The Securities Exchange Act of 1934 (hereinafter the 1934 Act),[25] reports are required from insiders of a company which has any class of its securities listed on a stock exchange *or* which has assets exceeding $1 million and 500 or more holders of a class of its equity securities.[26] The scope of companies to which insider reporting applies in these two jurisdictions may appear to be different but this is probably not the case. Companies embraced by a definition relating to assets and stockholders as a class should not be markedly different to those covered by definitions based on distributions to the public. In any case, listing on a stock exchange is covered similarly in both jurisdictions. Therefore, the United States example is not immediately helpful in offering directions for application.

The legislative provisions of Commonwealth countries do not distinguish between widely- and closely-held companies. In Britain,[27] Australia[28] and New Zealand[29] insiders of all companies are required to report. However, reporting is made to the company thereby reducing the impact of obligations imposed on insiders of closely-held companies. In the case of companies whose securities are listed on a stock exchange, the rules of the exchange impose additional obligations. For example, The [London] Stock Exchange requires reports upon application for listing and thereafter.[30] The Commonwealth examples show greater breadth of application to subject companies but it is doubtful whether reports to the company itself provide a better alternative for unlisted companies. Whether reports to an exchange in lieu of a securities

25 Securities Exchange Act of 1934 [hereinafter the 1934 Act].

26 *Id.* s. 12(g).

27 *See* Companies Act, 1967, U.K. 1967, c. 81, s. 2 (repeal of "exempt private company status"); *id.* ss. 27-29 (directors' duties to report); *id.* ss. 33-34 (reports from influential shareholders); *see also* REPORT OF THE COMPANY LAW COMMITTEE, Cmnd. No. 1749, at 88-91, 99, 141-47 (1962) (JENKINS REPORT); *see also* Companies Act, 1976, U.K. 1976, c. 69, amending the provisions.

28 *See e.g.* Companies Act, 1961, Victoria, Acts of Parliament, 10 Eliz. 2, No. 6839, *as amended*, ss. 69A-N (reporting by substantial shareholders); *id.* ss. 126-27 (reporting by directors); *see also* R. BAXT, H. FORT & G. SAMUEL, AN INTRODUCTION TO THE SECURITIES INDUSTRY ACTS (1977) for details of regulatory patterns.

29 *See generally*, Companies Act, New Zealand Stats., No. 63 (1955) *as amended*; FINAL REPORT OF THE SPECIAL COMMITTEE TO REVIEW THE COMPANIES ACT (New Zealand, March 1973) (MACARTHUR REPORT).

30 *See* THE STOCK EXCHANGE, ADMISSION OF SECURITIES TO LISTING, ¶ 2, ss. 4(e), 6(h), 9(e), 9(j) ("Listing Agreement").

commission are an improvement on the Canadian provisions is questionable.[31]

There has been a slight trend toward expanding the class of companies in which insiders must report in Canada.[32] At the same time, such refinements to the definitions do not appear to be material or, in any case, the subject for additional national regulation. In the absence of other than arbitrary standards to increase or decrease the number of companies involved in the present system, there is no apparent need for change.

C. DEFINITION OF INSIDER FOR REPORTING PURPOSES

Canadian statutes are relatively uniform in designating "insiders" for reporting purposes. Directors, officers, owners of or individuals or companies exercising control or direction over 10% or more of the equity shares are subjected to reporting obligations.[33] Affiliated companies, which are sister, subsidiary, sub-subsidiary and parent companies, are included in the definition of insider for reporting purposes.[34] An insider of a corporate insider of a company is deemed to be an insider of the company.[35] In corporations statutes which permit a company to buy its own shares, the company is an insider of itself.[36] The only major variation in the definition of insider for reporting purposes in Canada is contained in the British Columbia Securities Act.[37] In British Columbia, "associates", which include companies in which the insider has a 10% or greater equity interest, partners of an insider, trust or estates in which the insider has a substantial beneficial interest or in which the insider acts as trustee, the immediate family of the insider and relatives of the immediate family sharing the same residence are insiders.[38] The definitions of insider for reporting purposes are relatively clear and specific.[39]

31 An interesting contrast may be found in SECOND REPORT OF THE COMPANIES LAW REVISION COMMITTEE, COMPANY LAW 250-59 (Hong Kong, April 1973) where the concept of insider reporting is rejected for reasons, *inter alia*, of Chinese traditions of secrecy in business.

32 *See* Ontario Bill 30, s. 1(1)(36) (definition of "reporting issuer"). An example cited in D. JOHNSTON at 279, n. 16, is a debenture of a trust.

33 *See e.g.* Canada Act, s. 100(1) "insider".

34 *See e.g.* Canada Act, s. 100(2)(d). A subsidiary company would be deemed to own the securities held by its parent. *See also id.* ss. 100.1(7), (9).

35 *See e.g.* Canada Act, ss. 100(2)(a), (b), (c).

36 *See e.g.* CBCA, s. 121(1) "insider".

37 *See* British Columbia Securities Act, s. 106.

38 British Columbia Securities Act, s. 106(1)(c).

39 There is, however, no guidance on the meaning to be attributed to "direction" over equity securities. Presumably an insider need not have absolute control but the degree required for "direction" is uncertain. In the U.S., the SEC has equated "direction" with rights to direct voting, disposition of the securities, dividends or

In the United States, pursuant to section 16(a) of the 1934 Act, an insider for reporting purposes is substantially the same as in Canada. Directors, officers and 10% shareholders constitute the class of persons required to report. However, there are three important differences. The position of the Securities and Exchange Commission (SEC) has been that spouses and members of the insider's immediate family sharing his home are covered by the reporting requirements[40] and, with the exception of British Columbia, this requirement has not been the case in Canada. The 1934 Act does not extend reporting obligations to affiliates and insiders of insiders. There are exemptions from the reporting requirements for a number of transactions which would otherwise be reported in Canada such as, for example, small transactions, dealings of market-makers in securities and arbitrage transactions.[41] As will be discussed more fully below, the principles of identifying insiders for reporting purposes are similar but the differences are material.

In the Commonwealth countries, the definition of "insider" for reporting purposes is, again, substantially the same as in Canada.[42] Directors and substantial shareholders must file insider reports.[43] However, the basis for insider reporting is somewhat different. In Canada, insider reporting emanates from influence and access to confidential information.[44] The British position, which has been followed in the Commonwealth countries, has been described as follows:

> "[D]isclosure of holdings and dealings by directors has been regarded as necessary to prevent the abuse of insider information, whereas disclosure by other shareholders has been thought of as required mainly to protect direc-

proceeds of sale; *see* SEC, Securities Exchange Act of 1934 Release No. 11,616, August 25, 1975, [1975-1976 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,285; *see also* CBCA, s. 228(2).

40 *See e.g.* SEC, Securities Exchange Act of 1934 Release No. 7793, January 19, 1966, 3 CCH FED. SEC. L. REP. ¶ 26,031-32 (securities held by family members).

41 *See* 17 C.F.R. ss. 240.16a-1-10 (1977) cited in 3 CCH FED. SEC. L. REP. ¶¶ 26,001-010; *see also* SEC, Securities Exchange Act of 1934 Release No. 21, October 1, 1934, 3 CCH FED. SEC. L. REP. ¶ 26,021-25; SEC, Securities Exchange Act of 1934 Release No. 116, March 9, 1935, 3 CCH FED. SEC. L. REP. ¶ 26,026-27; SEC, Securities Exchange Act of 1934 Release No. 1965, December 21, 1938, 3 CCH FED. SEC. L. REP. ¶ 26,041-50; SEC, Securities Exchange Act of 1934 Release No. 7824, February 14, 1966, 3 CCH FED. SEC. L. REP. ¶ 26,030; SEC, *supra* note 40.

42 *See* material in notes 27-30 *supra*.

43 An interesting comparison may be found in the Companies Act, 1967 U.K. 1967, c. 81, ss. 28, 30, 31, where interests of "associates" are deemed to be insider interests that must be reported.

44 *See* KIMBER REPORT. ch. 2.01.

tors (and members and employees) against having their companies taken over without their knowledge."[45]

This position on reporting gives weight to the value of publicity in directors' dealings, as is the case in Canada, but also emphasizes the prevention of secretive acquisitions of control.

Canadian legislation has extremely broad application in its listing of the insiders required to report. The application to directors, officers and 10% shareholders involves a relatively straightforward determination of what is usually a small class. However, the provisions of the statutes which deem affiliates to be insiders, as well as those which require an insider of an insider to report, are onerous. In the example where the company is a subsidiary of a multinational corporation, the effect of such provisions is to impose worldwide corporate and personal obligations since directors and officers of remote sister companies must report. In Ontario, until recently, the obligation was imposed whether or not the insider owned any securities of the company since he had to file "Nil" reports. The position, rejected in Ontario, has found favour in British Columbia, Alberta, Québec and federally so that insiders must report even if they own no securities of the company.[46] Even if a remote insider does own securities in the "Canadian" company, the reporting obligation applies whether those securities will ever be traded in Canada or whether they are likely to be bought or sold in transactions with Canadians. While this extensive reporting obligation may be reduced by exemption orders and by the provisions of the statutes and regulations to permit abbreviated reporting[47] there is, by any measure, a substantial obligation. There is justifiable criticism on the basis of undue breadth of regulation with the corollary that such broad application may constitute an invitation to disregard legal obligations and to lenient administration of the provisions.

As much as the obligation to report is broadly based, it is also quite narrow. In Canadian jurisdictions, except for British Columbia, the ready avoidance of insider reporting obligations is exemplified by the insider who effects transactions for the account of his spouse or children. In all the Canadian jurisdictions at present,

45 L. GOWER at 389.

46 KIMBER REPORT ¶ 2.17 recommended "Nil" reports. As a result of criticism, the OSC rescinded this requirement in Ontario Securities Commission Policy No. 3-13, November 1, 1975, 2 CCH CAN. SEC. L. REP. ¶ 54,907; *see* CBCA, ss. 122(1)-(3) and form 24 of the CBCA Regulations; British Columbia Securities Commission, Policy No. 3-23, April 13, 1977, 2 CCH CAN. SEC. L. REP. ¶ 29-973; Alberta Securities Commission Policy No. 3-10, May 15, 1971, 1 CCH CAN. SEC. L. REP. ¶ 24-510; Quebec Securities Commission, Policy No. 22, September 20, 1973, 3 CCH CAN. SEC. L. REP. ¶ 66-076.

47 *See e.g.* Canada Act, ss. 100.1(6)-(8).

the use of agents, nominees and other secretive activities will contravene the spirit of the controls.[48] Insider reporting obligations must be seen to extend to the visible parties with access to confidential information but the application is hardly exclusive with its omission of other classes of "insiders". Fundamentally, the reporting obligations exclude from their ambit as many persons with access to confidential information as they cover.

To date, Canadian legislation and proposals for its change have not enunciated a concern with the breadth of current regulation but there has been consideration of the omissions. The CBCA contains a minor deviation from the Canada Act which could require increased reporting by trust companies in whose names securities are registered.[49] Ontario Bill 30 has heightened reporting obligations when the insider uses agents, nominees or custodians of securities.[50] However, the CBCA and Ontario Bill 30 hardly contain or propose real improvements. The effort has been limited to visible abuses, such as, for example, cases where there is a deliberate effort to conceal. There has been insufficient consideration of the attendant price that is exacted. At best, the current system requires many more reports than are reasonably required with the result that the administrative costs and number of defaults are high.

The issue of which insiders should report is inherently one that requires a compromise solution. Legislation imposing reporting obligations cannot apply to everyone who may know or have access to confidential information. But, to date, the compromise in the legislation has taken the form of identifying the parties who should report, requiring them to report on every holding and each subsequent transaction and, with each revision of the legislation, to consider increasing the numbers required to report without being exclusive of the class. Legislation has always responded to the question of "who should report" by embracing as wide a class of persons as was considered feasible at the time.

It is instructive that, in comparable jurisdictions which impose reporting requirements, none has imposed obligations on "affiliates" and insiders of corporate insiders.[51] While these jurisdictions could have followed the Canadian example, it may be

48 The U.S. experience in this regard is documented in SEC, PRELIMINARY REPORT ON THE PRACTICE OF RECORDING THE OWNERSHIP OF SECURITIES IN THE RECORDS OF THE ISSUER IN OTHER THAN THE NAME OF THE BENEFICIAL OWNER OF SUCH SECURITIES 18-19 (1975).

49 *See* CBCA, s. 2 (definition of "beneficial interest"); CBCA, s. 228(1) (provisions permitting investigations).

50 *See* Ontario Bill 30, s. 106.

51 *See e.g.* W. PAINTER, FEDERAL REGULATION OF INSIDER TRADING 144 (1968 & Supp. 1976).

presumed that the price to be paid for increased disclosure outweighed the ostensible benefit from a more broadly based reporting obligation. It may also be that, if the liability provisions are sufficiently broad or if a substitute can be found, there is no need for regular reporting from so broad a class of persons. Furthermore, the supposition of actual access of all who are currently covered by Canadian legislation may not be a valid assumption. The reporting obligations should be reexamined in light of the experience of other jurisdictions to determine whether so many must report.

On a similar basis, the question should be asked whether, if the number of reporting insiders is great, it is helpful that all transactions be reported. If the wife of a company's president buys 50,000 shares of the company, the market could have an immediately justifiable interest just as it could gauge the materiality of such a transaction. This transaction would not be reported in most Canadian jurisdictions. On the other hand, if a vice-president of the company exercises his company stock option over or made a gift of, for example, 500 shares of the company, such a transaction would be recorded. These examples underline an apparent inconsistency in the legislation. While the market may be less concerned with insider transactions just because they are for the account of an insider, the legislation is responsive only to whose transaction rather than the substance of it. In searching for a rationale for which insiders should report, the question should more accurately be framed "who should report what" rather than "who should report".

There is a broad class of persons whose material transactions are of critical importance and, provided that the arbitrary general obligations in current legislation are avoided, such information can be elicited and the duty to report need not be onerous. A director, officer or influential shareholder should indicate which securities he owns or controls and, as the avoidance of reporting can be so easily effected through the use of "associates", nominees or custodians, such an insider should be obliged to include as part of his holdings of securities the holdings of associates. Current legislative provisions which permit an influential shareholder to report on behalf of himself or itself and give effect to the holdings of affiliated companies should be clarified, preserved and expanded to require reports on the holdings of associates of influential shareholders.[52] A report of an issuer should give details of the

52 At present, the abbreviated procedures referred to in note 47 *supra* are permissive ("a report...shall be deemed"). The same applies with the CBCA provisions; there is no obligation for a single filing. These provisions should be mandatory.

holdings of its affiliates and associates.[53] The foregoing would expand somewhat the class of insiders whose transactions are covered by reports but should decrease the numbers of reports and persons required to file them.[54]

Whether individuals who are insiders of corporate insiders should be obliged to file reports raises a significant question. On the one hand, the potential for abuse from such insiders is great. At the same time, there is merit to a position asserting that an officer of, for example, a European or Asian affiliate of an issuer should not have to report his transactions.[55]

Furthermore, there are significant jurisdictional issues when so broadly based an obligation applies to individuals outside Canada.[56] On the basis that none of the arguments on this issue are completely persuasive and that any compromise is unnecessarily arbitrary, it is suggested that the current provisions requiring individual insiders of corporate insiders to report, subject to the exemptions hereinafter suggested, be preserved.

D. FILING OF REPORTS

1. *General*

Insiders of the company are obliged to report on their beneficial ownership, control or direction over securities of their company.[57] A report will disclose the insider's holdings of securities of the company and, except for the CBCA provisions which are somewhat different, the acquisition or disposition by an insider of a put, call or other transferable option respecting a security is deemed to be a change in the beneficial ownership of the underlying security and must be reported.[58] The provincial statutes deem ownership to pass upon acceptance of an offer to purchase or

53 To the extent that a prohibition such as is contained in s. 19 of the Canada Act does not prevail, the issuer should be responsible for these insider reports as well.

54 It would be anticipated that there would be only one report for each major shareholding. There appears to be a prevailing practice where several companies in a chain of control file separately thereby increasing the number of reports and adding to the confusion. This should be avoided.

55 *Quaere* whether insider reporting in Canada will assist foreign purchasers or sellers of securities or whether the legislation should protect where Canadian residents are not parties to the transaction. Such a person's access to confidential information is also suspect.

56 *See generally, Hebenton & Gibson.*

57 *See e.g.* Canada Act, s. 100.1(1); CBCA, s. 122, and CBCA Regulations, form 24; Ontario Act, s. 110(1). The deviations in the wording of these sections do not appear to be material.

58 *Compare* Canada Act, s. 100(2)(e), *and* Ontario Act, s. 109(2)(b), *with* CBCA, s. 121(2)(c).

sell.[59] Insider reports, therefore, relate to ownership of and transactions in any securities of the company but there are some material deviations in the reporting procedures.

The Canada Act and the CBCA contain unnecessary departures in reporting procedures. Both statutes do not state precisely when the transaction at issue should be reported as do, for example, the provincial statutes which deem ownership to pass at a point in time. A person who agrees to buy securities of the company by contract dated the thirtieth day of a month to be completed on the twentieth day of the next following month would, under provincial law, have acquired the securities on the thirtieth whereas, under the federal statutes, he would have acquired them on the twentieth. Similarly, in the CBCA, it is provided that the acquisition or disposition of an option or right is deemed to be a change in beneficial ownership whereas, under the Canada Act and provincial statutes, it is the acquisition of a put, call or other *transferable* option that causes a change in ownership. For immediate purposes, the example of employee stock option plans demonstrates that, under the CBCA, the acquisition of the stock option gives rise to a reporting obligation whereas, under the Canada Act and provincial statutes, the exercise of the option must be reported. Until the option is exercised, the option was not "transferable".[60] These slight deviations should cause significant concerns for insiders who must file in several jurisdictions.

Insiders must report within specified time periods and such reports must be lodged with the applicable regulatory authorities. On becoming an insider, a person must file an initial report to disclose his holdings within ten days of the month after the month in which such status is obtained.[61] Under the CBCA and in British Columbia, Alberta and Québec, "Nil" reports must be filed, as the case may be.[62] Reports of subsequent changes in holdings of securities must be filed within ten days of the month following the month of the transaction.[63] The reports are available for public inspection and summaries thereof are periodically published by the regulatory authorities.[64]

The reporting obligations in other jurisdictions compare with the Canadian obligations. In Britain, Australia and New Zealand,

59 *See e.g.* Ontario Act, s. 109(2)(c). This presumably ignores the time of settlement, *see* D. JOHNSTON at 290, but may give rise to difficult conflicts where securities are not bought on an exchange as described in the text following.

60 Canada Act, s. 100(2)(e); Ontario Act, s. 109(2)(b); CBCA, s. 121(2)(c).

61 *See e.g.* Canada Act, ss. 100.1(1)-(3).

62 *See* material on "Nil" returns at note 46 *supra*.

63 *See e.g.* Canada Act, s. 100.1(4).

64 *See e.g.* Canada Act, s. 100.2(3); public inspection is permitted under Canada Act, s. 100.2(1).

insiders must report to their companies on their initial interests and subsequent transactions in securities and such reports are required within fourteen days of the event giving rise to the reporting obligation.[65] However, this obligation to file is significantly broadened in the case of companies which are listed on a stock exchange. As mentioned above, The [London] Stock Exchange requires insiders of listed companies to report to the exchange and, except for insider transactions involving a change in control, there is no comparable obligation in Canada.[66] In these Commonwealth countries, the principle of reporting is comparable but the obligations are somewhat different.

In the United States, there are more significant differences in the reporting obligations. Rule 16a-9 under the 1934 Act gives an exemption from the reporting requirements for small transactions so that the reporting requirements do not apply to all transactions.[67] The SEC has been careful to enunciate, pursuant to formal rules and interpretative releases, how various transactions and interests such as stock options, interests in trusts, etc.,are to be treated for reporting purposes and, therefore, some of the difficult interpretative questions have been answered.[68] Section 16(e) of the 1934 Act gives a specific exemption for market-makers in securities and Rule 16e-1 extends an exemption for arbitrage transactions.[69] The procedure for filing reports is somewhat different than in Canada since, if the company's securities are listed on an exchange, the reports must also be filed with the principal exchange on which the company's securities are listed.[70] United States regulation is more precise in defining the obligations and, while this may not involve great substantive differences, there is the benefit of greater clarity in the legislative provisions.

Canadian legislation on the filing of insider reports should be reconsidered. At present, every insider transaction must be reported without discrimination as to what information is being furnished and why it has been required. Whether the transaction is of great significance, such as the sale or purchase of a large block of securities, or relatively insignificant, such as the exercise of a stock option in the ordinary course or a gift of a nominal amount of securities, the transaction must be reported. In the great major-

65 *See* materials at notes 27-29 *supra*; the U.K. requirement was amended in 1976 to reduce the time period to five days.

66 THE STOCK EXCHANGE, *supra* note 30.

67 Rule 16a-9, *supra* note 41.

68 *See* material in note 41 *supra*.

69 *Compare, e.g.* Canada Act, s. 100.1(1), "insider" (b).

70 Note Rule 16a-1(c), 17 C.F.R. s. 240.16a-1(c) (1977), whereby insider designates principal exchange and filing with the company is provided by Rule 13d-1, 17 C.F.R. s. 240.13d-1 (1977).

ity of cases, insider transactions will neither be evidence for subsequent legal proceedings, give the market the insider's assessment of the company's securities nor do more than create a bothersome obligation for the insider. This extensive reporting must add large administrative costs to the processing and dissemination of information about insider reports. There is the risk that a material transaction of an insider will be overlooked in that such a transaction will be camouflaged among the reports of many insignificant transactions. Some effort must be made to distinguish between transactions of interest to the market at large and those of lesser import.

It is submitted that there are three types of transactions which involve an insider, namely, a transaction of interest to all segments of the market, one of interest to the small segment of the market which follows insider reports *per se* and, finally, the type effected in good faith, without improper purpose but being of interest to the company's shareholders. The type of transaction which would be of interest to the market at large is one where a substantial block of securities changes hands. Whether or not such a block of securities affects control of the company would be secondary since, in any case, the insider's involvement in a large trade is material. At the other extreme, the exercise of non-transferable stock options, a gift of shares to a child, the purchase or sale of small numbers of securities and dispositions of securities within the controlling group do not necessarily indicate the insider's motive or demonstrate material facts. Indeed, the latter transaction can be misleading.[71] Between these extremes, transactions are material but that would depend on how closely one is following the securities or fortunes of a particular issuer. Within this framework, it is suggested that a more rational reporting obligation can be framed.

In the case of "small transactions", these transactions are of academic interest to the market at large but they may be of significance to shareholders of the company. A small transaction exemption is warranted under which monthly reporting need not be made of transactions having a value of, for example, up to $10,000 or $15,000, the exercise of stock options, gifts of securities involving no consideration, transactions involving a change of ownership but no change in the position of insiders as a group.[72] As

71 For example, an insider of a company may exercise stock options granted over the years merely because they are expiring and not out of interest in the company's immediate prospects. An insider's estate planning may appear to involve substantial sales but may in fact be no more than an "estate freeze".

72 The OSC has responded to this problem to a very limited extent with respect to payroll deduction stock option plans; *see* D. JOHNSTON at 294. *Quaere* whether the

these transactions may be material in the aggregate or, in themselves, material to shareholders of the company, they should be reported upon, and it is submitted that sufficient reporting could be effected by including such information in reports of management to its shareholders. The substantive issues raised by a reporting obligation would not be ignored by such staggered reporting whereas the obligations on the insider and the administrative and enforcement questions would be significantly reduced.

A further exception would be for "block transactions" which should be reported upon more quickly. Any definition of "block transactions" would be arbitrary but, for immediate purposes, the lesser of 5% of shares of an outstanding class and $500,000 aggregate monetary value would indicate the type of substantial commitment by an insider that an accelerated reporting obligation should cover. In the case of block transactions, a time period following the date of the transaction consistent with timely disclosure of material corporate events should be considered as the time for reporting.

The existing system of reporting should be preserved except for the "small transactions" exemption and the treatment of "block transactions". In these reports, a significant number of insider transactions would be reported upon[73] and the general impact of insider trades could be traced. Such reports could also provide information where the cumulative impact of "small transactions" became material. This monthly system of reporting complemented by accelerated reporting for material transactions and annual reporting for the less significant ones should be responsive to the purposes of insider reporting.

In framing the reporting obligations, it is essential that clarity and consistency be sought. A concerted effort should be undertaken following which similar transactions will be treated in approximately the same fashion regardless of which reporting system is being examined. For example, there is dubious value to having insiders file "Nil" reports since there is no benefit to knowing that an insider owns no securities.[74] An insider is entitled to report the same transaction at the same time and in the same

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administrators should require the costs and occasion the difficulties attending formal applications for exemption.

73 Some consideration might be given to a sliding scale for the exemption for small purchases and sales. Clearly, a $10,000 or $15,000 exemption will vary in importance with the price of the security and greater numbers of reports for higher priced securities may not be desirable.

74 D. Johnston at 291 and P. Anisman at 109, n. 3, trace the arguments. It is submitted that the costs of obtaining "Nil" reports far exceed the benefit of knowing who the insiders are.

fashion under all reporting provisions. While this may create difficulties with provincial administrators, it is suggested that an insider, having decided to report, should not be required to understand the nuances of several different jurisdictions in meeting his duties.

2. *Timing of Reports*

The issue of when insider reports should be filed raises a number of considerations. In view of the purposes for which insider reporting obligations are imposed, contemporaneous reporting of material transactions would be invaluable. However, the desirability of immediate reporting must be weighed against the consideration of how onerous an obligation immediate reporting would create. The current system of reporting is a compromise between these two considerations. Monthly reporting has been deemed reasonably timely by the legislation.

There is an exception to this compromise in provincial legislation.[75] Any person who makes open market acquisitions of a 20% interest in the voting securities of a company must report within three days and each subsequent acquisition of 5% must be reported upon within three days. The accelerated obligation supersedes the obligation to file monthly reports and complementary provisions regarding summary and publication of reports are provided. At present, the accelerated obligation is expressly limited to open market purchases. This provincial position on accelerated reporting compares with similar provisions in the United States[76] and in the Commonwealth countries[77] and follows the proposals contained in the *Ontario Securities Commission Disclosure Report*[78] which proceeded from the assumption that a one-month delay in the reporting of an actual or imminent change of control was too long.[79] And Ontario Bill 30 would expand the provincial position so that it would not be limited to open market purchases. However, the federal position, as well as that of several of the provinces, has been against the imposition of an accelerated reporting obligation[80] and there are arguments to be made questioning the effect[81] or value[82] of such provisions. There are obvious inconsist-

75 *See e.g.* Ontario Act, s. 110a.

76 *Compare* the 1934 Act, ss. 13(d), (e).

77 *See e.g.* Companies Act 1967, U.K. 1967, c. 81, s. 33; and Companies Act, 1961, Victoria, Acts of Parliament, 10 Eliz. 2, No. 6839, s. 69D.

78 ONTARIO SECURITIES COMMISSION DISCLOSURE REPORT.

79 *Id.* ¶¶ 7.11-7.14, 7.36(3).

80 Note that neither the Canada Act nor the CBCA has adopted this position. Similarly, it has not found favour in B.C., Québec or the eastern provinces.

81 *See* P. ANISMAN at 111.

82 *See e.g.* 1 BUSINESS CORPORATIONS PROPOSALS ¶ 429.

encies in the reporting obligations in Canada at present and this should not continue.

In order to determine the appropriate time frame for reporting, it would be worthwhile to reconsider the reasons for having a reporting obligation at all. If the only considerations relating to when reports should be filed were to create evidence for subsequent legal proceedings and to advance the salutary effect of insider reporting on the insider himself, the fact that a report is required at any time within the prescription period for litigation would be sufficient. However, the issue of timing becomes acute if the reporting system will give credence to the rationale that knowing an insider's behaviour is of benefit to the market at large. Reporting *per se* is not sufficient but, rather, any such consideration leads to the conclusion that, without a determination of what constitutes timely reporting, the system breaks down.

If the materiality of different types of transactions is determined and the reporting system adjusted, as suggested above, the issue of timeliness becomes less difficult. The principal obstacle to contemporaneous and, therefore, most timely reporting is that the price exacted would be too great for all insider transactions. But, if the legislation segregates between types of insider transactions, a more flexible system would prevail. A substantial delay in the reporting of small transactions being permitted would give rise to a significant reduction in the number of insider transactions at issue generally. From that basis, the few block transactions could be segregated and an insider should be obliged to report them as soon as possible. This position would permit the remaining insider transactions to be left in the monthly reporting system.

The time periods for reporting must be relatively arbitrary. In the case of "small transactions" these should be reported by management of the company in its reports to shareholders. Whether these are done on a quarterly, semi-annual or annual basis is not material and, in any case, as reports to shareholders are filed with regulatory authorities, this could effect the public filing that may be desirable. Contemporaneous reporting of block transactions, for example, within two business days, should be rationalized as a material change in the affairs of a company and, as companies are required to make immediate disclosure to securities commissions and stock exchanges at present and under any proposed form of continuous disclosure,[83] insider reporting in these circumstances should be treated similarly. Together with the system for small

83 *See e.g.* Uniform Act Policy No. 2-12, revised December 6, 1971, 2 CCH CAN. SEC. L. REP. ¶ 54-822; and Ontario Securities Council Policy No. 3-23, December 6, 1971, 2

transactions and block transactions, a relatively workable system for monthly reporting would be retained.

3. *Publicity in Reporting*

Insider reports filed with a regulatory body responsible for publishing summaries of them provide a limited publicity function. In order for an observer to determine insider trading activity promptly, he must attend at the office of the regulatory authority and examine the reports. Parties that are interested but more passive may await the periodic publication of results in reports of the regulatory bodies or rely on the limited and selective summaries of insider reports published by the financial press. In any case, the total dissemination of insider report information is narrow.

A corollary to the issue of timing of reports is the fact that the information contained in published summaries is always quite old. At a minimum, the obligation to file, the earliest inspection and first publication may not be completed until the tenth day of the month following the transaction. If an insider has satisfied the accelerated reporting obligations, the obligation to file within five business days means that first inspection and subsequent publication is not possible until one week after the transactions are completed. Consideration of insider reports by the public may become a rather academic exercise.

Insider reports should be more broadly publicized and procedures established for the earliest and widest possible dissemination of information. Reports should be filed with stock exchanges since, at least, inspection procedures are thereby extended. In the case of block transactions, exchange and newspaper services should be more widely employed. While the regulatory authority cannot require the public to review reports, it should be striving to make the information contained therein as widely available as possible and, to that end, it should not be relying so heavily on its own publication for dissemination of information.

E. EXEMPTIONS

1. *Procedural*

The statutes regulating insider trading in Canada, or the regulations thereunder, provide for an abbreviated reporting obligation. A company is permitted to file an insider report on behalf

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CCH CAN. SEC. L. REP. ¶ 54-918; *see also* Ontario Bill 30, pt. XVII; and *Grover & Baillie.*

of itself and its subsidiary companies. An individual may file an insider report on his own behalf as well as on behalf of companies he controls and companies affiliated with his controlled companies. Such provisions do not exempt subsidiary and affiliated companies as such but, as a procedural matter, if a controlling company or individual files a detailed report, a significant number of reporting obligations are satisfied. Since the subsidiary or affiliated company remains primarily liable to file insider reports, there is some exposure where an insider relies on controlling companies or individuals to file reports on its behalf.

A second type of procedural exemption is obtainable on application to the regulatory authority. Insiders are permitted, customarily, to file reports on the forms prescribed by the primary regulatory jurisdictions and will not be required to use the local forms. Alternatively, the regulatory authority may require a first filing on its own form and subsequent filings are permitted on the primary jurisdiction's forms, this variation being customary where the secondary jurisdiction would otherwise receive no reports. As an example, a federal company may make application in Ontario on behalf of its insiders so that the insiders will be permitted to file reports on the federal insider reporting form with the Ontario Securities Commission (OSC).[84] There is, however, no variation in the substantive obligations.

2. *Substantive*

Although some of the provinces have dispensed with the need for a formal application,[85] insiders may be exempted from substantive obligations to file upon application to the regulatory body. The most commonly articulated justification for exemption is that selected insiders are remote from access to confidential information and, therefore, could not be involved in abuses.[86] Similarly, some of the provincial statutes and regulations provide expressly that, if the company has no local connection its insiders are not required to file insider reports.[87] Often, the justifications for substantive exemption are intertwined and an example of the types of

84 *See e.g.* Ontario Securities Commission, Policy No. 3-16, April 5, 1971, 2 CCH Can. Sec. L. Rep. ¶ 54-910.

85 *See* Alberta Securities Commission, Policy No. 3-12, May 15, 1971, 1 CCH Can. Sec. L. Rep. ¶ 24-512; Saskatchewan Securities Commission, Policy No. 6, effective July 1, 1972, 3 CCH Can. Sec. L. Rep. ¶ 69-307; Manitoba Securities Commission, Policy No. 3.08, June 1, 1972, 2 CCH Can. Sec. L. Rep. ¶ 34-998; Quebec Securities Commission, Policy No. 22, *supra* note 46.

86 *Id. See also* Re British American Oil Ltd., [1967] OSC Bull. 9 (June); D. Johnston at 291.

87 *See also* materials in note 85 *supra.*

considerations that would apply is the application and exemption for insiders of Sony Corporation in Ontario.[88]

The insiders of Sony Corporation were exempted entirely from the obligation to file insider reports by the OSC in advance of the company's application to list its American Depositary Receipts on the Toronto Stock Exchange. Insider reporting was alien to legal obligations applicable in Japan, Sony's jurisdiction of incorporation, and an argument respecting conflicting legal obligations was made. Sony's insiders had been availing themselves of the foreign issuer exemption pursuant to the 1934 Act in the United States[89] so that a law of a jurisdiction containing substantially similar requirements as Ontario's had viewed the Sony case favourably. Sony's insiders were remote from Canadian facilities by which to take advantage of confidential information and it would be unlikely that Canadians would be harmed. For jurisdictional and geographic reasons, insider reporting obligations might not be enforceable. Finally, implicit in the OSC's consideration, denial of the exemption might contribute to making Sony's securities unavailable to Ontario residents. The considerations on this application demonstrate the varied nature of the arguments that can be raised.

Exemption applications have been quite common and most of the regulatory authorities have published policy statements and guidelines to assist applicants. Of these published statements, a draft Information Statement No. 9[90] under the Canada Act is the most detailed and demonstrates much of the current concern of the regulators. Unless special circumstances can be shown, Consumer and Corporate Affairs Canada citing as its example the participation by an insider in a stock-investment plan for employees, exemption orders will not generally be granted to each of the following insiders: (i) directors and officers, (ii) affiliates, (iii) directors and officers of controlling companies, (iv) important subsidiaries, (v) directors and officers of affiliates engaged in research, development or exploration, the announcement of whose reports could materially affect the value of the company's securities, and (vi) directors and officers of affiliates supplying essential materials or services to the company. In any case, exemption orders will not generally be given for longer than three years from the date of issue. It would appear that exemption orders could be somewhat more difficult to obtain than might have been expected.

88 OSC Weekly Summary, July 25, 1974, at 4A (it may be noted that counsel for the applicant in the matter was the law firm with which the writer was associated at the time).

89 "Foreign Issuer Exemption" appears in Rule 3a12-3, 17 C.F.R. s. 240.3a12-3 (1977).

90 4 CCA Bull. 7 (December 1974).

The approach toward exemptions should be flexible and, it is submitted, not along the lines enunciated by the federal department. In considering exemption applications, the regulator cannot hope to isolate every avenue of potential abuse by someone with presumed access. Applying the federal department's guidelines, every affiliated company engaged in research and development or supplying any product or service can be seen to either make a discovery materially affecting the market price of the parent company's shares or to be supplying an essential good or service. However, where the reporting system imposes such wide corporate and personal obligations, the risk of abuse of confidential information should be considered more carefully. The departmental position appears to indicate a substantial number of situations where it would be indisposed to grant an exemption whereas its position should be that, upon demonstration of lines of reporting and information flow within a corporate organization, an exemption should be granted. The department's position on exemptions should not be to attempt to preserve the great number of reports that are already being filed (and would be proliferated further with the need for "Nil" reports) but to work toward a more pragmatic approach to insider reporting. After all, the exemption from reporting does not operate to exempt from liability for abuse of confidential information.

F. SANCTIONS AND ENFORCEMENT

1. *Penalties*

Each of the Canadian jurisdictions provides penal sanctions for failure to file insider reports and for filing false or misleading reports. Individuals, as well as directors and officers of corporate insiders, may be found guilty of an offence and liable to penalties.[91]

In addition to penal sanctions, the regulatory authorities may avail themselves of administrative remedies. A regulatory authority may seek a compliance order requiring an insider to file his reports[92] or use its investigative powers to determine the factual background from which other liabilities may be invoked.[93] The OSC has a policy not to grant a prospectus receipt to an issuer whose insiders are in default of their reporting obligations.[94] An

91 *See e.g.* Canada Act, ss. 100.3(1), (2).

92 Canada Act, s. 100.3(5).

93 *See e.g.* Ontario Act, s. 21.

94 Ontario Securities Commission, Policy No. 3-04, April 18, 1974, 2 CCH CAN. SEC. L. REP. ¶ 54-898.

insider may be denied the statutory exemption which he requires in order to trade in securities by a regulatory authority.[95] Any remedy available under the authorizing statute may be used depending on the factual background.

To date, there have been few reported prosecutions expressly based on a failure to file insider reports and no reported instances of actions against the filing of false or misleading reports. In that regard, the OSC obtained a compliance order pursuant to section 143 of the Ontario Securities Act and the remedy granted by the Supreme Court of Ontario was to restrain the insider from violations of that act by trading without filing insider reports.[96] The order required future compliance with the insider reporting obligations.

2. *Administrative Record*

It is apparent that many insiders have ignored their reporting obligations. The OSC, in a policy statement, has confirmed that many have neglected their obligations and that a more aggressive administrative posture will be taken in the future.[97] To date, it appears that the OSC has continued to rely on stern warnings and, as it has sought to enforce these obligations to report so rarely,[98] made minimal efforts to change the legislation[99] or to otherwise demonstrate a commitment to the problem, it must be assumed that this is not one of its highest priorities. It is apparent that the failure to file insider reports is a problem which persists under existing legislation.

The insider who files false, misleading or incomplete insider reports has been subjected to several administrative practices. In the case of reports filed in Ontario, the OSC will publish a summary of the report if it does not notice the impropriety. If the information disagrees with existing records, the insider will be advised of the discrepancy and publication consists of noting a transaction without details with an asterisk notation disclosing an error.[100] The only available disclosure to the market is by way of inspection. With filings pursuant to the Canada Act and the CBCA, the practice appears to be that an improper report will be accepted and

95 *See e.g.* Ontario Act, s. 19(5).

96 *See* OSC Weekly Summary, June 13, 1974, at 2A; *but see* Re Saskatchewan Securities Commission v. Premier Products Ltd., 36 D.L.R. (3d) 476 (Sask. Q.B. 1973).

97 Ontario Securities Commission, Policy No. 3-24, January 13, 1972, 2 CCH Can. Sec. L. Rep. ¶ 54-918.

98 There has been only one formal prosecution in Ontario; *see supra* note 96.

99 *See* text *infra* and materials in note 13 *supra*.

100 *See* the inside front cover of any edition of the OSC Bull. ("Guide to Symbols"), where * stands for "returned for reconciliation purposes".

published subject to later correction and republication. None of these procedures is justifiable since they provide for improper or no disclosure.

Ontario Bill 30 has indicated that these problems may be part of a general default in filings. Several exemptions are contingent upon being in full compliance with the proposed act.[101] However, any further revised policy is not apparent from the proposed legislation and, in any case, it is not clear that such provisions are aimed at insider reporting.

There is no legal rationalization for permitting failure to file reports or for the current procedures with improperly filed reports. It is imperative that properly completed reports be processed carefully and published as soon as possible and there can be no justification for legislation and an administrative system which does not complement these motives. Insider reporting obligations should be framed with the view that the required reports will be filed and the publication of incorrect reports or resulting non-disclosure will be avoided.

The apparent reasons for the administrative record with insider reporting may suggest some solutions. As the regulatory authority processes such a great quantity of reports, it may be assumed that no more than a cursory review of individual reports will result. If the sheer number of reports is reduced, part of the administrative problem with improper reports may be solved. In the case of reports which are not filed, since the regulatory body is the only one involved in policing, presumably a stock exchange, its membership and other persons registered to trade in securities could assist the regulatory body in finding non-reporting insiders. It appears that problems with reporting could be curtailed with more active and broadly based enforcement in an environment where fewer reports are required.

Among the considerations with insider reporting is the substantial number of jurisdictions in which reporting is required. An insider may have to report in up to seven jurisdictions in Canada. From the insider's viewpoint, there must be general annoyance with such a broadly based obligation and an attendant ignorance or apathy towards other than the local jurisdiction. There is an evident "home jurisdiction bias" with, for example, the Ontario resident who has filed with the OSC and feels he has complied with all the applicable laws. Furthermore, whether as a matter of priorities a regulatory body in a province would prosecute out-of-province insiders is debatable notwithstanding that, in theory, each of the regulatory bodies has staff policing the insider report-

101 *See e.g.* Ontario Bill 30, s. 73(5)(a).

ing provisions. Centralization and perhaps integration of insider reporting obligations would encourage insiders to report and enforcement would be more precise.

Another of the reasons why insider reporting obligations have yielded limited results is the fact that the sanctions and remedies for improprieties are not being used to their full extent. It is understandable that a regulatory body will be hesitant to seek criminal penalties except in extraordinary situations because a publicized criminal prosecution has unsavory side effects and an impact that may be too great for the impropriety.[102] But, in the case of compliance orders, this less stringent sanction should have been sought more often notwithstanding such a proceeding involves an application to court, publicity and significant impact if small transactions are involved. Remaining remedies in the statutes appear to have been largely unnoticed. While existing procedures may be adequate on their face, they have not been used sufficiently and there is little sign that more aggressive postures will be taken.

Abbreviated procedures and less expansive penalties should have been sought to enforce the reporting provisions. The OSC's attempt to impose a sanction on the issuer[103] is a convenient remedy for reports which are an obligation of that issuer; it is clearly inapplicable for cases where an individual is in default and the company is not to blame. For individuals, publicity is the best warning and should be followed shortly thereafter with applications for compliance orders or suspensions of trading exemptions. If an individual's defaults are published in the regulatory body's report of transactions, that individual should respond to such unfavourable comment and any failure to respond indicates sufficient wilfulness for the imposition of more onerous sanctions. The emphasis of the regulatory authorities and in the sanctions must be publicity and the administrative tools are already available.

102 While, for example, Ontario Act, s. 144, provides a small sanction with a fine of up to $1,000, a securities commission would be understandably reluctant to investigate a public hearing with attendant publicity for what may be honest oversight or misunderstood obligations. Such hearings, involving a relatively small industry, have a "branding effect".

103 *E.g.* an order pursuant to Ontario Act, s. 144; an investigation of trading in the company's securities pursuant to Ontario Act, s. 21; application of Ontario Securities Commission Policy 3-04, *supra* note 34 ¶ 2(d) (grounds for refusal to issue receipt for a prospectus).

Chapter III
Insider Liabilities

A. COMMON LAW LIABILITIES

1. *In Favour of Shareholders*

The leading case governing an insider's liabilities to shareholders of the company at common law is *Percival v. Wright.*[104] The chairman of the board and two other directors of the company bought shares from existing shareholders without disclosing to them the existence of negotiations for a sale of the company's undertaking. The plaintiffs were unsuccessful in an action for rescission and the generally accepted interpretation of the judicial opinion is that, at common law, directors do not owe a fiduciary duty to individual shareholders of their company and, therefore, cannot be liable. By implication, directors do not owe such a duty to prospective purchasers of the company's shares. On the basis of insider trading only, there would be no liability for directors and officers. The principle of this case has never been doubted in any reported English case.[105]

The case of *Percival v. Wright* has been criticized[106] and distinctions have been drawn in subsequent cases. In the case *Allen v. Hyatt,*[107] the court imposed a duty on directors in favour of their shareholders on the basis that the directors under consideration had been appointed agents of their shareholders.[108] Similarly, from *dicta* in *Pickford v. Thompson*[109] and the decision in *Gadsden v. Bennetto,*[110] Canadian courts have suggested that such a fiduciary duty to shareholders exists on the basis of a "special facts" doctrine.[111] Notwithstanding the criticisms and apparent exceptions, the continued vitality of the principles outlined in the *Percival* case should not be questioned.[112]

The common law position on directors' liability in the United

104 [1902] 2, ch. 421.

105 *See*, JUSTICE, INSIDER TRADING: A REPORT ¶ 5 (W. Goodhart Chairman 1972); *but see* Coleman v. Myers (N.Z. Ct. App., August 11, 1977, unreported).

106 *See e.g.* L. GOWER at 546-47; Loss, *Foreword* to A. YORAN, INSIDER TRADING IN ISRAEL AND ENGLAND 7 (1972).

107 17 D.L.R. 7 (P.C. 1914).

108 *Id.* at 10, 12.

109 40 N.S.R. 632 (S.C. 1902).

110 9 D.L.R. 719 (Man. C.A. 1913).

111 *Contra* Green v. Charterhouse Group Canada Ltd., [1973] 2 O.R. 677, 733 (H.C.), *aff'd*, 12 O.R. (2d) 280 (C.A. 1976) whereby the "special facts" doctrine is said to be inapplicable in Canada.

112 *See* L. GOWER at 517 and KIMBER REPORT ¶ 2.03.

States was not materially different. Under what has been described as the "majority" or "strict" rule, a position similar to the *Percival v. Wright* rule was applied in most jurisdictions.[113] A few of the state courts followed a "minority" or "fiduciary" rule which imposed fiduciary standards in such transactions.[114] The remaining states, with what was eventually the most widely followed rule, applied the "special facts" doctrine outlined by the U.S. Supreme Court in *Strong v. Repide.*[115] Professor L. Loss has stated that "[T]his is the dialectic...an advocate can never afford to ignore" but goes on to state that the divisions between the rules are often hard to distinguish.[116]

The duty of controlling shareholders to other shareholders varies more widely in a comparison of the Anglo-Canadian position with the American. In the former case, there is little basis for finding such a duty whereas in the latter such a duty has been found.[117] However, as these early cases involved, for the most part, closely-held companies, controlling shareholders were also directors and officers and distinctions are, therefore, not entirely warranted.

Such common law rules do not offer significant protections. In the absence of a court's finding of a special duty or fiduciary relationship, the most likely conclusion from litigation would be that the insider is not required to disclose information affecting the value of shares that are the subject of a transaction or to refrain from trading. Government reports have gone so far as to suggest that, even if the *Percival* case were expressly overruled, the fiduciary relationship would apply only to dealings with directors and there would be no automatic extension of liability to a broader category of insiders.[118] The lesson from these cases, which has not been tested extensively where open market transactions are involved,[119] is that legislation was necessary in order to enunciate the principles of liability and to formulate the nature of the relief to be granted.

113 *See* 3 L. Loss at 1446.

114 *See e.g. id.*: and Oliver v. Oliver, 45 S.E. 232 (Ga. 1903); essentially directors should disclose all material facts not otherwise public.

115 213 U.S. 419 (1909); *but see* Brown v. Halbert, 76 Cal. Rep. 781, 788 (1969). Essentially this is an application of the "minority" rule where there is great disparity in the perceived values of shares.

116 *See* Loss, *supra* note 106.

117 *Compare* Fergusson v. Wallbridge, [1935] 3 D.L.R. 66 (P.C.); L. Gower at 563; Magnusson, *supra* note 6 *with* 3 L. Loss at 1446, n. 4, *and* Brown v. Halbert, *supra* note 115.

118 *See e.g.* 1 Business Corporations Proposals at 90, 91.

119 *See e.g.* Goodwin v. Agassiz, 186 N.E. 659, 661 (Mass. 1933), where, in a widely criticized *dictum*, the "special facts" doctrine was said not to apply to stock exchange transactions.

2. *In Favour of the Company*

The liability of insiders at common law to their companies has been described as follows:

> "The position of the corporation...is not, in our view, nearly so exposed as that of the individual shareholder. Existing rules are perfectly well adaptable to cover the case of an insider, whether director or not, making use of confidential information for his own benefit or advantage. Well-settled law about breaches of confidence, misappropriation of corporate assets, secret profits and conflicts of interest and duty are, in our view, adequate to the point, and their application to the case of insider trading, while not free of difficulty, does not present the same doctrinal problems as does their application to the relationship between insider and shareholder. Indeed, quite apart from the results on the facts, the decisions in a number of recent cases, such as *Peso Silver Mines Ltd. v. Cropper* (1966) 58 D.L.R. (2d) 1 and *Boardman v. Phipps* [1967] 2 A.C. 46 amply demonstrate the flexibility of this body of law. It should also be said that, in most cases, improper share trading by an 'insider' of a corporation will not in any event cause a loss to the corporation, however unfair it may be to individual shareholders of that corporation."[120]

It may be that the duty of insiders to their companies is sufficiently established for the courts to enable companies to recover from their insiders. However, in Britain and Canada, there has been no reported judicial decision which has permitted such recovery. Notwithstanding that the courts in Canada have spoken favourably about the duties which would lead to liability[121] and that, in the United States, several state courts have taken initiatives in this area to permit recovery by the company,[122] the issue of whether a company can recover insider profits in Canada by means of a common law remedy must be seen as unresolved.[123]

120 1 Business Corporations Proposals at 90, 91.

121 *See e.g.* Canadian Aero Service Ltd. v. O'Malley, [1974] S.C.R. 592 and cases cited therein.

122 *See e.g.* Diamond v. Oreamuno, 238 N.E.2d 910 (N.Y. 1969).

123 It may also be noted that the enforcement procedure is not straightforward; *see, Anisman* at 172.

B. PROHIBITIONS ON TRADING

Quite apart from the considerations raised by the insider who trades making use of confidential information, there are several prohibitions imposed by legislation against speculation by insiders. The Canada Act states that an insider shall not effect "short sales" in the securities of the company[124] and a similar prohibition appears in the CBCA where an insider is prohibited from effecting such transactions in voting shares of the company and its affiliates.[125] The latter prohibition follows the view expressed in the *Business Corporations Proposals* that there "is nothing to be said in favour in allowing an insider to 'sell short' the shares of a corporation in which he is an insider"[126] and both mirror the attitudes adopted in other jurisdictions.[127] However, in the CBCA, the redrafted offence expands liability to voting shares of affiliates but creates an unwarranted distinction between transactions in voting shares and non-voting securities of the company. These provisions on short sales will not necessarily reduce speculation but will operate to prevent the insider from employing this type of transaction to do so.[128]

A second prohibition in the legislation against insider speculation prevents an insider from purchasing put or call options. Under the Canada Act, an insider may not purchase put or call options in respect of the company's securities and the CBCA extends the prohibition to the voting shares of the company and its affiliates.[129] The CBCA again makes the unwarranted distinction between voting and non-voting securities.[130] Both statutes would reduce leverage in the purchase of options by insiders but they have also, by inference, characterized the purchase of options by insiders differently than the sale of them.[131] And the entire ques-

124 Canada Act, s. 100.6.

125 CBCA, s. 124.

126 1 BUSINESS CORPORATIONS PROPOSALS ¶ 265.

127 *See e.g.* 1934 Act, s. 16(c).

128 *See e.g. Anisman* at 205; ALI FEDERAL SECURITIES CODE, Tent. Draft No. 2, s. 1413, comment (1)(b) (1973).

129 Canada Act, s. 100.6; CBCA, s. 124.

130 The prohibition relates to "shares" which, in CBCA, s. 121(1), are defined as voting securities; *quaere* whether participating but non-voting securities raise different considerations.

131 Presumably, the writing (sale) of "covered" options is lawful; *quaere* whether the writing of options by an insider should be treated differently than the purchase of them. It can be said that the writing of options is an attempt to increase yield on an otherwise stagnant portfolio, that the insider expresses confidence by speculating, that there will be no movement in the price of the underlying security and that this will be disclosed in insider reports.

tion of insider dealings in options takes new dimensions with the increased interest in and liquidity of options in recent years.

There are a number of additional statutory provisions which may be seen as prohibitions on insider trading. Controlling shareholders are prevented from freely selling their securities in that they may be engaged in a "distribution to the public" within the meaning of provincial securities statutes.[132] A recent interpretation of the fraud provisions in the Criminal Code indicates that, in a face-to-face transaction with shareholders of the company, misrepresentations may give rise to criminal sanctions.[133] Foreign ownership restrictions in federal and provincial legislation operate to prohibit insiders and prospective insiders from freely dealing in securities of their companies.[134] This latter group of examples demonstrates areas where an insider may be constrained regardless of his knowledge of confidential information and his speculative intent.

C. STATUTORY LIABILITIES

1. *Introduction*

While there are detailed and extensive statutory liabilities in Canada, it must be remembered that, to date, they have not been extensively interpreted by Canadian courts. One case, *Green v. Charterhouse*,[135] has been tried and proceeded to judgments. *Dictum* on a motion in the case of *Farnham v. Fingold*,[136] which did not proceed to trial, discussed insider obligations. The Supreme Court of Ontario gave an order requiring the OSC to commence an action to enforce liability in the proceeding *In the Matter of Multiple Access Limited* but this case has not yet proceeded to trial on the merits and appears to have been unsuccessful on constitutional grounds.[137] Two other cases have been reported in newspapers as having been settled prior to trial.[138] An inquiry of the OSC ab-

132 *See e.g.* Ontario Act, ss. 35, 58.

133 R. v. Littler, 65 D.L.R. (3d) 443 (Que. C.A. 1974), *aff'g*, 13 C.C.C. (2d) 530 (Que. C.S. 1972) (on the merits); R. v. Littler, 65 D.L.R. (3d) 467 (Que. C.A. 1975), *modifying*, 13 C.C.C. (2d) 530 (Que. C.S. 1972) (reducing sentence). The order for restitution, 65 D.L.R. (3d) at 467, is the most interesting aspect of the case. *See also*, *Johnston*, Comment, 2 CAN. BUS. L.J. 234 (1977).

134 *See e.g.* Foreign Investment Review Act, S.C. 1973-74, c. 46, ss. 19, 20.

135 Green v. Charterhouse Group Canada Ltd., *supra* note 111.

136 [1972] 3 O.R. 688, 695-96 (H.C.); *rev'd on other grounds* [1973] 2 O.R. 132 (C.A.).

137 *See* Multiple Access Ltd. v. McCutcheon, (Ont. H.C. 1973) (unreported); Multiple Access Ltd. v. McCutcheon (No. 2); 11 O.R. (2d) 249 (H.C. 1975), *rev'd on other grounds*, 16 O.R. (2d) 593 (Div'l Ct. 1977).

138 *See* Dow, *How Our First Insider Trading Case Developed*, The Toronto Daily Star, June 24, 1969, at 14, col. 1; Dow, *Hard to Get Details of Unique Insider Case*, The

solved insiders in another case.[139] As will be shown below, statutory insider trading liabilities in Canada are at best uncertain in view of what should be seen as vague statutory language which has not had the benefit of analysis by the courts.

Although there are variations in the legislation imposing statutory liabilities in Canada, the example of section 100.4 of the Canada Act is typical of the rules and states:

> "(1) Every insider of a company, every person employed or retained by the company, the auditor of the company and every associate of the insider and affiliate of the insider...who, in connection with a transaction relating to the securities of the company, makes use of any specific confidential information for his own benefit or advantage that, if generally known, might reasonably be expected to affect materially the value of the securities of the company, is liable to compensate any person for any direct loss suffered by that person as a result of the transaction, unless the information was known or ought reasonably to have been known to that person at the time of such transaction, and is also accountable to the company for any direct benefit or advantage received or receivable by such insider, employed or retained person, auditor, associate or affiliate, as the case may be, as a result of the transaction.
>
> "(2) An action to enforce any right created by subsection(1) may be commenced only within two years after the date of completion of the transaction that gave rise to the cause of action or, if the transaction was required to be reported...then within two years from the time of reporting in compliance...
>
> "(3) For the purposes of this section, every director or officer of any other company that becomes an insider of a company shall be deemed to have been an insider of that latter company for the previous six months or for such shorter period as he was a director or officer of that company."

· Toronto Daily Star, June 25, 1969, at 18, col. 2; McMynn v. Tappin Copper Mines Ltd., 56 D.L.R. (3d) 443 (B.C.S.C. 1975) appears to have been settled; *see* The Globe and Mail (Toronto), March 11, 1976, at B2, col. 6.

139 Re Harold P. Connor, [1976] OSC Bull. 179 (June); *see also In re* Archibald Robb, B.C. Securities Commission Weekly Summary, March 2, 1973; *In re* William F. Robertson, B.C. Securities Commission Weekly Summary, March 2, 1973; *see also* Re Robertson, 35 D.L.R. (3d) 451 (B.C.S.C. 1973), *rev'd*, 42 D.L.R. (3d) 135 (B.C.C.A. 1973), *aff'd* (S.C.C. May 27, 1975) (unreported).

The elements of liability pursuant to this section will be discussed in more detail below.

The CBCA effected, as Ontario Bill 30 proposes to effect, significant changes to statutory insider liabilities. Both the federal statute and the provincial proposals varied the class of persons to whom insider liabilities would apply and included "tippees" and Ontario Bill 30 includes "tippers".[140] The CBCA also extended liabilities to insiders of closely-held companies and, while Ontario Bill 30 does not go so far with civil remedies, it suggests criminal liabilities for insiders who violate the proposed statute.[141] These bold directions, however, have not been responsive to several of the problems in the legislation and, therefore, the comments below will be seen as equally applicable to the new laws.

In Britain, current insider liabilities in favour of shareholders are limited to common law obligations. Remedies appear to be governed by the rule of *Percival v. Wright* discussed above except to the extent that the decision may be distinguished by, for example, the rule of *Allen v. Hyatt*.[142] This limited insider trading liability does not appear to expose insiders in Britain to substantial risks of litigation from shareholders.

An insider's liability to the company may be more substantial in Britain, also at common law only, based on the rule in *Phipps v. Boardman*.[143] That case stated, in effect, that a person who acquired confidential information in the course of performing fiduciary duties must account to the company for any benefits he obtains from use of that information. But the questionable nature of this liability has been described as follows:

> "[T]here seems to be no obstacle to such a claim (based on the principle of *Phipps v. Boardman*) in legal theory. In practice, for various reasons, such as the reluctance of co-directors to commence proceedings and the difficulties which the rule in *Foss v. Harbottle* presents to shareholders wishing to bring action themselves, it is probably not to be expected that this remedy will be much pursued even after the support it has been given by *Phipps v. Boardman*."[144]

Although the rules of The [London] Stock Exchange have prohibitions regarding insider trading with attendant liabilities,

140 CBCA, s. 125(1)(f); Ontario Bill 30, s. 133.

141 CBCA, s. 125 "corporation" refers to s. 2; Ontario Bill 30, s. 77; perhaps anticipating the trend, *see* British Columbia Securities Act, s. 111(b) (criminal liability imposed for insider trading).

142 Percival v. Wright, *supra* note 104; Allen v. Hyatt, *supra* note 107.

143 [1967] 2 A.C. 46 (H.L.).

144 Justice, *supra* note 105, at 7.

the scope of such regulation is limited in that the rules apply primarily to takeovers and mergers.[145] Also, as any prohibition is only exercisable by The Stock Exchange against its membership, the effect of the rules of The Stock Exchange may be limited to being an evidentiary base from which to assert common law liabilities.[146]

The issue of insider liabilities in Britain is being reconsidered and will probably result in expansion of existing liabilities and remedies by statute. Criticisms and suggestions that insider liabilities be broadened have appeared in various public and private reports[147] and the reports have been uniform in recommending broad revisions to the law. Generally, the proposed policies have been typified by the following:

> "The efficient operation of the market as a source of capital, as a measure of industrial success and hence as a means of achieving a desirable and efficient disposition of resources, requires that reliable information should be fairly available, and that all investors should be able to back their knowledge and judgment rather than that favoured individuals should be able to take private advantage of confidential information...in principle someone who profits unfairly in this way should be liable at law to the other parties concerned, the person with whom he dealt and the company in whose securities he dealt whose information he used in so doing."[148]

As for the scope of liability which may be expected, the *Justice Report* stated:

> "In our view, the definition of 'insiders' should be a wide one. It should include not merely directors but also employees of the company and any other persons having access, in the course of their employment, business or profession, to confidential information relating to the company...there should be a rebuttable presumption that any insider was aware of information which would be likely to have been known by or disclosed to someone in his position."[149]

Similarly, prior to proposing its bill, the position of the now defeated Conservative government was as follows:

145 *See generally* THE CITY CODE ON TAKEOVERS AND MERGERS (U.K. rev. February 1972, amended June 1974).

146 Consider, however, Bedford v. Bagshaw, 4 H. & N. 538, 157 E.R. 951 (Ex. 1859).

147 A relatively complete list of such reports may be found in *Anisman* at 153, n. 3; to this list add DEPARTMENT OF TRADE, THE CONDUCT OF DIRECTORS, Cmnd. 7037 (U.K. 1977).

148 DEPARTMENT OF TRADE AND INDUSTRY, COMPANY LAW REFORM 8 (U.K. 1973).

149 JUSTICE, *supra* note 105, at 7.

> "The government's view is that dealing in a company's securities by anyone who, by reason of his relationship with the company or with its officers, has information which he knows to be price-sensitive, should be a criminal offence unless he can show that his primary intention in dealing at that particular time was not to make a profit or avoid a loss."[150]

In the circumstances, fairly broad statutory liabilities may be expected. There is the uniform recommendation that liability be based on general access to information instead of pursuant to a designation of specific insiders who should be liable so that it may be expected that liabilities will be more significant than is the legislative standard prevailing in most of the jurisdictions in Canada.[151] Without existing experience, these proposals for change have limited value.

In Australia, The "Uniform" Companies Acts of most of the states contain insider trading liabilities.[152] Designated insiders may not make improper use of information acquired by virtue of their positions to gain advantage for themselves or others or cause detriment to the corporation.[153] Offending insiders are liable to the corporation for their profit or advantage and to compensate sellers and purchasers for their losses.[154] These Australian provisions are not markedly different in concept from their Canadian counterparts.

The Securities Industry Act of New South Wales contains prohibitions against insider trading.[155] "Where through his association with a corporation...a person has knowledge of specific information relating to the corporation...or to [its] securities...and that information is not generally known but...might reasonably be expected to affect materially the market price of those securities", a criminal offence is committed if such person deals in the securities or divulges the information to another and, similarly, such a person may be liable to compensate sellers and purchasers for their losses and accountable to the company for the benefit obtained.[156] This section is clearly similar to the provisions suggested by the Ontario bill and comparable to the provisions as to civil liability in the CBCA.

In 1974, a federal Corporations and Securities Industry Bill

150 Department of Trade and Industry, *supra* note 148, at 8.

151 As all of the recent reports have proposed an "actual access" test for liability, this is more stringent than all of the Canadian statutes except for the CBCA.

152 Companies Act, 1961, Victoria, Acts of Parliament, 10 Eliz. 2, No. 6839, *as amended.*

153 *Id.*

154 *Id.*

155 Securities Industry Act, 1970, New South Wales, Act No. 35 (1970) *as amended.*

156 *Id.* s. 75A.

was introduced in Australia.[157] Sections 123 and 125 created an offence where persons "connected with a prescribed corporation" deal in its securities when they have "possession of information that is not generally available but, if it were, would be likely materially to affect the price of those securities". Similarly, "[a] person who contravenes...is liable to compensate any other person who has purchased or sold securities at a price affected by the transaction...for any loss suffered by that other person as a result of the purchase or sale". The referenced sections in this statute which did not become law are similar to comparable Canadian provisions and offer alternatives for draftsmanship of the elements of offensive behaviour and enforcement actions.[158]

In New Zealand, insider liabilities have been suggested by a government report[159] but, to date, there has been no legislation to effect them.

The existing and proposed statutory controls over insider trading in the legislation and proposals of Britain, Australia and New Zealand are of value for Canadian reference. They provide additional analysis of the problems and suggested solutions. However, there is limited experience with the effects and, indeed, the Canadian experience with legislation of this type is more extensive. For comparative purposes, United States regulation offers a more realistic consideration of alternatives because greater experience and breadth of consideration have isolated and refined consideration of the problems.

In the United States, the 1934 Act contains one prohibition against insider trading *per se* and another which has been interpreted to regulate insider trading notwithstanding that no express mention is made of the subject. The insider trading provision as such is section 16(b) which states:

> "For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable

157 Corporations and Securities Industry Bill, 1974, Commonwealth of Australia, 29th Parliament, 1974.

158 Note particularly the treatment of causation which does not refer to "direct loss...as a result of the transaction".

159 FINAL REPORT OF THE SPECIAL COMMITTEE TO REVIEW THE COMPANIES ACT, *supra* note 29.

by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection."

The more important control has been section 10(b) of the 1934 Act and Rule 10b-5 thereunder which state:

"[10] It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange...

"(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors....

"[5] It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

"(1) to employ any device, scheme, or artifice to defraud,

"(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

"(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

Together, these provisions have had severe impact in an unclear area of the law.

Section 16(b) was conceived as a limited remedial measure. Its key conceptual features are the designated relationship of the insider to the public issuer and a "short-swing" profit attributable to two transactions within six months. From that base, the remainder of the section relates to the mechanical aspects of litigation pursuant to the section – the exceptions, the forum for an action and the limitation period. This is the companion sanction to the reporting obligation of section 16(a) and provides for an obviously arbitrary remedy. It is apparent that the section was not meant as an exclusive control over the problems it purports to remedy.[160]

Section 16(b) has several features in common with comparable Canadian legislation which provides for recovery by the company. The section relates to public companies, albeit somewhat differently defined,[161] and provides for derivative action and recovery. The insiders who may be liable are specifically designated and mirror the class of insiders subject to the reporting obligation of section 16(a). It immediately precedes the prohibition against insider short sales of section 16(c). Canadian legislation has clearly borrowed from this legislative example.

However, section 16(b) differs markedly from Canadian legislation as well. Pursuant to section 16(b), the successful claimant must prove (i) insider status throughout the six-month period,[162] (ii) a purchase *and* sale of an equity security,[163] (iii) the six-month period within which the two transactions took place,[164] and (iv) the profit realized by the insider.[165] The only defences relate to how the mechanical rule is to be interpreted[166] and, until recently, there was no issue of blameworthiness, improper use of confiden-

160 *See* Ward LaFrance Truck Corp., 13 SEC 373 (1943); *contra* MANNE, *supra* note 3, chs. 1-3.

161 1934 Act, s. 12(g).

162 *See e.g.* Stella v. Graham-Paige Motors Corp., 104 F. Supp. 957 (S.D.N.Y. 1952), *rev'd on other grounds*, 232 F.2d 299 (2d Cir. 1956); *see* more recently Foremost-McKesson Inc. v. Provident Sec. Co., 423 U.S. 232 (1976).

163 *See e.g.* Park & Tilford v. Scholte, 160 F.2d 984 (2d Cir. 1947); Blau v. Lamb, 363 F.2d 507 (2d Cir. 1966); *see* more recently Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973); *but* the issue appears to be resolved in Foremost-McKesson Inc. v. Provident Sec. Co., *supra* note 162; Santa Fe Indus. Inc. v. Green, 97 S. Ct. 1292 (1977).

164 *See e.g.* Lockheed Aircraft Corp. v. Campbell, 110 F. Supp. 282 (S.D. Cal. 1953); Colby v. Klune, 178 F.2d 872 (2d Cir. 1949); *see also* Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418 (1972).

165 *See e.g.* Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir. 1943).

166 *See e.g.* W. PAINTER, *supra* note 51, ch. IV (treatment of partnerships); *but see e.g.* Feder v. Martin Marietta Corp., 406 F.2d 260 (2d Cir. 1968).

tial information or the plaintiff's good faith.[167] Liability for profit earned in less than six months is almost automatic. And while Canadian legislation has borrowed concepts from section 16(b), it has not followed the arbitrary nature or narrowness of scope to recover "short-swing" profits and to impose such liabilities.

It may be noted that section 16(b) has been criticized as a legislative control. Private enforcement of liabilities by persons who, because of the derivative remedy need not have been securityholders during the six-month period and the fact that attorney's fees are recoverable by the plaintiff have led to apparent champerty and maintenance.[168] With the importance and vitality of Rule 10b-5 under the 1934 Act, there has been a question of whether there is any theoretical foundation left for section 16(b).[169] Notwithstanding the criticisms, it appears that section 16(b) has severely curtailed a visible abuse with a bounty system.

On a literal reading, Rule 10b-5 was not meant to remedy abuses of insider trading. It is framed in criminal law terms and was conceived as a corresponding section to regulate purchases of securities since section 17 of the Securities Act of 1933 (hereinafter the 1933 Act)[170] had application only to sales of securities. There is no reference to nor directory language from which to infer that the rule was meant to regulate insiders. However, from the SEC's first consideration of the rule,[171] it was apparent that a wide scope of activity would be regulated with the implication that insider trading would also be covered.[172] In time, the rule has become the most important regulatory tool for insider trading, and interpretations of cases pursuant to the rule have become the model for other jurisdictions' sanctions.

Rule 10b-5 may be invoked in several ways. The SEC may bring administrative, criminal or equitable proceedings to enforce it.[173] From theories of statutory tort, voidability, implication and policy, private parties may bring action, either personally, as a class, or derivatively, against violators of the rule.[174] Therefore, the rule operates differently depending on the "plaintiff" and the

167 In this regard, the Kern case, *supra* note 163, represented a real departure in that the defendant's lack of access to information and the absence of potential for abuse absolved it of liability.

168 *See e.g.* KIMBER REPORT ¶ 2.28; 2 L. Loss at 1053.

169 *See* ALI FEDERAL SECURITIES CODE, Tent. Draft No. 2 (1973), s. 1413, comments (1), (2).

170 The said statute will be referred to hereinafter as the "1933 Act".

171 *See* Ward LaFrance Truck Corp., *supra* note 160.

172 *Id.*

173 1934 Act, ss. 21, 32.

174 *See* 1 A. BROMBERG, SECURITIES LAW: FRAUD - SEC RULE 10B-5, 27 (1977) [hereinafter cited as A. BROMBERG].

type of remedy being sought and, in reviewing the jurisprudence of the rule, the distinction as to who is the "plaintiff" is critical.

This source material for statutory insider trading liabilities lends itself to several preliminary observations. Insider liabilities are not straightforward homogeneous concepts. The foundation for the theory of liability is the fiduciary concept and, not surprisingly, the common law more readily recognized insider accountability to the company. But the fiduciary obligation does not lend itself so easily to an interpretation which would compensate the market or shareholders for losses. Therefore, fraud concepts and penal considerations of fair trading in securities markets have been adapted to regulate this type of behaviour. It is clear that insiders must serve many masters and be responsive to several theories of proper ethics.

2. *Affected Companies*

All Canadian legislation excepting the CBCA imposes statutory liabilities for insiders of "public" companies only.[175] The legislative concern to which the statutory liability provisions respond was not to override or vary the common law rules generally but only to do so for insider trading in selected widely-held companies. Therefore, shareholders of closely-held companies must resort to their common law remedies in order to assert liability. Statutory liabilities apply to a limited minority of companies in Canada notwithstanding that the facts giving rise to the common law decisions, for the most part, represented abuses in closely-held companies.[176]

Such a distinction between widely-held and closely-held companies applies with respect to section 16(b) of the 1934 Act but Rule 10b-5 has not been subjected to such a limited reading. The rule covers all companies, whether or not they have issued securities publicly and regardless of whether the transaction in question took place in a public market. As a matter of policy, when a complaint is prosecuted by the SEC, action will only be taken in respect of widely-held companies. However, since the first private action pursuant to Rule 10b-5, *Kardon v. National Gypsum Co.*[177] which involved private transactions in a closely-held company, the rule has been applied to any company. Unlike section 16(b) and most Canadian legislation, the rule has universal application.

175 *Compare* CBCA, s. 125 (using definition of "corporation" in CBCA s. 2(1)) with Canada Act, s. 100.4 (using definition of "insider of a company" in Canada Act, s. 100(1)).

176 *See e.g.* Percival v. Wright, *supra* note 104; Gadsden v. Bennetto, *supra* note 110.

177 73 F. Supp. 798 (E.D. Pa. 1946).

The CBCA, which heralded liabilities for insiders of closely-held companies, is a positive development. An insider of a closely-held company who avails himself of his position for advantage at the expense of his shareholders or affected purchasers or sellers will commit no less dishonourable an act than would the insider of a public company. To permit such behaviour in closely-held companies is inconsistent and there are no persuasive arguments to exempt insiders of closely-held companies from such standards. At best, it may be said that such a distinction is responsive to the penal considerations with insider trading in public markets but it would negate fiduciary and compensatory principles applicable to this area of conduct.

There may, however, be practical limitations on the broad imposition of insider trading liabilities to all companies. The constitutional basis from which the federal corporations law states that insiders of all corporations incorporated under that law are subject to certain liabilities is clear.[178] However, whether federal legislation can or should apply to all companies regardless of jurisdiction of incorporation and to cases which will involve purely local considerations raises a host of different considerations. Even in the United States, insider trading liabilities pursuant to section 16(b) preceded by several years the imposition by federal law of liabilities in closely-held companies in a purely local environment. If the considerations are purely remedial, insider liability should apply in all cases. If, however, there should develop a question of constitutional or policy priorities, the regulation of insider trading in closely-held provincially incorporated companies should be left to provincial law.

3. *Insiders for Liability Purposes*

Insiders who may be liable pursuant to the statutory liability provisions constitute a broader class of persons than those who are required to report. In the provincial statutes, "associates", "affiliates" and, in corporations statutes which permit a company to buy its own shares, the company itself may be held responsible. The Canada Act extends potential liability to persons employed or retained by the company and its auditor. These legislative provisions attempt to identify specific persons for purposes of liability. But, while this designation is responsive to a theory of accountability for corporate office, it demonstrates a compromise with the view to certainty. It is clear that, regardless of the breadth of the statutory designation, such a list of persons will not embrace all

178 *See* most recently, *In re* Multiple Access Ltd., *supra* note 137.

who have access to or who may act on confidential information. Therefore, and by way of example, the Canada Act has broader application than the Ontario Securities Act but both statutes consider access as being synonymous with accountability for a specified corporate relationship. Liability does not extend to all who may misappropriate information but to specific persons who may do so.

The CBCA and Ontario Bill 30 have abandoned the concept of listed insiders for liability purposes.[179] However, before reviewing these new and proposed provisions for insider trading liability, it is useful to examine the jurisprudence pursuant to Rule 10b-5 which, to a great extent, has influenced Canadian legislative developments.

Rule 10b-5 applies to "every person" so that there is no express limitation governing who may violate the rule. However, there are a number of features of the rule itself indicating that there are practical limitations in the area of insider trading. First, the rule has much broader application than the regulation of insider trading and, for the most part, it is the references to non-disclosures of subclause (2) and the operation as a fraud or deceit in subclause (3) of the rule that have primary application to the subject. Second, the type of remedy sought will influence the scope of the phrase "every person". There is a distinction between proceedings to regulate fraudulent behaviour in the market, of which insider trading may be a part, by the SEC and those of a private plaintiff seeking compensation or rescission.[180] Therefore, although the rule has no express limitation as to who may be liable, that has not meant that every person, literally, may be liable for insider trading.

In the early years of enforcement of the rule, there was no substantial difference as to who might be liable on the basis of insider trading in SEC or private actions. The first Rule 10b-5 cases were limited to seeking recovery from primary insiders such as directors, officers and substantial shareholders.[181] It was not clear whether a private plaintiff could prove all the elements required to succeed in his private action if he attempted to hold a broader class of insiders liable.[182] In effect, until the decision in

179 CBCA, s. 125(1)(f); Ontario Bill 30, s. 133.

180 *Compare, In re* Cady, Roberts & Co., SEC, Securities Exchange Act of 1934 Release No. 6668, November 8, 1961, 40 SEC 907 (1961) *with* Ross v. Licht, 263 F. Supp. 395 (S.D.N.Y. 1967).

181 *See e.g.* H. MANNE, *supra* note 3, ch. 3.

182 *See* discussion of "privity" and "reliance" in text *infra*.

Cady, Roberts & Co.,[183] insider liabilities pursuant to Rule 10b-5 paralleled section 16(b) in terms of who might be liable.

Cady, Roberts was an SEC disciplinary proceeding for violations of section 10(b) of the 1934 Act and section 17(a) of the 1933 Act. A registered representative of the broker, *Cady, Roberts*, was a director of a public issuer and the price of the issuer's securities had been rising. During a recess of a meeting of the issuer's board at which the quarterly dividend was reduced, the *Cady, Roberts* representative notified a partner of his firm of the reduction. The issuer's securities were sold for various customers and several short sales were effected before news of the dividend reduction first appeared on the Dow Jones service. The SEC found that *Cady, Roberts* had committed a violation but it did not proceed further against the broker or its registered representative. The partner was suspended from trading on the New York Stock Exchange for twenty days.

Cady, Roberts was the first major pronouncement of an actual "access test" for insider trading liability. Chairman Cary stated:

> "Analytically, the obligation [of insiders] rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing."[184]

However, this actual "access test" was enunciated in a disciplinary proceeding, one of the SEC's functions in the general administrative regulation of fraud in the securities market, and there remained the issue of whether a similar result could be expected in court proceedings and for purposes of civil liability.

Ross v. Licht[185] involved the first consideration of an actual "access test" in a civil action. The company was closely-held and, in anticipation of an offering of shares to the public at a higher price, its officers and directors as well as the remaining substantial (but not 10%) shareholder employees and their friends purchased the plaintiff's shares. In an action pursuant to Rule 10b-5, the court stated:

> "[Two defendants] were substantial stockholders and responsible employees of National and as such learned of the proposed private and public offerings....In determin-

183 *In re* Cady, Roberts & Co., *supra* note 180.

184 *Id.* at 912.

185 Ross v. Licht, *supra* note 180.

> ing whether a person, not a director or officer, is a corporate insider...the test is whether he had such a relationship to the corporation that he had access to information which should be used only for a corporate purpose and not for the benefit of anyone."[186]

Furthermore:

> "If...[three defendants] were not insiders, they would seem to have been 'tippees' (persons given information by insiders in breach of trust) and subject to the same duty as insiders....And in any event...[they] would be equally liable for aiding and abetting a violation of Rule 10b-5."[187]

The court proceeded to hold the defendants liable in damages.

The paramount decisions on the issue of an actual "access test" were the landmark cases of *SEC v. Texas Gulf Sulphur Co.* (TGS).[188] This case involving insider trading before public announcement of a significant mineral discovery endorsed the *Cady, Roberts* view that "anyone who, trading for his own account in the securities of a corporation has 'access, directly or indirectly...' " was subject to Rule 10b-5. A company engineer, the chief geologist, another geologist and an attorney were censured. A determination of a geologist's liability for "tipping" was requested and he was held liable for "tippee's" profits.[189] On the question of the "tippee's" liability, the court's *dicta* indicated that tippee trading was as reprehensible as trading by other insiders.[190] The appellate court's decision in TGS completed the analysis of who should be liable pursuant to Rule 10b-5.

This conclusion of who should be liable for insider trading constituted important extensions in traditional thinking on insider trading. An actual access approach to liability replaced any formulation of a mechanical and, by definition, futile attempt to designate relationships that give rise to obligations and liabilities. A person did not have to hold office or influence with the company in order to be accountable to the market. Determinations of liability would have to change from an emphasis on the identity of the trader to the broader context of the nature and source of his information. For these reasons, there was a justifiably broad and ambivalent reaction to the expanded scope of liability.[191]

186 *Id.* at 409.

187 *Id.* at 410.

188 258 F. Supp. 262 (S.D.N.Y. 1966), *rev'd*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

189 401 F.2d at 843; *see also* SEC v. Texas Gulf Sulphur Co. (No. 2), 312 F. Supp. 77, 95 (S.D.N.Y. 1970) (on remand).

190 SEC v. Texas Gulf Sulphur Co., 401 F.2d at 852, 853.

191 *See e.g.* H. MANNE, *supra* note 3, at 45.

This actual "access test" for liability raised important corollary issues. Should the conveyor of information, the "tipper", be liable for trading losses of others or trading profits which he does not realize personally?[192] Does the mere fact that confidential information is conveyed give rise to liability or must there be trading profits before an offence is committed by the "tipper" or "tippee"?[193] If there are trading profits, how should the "tipper" and "tippee" share liability and to whom should recovery be permitted?[194] What are the obligations of the "tipper" and "tippee" as between themselves?[195] There are obvious implications with what is a simple conceptual refinement in the focus of liability.

The most important issue raised by the actual access test is the question of what insider trading would be following removal of specific designations for liability. Traditionally, insider trading and the liability which is extended therefrom is the trading in securities of a company by a person who has a relationship to the company. He owes a duty and, if he breaches that duty, he should be liable. Colloquially, the law will protect against the person "on the inside" who takes advantage of those "on the outside" to whom he owes a duty of good faith. With application of the actual access test, the relationship to the company may be blurred and, on the basis of access and a qualitative valuation of the information, there could be liability. What remains of liability on the basis of relationship to the company? The SEC[196] has leaned towards extending liability with emphasis on whether the information was generally known. It appears that the source of the information or relationship is becoming less important when imposition of more general standards in the trading of securities is at issue. Commentators in the United States[197] have urged retention of the relationship aspect before insider liability is imposed in civil cases in that the offending trader should know that the information emanated from a corporate source. Liability in this latter case is clearly based

192 *See e.g. In re* Investors Management Co. Inc., SEC, Administrative Proceeding File No. 3-1680, June 26, 1970, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,832; (*see also* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 353 F. Supp. 264 (S.D.N.Y. 1972), *aff'd*, 495 F.2d 228 (2d Cir. 1974).

193 *See e.g.* Financial Industrial Fund Inc. v. McDonnell Douglas Corp., 315 F. Supp. 42 (D. Colo. 1970); *In re* Fabergé Inc., SEC, Securities Exchange Act of 1934 Release No. 10174, May 25, 1973, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,378.

194 *See e.g.* Nathanson v. Weis, Voisin, Cannon Inc., 325 F. Supp. 50 (S.D.N.Y. 1971).

195 *See e.g.* James v. DuBreuil, 500 F.2d 155 (5th Cir. 1974); Kuehnert v. Texstar Corp., 412 F.2d 700 (5th Cir. 1969); Wohl v. Blair & Co., [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,619 (S.D.N.Y. 1970).

196 *See e.g. In re* Investors Management Co. Inc., *supra* note 192; *In re* Fabergé Inc., *supra* note 193.

197 *See e.g.* ALI FEDERAL SECURITIES CODE, Tent. Draft No. 2 (1973), s. 1303(b)(4) and comments.

on "insider" trading. This issue has not been resolved fully in the United States.[198]

Against this background, the CBCA and Ontario Bill 30 expanded the scope of who might be liable for insider trading. The CBCA included "a person who receives specific confidential information from...[another insider]...and who has knowledge that the person giving the information is...[another insider]".[199] In effect, "tippees and sub-tippees" are included in the definition of insider. Ontario Bill 30, adopting the more general approach from the SEC's interpretation of Rule 10b-5, refers to "every person or company...with knowledge of a material change with respect to the responding issuer...".[200] In addition, the regulatory authority would receive the power to sanction insider trading directly in the Ontario Bill.[201] However, neither of these two extensions of liability have responded to all of the issues raised by the actual "access test".

In the case of Ontario Bill 30, there are a number of technical difficulties. For purposes of civil liability, a person is liable to compensate a purchaser or vendor of such securities if the person has knowledge of "a material change with respect to such issuer". However, for purposes of penal sanction, a person may not "purchase or sell securities of a reporting issuer with knowledge of a material change in the affairs of the reporting issuer".[202] This deviation in wording may lead to the strange conclusion that, for purposes of criminal liability the material change must be from a corporate source since it must be related to the affairs of the issuer whereas, in the case of civil liability, any material change with respect to the issuer will be sufficient. In effect, the drafting may not respond clearly to liability founded on fiduciary concepts as compared to that which is founded from the desire to maintain fair dealing in markets generally. There is doubt, therefore, as to how "market information" would be treated under the new legislation.[203] Basic questions as to the liability of the "tipper" as opposed to the "tippee" are not answered.[204] There is no attempt to deal with the problem of the financial institution described as having

198 *See e.g.* Zweig v. The Hearst Corp., [1975-1976 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,391 (D.C. Cal. 1975).

199 CBCA, s. 125(1)(f).

200 Ontario Bill 30, s. 133(1).

201 *Id.* s. 77.

202 *Id.* ss. 77, 133(1).

203 "Market Information" is information affecting the market for the company's securities but not necessarily the company itself; *see* Fleischer, Mundheim & Murphy, *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798 (1973).

204 Note that Ontario Bill 30, s. 133(1), includes "tippers" but the measure of damages provisions in s. 133(5) draws no distinction between traders and "tippers".

"Chinese walls".[205] Ontario Bill 30 has made progress in adopting new theories of liability but there are serious questions of interpretation which must be resolved.

In the case of the CBCA, there are similar questions of interpretation. The definition of "insider" contains a number of redundancies with the result that there may be significant questions in the future.[206] While there is no question concerning the source of the information, and it is relatively clear that "market information" is not contemplated, a "tippee" is accountable to the company notwithstanding that he has no immediate fiduciary relationship from which liability should be founded.[207] Reconsideration of the CBCA provisions would be helpful.

An actual access test would be preferable to designation of specific individuals for liability purposes but clear delineations of sources of liability are essential. A response to the fiduciary considerations underlying insider trading liabilities would require that a corporate source for the confidential information be the foundation for liability. "Market information" would not be treated as a source for insider abuse. However, since the abuse follows dissemination of confidential information, it should be clear that an "insider" need not trade before liability is imposed. A "tipper" could therefore be more responsible than a "tippee" since the "tipper" may be the fiduciary. Recovery by the company should be limited to primary insiders in order to preserve the theory of accountability from fiduciaries. This would also mean that, in the case of the company, it would only have recourse against the "tipper" and the "tipper" could, in any case, pursue his remedies against his "tippee". In the case of actions for compensation, there is much to be said for preserving fiduciary principles of accountability as the primary basis for liability.

Insider trading standards and fiduciary principles coalesce, to a great extent, with responses to the need for fair and orderly securities markets. Remedial measures which are based on penal considerations should not be limited by requirements of demonstration of fiduciary connection. The CBCA, which requires a corporate source and correctly traces fiduciary standards as a basis for liability, would not extend far enough for purposes of general market regulation. Ontario Bill 30 is too general and will invite narrow interpretations by the courts of both insider trading and more general market regulation cases. The difficulty, typified by the treatment of "market information" cases, stems from the

205 *See e.g.* Miller, *Chinese Walls*, 8 Rev. Sec. Reg. 865 (1975).

206 *See e.g. Anisman* at 215.

207 CBCA, s. 125(5)(b).

need to delineate insider trading and market regulation liabilities more precisely.

It is suggested that, under the subject of insider trading, the persons who should be liable would be those prescribed by a refined definition along the lines of the CBCA.[208] Issues such as market information and absence of an insider source for confidential information should be the subject of regulation under a separate heading.[209]

4. *Connection with a Transaction*

All of the statutes which regulate insider trading impose liability "in connection with a transaction" and there is a significant question as to the scope of liability that is contemplated. Under the Canada Act, it is "a transaction relating to the securities of the company" and the CBCA states that it is "a transaction in a security of the corporation or any of its affiliates". Clearly, purchases or sales by insiders are embraced by the legislative provisions. However, it is not clear whether the expression does not extend liability further.

Consider, for example, a profitable purchase and sale effected by a friend of an insider with the assistance of confidential information from the insider. The friend's transaction, quite clearly, qualifies for "in connection with *a* transaction" and the friend's profit may result in the insider's "own benefit or advantage" if a favour is owed or given in return. It can also be argued that this is the very type of behaviour that the legislation was meant to remedy. If such a case were made, the insider's exposure is, at best, unclear and the statute would appear to indicate that "tipper" liability is possible.

The CBCA's slight variation to the connection requirement to include the securities of affiliated companies becomes more meaningful. A broader category of transactions is contemplated in that, for questionable dealings in an affiliate's securities, the rights of an affiliate's shareholders are extended to the company's shareholders. One obvious interpretation would give the shareholder of a parent company the right to bring action against a "tippee" of a subsidiary's insider for a trade in the subsidiary's securities. With the extended definition of insiders who may be liable, the broader connection requirement becomes significant.

Ontario Bill 30 has clarified the connection requirement by contracting the scope of potential liability to apply only to the

208 The definition of s. 125 could have deleted all except subsections 125(1), (2), (3), (4).
209 In this respect, Ontario Bill 30, s. 77, would be a convenient beginning.

company but expanding potential liability to include "tippers". In the section on civil liability, section 133, the person must sell, purchase or inform the vendor or purchaser about securities of the reporting issuer. There is no express extension to transactions in affiliated company securities. For purposes of criminal and other public liabilities, in section 77, the prohibition applies to purchases, sales and informing about securities of a reporting issuer. In this latter case, the expression "purchase or sell" has replaced earlier wording which used "trade".[210] Ontario Bill 30 represents a significant departure from federal legislation and possible interpretations of existing legislation in the provinces.

The transaction test appears to have borrowed from similar wording in Rule 10b-5 and it is instructive to examine the U.S. experience with the phrase "in connection with the purchase or sale". The phrase has been interpreted often since plaintiffs in private actions, wishing to avail themselves of the advantages of a hearing in a federal court where broader liabilities on the basis of "fraud" may be extended, must demonstrate "connection" as a jurisdictional matter. In that regard, Professor A. Bromberg has stated that:

> "The 10b-5 requirement of 'connection' between misconduct and a security transaction ...presents no obstacle to litigating conflict transactions consisting of (1) securities trades between the company and insiders ...or (2) mergers or similar transactions on unfair terms for minority shareholders. These are security purchases or sales and the misconduct is ultimately related to them. But the 'connection' problem does arise, e.g., when the conflict transaction is not itself a security transaction but is in some way related to one."[211]

The two types of cases which are of interest for comparative purposes are, first, the type of "connection" from the point of view of remoteness before the rule may be invoked and, second, whether the plaintiff must be a purchaser or seller of securities in order to avail himself of the rule.

Initially, federal courts were reluctant to broadly interpret the word "connection" in their consideration of transactions since the result of seeking expansive jurisdiction could be controls beyond the scope of conduct the legislative censure was meant to cover.[212] More recently, the courts have acknowledged jurisdiction in a broader number of instances and, for example, transac-

210 *See e.g.* Ontario Bill 75, ss. 1(36), 74.

211 1 A. Bromberg, *supra* note 174, at 88.1.

212 *See e.g.* Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952).

tions in securities of affiliated companies indicated sufficient "connection" for purposes of liability.[213] "Tipper" liability has also been imposed on this basis.[214] The Supreme Court, in its unanimous decision in *Sup't of Insurance v. Bankers Life & Casualty Co.*[215] suggested that the "connection" could be tenuous and, as a synonym, used the word "touching".[216] The Court did not, however, explicitly state what the connection requirement should be. It is clear that "connection" will be liberally construed but the exact scope is unclear.

On the issue of whether the complainant had to have been a purchaser or seller, the courts have recently retreated. The original formulations of liability were careful to restrict application of the rule for recovery only to purchasers or sellers and to reject any opportunity to police corporate mismanagement.[217] The erosion of this strict rule became apparent in derivative actions, in cases involving broad interpretations of the type of transaction to be covered and in instances where liberal interpretation of the causal connection of the loss before and after the misconduct assisted in making the "connection".[218] However, the reluctance to compensate if the complainant was not involved in any transaction or if the only transaction turned out to be abortive followed the more historical view with two recent cases in the Supreme Court of the United States.[219] It is clear that the complainant had to have been a purchaser or seller of securities.

The "connection" requirement is still a much more important issue in the United States than Canada. In the United States, the issue is closely linked to questions of jurisdiction and standing to bring action quite apart from the considerations of remoteness which are common to both jurisdictions. However, the resolution of the question of remoteness in the United States provides examples of the issues which may have to be considered in Canada under applicable legislation. For example, a sale of shares at a premium

213 *See e.g.* Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968).

214 *See e.g. In re* Investors Management Co. Inc., *supra* note 192; Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, *supra* note 192.

215 404 U.S. 6 (1971).

216 *Id.* at 12, 13.

217 *See e.g.* Birnbaum v. Newport Steel Corp., *supra* note 212.

218 *See e.g.* James v. Gerber Food Products Co., 483 F.2d 944 (6th Cir. 1973); Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787 (2d Cir. 1969); Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir. 1967), *cert. denied*, 389 U.S. 970 (1967); Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1960).

219 In Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), the Court unequivocally required that the plaintiff be a purchaser or seller to have standing; shortly thereafter, in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), the Court's finding with respect to scienter, discussed *infra*, indicated a further trend to restrictive interpretation.

by insiders such as took place in the *Farnham* case in Canada may be litigated pursuant to statutory insider trading provisions in the future.[220] As a result, the experience of the United States sheds light on the type of fact situations which give rise to causes of action and should be considered notwithstanding the impression that the cases relate primarily to jurisdiction.[221]

The lack of jurisprudence under the Canadian provisions requiring a transaction underscores the vagueness of the provision and the interpretation problems which may be expected. Courts may very well choose a narrow transaction test, as is suggested in Ontario Bill 30, whereby the insider must be the purchaser, seller or "tipper" in respect of the issuer's securities. A more expansive approach, even under the older legislation, could result in, for example, liability for inducing not to trade or to trade in holding-company shares or not to require the complainant to have been a purchaser or seller of securities. It would be helpful if the legislative provisions were clarified.

Ontario Bill 30 has indicated one approach at clarification. By limiting the scope of the liability to transactions of or "informing" by the insider in securities of the company only, the legislation has emphasized the insider's accountability to the corporation for actual transactions in its securities. As such, it appears that the vibrancy of the immediate fiduciary relationship is preserved and the only outstanding questions become whether an actual transaction should be so critical and whether the complainant must have been the purchaser or seller of those securities if, for example, he was induced not to trade. It is difficult to justify a restriction to transactions in the issuer's securities only and it would be a narrow obligation indeed if an insider could avoid fiduciary obligations by trading in the securities of an affiliated company or by inducing inactivity. Similarly, it is an arbitrary liability which imposes obligations on a "tipper" and "tippee" of confidential information without resolving how they are to share liability. The attempt to clarify falls short.

The connection requirement should vary with the type of remedy being sought. In the case of public sanctions for purely remedial purposes, there is no immediate need for a transaction test as such. Misrepresentations or concealments by insiders may and should give rise to remedies whether or not the insider trades or "informs" in connection with actual trades. There will be aggrieved parties. For purposes of civil liability, the considerations would be different. Ontario Bill 30 which requires the complainant

220 Indeed Farnham, *supra* note 136, is similar to Birnbaum, *supra* note 212.
221 *See* 1 A. BROMBERG, *supra* note 174, at 87.

to have been a purchaser or seller of securities of the company is too narrow. There should be liability where an insider induces trades or maintenance of a position and this should apply in cases of the issuer's as well as affiliated company's securities. There should be a "connection" to a trade for civil liability purposes but the connection should be established if the transaction or inducement took place in securities of the company or affiliates and, in any case, where the insider had a hand in the course of dealings which ultimately took place. This would be consistent with an insider's fiduciary obligations and the courts should adequately restrict against undue remoteness. The insider would have a higher standard for purposes of public sanctions and one which is only slightly reduced for civil liability purposes.

5. *Making Use of Specific Confidential Information*

Each of the Canadian statutes provides that the insider must "make use of...specific confidential information" as a basis for liability and this phrase raises a number of issues for resolution. What constitutes "making use"? How will the courts interpret the phrase "specific confidential information"? This phrase in the legislation outlines the offensive behaviour of the insider which must be proved.

An insider will "make use" of information if his knowledge of the information motivates him to trade with the benefit of that information. The narrowest interpretation of the phrase would require proof of the insider's knowledge of the information, his motivation by and reliance on such facts and his resulting trade. Such a view, drawing strongly from the penal considerations attendant with insider trading, has been looked on favourably by the courts in *Green v. Charterhouse* and by the OSC where the notion of the insider's motive for profit was inferred from the phrase and emphasized.[222] If this narrow interpretation continues as the general view, the connection requirement outlined above will be reinforced, proof of scienter will have been imposed and it is only the insider's trades which will give rise to liability. As D. Johnston has pointed out, the entire behaviour pattern will have to be abusive.[223]

A narrow interpretation of "making use" is neither directed by the legislation nor would that be warranted. It would be an

222 Green v. Charterhouse Group Canada Ltd., *supra* note 111, [1973] 2 O.R. at 737 (H.C.); 12 O.R. (2d) at 307 (C.A.); *In re* Harold P. Connor, *supra* note 139 at 168; *see also*, *Anisman*, at 218, 222; Davies, *supra* note 6, at 231; Johnston, *supra* note 6, 51 CAN. B. REV. at 676; Johnston, *supra* note 6, 15 WESTERN ONT. L. REV. at 241.

223 Johnston, *supra* note 6, 51 CAN. B. REV. at 686.

onerous requirement indeed that would provide for an aggrieved party to evaluate and prove the varying and perhaps numerous motivations of an insider. Similarly, such a requirement gives little weight to the compensatory considerations which should stand with at least the same importance as the penal. The wording of the statute, in stating that it is "in connection with a transaction" and in not directing a specific use permits the inference that "making use" was not intended to apply in the most or in a particularly limited sense.[224] In providing for a means of statutory compensation, the legislation should not be read as providing a narrow quasi-criminal standard allowing for ready avoidance by insiders.

Ontario Bill 30 does not solve this interpretation question. The proposed section is framed to provide that a purchase, sale or informing by the insider gives rise to compensation as opposed to "making use" being the offensive behaviour; however, if the insider did not "make use" of the information, he has a defence.[225] Apart from begging the question of what constitutes "making use", this solution should be viewed with reference to the narrow "connection" requirement in Ontario Bill 30 described above. The issue is settled in Ontario Bill 30 by removing the question of remoteness to some extent, *i.e.*, avoiding inferences of liability for other than specific purchases or sales of the issuer's securities, and extending what may be an overly restrictive interpretation of "making use" by the courts. This will not assist potential plaintiffs.

United States federal regulation demonstrates how difficult interpretation of such a phrase can become. Under section 16(b) of the 1934 Act, the mechanical approach to liability did not raise significant obstacles to interpretation until recently when usage of information was considered.[226] Moreover, interpretations under Rule 10b-5, which is introduced with the phrase "use or employ", were the subject of increasingly liberal interpretations of what constituted use until recently.[227] United States courts appear to have come full circle from narrow to expansive and back to restrictive interpretations of the phrase. This trend to defendant-oriented conclusions appears to be inherent in the Canadian provisions.[228]

What constitutes "specific confidential information" may be a more difficult issue. The phrase itself, irrespective of the other

224 *See*, *Anisman* at 224.

225 Ontario Bill 30, s. 133. Essentially, this sanctions the Green v. Charterhouse interpretation.

226 *See* Kern, *supra* note 163.

227 *See* Ernst & Ernst v. Hochfelder, *supra* note 219; *see also* discussion of scienter, *infra*.

228 A good analysis of this U.S. trend may be found in Lowenfels, *Recent Supreme Court Decisions under the Federal Securities Laws*, 65 GEO. L.J. 891 (1977).

modifying features in the sections, gives rise to immediate concerns for insiders. Directors and officers are almost always in possession of "confidential" information about the issuer and it can be postulated that it is impossible to carry on a broadly based business keeping the market sufficiently apprised so that it is safe for them to trade. Even if the insider's only motivation was full disclosure so that he could trade, he would have difficulty generally determining the "specific confidential information" that could give rise to liability.

The decisions in *Green v. Charterhouse*[229] underscore the potential problems with scope of the phrase. The trial judge stated that "specific confidential information" consisted of information obtained as a result of the insider's access and which was acquired for corporate purposes.[230] Such a description emphasizes the fiduciary duty of the insider founding liability on the basis of accountability for corporate sourced information. On appeal, and by way of dictum, the court indicated that "specific confidential information" will likely be from a corporate source but need not necessarily be.[231] In effect, the appellate court opened the question of liability for "market information" [232] regardless of source thereby emphasizing penal and compensatory considerations somewhat at the expense of accountability. The question of access might be relegated to a means of avoiding remoteness. Such interpretations may be workable and reasonable in face-to-face transactions with insiders but the consequences are unclear and less precise in open market transactions.

The confidential information must be "specific". In *Green v. Charterhouse*, the issue of specificity was one of ripeness of the confidential information.[233] Were the merger discussions sufficiently advanced for purposes of determining specificity? The court, in rejecting the plaintiff's claim, indicated that specificity could be equated with the degree of development of the information. Presumably, the question of specificity will be raised in other cases of remoteness, and where the information is too general or of dubious materiality.[234]

The CBCA does not give assistance on the question of "specific

229 Green v. Charterhouse Group Canada Ltd., *supra* note 111.

230 [1973] 2 O.R. at 740, 741.

231 12 O.R. (2d) at 309.

232 *See*, *Anisman* at 226; Johnston, *supra* note 6, 15 WESTERN ONT. L. REV. at 244.

233 *Compare* trial judgment in Green v. Charterhouse Group Canada Ltd., *supra* note 111, [1973] 2 O.R. at 742 *with* appellate finding, *supra* note 111, 12 O.R. (2d) at 306-07.

234 Indeed by observing the self-evident fact that specific is the opposite of general, the Court of Appeal in Green v. Charterhouse begged the question; *see* material in note 232 *supra* for attempts at resolution.

confidential information" but the issue would be varied somewhat by Ontario Bill 30.[235] Any person trading "with knowledge of a material change" as opposed to "making use of any confidential information" will be liable. Of the two possible interpretations which the courts discussed in *Green v. Charterhouse* Ontario Bill 30 would choose to emphasize materiality at the expense of preserving corporate source as the basis for confidentiality. And the full implications of liability based on market information would soon become apparent. A marked change from liability based primarily on a theory of accountability to liability based on materiality to the market may be expected.

In United States federal regulation of insider trading, there is no concept of "specific confidential information" as such in either section 16(b) or Rule 10b-5 under the 1934 Act. A number of cases and commentators have offered examples which would and would not qualify for liability purposes.[236]

The phrase "making use of specific confidential information" has given rise to unusual reactions. Tribunals and legislative draftsmen have reacted against a wide meaning of the phrase "making use" while, contemporaneously, suggesting the broadest meaning for "specific confidential information".[237] The reverse should have been the case. The principal basis for the offence of insider trading is breach of duty and the theory of recovery is primarily one of accountability for position with a company. Any "use", regardless of motive, should give rise to liability. However, it is debatable whether "any" material information should be characterized the same way. The regulation of insider trading, as indicated above, is one aspect of regulation of behaviour in markets. If it is to be given status independent of the regulation of fraud and disclosure in the markets, it must be on the fiduciary and accountability levels of consideration. For these reasons, the "offence" of insider trading as such should occur when an insider makes any use of corporate source information.

6. *Materiality*

The CBCA requires the "specific confidential information" to be such as "might reasonably be expected to affect materially the value of the securities". This materiality test raises similar ques-

235 Ontario Bill 30, s. 133.

236 *See e.g.* Geller v. Transamerica Corp. (1934), 53 F. Supp. 625 (D. Del. 1943), *aff'd*, 151 F.2d 534 (3d Cir. 1945); SEC v. Geon Industries Inc., 381 F. Supp. 1063 (S.D.N.Y. 1974); Harnett v. Ryan Homes Inc., 496 F.2d 832 (3d Cir. 1974); Rochez Bros. Inc. v. Rhodes, 491 F.2d 402 (3d Cir. 1974).

237 *See* Farnham v. Fingold, *supra* note 136; Birnbaum v. Newport Steel Corp., *supra*

tions of interpretation with the absence of judicial consideration of the provision. The common law rule which is, in effect, that a fact is material if it would influence the ordinary person in making his investment decision[238] should be considered in light of the breadth of facts which investors at large or individual market actors would consider to be important. And whether the common law rule as to materiality is to be equated with that which "might reasonably be expected to affect materially the value of the securities" is a separate issue. There should normally be a difference between a "material fact" as such, and its impact or effects which are the conclusions contemplated by the statute. But there is even some question of whether the word "value" in the legislation, in the absence of being modified by the word "market", means the quoted price. The current materiality test should not give rise to problems in gross instances of insider abuse but the issue may be more difficult to resolve in practice when there is doubt as to whether the information will affect the price.

As an example, consider the facts of *Green v. Charterhouse.*[239] In this instance of non-disclosure of what became merger negotiations, the courts' primary concerns related to whether the fact of the impending transaction had matured sufficiently for the confidential information to be specific enough. But apart from the issue of specificity, what of materiality? The merger or a takeover would be material but the question of ripeness of the facts is an obvious further consideration. If the *Green* insiders had elected to disclose, how much and what should have been disclosed as being material with the attendant risk that, if the transaction had not proceeded, the misrepresentation of those insiders could have founded liability? The court in *Green* alluded to the plaintiff's experience as an investor[240] so that the lesson to be learned may be distinguishable on the facts in future cases. The *Green* case is not the best example but it does serve to illustrate some of the complexity raised by current standards which in any event, will be applied with the marked benefit of hindsight.

There has been no alteration to the materiality test in the CBCA but Ontario Bill 30 has attempted to clarify. At first glance, sections 77 and 133, by referring to "material change" with respect to the reporting issuer or its affairs, indicate emphasis on the

note 212; Green v. Charterhouse, *supra* note 111, [1973] 2 O.R. at 740, 741 (H.C.); 12 O.R. (2d) at 309 (C.A.).

238 *See e.g.* Pigott v. Nesbitt Thomson & Co. Ltd., [1939] O.R. 66, 76 (C.A. 1938), *aff'd*, [1941] S.C.R. 520.

239 Green v. Charterhouse Group Canada Ltd., *supra* note 111.

240 *Id.*, [1973] 2 O.R. at 743 (H.C.).

materiality of the facts themselves as opposed to their probable effects. However, "material" has been defined in section 1(22) to include "that [which] would reasonably be expected to have a significant effect on the market price". Little progress on resolving interpretation questions has been made since, in effect, the only real change relates to that which "would" rather than "might" affect.[241] Indeed, Ontario Bill 30 has begged the question of what would constitute a "material change".

Consideration of the materiality issue in the United States pursuant to Rule 10b-5 and similar provisions where the issue is raised are instructive. In *Kardon v. National Gypsum Co.*,[242] the reference was to a fact which "would materially affect the judgment of the other party to the transaction". In *TGS*, a case involving judgments in the open market, emphasis was placed on the reasonable man's judgment which "include not only information disclosing the earnings and distributions of a company but also those facts which affect the probable future of the company and those which may affect the desire of investors to buy, sell or hold the company's securities".[243] On the other hand, in *Kohler v. Kohler Co.*[244] material facts were those "which would clearly affect 'investment judgment' " whereas in *Hafner v. Forest Laboratories, Inc.*,[245] "[m]ateriality must be judged in the last analysis by effect on market price". Quite apart from the question of whether the information must affect the investor or the price, in *Mills v. Electric Auto-Lite Co.* and *Affiliated Ute Citizens of Utah v. United States*, the courts looked to whether "the defect was of such a character that it *might* have been considered important".[246] More recently, in *TSC Industries v. Northway, Inc.*, the court looked to "if there is a substantial likelihood that a reasonable shareholder *would* consider it important".[247] While the statements of definition do tend to coalesce in most insider trading cases, the distinctions should be considered.[248]

The imprecision attending the concept of materiality in Canada, where there is a dearth of authority, and in the United States, with many examples, underscores the futility of trying to set an

241 This may be an attempt to settle an objective standard as opposed to a more subjective standard relying on speculation; *see* notes 243-47 *infra*.

242 *See* Kardon v. National Gypsum Co., *supra* note 177, at 800.

243 401 F.2d 833, 849 (2d Cir. 1968).

244 319 F.2d 634 (7th Cir. 1963); *see also* Myzel v. Fields, 386 F.2d 718, 734 (8th Cir. 1967).

245 345 F.2d 167, 171 (2d Cir. 1965).

246 Mills v. Electric Auto-Lite Co., 396 U.S. 375, 384 (1970); Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 153 (1972).

247 96 S. Ct. 2126 (1976).

248 Indeed, there is a trend to narrowing exposure to liability; *see* Lowenfels, *supra* note 228.

objective standard when there are so many subjective considerations. There may not be a single test of materiality which would apply in face-to-face dealings and in the open market and which would account for behaviour of all reasonable men. Furthermore, faced with an insider who has profited, it may be difficult for a court to state that facts were immaterial and, thereby, contradict empirical data of someone who has engaged in trading. And whether materiality is defined or not may become somewhat academic since it is difficult to postulate an example where a defence based on immateriality would succeed in absolving an insider. There may be no real substitute for a measure of imprecision and uncertainty and, therefore, there is no real reason to define materiality as such.

At the same time, the legislation can and should assist in questions of materiality. With heightened continuing disclosure standards for issuers, the insider should have rules to which, by analogy, he can refer for evaluating proposed conduct in the open market. Such standards, which should be based on factors like the size of the issuer, the nature of its business and outstanding securities, commercial and legal experience with information of this type, will contribute to determination of whether facts are material and will assist, if there is proper corporate disclosure, on questions of timing of the insider's transactions. In open market cases, the insider should be able to take comfort from reliance on a fact which, for purposes of disclosure by the company, was not material. In face-to-face dealings of an insider with others, legislation cannot assist as greatly since it would be difficult if not impossible for legislation to trace individual motivations. It should not really matter whether the information "might" or "would" have an effect and this area should remain imprecise for this reason. Legislation should assist by settling disclosure required of the company and, by implication, it would set standards for insider dealings.

There will, of course, remain questions for the insider to decide. His judgments as to ripeness of the information, its general relevance and price sensitivity, who he is dealing with if it is a private transaction and similar considerations will still be important. But notwithstanding that disputing materiality may be one of few assertable defences of an insider, there must remain flexibility in the legislation and for the arbiter of disputes where the insider always has the option not to trade.[249] It is conceded that the insider loses much of the benefit of favourable news and ability to cut losses with adverse information, especially for cases where

249 *See* 3 A. Bromberg, *supra* note 174, at 287.

the fact of insider trading may be material, but this is consistent with the fiduciary duties which the insider has undertaken. The risk attending the issue of materiality must remain with the insider.

Treatment of "market information" also shapes the materiality question. However, as has been the position above, the materiality of this type of information should not affect insider trading which is based on corporate sourced information.

7. *Causation*

There are a number of causation tests implicit in the insider liability sections of the Canada Act. The insider is liable to compensate for "any direct" loss which arises "as a result of" the transaction and is also accountable to the company for "any direct" benefit or advantage he receives "as a result of" such transaction. Establishing causal relationships may not appear to create problems unique to insider trading. However, the nature of causation required to be proved should raise peculiar interpretation questions in open market transactions.

In cases which ultimately proceed to trial and where liability must be quantified under the section, the following causation issues are evident. First, the court must decide the cause of "any" loss by determining what results the transaction may have had in a relatively broad market or the "transaction causation".[250] Second, the court should consider the "direct" loss itself or the "loss causation".[251] Third, the court may quantify the direct benefit that an insider receives or a form of "loss causation". Finally, there is the "transaction causation" which is to be accounted for in quantifying the benefit resulting from the insider's transaction in the market. It may be expected that a court will ultimately overcome the causal connections difficulties based on the purpose of the provision.[252] However, at present, the causation issues are not settled and there are significant doubts as to how the legislation will be interpreted.

The causation issue may be the most difficult question to be answered for purposes of determining civil liability for insider trading in public markets. In such transactions, their essence is that a shareholder makes an impersonal trade which will blend with many others in the market. How does the shareholder prove losses or results of the insider's transactions without matching all

250 The concepts of "loss causation" and "transaction causation" are described in detail in 1 A. BROMBERG, *supra* note 174, at 86.1, 86.5 respectively.

251 *Id.* at 86.5.

252 KIMBER REPORT ¶¶ 2.21, 2.24, 2.25.

transactions in a given period?[253] If causation must be proved by matching transactions, recovery may be based on the purely fortuitous event that the insider bought or sold the specific securities of the complainant. If matching of transactions will not be the rule, the insider may be liable for all transactions of a specified period with a result that there is almost unlimited liability and, in any event, liability for more than his profit. It may very well be that unless these causation tests give rise to no recovery, unless there is privity of contract, insider trading gives rise to unquantifiable liability.[254]

The concept of causation in the insider liabilities section is unfortunate. It is "neither fish nor fowl" in that analysis based on theories of accountability or compensation, tort or contract, will yield different and inconsistent results proceeding from different theories. Liability may be readily determined in face-to-face transactions where there are finite steps and no uncertainty cast by interpositioning of an open market. But the theory breaks down for the examples which were the primary concerns of the provisions, namely, stock exchange transactions.[255] It may be argued that the legislation should be given any of several constructions giving credence to the purpose of the provisions.[256] But no argument gives full weight to the express language.

The CBCA has adopted the language of the Canada Act on this point but there have been suggested changes in Ontario Bill 30. In respect of OSC remedies under section 77, there is no concept of causation. But civil liabilities pursuant to section 133 are based on compensation "for damages as a result of the trade". The company is entitled to recovery since specified insiders are "accountable to such issuer for any benefit or advantage" received by such insider. Ontario Bill 30 represents a constructive change to the concept of causation.

A court interpreting Ontario Bill 30 should not have the same difficulties as before. The courts are assisted by having to determine "damages" instead of "direct loss" so that there is significant flexibility for open market cases. They may determine the "result of such trade" in open market cases on the basis of subsection 133(5) and not look to causation.[257] However, in face-to-face transactions, there is a basis for compensation in excess of actual loss

253 *See* J. Williamson, Supp. at 361; Davies, *supra* note 6, at 232.

254 *See, Anisman* at 239.

255 *See* Downs, *supra* note 6, at 97.

256 *See, Anisman* at 234.

257 Ontario Bill 30, s. 133(5), states, unequivocally, a formula for damages in all cases. *Quaere* the equity of this solution if the "plaintiff" succeeds in mitigating his damages.

since "damages" may entail satisfaction of interests in excess of an out-of-pocket or restitution measure and subsection 133(5) would endorse that. In open market cases, there is the risk of unlimited liability. Actions by the company are clarified in that the causation test has been replaced with a strict accounting. But it is clear that not only double liability, to the market and to the company, is intended but that the insider's profit may constitute a small portion of the amount of his liability.

The question of causation has been considered pursuant to Rule 10b-5 but interpretations have varied with the nature of the relief sought. As the rule may be invoked for purposes of penal, administrative and civil relief, causation is only relevant for cases where direct compensation is sought. The SEC need not prove causation just as a plaintiff pursuing a class action or with derivative status need not prove causation.[258] Injunctive relief may be available without such proof and, subject to ultimate proof of his damages, a private plaintiff may obtain partial summary judgment on the issue of liability.[259] Therefore, in private actions for monetary recovery, a plaintiff must prove causation notwithstanding that the rule does not direct its proof.

There have been a number of cases where "loss causation" has been considered.[260] The plaintiff has had to prove his compensable loss and the connection between the defendant's breach of the rule and the plaintiff's loss. Cases which have proceeded to trial have followed general tort theories of damages, which will be discussed below, and there are interesting examples of connection of a breach of the rule and compensable loss to the company, shareholders and creditors.[261] U.S. courts have struggled with problems of remoteness,[262] it having been advantageous that the vast majority of cases have involved face-to-face dealings. In respect of "loss causation", the courts have taken a flexible approach.[263]

"Transaction causation", which responds to the impact of the insider's transaction, has been more difficult. In face-to-face transaction, "loss causation" and "transaction causation" have proven to be synonymous. The open market cases are more difficult, the most stringent view having been typified by *Barnett v. Anaconda Co.*[264] where the plaintiff had to prove his transaction would not have taken place but for the offensive behaviour. The

258 *See* 2 A. Bromberg, *supra* note 174, at 213; *see also* 1 A. Bromberg, *supra* note 174, at 86.4.

259 *Id.*

260 *Id.* at 86.1.

261 *Id.*

262 *Id.*

263 *Id.*

264 238 F. Supp. 766, 776 (S.D.N.Y. 1965).

more prevalent tests typified by *Laurenzano v. Einbender*[265] and *Globus Inc. v. Jaroff*[266] sought the "transactional function" and the "lesser or minimal causal nexus", respectively. These cases are not, incidentally, insider trading cases so that the scope for "transaction causation" in such cases is unclear.

Most courts that have considered causation have spoken in more general terms. For the most part, causation has been inferred, *i.e.*, "causation in fact",[267] without particular analysis as to the type or concept of causation. In permitting a private action based on a penal provision, the courts have used causation interchangeably with other elements of a private action for deceit, *i.e.*, synonymous with reliance,[268] privity[269] and scienter,[270] and with materiality.[271] This U.S. experience underlines the difficulty of a concept such as causation for insider trading cases and is helpful to highlight the concerns which Canadian courts may have.

The source of causation as an element of proof of insider liabilities is the underlying compensatory consideration. Were the sole theory of liability that of accountability, whether criminal or civil, it should not matter what loss was caused by the misrepresentation or non-disclosure nor would the results of the insider's trades be particularly relevant. The insider could account on the basis that the behaviour was wrongful *per se* and a penalty consisting of disgorging of profits should be imposed.[272] However, when compensation is considered, it can be argued that causation is the critical element because there is the risk of unjust enrichment, *i.e.*, the plaintiff that cannot prove a loss, or unlimited liability, since causation may be helpful to measure and restrict recovery of damages. The vibrancy of the concept of causation as a basis for insider liability is not that it is an element of wrongful behaviour but rather that it limits the scope of liability for ultimate recovery in civil actions.

It may be seen that maintenance of a causation test results in a price to be paid for limiting liability and preventing unjust enrichment in that much of the credibility to civil recovery for insider trading is lost. As indicated, in the absence of judicial

265 264 F. Supp. 356, 360 (E.D.N.Y. 1966).

266 226 F. Supp. 524, 530 (S.D.N.Y. 1967).

267 *See* Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 154 (1972).

268 *See e.g.* List v. Fashion Park Inc., 227 F. Supp. 906 (S.D.N.Y. 1964), *aff'd*, 364 F.2d 457 (2d Cir. 1965).

269 *See e.g.* Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701 (S.D.N.Y. 1951).

270 *See e.g.* Ernst & Ernst v. Hochfelder, *supra* note 219.

271 Affiliated Ute Citizens of Utah v. United States, *supra* note 267; List v. Fashion Park Inc., *supra* note 268.

272 Indeed, that is the theory of recovery by the company under Canadian legislation.

authority, it may be difficult for a plaintiff to prove "loss causation" in open market transactions and the weight to be given to "transaction causation" is an even more difficult issue for resolution. The risk in compensation actions is clearly with the party the litigation aims to assist. What is less clear is why activities of an insider which are considered offensive must give rise to this statutory tort theory for recovery. There are means to protect against unintended liability which do not have the impact of frustrating the purpose of the legislative provisions and which avoid the irony of recovery being denied notwithstanding proof of improper insider trading. Equities can be maintained without causation as an element to be proved before recovery.

Assuming that the insider has traded improvidently and thereby triggered a measure of accountability, what should an aggrieved plaintiff be required to prove? In the open market examples, a plaintiff should only be required to prove that he traded the company's securities contemporaneously. If causation need not be proved, the plaintiff does not attempt to match transactions for "loss causation" nor does the result of the insider's trade become material. The insider's trades alone are the basis for the recovery. There is no unjust enrichment for the plaintiff since it should be presumed he would have acted differently had he the insider's knowledge at the time the trade was effected. The risk of unlimited liability is real but this should be answered below under "Measure of Damages". Removal of the causation requirement has the effect of emphasizing the penal considerations and the theory of an insider's accountability for insider trading, reducing the risk of proof to parties the legislation is trying to protect and characterizing the offensive behaviour as other than classical tort or contract examples for purposes of remedy.

8. *Scienter, Privity and Reliance*

The statutory remedies for insider trading do not expressly require a plaintiff to prove any of scienter, privity or reliance. However, the wording of the legislative provisions indicates that these concepts remain relevant for insider liability questions. Consider the tippee's knowledge of the source of information in the CBCA as an example of scienter, or the plaintiff's knowledge being a bar to recovery in the Canada Act as an example of reliance, or the causation questions discussed above when there is no privity. It may be expected that courts will consider these concepts in Canada as they have in the United States where Rule 10b-5 also makes no express reference to privity, scienter or reliance. Commenting on whether and how these elements of an

action must be proved in the United States, L. Loss reminds that "all that glitters is not gold"[273] and A. Bromberg that "[i]n practice they have all been balled up together".[274] The Canadian attempt to define a scope for liability shows that it will be helpful if not necessary to prove scienter, privity and reliance.

a. *Scienter*

While Canadian legislation and proposals to amend it do not require a positive intention to deceive, there are inferences of scienter that may be drawn. In the Canada Act, there is the connection of making use for the insider's benefit or advantage or what may be the intent to make a profit. This continues in the CBCA and, in the case of tippees, the person must know the source of the confidential information to be from another insider. Ontario Bill 30 permits a defence of good faith where the insider "had reasonable grounds to believe that...the material change had been generally disclosed" or that "he did not make use of" the information.[275] The courts and the OSC have clearly looked to the motivation of the insider when he traded.[276] It is apparent that more than wilful acts of the insider will be required.

In the United States pursuant to Rule 10b-5, the scienter requirement for SEC and related proceedings was typified by the finding in *SEC v. Capital Gains Research Bureau, Inc.*[277] where it was stated that:

> "Failure to disclose material facts must be deemed fraud or deceit within the intended meaning for...the darkness and ignorance of commercial secrecy are the conditions upon which predatory practices best thrive. To impose upon the Securities and Exchange Commission the burden of showing deliberate dishonesty as a condition precedent to protecting investors through the prophylaxis of disclosure would effectively nullify the protective purposes of the statute."[278]

The SEC did not need to prove intent to deceive or even wilfulness since a finding that the defendants were negligent will support enforcement or injunctive relief. And if negligence was sufficient, the primary issues for consideration were the defendant's good faith and his standards of care.[279]

273 3 L. Loss at 1765.
274 2 A. Bromberg, *supra* note 174, at 195.
275 Ontario Bill 30, s. 133.
276 *See* material cited in note 222 *supra*.
277 375 U.S. 180 (1963).
278 *Id.* at 193.
279 *See*, A. Bromberg, *supra* note 174, at 204, 211.

In compensation actions, the U.S. courts were somewhat divided. One line of cases typified by *Fischman v. Raytheon Mfg. Co.*[280] supported the contention that Rule 10b-5 should not be interpreted more broadly than other anti-fraud provisions such as sections 11 and 12(2) of the 1933 Act. Therefore, the defendant must not exhibit intention as required to support common law deceit but there must be a finding of fault, wilfulness or recklessness. Another group of cases typified by *Ellis v. Carter*[281] would have been more lenient to the plaintiff and almost mirror the SEC proceedings standard. The scienter standard to be applied appeared to vary with the circuit in which the case was litigated.

Two recent cases in the Supreme Court have both settled and reaffirmed the scienter requirement. In *Ernst & Ernst v. Hochfelder* and *Santa Fe Industries v. Green*[282] the court has unequivocally stated that, having regard to the history and purpose of the provision, proof of scienter is required to succeed in private actions under Rule 10b-5.[283] This standard has been followed in an SEC injunctive proceeding.[284] While the spectrum between a positive intent to deceive and recklessness remains open, it is clear that negligence will not suffice, at least for private actions.[285]

It is difficult to consider the question of scienter in the abstract or independent of the facts of a particular case. While it is theoretically possible that an insider's trade was effected in circumstances where there is no blameworthiness, *i.e.*, a pledgee of shares realizing on the insider's posted security, the usual case involves a wilful act with intent to profit. The insider's motivation, intention or other knowledge is academic where a regulatory body seeking to protect the public or a plaintiff seeking compensation can show the insider's relatively better position because of certain trades when compared to the rest of the market holding or having disposed of those securities. Similarly, scienter may be inferred in cases where the plaintiff can show causation or reliance and the materiality of the information upon which the insider relies often characterizes the insider's intentions. One is left with the conclusion that there may be room for a scienter standard in insider trading cases but that, for the most part, it is an artificial issue to be viewed with suspicion.

The standard of scienter that should be imposed should be

280 188 F.2d 783 (2d Cir. 1951).

281 291 F.2d 270 (9th Cir. 1961).

282 Ernst & Ernst v. Hochfelder, *supra* note 219; Santa Fe Industries v. Green, *supra* note 163.

283 *See e.g.* 425 U.S. 185, 207 (1976).

284 *See e.g.* SEC v. Bausch & Lomb Inc., 420 F. Supp. 1226 (S.D.N.Y. 1976).

285 Ernst & Ernst v. Hochfelder, *supra* note 219; Santa Fe Industries v. Green, *supra* note 163.

minimal varying, if at all, with the nature of the sanction to be imposed and, in any case, an element which the insider should be required to prove. Wilfulness, in the sense that involuntary trades or behaviour may be an exception, should be the initial consideration for compensation actions. But proceedings of a regulatory body should be judged by a negligence standard. If any party to the litigation must prove scienter, it should be the insider and there may be the unusual case where a transaction is not wilful and should not give rise to liability for compensation. Based on considerations of accountability and maintenance of fairness in the market, there is really no justification for absolution if the insider had other motives or failed to see all the consequences of his acts.[286] It would be inconsistent with the purpose of the remedial measures to require proof of intention or motive and legislation should not permit the inference that proof of scienter is required.

b. *Privity*

The inference that privity between the insider and the plaintiff seeking compensation will be helpful if not required in order to succeed in insider trading actions has been discussed, for the most part, under "Causation" above. To repeat, it would be difficult to demonstrate causal connections as contemplated by the legislation if there is no privity. But this question has been settled in Rule 10b-5 actions in the United States. In 1961, L. Loss stated that "[T]wo cases in the Second Circuit give pause, but may not be conclusive"[287] on the issue of privity. By 1969, he was able to state that "[T]wo cases in the Second Circuit...give pause, but quite clearly – one may now say – are not conclusive".[288] These references to "a semblance of privity" as suggested in *Joseph v. Farnsworth Radio & Television Corp.*[289] and to the fact that Rule 10b-5 "extended protection only to the defrauded purchaser or seller" in *Birnbaum v. Newport Steel Corp.*[290] have become historical to the point where "[p]rivity has become so unimportant that it is rarely mentioned".[291] It is hoped that Canadian courts would reach the same conclusions.[292]

Canadian legislation should not permit an inference that proof of privity be required and the risk that this artificial barrier

286 In this regard, the statement by the Court of Appeal in Green v. Charterhouse Group Canada Ltd., *supra* note 111, 12 O.R. (2d) at 307, that confidential information was "a factor" instead of "the factor" in the decision to trade is not helpful.

287 3 L. Loss at 1967.

288 6 L. Loss at 3890.

289 Joseph v. Farnsworth Radio & Television Corp., *supra* note 269.

290 Birnbaum v. Newport Steel Corp., *supra* note 212, at 464.

291 2 A. Bromberg, *supra* note 174, at 208.1.

292 *See*, however, materials cited in notes 253, 255, 256 *supra*.

be raised. It is fundamental to the regulation of an impersonal market that no prospective claimant be required to match his transactions, much less on the purely fortuitous basis that they correspond with an insider's. Removal of strict causation requirements will assist in the destruction of the privity concept in securities legislation. The only consideration of privity must be supplemental, for example, to assist in showing scienter, reliance, measuring damages. If that is the case, courts will not hesitate in giving credence to the statutory purpose.

c. *Reliance*

The inference in Canadian legislation and in *Green v. Charterhouse*[293] that a plaintiff will be required to prove reliance is disturbing in light of the U.S. experience with this deceit concept. Reliance has not been particularly relevant in SEC proceedings but it has been helpful if the market did or might have relied on actions of insiders.[294] In private compensation actions, it has been assumed that proof of reliance is a prerequisite to recovery.[295]

From the first private action under Rule 10b-5, courts sought to read in the need for a finding of reliance. While it was not a primary issue, in *Kardon v. National Gypsum Co.*,[296] the court found expressly that the plaintiff had relied on the defendant's conduct in the sale of the securities. In one of the leading cases, *List v. Fashion Park, Inc.*,[297] where the plaintiff sold his shares to a director who allegedly knew of a pending sale of the company and who resold the shares at a substantial profit, the plaintiff, an "experienced and successful investor" failed in the action. The court found that the purchaser of the shares had not availed himself of confidential information and that the plaintiff had not relied on the defendant's conduct for purposes of the sale. On the issue of reliance, the court was not convinced that the plaintiff would not have sold had he possessed the information allegedly known by the defendant and "[T]he proper test is whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact".[298]

While the U.S. courts have regularly stated that some form of reliance is necessary for civil recovery, the exact scope contemplated is difficult to determine. In cases of non-disclosure, which

293 Green v. Charterhouse Group Canada Ltd., *supra* note 111, 12 O.R. (2d) at 743 (C.A.).

294 SEC v. Texas Gulf Sulphur Co., *supra* note 188; SEC v. Texas Gulf Sulphur Co. (No. 2), 312 F. Supp. 77 (S.D.N.Y. 1970) (on remand).

295 3 L. Loss at 1765; 6 L. Loss at 3875; *see also* 2 A. Bromberg, *supra* note 174, at 209.

296 Kardon v. National Gypsum Co., *supra* note 177.

297 List v. Fashion Park Inc., *supra* note 268.

298 *Id.* at 463.

cover the bulk of insider trading cases, and in open market cases the relevance of reliance itself is doubtful. Therefore, reliance appears to have become a more diverse concept. In cases of direct dealing apart from the open market, reliance may be a substitute for privity.[299] It may be considered as part of causation and inferred from materiality:

> "Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of his decision.... This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact."[300]

It may be considered together with and part of scienter and causation, *i.e.*, "unnecessary in the limited instance when no volitional act is required and the result of a forced sale is exactly that intended by the wrongdoers".[301] Reliance may be a combination of privity and causation, *i.e.*, it becomes a question of "whether the plaintiff's injury was foreseeable" and, accordingly, the plaintiff "relied, if at all, on the fact that [the defendants] made tender offers in the first place".[302] The inference that reliance *per se* is a necessary element to determine recovery has troubled the courts. This may be the case when similar litigation arises in Canada.

As most insider trading cases involve non-disclosure of material facts, it is difficult to justify reliance as an element of offensive behaviour. It would be inconsistent to require reliance on facts which are not disclosed and the presence or absence of reliance on facts which would be varied by additional disclosure should not contribute to the gravity of an offence based on accountability. Whether it is a face-to-face or open market situation, there is no place for reliance on undisclosed information.[303]

In cases where the insider's representations in face-to-face transactions are at issue, there may be room for consideration of reliance.[304] Where the plaintiff gives no weight or credence to the insider's representations, knowing them to be false or incomplete, it may be proper to assert that recovery should be denied. Similarly, the insider who corrects misrepresentations may have a credi-

299 *See e.g.* Joseph v. Farnsworth Radio & Television Corp., *supra* note 269.

300 Affiliated Ute Citizens of Utah v. United States, *supra* note 267.

301 Vine v. Beneficial Finance Co., 374 F.2d 627, 635 (2d Cir. 1967).

302 Mutual Shares Corp. v. Genesco Inc., 266 F. Supp. 130, 133 (S.D.N.Y. 1967), *aff'd in part*, 384 F.2d 540 (2d Cir. 1967).

303 *See* 2 A. BROMBERG, *supra* note 174, at 209.

304 *Id.*

ble defence. But even in such cases of non-reliance, the claimant should not be required to assert or prove reliance. The insider's obligations are founded on his duty to make full disclosure and the claimant's reliance or absence of it should be considerations for the insider defending the action. And if the insider can show the claimant was properly informed, his defence should succeed.

In any case, reliance should be a secondary consideration. This remnant of deceit actions can confuse the policy behind controls on insider trading when its only probative value is to amplify the nature of the insider's breach of duty and accountability. The relevance of reliance should only continue for purposes of proving such issues as materiality and, as the case may permit, causation, scienter and privity.

9. *Exceptions*

Notwithstanding the insider's use of specific confidential information, the Canada Act makes an exception for cases where "the information was known or ought reasonably to have been known" by the prospective claimant. The CBCA excepts cases where "the information was known or in the exercise of reasonable diligence could have been known". Ontario Bill 30 would permit a defence where there is "reasonable grounds to believe that such material change had been generally disclosed" or when "such material change was known or ought reasonably to have been known". The knowledge of the prospective plaintiff and the market may be critical, either as an adjunct of the insider's duty to disclose or as a corollary of whether the information was specific and confidential when used.

This exception should be workable in face-to-face transactions but may cause some interpretive questions for public market examples. In direct dealings, the court can reconstruct the plaintiff's knowledge at the time of a transaction and can respond to issues of causation, materiality and reliance before it considers the defence. But in the public market examples, the court has a more difficult task. It must determine the insider's duty to disclose particular facts, the impact in the market generally of the insider's behaviour and the obligations of particular market actors to be or become informed. The one opportunity for the court to have considered these questions, *Green v. Charterhouse*,[305] left an unsatisfactory conclusion in that, when it was determined that the quality of the information was not specific and confidential, the plaintiff's knowledge became somewhat academic. How the ques-

305 Green v. Charterhouse Group Canada Ltd., *supra* note 111.

tions of duty to disclose and obligation to learn will be answered is most material.

There is precedent for the insider's positive duty to disclose. At common law[306] and in *Green v. Charterhouse*,[307] there is reference to a duty to disclose in face-to-face transactions, the public market examples being less clear. In the United States, the court stated in *Kardon v. National Gypsum Co.*:

> "[T]hese provisions apply to directors and officers who, in purchasing the stock of the corporation from others, fail to disclose a fact coming to their knowledge by reason of their position, which would materially affect the judgment of the other party...."[308]

And in *Speed v. Transamerica*:

> "The duty to disclose stems from the necessity of preventing a corporate insider from utilizing his position to the unfair advantage....One of the primary purposes of [the 1934 Act] was to outlaw the use of insider information for ...financial advantage to the detriment of uninformed public securityholders."[309]

While it has been said that:

> "Requiring an insider to reveal every detail of the practice of the corporation with reference to its accounting methods and reserves and with reference to its assets and liabilities in general to a person as familiar with the company and its practices as the plaintiff would place an intolerable burden on insiders."[310]

The conclusion appears to be as follows:

> "An insider is not always foreclosed from investing in his own company merely because he may be more familiar with company operations than are outside investors. An insider's duty to disclose information or his duty to abstain from dealing in his company's securities arises only in those situations which are essentially extraordinary in nature and which are reasonably certain to have a substantial effect on the market price of the security if [the extraordinary situation were] disclosed."[311]

Canadian courts have the source material to quantify the insider's duty to disclose before they consider the plaintiff's knowledge.

If the insider proposes to make disclosure, what activity will

306 Gadsden v. Bennetto, *supra* note 110; Strong v. Repide, *supra* note 115.
307 Green v. Charterhouse Group Canada Ltd., *supra* note 111, 12 O.R. (2d) at 309 (C.A.).
308 Kardon v. National Gypsum Co., *supra* note 177.
309 99 F. Supp. 808, 829 (D. Del. 1951).
310 *See* 6 L. Loss at 3586, *quoting* Kohler v. Kohler Co., *supra* note 244, at 821.
311 SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968).

be sufficient? In direct dealing cases, the insider can determine the fullness of disclosure to the person with whom he deals and may elect not to disclose generally. In public market cases, the court in *Green v. Charterhouse*[312] was urged to adopt the standards in *TGS* where the court stated:

> "The release of a news release...is merely the first step in the process of dissemination required for compliance with the regulatory objective of providing all investors with an equal opportunity to make informed investment judgments. Assuming that the contents of the official [corporate] release could instantaneously be acted upon, at the minimum [the insider] should have waited until the news could reasonably have been expected to appear over the media of widest circulation, the Dow Jones broad tape, rather than hastening to insure an advantage to himself and his broker son-in-law."[313]

And further by way of *dictum*:

> "[W]here the news is a sort which is not readily translatable into investment action, insiders may not take advantage of their advance opportunity to evaluate the information by acting immediately upon dissemination."[314]

No Canadian court has been required to establish the standard of disclosure which would absolve insiders, but again, the results can be anticipated.

The plaintiff's obligation to inform himself is less clear. The CBCA, by referring to what the plaintiff could have known with reasonable diligence may have set a higher standard for the plaintiff than the Canada Act's reference to what ought to have been known. Ontario Bill 30 maintains the basic test of the plaintiff's knowledge of the Canada Act but permits the insider "reasonable grounds" for belief of general disclosure. Regardless of the language, the plaintiff appears to have a duty to be informed but whether he must take extensive steps toward diligent inquiry remains to be seen.[315]

As a general rule in Rule 10b-5 actions, a plaintiff's actual knowledge of undisclosed information will bar recovery. It is an unusual non-disclosure case which will permit recovery if the plaintiff is well informed.[316] The same general rules apply in

312 Green v. Charterhouse Group Canada Ltd., *supra* note 111, 12 O.R. (2d) at 309 (C.A.), [1973] 2 O.R. at 731 (H.C.).

313 SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 854 (2d Cir. 1968).

314 *Id.*

315 *See*, *Anisman* at 253; Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 106, (10th Cir. 1971).

316 *See e.g.* Texas Continental Life Ins. Co. v. Dunne, 307 F.2d 242, 247 (6th Cir. 1962).

misrepresentation cases where the plaintiff who is not misled will not likely recover.[317] But, for example, in derivative actions where the insider controls the plaintiff's behaviour, the corporation's actual knowledge is not critical.[318] The Canadian provisions should follow the U.S. example in cases of actual knowledge.

U.S. courts have been divided, however, in cases where the plaintiff has constructive knowledge of confidential information. It is these cases, where the exercise of due diligence by the plaintiff may have caused different results, that may be highly relevant for Canadian purposes. In the circuits where the courts have imposed a low scienter standard for the insider, a high standard of plaintiff's diligence has been required.[319] But in those circuits where scienter of the insider has been more critical, the plaintiffs have been permitted a lower standard of diligence in their inquiries.[320] And the impact of *Ernst & Ernst v. Hochfelder* may apply to vary.[321] This dichotomy on the question of constructive knowledge may trace the differences in wording between the Canada Act and the CBCA but, in any case, there is no conclusive rule which could be presented for Canadian purposes.

The equity barring recovery for plaintiffs who have not been affected by non-disclosure or misrepresentation can be lost if the rules to give effect to that give rise to a lower duty of the insider to disclose or a burdensome duty of diligence in the market. There can be little adverse effect on the insider's duty if the insider's defence is limited to cases of actual knowledge of the plaintiff. But the risk is that the market would be urged not to consider the insider's disclosures in open market cases. For cases where the insider deals directly with the complainant, the plaintiff's actual knowledge is an appropriate measure for this defence. In these cases, where reliance is material, the insider has the option and is encouraged to make detailed disclosure and to record this in agreements if he is unsure. In open market cases, actual knowledge and constructive knowledge of broadly disclosed public information should support an insider's defence. In this way, the insider is induced to either disclose or not trade and the standard imposed on market actors is to keep abreast of the information available in the market.

The remaining issue as to how much disclosure should be sufficient in open market cases is easily resolved. In addition to

317 *See e.g.* Gilbert v. Nixon, 429 F.2d 348, 355 (10th Cir. 1970).
318 *See e.g.* Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968).
319 *See generally* 2 A. BROMBERG, *supra* note 174, at 204, 248.
320 *Id.*
321 Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

examples of timely disclosure as are offered for issuers,[322] an insider should disclose to the regulatory agency, stock exchanges and to the press in accordance with precedents.[323] A reasonable time for dissemination should be required. However, rules must be flexible since interlisted securities traded across Canada will raise clearly different questions than a locally traded over-the-counter issue. The theory must be to equalize bargaining to the extent reasonably possible.

10. *Measure of Damages*

The Canada Act and the CBCA provide that the insider should compensate for "any direct loss suffered" and is accountable to the corporation "for any direct benefit or advantage received or receivable". Ontario Bill 30 would provide compensation "for damages as a result of the trade" and the insider would be accountable "for any benefit or advantage"; however, a formula for the measure of damages is provided.[324] The issues raised by these provisions extend beyond customary valuation questions in the absence of judicial interpretation.

It is difficult to quantify "direct loss".[325] There is no guidance as to whether the loss is to be determined following an assumption that the investor would have obtained the best price for the security in the intervening period, or on the basis that an improvident transaction with an insider was at a better price than could have been expected absent the insider's activities. All that can be readily determined when an insider buys is that the vendor decided to sell at the same time and that a different decision may have been made by the investor were he to have had the insider's knowledge. What cannot be determined is what the investor would have actually done. If the insider sold to an investor, it is clear that the buyer had an interest in purchasing but, again, it is debatable what the buyer would have actually done with different information. Would the investor elect against the transaction or merely postpone his activities and, if he postponed, for how long? There is room for significant speculation as to the measure of "direct loss".[326]

An accounting of the insider's benefit may be more straight-

322 *See e.g.* TORONTO STOCK EXCHANGE, MEMBERS MANUAL G1-1 (1971); *see also* Uniform Act Policy No. 2-12, *supra* note 83; Ontario Securities Commission Policy 3-23, *supra* note 83.

323 *See generally* 3 A. BROMBERG, *supra* note 174 ¶ 12.10.

324 Ontario Bill 30, s. 133(5).

325 *See, Anisman* at 243.

326 *See e.g. dictum* of the Court of Appeal in Green v. Charterhouse Group Canada Ltd., *supra* note 111, 12 O.R. 2d, at 313.

forward but it is hardly free from doubt. If the insider bought with the benefit of confidential information but has not yet sold, how will benefit be calculated? As the insider is still holding the securities, he must expect further appreciation in value but, when allegations are made, is the insider deemed to have sold, to have achieved optimum benefit during the period, or to be the subject of another standard? The supposition that the insider's benefit has run its course is as difficult when the insider sells to avoid a loss. The insider can be seen as having a benefit at any one of a number of subsequent prices. The measure of benefit is also susceptible to a number of interpretations.[327]

Ontario Bill 30 refers to "damages" and, to assist in the measure of them, subsection 133(5) provides that the price be compared to the sixty-day period following the transaction. This is a most constructive development in that a precise measure which the insider can take into account before he trades is provided. In addition, the test is somewhat more responsive to questions of causation than a measure formulated from "direct loss...as a result of the transaction". However, this measure is somewhat arbitrary in that "damages" are not always referable to a sixty-day price formula[328] and there is no account for the fact that litigation by many traders could have a draconian impact on the insider – indeed, far in excess of the insider's profit.

The wording of these provisions can be given weight in face-to-face transactions. In cases where there is privity, the expression "direct loss" lends itself to the interpretation that either a rescission or restitution theory of recovery is contemplated. Similarly, while "damages as a result of the trade" can be taken to include a theory of expectation interest limited by foreseeability, the formula to measure damages places the plaintiff in virtually the same position. "Direct benefit" or "any benefit" can be quantified. To the extent that there is a public market for the securities in question, evidence of securities prices and fluctuations during

327 Interestingly enough, Ontario Bill 30, s. 133(5), does not apply to s. 133(3), the provision of accountability to the corporation. In any case, *quaere* whether an insider receives any credit for damages paid to purchasers or sellers when the accounting is made for derivative recovery.

328 Although this is partially a question of semantics, the word "damages" is inappropriate. Ontario Bill 30, s. 133(5), sets a precise penal and compensation measure whereas use of the word damages presupposes that a court would consider classical contract or tort theories before reaching a conclusion. For example, consider the case of insider trades motivated by what is disclosed on the 1st to 30th days and a second price rise occurring on the 45th to 60th days referrable to new information which the insider did not use; the insider's liability is increased notwithstanding that he did not "make use" of the new information and the "damages" of the purchaser for insider trading are not referrable to such information.

specific time periods would be persuasive.[329] While there is risk of some imprecision,[330] the purpose and intent of the provisions should give rise to credible conclusions in private transactions.

The principal difficulties with the measure of damages as contemplated are in open market transactions. Here, in addition to the question of causation for purposes of measuring the "direct loss" and the possibility that matching of transactions may be required, there is the problem of timing. Is "direct loss" the same as "damages" having regard to the sixty-day average price or fluctuation in price that will be considered during, up to or some time after the transaction with the insider and the disclosure of the price-sensitive information?[331] In any case, if matching is not required, there is the possibility of unlimited liability of the insider as the direct losses and damages of many traders absent privity may be well in excess of the insider's profit and his financial worth. The conflicts within the provisions are further magnified by the fact that the benefit of the insider is simultaneously recoverable by the corporation. As the courts seek out an equitable solution, it may well demonstrate that these provisions are unworkable in open market cases with many plaintiffs.

In the United States with the experience of Rule 10b-5 cases similar problems are apparent. It may still be said that:

> "Few 10b-5 cases have reached the relief stage, so there is [relatively speaking] little law to report. Since far more decisions have gone for plaintiffs on the existence of a cause of action, the settlement proportion has been high but the terms have gone unpublished."[332]

The rules for measuring damages are developing and there are attendant theoretical difficulties.

In cases where there are few plaintiffs, the following rules have developed. Buyers from insiders have recovered damages on the basis that they receive back their purchase price.[333] This equivalent of court ordered rescission is without account for expectations or speculative profit. Sellers have recovered on the basis of an accounting of the insider's profit on resale, whether or not it is contemporaneous, and more recently on the basis of the difference between the amounts received and what the court determines to have been the actual value on the date of sale had the price-

329 *See*, *Anisman* at 245 for attempt at resolution.

330 *Id.*

331 *Quaere* whether a court interpreting the Canada Act or CBCA provisions will be persuaded by the Ontario Bill 30 formula if the latter is enacted.

332 3 A. Bromberg, *supra* note 174, at 225.

333 *See e.g.* Stevens v. Vowell, 343 F.2d 374 (10th Cir. 1965); Royal Air Properties Inc. v.

sensitive information been properly disclosed.[334] Where there are no special considerations of many pending actions, the courts can and have treated damages as they would in simple tort or contract cases and the existence of and behaviour of securities in the public market constitute additional empirical data.

Where there are many actual or potential plaintiffs, there are obviously different considerations. The leading example of what can be done is *TGS* where the court[335] ordered the insiders to pay into a fund the difference between their purchase prices of shares and the mean average price of those shares on the date of full disclosure of the price-sensitive information to the public. The amount was to be held in escrow pending claims against it by the SEC, interested persons (such as sellers during the period) and the court. The court proposed to decide on individual recoveries and the balance of the fund would accrue to the company. This accounting might not be sufficient for all of the claims and expenses that could be satisfied in the case. However, this novel approach of the court underscores the different considerations where a large impersonal market is involved.

The U.S. example is useful for Canadian purposes but does not offer a complete solution. Canadian courts, to the extent it is necessary, will probably be persuaded by the U.S. authorities in cases where there is privity or where few claimants are involved. For the broader market cases, the results are unpredictable. In the former case, the court would be measuring damages on a basis consistent with the wording of the section and the causation test that are implicit. For the latter example, the court will not likely compensate for all "direct loss" or "damages" if that would cause too gross an impact on the insider and the court may, by relying on causation, privity or reliance, settle different rules. The *TGS* example does not follow from Canadian legislation and therefore the U.S. experience is helpful but hardly conclusive.

The concept of double liability whereby the insider may also be required to account to the company further complicates the area. This provision, which is somewhat unique to Canada,[336] is less than clear. For example, if plaintiffs have recovered direct losses

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Smith, 343 F.2d 374 (9th Cir. 1962); Royal Air Properties Inc. v. Smith (No. 2), 333 F.2d 568 (9th Cir. 1964).

334 *See e.g.* Janigan v. Taylor, 344 F.2d 781 (1st Cir. 1965); *see also* Affiliated Ute Citizens of Utah v. United States, *supra* note 267; Rochez Bros. Inc. v. Rhoades, 491 F.2d 402 (3d Cir. 1974): *see also, Anisman* at 243 for additional examples including comparable Canadian authorities.

335 446 F.2d 1301 (2d Cir. 1971); *see also* SEC v. Shapiro, 494 F.2d 1301 (2d Cir. 1974).

336 *See e.g.* 3 L. Loss at 1473; 6 L. Loss at 3646; SEC v. Texas Gulf Sulphur Co., *supra* note 335.

or damages, the insider may have no profits left or receivable as a result of the transactions which the company could recover.[337] And there may be an anomaly based on which insider liability action came first. Equally important, if the insider is liable to the company and personal plaintiffs follow, the court will be tempted to avoid undue harshness on the insider. It is apparent that double liability is intended but the practical applications cannot be accurately anticipated.

The measure of damages is an area where compromise should be sought. The small current risk of unlimited liability of the insider would be heightened significantly if causation concepts are removed from the legislation. At the same time, there are persuasive arguments that the insider should account for his benefits and compensate affected parties. The compromise that should appear in the legislation must make priorities within these considerations. While the insider commits an offence in the market when he abuses his position, the foundation for his liability is the abuse of position; the offence is the abuse and compensation is the punishment. Liability for this offence should be limited to a strict accounting of the insider's profit since insider liability should not be conceived as a broad insurance scheme for the market. Similarly, liability in excess of the insider's profit is a harsh sanction since a return of profits attended with adverse publicity and tax consequences should be sufficient. Individuals who seek compensation and the company should divide the insider's profit and, while it would be unusual for there to be adequate compensation for all, there would be at least a gesture of restitution in public market cases and almost full rescission in private transactions. This suggested solution would indicate that a plaintiff's cost at not proving causation and other elements of the offence would be that full tort or contract recovery may not be available.

How would profit be measured? If the insider resells or repurchases, he quantifies liability for primary consideration purposes. However, this would not account for the possibility that the insider has been a less than capable judge of the market or for the likelihood that an insider may taint the company's securities by virtue of his activities.[338] The court should be given the flexibility to determine the actual value of the securities at the time of the transaction and the insider's profit should be the court's determi-

337 *See e.g.* J. WILLIAMSON, SUPP. at 362; F. IACOBUCCI, M. PILKINGTON & J. PRITCHARD, *supra* note 6, at 359; D. JOHNSTON at 309.

338 While it may be argued that, ultimately, an action against insiders may promote the integrity of those same insiders, the immediate impact of insider activity should be suspicion of the company's securities generally.

nation of the difference between actual value and the insider's price.[339] With the conceded benefit of hindsight, the court can find the impact of the price-sensitive information and it will have the appropriate records of trading. The risk that such use of hindsight may impute advantage to the insider in excess of his actual profit should appropriately be the insider's. In effect, the insider's profit should be an exercise in effecting rescission.

11. *Limitation Period*

The Canada Act and the CBCA provide that an action to enforce insider liabilities may be commenced only within two years from the date of the completion of the transaction giving rise to the cause of action or, if the transaction should have been reported in insider reports, within two years from the time of reporting in compliance with the reporting obligations.[340] Ontario Bill 30, in section 137, has provided a fixed three years from the date of the transaction that gave rise to the liability. There is no guidance as to the interpretation of a number of considerations raised by these limitations.

Assuming that the insider is involved in a number of transactions, from what date is the two- or three-year limitation period calculated? In order for an insider to accumulate a significant number of securities, "the" transaction could, as a practical matter, be a number of transactions taking place over a number of weeks or months. In cases involving multiple transactions, "the" transaction may not be the clearest indication.[341] Similarly, "the" transaction which gives rise to "direct loss" would be different for various plaintiffs and there are procedural considerations which would have to be taken into account.[342] The description of the limitation periods in the statutory provisions could have been more clearly stated.

The more important consideration raised by the limitation period is the treatment of the transactions which should have been reported. The section contemplates that if the transaction is required to be reported, it would have been reported in compliance with the legislative provision. However, if the transaction is not

339 *See e.g.* ALI Federal Securities Code, Tent. Draft No. 2, s. 1402(f)(2)(B) (1973).

340 Canada Act, s. 100.4(2); CBCA, s. 125(6); *see*, *Anisman* at 265; D. Johnston at 309.

341 As a matter of statutory interpretation, the singular would include the plural; *quaere*, how a sale by a plaintiff two years and six months preceding the date of action will be treated if the last of the insider's trading took place 18 months before the action is bought by the plaintiff.

342 For example, can the hypothetical plaintiff referred to *id.* be sheltered by a later action? It is submitted that the limitation period does not properly address the open market cases.

reported, does this mean that no limitation period applies? On the other hand, if the transaction is reported late, which would not be in compliance with the legislation, or not reported at all, does the limitation period run from the time that the report should have been filed or, in the case of a late report, from the date of the filing of the late report? In such cases, an insider who is concerned about his liability may be advised not to file his insider reports and run the risk of prosecution for failure to file since several available interpretations might operate to his favour. The limitation period is suspect and therefore undesirable.

The earlier version of Ontario Bill 30 highlighted the peculiar problem with limitation periods for insider trading. In Ontario Bill 75,[343] an action had to be commenced "only within one year after the date knowledge of the facts that gave rise to the action first came to the attention of the plaintiff or reasonably ought to have come to his attention". As essential features to insider trading involve use of secret information and masking identity of the trader, it is usually difficult to determine when an insider has traded and, therefore, when a cause of action has accrued. This becomes especially difficult when the category of persons who may be liable as insiders is broadened to include people who need not report their transactions. The policy of including a limitation period is justifiable but the risk of making the limitation period "reasonable" or permitting it to commence from the time the insider traded is that it would be difficult if not impossible to determine that a cause of action existed within the time prescribed. For this reason, the limitation period must be framed with reference to availability of information for purposes of an insider liabilities action.

The limitation period set forth in insider trading provisions should be varied with a view to clarity and in a manner which is sympathetic to how insider trading takes place. In cases where the insider is subject to the reporting requirements, a limitation period of two years should apply from the later of the last transaction constituting improper insider trading or first disclosure of the price-sensitive information. The aggrieved party would within that time know that the insider traded at a time that confidential information was not disclosed. For cases where the insider need not report his transactions, a limitation period of three years should apply from the date of first public disclosure of confidential information. The addition of one year to the limitation period is purely arbitrary with the only justification for the additional time

343 Bill 75, The Securities Act, 1974, Ontario, 29th Legis., 4th Sess. (First Reading, June 7, 1974).

being that in such cases it would take a prospective plaintiff somewhat longer to determine that improper insider trading has taken place. The remaining possibility, that of an insider who should have reported but did not, should be treated as a case where the insider did not need to report in that a three-year limitation period from the date the confidential information was first made public should apply. The solution for this last case is again arbitrary so that some limitation period will apply and, for the insider who chooses to run the risk of not reporting, he will be subject to a longer limitation period and the risk of prosecution for failure to file reports. Finally, the court should be left with some flexibility in that, if the insider makes efforts to deliberately conceal his transactions, an appropriate remedy should be extended.

12. *Additional Considerations in Bringing an Action*

The dearth of reported cases pursuant to the insider liability provisions indicates that there are a number of considerations against bringing insider liability actions. Since insider liabilities are closely tied to private enforcement, these considerations are of paramount importance.

In the preceding sections, the legal questions of proof facing a plaintiff were discussed. It is apparent that unless the plaintiff was victimized in a face-to-face transaction, there are significant questions arising from the lack of clarity in the wording of the sections and, more important, the plaintiff's burden of proof in respect of causation and the possible inference that proof of privity, scienter and reliance will be required. While the purpose and intent of the liability provisions are determinable, a plaintiff would be concerned as to the nature and amount of his damages and, most important, whether he must match his transactions in order to prove damages at all. A plaintiff in Canada at present has little guidance on what he must prove to succeed and what he will recover if he does.

A more immediate consideration for a prospective plaintiff is the considerable cost of maintaining an action. Since contingency fees are not permitted in most Canadian jurisdictions, a plaintiff bears the cost of all preliminary investigations and of pursuing his action. If he finds that he does not have a cause of action after investigation, he forfeits those costs. If the plaintiff proposes to maintain a "borderline" action, he risks being liable for the costs of the insider defending such a lawsuit if it proves to be unsuccessful. These initial costs for a dubious return underline why very few plaintiffs will have a significant enough investment to even consider bringing an action. The prospective plaintiff should have a

substantial interest in the securities of the company before it is economically worthwhile to bring an action and it may be argued that the only potential plaintiffs with such a significant enough stake are shareholders who have enough influence to obtain confidential information on their own or financial institutions which may be receiving favoured treatment in any event. It may be seen that, while the liabilities may be technically very broad, the initial costs dramatically discourage enforcement to the point that an insider's risk of a lawsuit is minimal and the legislation may very well be unenforceable. The adage that a shareholder who does not agree with management policies sells his securities rather than fight management has a special relevance in the insider trading area.

These concerns of private enforcement must remain to some extent. Proposals for legislative change can give effect to clarifying the liabilities provisions, reducing legal barriers to successful action and promoting access to information. The section of this paper which follows should also be some consolation in that the legislative provisions will not rely exclusively on private enforcement for remedial impact. However, whether contingency fees or other inducements should be given to plaintiffs in insider trading actions is quite a separate question. In view of the mixed experience in the United States,[344] such inducements are not suggested herein. However, with experience in the new legislation, this issue should be reconsidered.

13. *Role of the Regulatory Agency*

Section 100.5 of the Canada Act provides that a person who was a shareholder at the time the insider's transaction took place or the Minister of Consumer and Corporate Affairs may apply to the court for an order and, if the court is satisfied, that the company has a cause of action for recovery of the insider's profits or that the company has failed to prosecute its claim diligently, the court may order the Director of the Corporations Branch to commence or continue an action for and on behalf of the company. This provision differs slightly from those contained in provincial securities statutes[345] which provide for the same remedial action but not for ministerial application. The CBCA provides that the Director is a "complainant"[346] with the result that he is entitled to invoke the remedies provided in the CBCA. Similar provisions are sug-

344 *See e.g.* KIMBER REPORT, ¶ 2.28; 2 L. Loss at 1053.
345 *See e.g.* Ontario Act, s. 114.
346 CBCA, ss. 125(5)(b), 231, 232.

gested in Ontario Bill 30, albeit with some clarification as to at whose expense the action will be brought and with the addition of the OSC as a complainant.[347] This regulatory agency-assisted derivative action is an interesting supplement to private enforcement.

Experience has shown this to be a less than exciting dimension to the regulation. Apart from the suspicions that were raised by commentators respecting the provincial provisions[348] and the concerns where the Minister and Director have been inactive, the one order made pursuant to section 114 of the Ontario Act in the *Multiple Access* case[349] was disappointing. The court's determination that the applicants would be required to pay costs of the company and of the OSC if the action on the merits was unsuccessful has the effect of making these agency-assisted derivative suits highly unlikely at the provincial level and perhaps generally. The exceptions for cases where there is absolute certainty or where the applicant's proportionate share in derivative recovery is an inducement remain. The theory of the agency's assistance to private plaintiffs is lost if the assisted party bears the risk of costs.

The attempt at clarification in Ontario Bill 30 and the addition of the OSC as a potential complainant may be constructive. The new provisions require a securityholder at the time of the transaction in question or the OSC to apply to the High Court which, if satisfied that there are reasonable grounds for action and the reporting issuer has either failed to commence an action after notice or to diligently prosecute one that was commenced, may order the OSC to proceed on behalf of the issuer. If the court is satisfied that the action is *prima facie* in the best interests of the company, the court may order that the company pay the costs. It is debatable whether the OSC's posture in the prosecution of insider trading cases will be materially changed. The OSC has had other remedies where there has been insider trading, such as conducting an investigation and hearing for the purpose of denying the exemption to trade, which have been used sparingly in the past.[350] Authority for the court to require the issuer to pay costs is in the statute currently (since the issuer was nominally the plaintiff) and the new provision may cause the issuer to pay costs even if it wins the action. In effect, there is no change and Ontario Bill 30 is merely directory as to interpretation.

The justifications for participation of the regulatory agency

347 Ontario Bill 30, s. 134.

348 *See*, J. WILLIAMSON, SUPP. at 364; W. PAINTER, *supra* note 51, at 372; *see also* D. JOHNSTON at 308.

349 *In re* Multiple Access Ltd., *supra* note 137.

350 Indeed, Connor, *supra* note 139, is the only significant example.

in civil enforcement are readily apparent. The private plaintiff's considerations of cost compared to his proportionate share of recovery, his risks both from uncertainty in the law generally and of meeting particular burdens of proof and the complexities of such lawsuits where information may be scarce are all much less relevant considerations for a regulatory agency. With comparatively greater access to information and, in any case, stronger investigative powers, a regulatory agency is the most credible complainant in such cases.[351] As a result, it can be said that the courts may yet give effect to the potential remedial impact of such provisions, and Ontario Bill 30, by clarifying the issue of costs and the specific addition of the regulatory agency as a complainant, may represent the appropriate response for immediate purposes.

It should be noted, however, that such a role for the regulatory agency is subject to significant limitations. Assistance of the agency on this derivative basis is only slightly responsive to the compensatory considerations with insider trading since recovery by the corporation does not mean the shareholder will receive any immediate benefit, either by way of distribution from the issuer or in the share price, and the remedy merely underlines the insider's accountability for profits. Sellers to insiders receive no benefit. While recovery by the corporation may offer subsequent evidence for private actions, questions of measure of damages and the limitation period may arise.[352] The disgorging of profits by the insider satisfies, to some extent, the penal considerations of insider trading but, if the agency's sole remedy is to seek repayment of the profits, that is a limited penal sanction in the final analysis. The involvement of the regulatory agency in this way should be seen as a first step to the agency's participation in the area.

Ontario Bill 30 contemplates a measure of criminal liability for insider trading.[353] Such provisions depart somewhat from the previous emphasis in the legislation whereby private compensation was the principal remedial feature of the regulation of insider trading. There is less reliance on the fact that insider trading must cause a sufficient loss before the remedial provisions are invoked and on the supposition that cases where private compensation will be sought will mirror instances of insider abuse meriting public concern. Imposition of criminal liability irrespective of compensation confirms that there are cases which should be prosecuted in the public interest, whether or not there is economic harm, and on the basis that general abuse should be curbed regardless of specific

351 In fact, if the insiders have secured shareholder ratification of their activities or the company has not suffered damage, it may be the only remedy; *see*, *Anisman* at 264.

352 *See* text at ch. III, sections c. 10, c. 11, *supra*.

353 *See* Ontario Bill 30, s. 77; *see also* British Columbia Securities Act, s. 111.

impacts. Furthermore, if the offence is characterized as more than a statutory tort, there is a more realistic basis for other relief, such as injunction, that could be sought by the regulatory agency. Criminal liability, with a corresponding prosecutorial role for the regulatory agency, is consistent with the public nature of the abuse of insider trading and follows the experience in other jurisdictions.

The role of the regulatory agency with insider trading liabilities should, therefore, be extensive. In the first instance, the agency should be permitted strong involvement on behalf of the company since, for many cases, this will involve a reasonable penal sanction, and some assistance for compensatory considerations and evidence for purposes of contemporaneous or subsequent private actions. Criminal prosecutions or injunctive relief should be available for gross cases of abuse or where economic loss is not readily apparent as this will furnish the sanction of adverse publicity and a further evidentiary base for subsequent civil actions. The final area where the regulatory agency should be involved is the provision in legislation for class actions by the agency. In addition to bringing action on behalf of the company, the agency should be permitted to bring action on behalf of all traders during the period the insider trading took place.[354] This final remedy satisfies penal and accountability considerations, *i.e.*, the economic sanction of disgorged profits and the compensatory considerations of proportionate recovery. These powers of the agency are complementary and the public sponsorship of such remedies is warranted by the experience.[355]

D. RELATED AREAS FOR CONSIDERATION

1. *Continuous Disclosure*

Implicit in the regulation of insider trading is that there be means and procedures for disclosure of material confidential information. It is not suggested that insiders be prohibited from trading but only that, when they trade, they do so within prescribed rules. Under the Canada Act and the CBCA, there are no express avenues provided for adequate public disclosure to the market and, as the statutes are corporations law, this may be justifiable. Under provincial securities law, there is provision pur-

354 For an example of the difficulties encountered with private class actions; *see* Farnham v. Fingold, *supra* note 136.

355 *E.g.* consider TGS in the absence of such remedies.

suant to policy statements for timely disclosure.[356] However, in statutes where the focus is disclosure on the distributions of securities and the regulation of industry personnel, such regulation by policy statement is less than desirable. For companies whose securities are listed on stock exchanges, the listing agreement and resulting rules that apply require timely disclosure and a procedure is provided;[357] this is not a substitute that is equitable for the insider seeking to comply with legal standards. At present, there is an incomplete system for the timely disclosure of material confidential information.

In the *Grover & Baillie* paper in this volume, disclosure is considered in greater detail. Similarly, initiatives as outlined in Ontario Bill 30 are constructive for purposes of establishing a more complete system for disclosure. However, it is expected that any expansion of duties and liabilities of insiders would be complemented by broader continuing disclosure obligations. Questions as to what is or might be disclosed by the issuer should not be overlooked.

2. *Takeover Bids*

Although there is detailed regulation of takeover bids in the Canada Act, the CBCA and provincial securities legislation,[358] the event of a takeover bid raises additional insider trading questions. In both the Canada Act and the CBCA, there are provisions responsive to some of the peculiarities in that, in both statutes, a person becoming an insider is deemed to have been an insider for the preceding six months and, in the CBCA, the definition of insider would embrace several of the interested parties in a takeover bid.[359] But, if the insider trading sections are meant to regulate transactions in circumstances of a takeover bid, the regulation is incomplete. The insider trading provisions have limited impact on "warehousing"[360] or, for that matter, on the takeover bidder if the information is not received from the corporation.[361] It must be decided whether insider trading liabilities are meant as a primary regulatory tool in the control of

356 *See* note 328 *supra*.

357 *Id.*

358 Comprehensive treatment of this subject is presented in P. ANISMAN.

359 *See, Anisman* at 267.

360 JUSTICE, *supra* note 105, at 10, defines warehousing as "a situation in which a number of parties act in undisclosed concert...each acquiring an interest in the equity of the company...thus enabling one or more of them to acquire by stealth a dominant position in that company". Essentially, "warehousing" avoids insider reporting and, in current provincial statutes and the Canada Act, insider trading liability; *see also* P. ANISMAN at 115-44.

361 *See* P. ANISMAN at 267 for a good discussion of CBCA impact.

takeover bids or whether such liabilities will merely be complementary.

To the extent that takeover bids raise special considerations, it is submitted that such considerations are somewhat alien to insider trading and should be treated separately. Regulatory considerations applicable to takeover bids have been well documented[362] but most if not all of the special considerations involve information which is not corporate sourced, *i.e.*, the fact that a bid will be made and the acquisition of shares pursuant to the bid. Such information, while clearly material and confidential, should not give rise to insider liabilities which are, to a great extent, founded on accountability for position. There is no immediate fiduciary relationship between a takeover bidder and the target company nor between the takeover bidder and the target company's shareholders so that the regulation of takeover bids is more directly a matter of market regulation than the regulation of insider trading. For these reasons, the regulation of takeover bids should be a consideration in the framing of insider trading liabilities where corporate-sourced information is at issue but, in cases where the material confidential information emanates from other than a corporate source, regulation should not be founded on theories of insider trading.

3. *Corporate Repurchases*

Recent amendments to corporations law permitting companies to purchase their own common shares[363] have heralded several recent efforts by companies to buy such shares in the open market. A company's decision to buy such shares may be motivated by such altruistic motives as the decision of management that the company's own shares are a good long-term corporate investment or that shares in the open market are cheaper for purposes of satisfying obligations in stock option and stock purchase plans than would be treasury shares. Reasons that such activities are suspect include that corporate repurchases may operate to confer an inordinate benefit on controlling shareholders to the exclusion of those who sell, provide artificial short-term price support for shares in the market, change control relationships in the company which may be material, sympathize with maintenance of current management in control of the company or show the shares are grossly undervalued in view of information which has not been disclosed. While each of the statutes permitting

362 *See* P. ANISMAN, *passim.*
363 *See e.g.* CBCA, s. 32.

companies to buy back their common shares provides that the company is an insider of itself,[364] there remains the question of whether this is sufficient regulation.

The arguments which would support the recent provisions requiring additional disclosure in the regulations pursuant to the CBCA and in the policy statements under the Ontario Securities Act are persuasive.[365] As corporate repurchases are often "exempt offers" and are treated otherwise than as takeover bids,[366] it should be argued that additional disclosures to the market are required. However, whether such additional disclosure should be part of insider trading regulation is quite a separate issue. If the company repurchasing its shares fails to disclose its activities in advance, it assumes the same risks as would any other insider in the acquisition of shares. If a higher duty is required of corporations buying their shares, such a duty does not emanate from the accountability of insiders but rather as a dimension of general market regulation.

4. *Other Conflicts of Interest*

There are a number of other situations which are often colloquially referred to as "insider trading ". The mutual fund manager who buys securities knowing that the mutual fund is contemplating a similar acquisition and the investment manager at a financial institution engaging in similar activities are two immediate examples. The more difficult case is the executive of a mining company who, knowing the pricing policies of his company, deals extensively in the commodity or the securities of a competitor thereby avoiding dealing in securities of the company. Many examples involving "market information" would fall into a similar category. All of the cases demonstrate dealing by someone who is considered an "insider" but, neither by definition in the statute or from the supporting theories for the regulation of insider trading are such activities regulated. It may be suggested that insider trading liabilities be extended to apply to such conflict-of-interest cases.[367]

While there may be merit in the extension of insider trading controls to cover conflicts of interest among corporate directors

364 *See e.g.* CBCA, s. 125(1)(b).

365 *See e.g.* CBCA, s. 187 "takeover bid".

366 For example, since shares purchased by a company become non-voting, a corporate repurchase would not be a "takeover bid" as defined by the Ontario Act, s. 81(g); *see* Ontario Securities Act, s. 81(b) for examples of expressly "exempt offers".

367 Indeed, a logical extension of the provisions of Ontario Bill 30 would regulate much of this type of behaviour; *see* discussion of "materiality" in ch. III, section c. 6 *supra.*

and officers generally, there would probably be too many attendant difficulties. At present, regulation of insider trading is conceived to provide codification of a standard of behaviour, information for purposes of enforcement and a relatively simple remedy. Whether the same should apply or could be reasonably extended to conflicts of interest generally is quite a different issue. With insider trading, the fiduciary duties of the insider meld with the fact that a public market for the issuer's securities imposes higher standards of care. Cases of conflict of interest not involving the immediate market for the company's securities should give rise to different considerations which, in any case, may not deviate from fiduciary responsibilities in the general corporations law. It would require significant additional analysis before one could impose liability of a mutual fund manager to the securities market or on a mining company executive to the commodities market and, for immediate purposes, it is submitted that such liability should not be imposed pursuant to regulation of insider trading.

Chapter IV
Role for Federal Regulation

A. INTRODUCTION

The proposition that additional federal regulation of insider trading would be desirable is debatable. Quite clearly, any new initiatives would be duplicative of existing and, in any event, proposed provincial laws. Similarly, there is the slight risk of conflict of any federal position with provincial standards. The fact that the Atlantic provinces do not regulate insider trading does not appear to be a significant enough justification for federal intervention in a vacant area in view of the smaller market and potential for abuse as well as the significant likelihood that questionable dealings would take place in a jurisdiction such as Ontario or Québec where the benefits of legislative controls would be extended. While each of these potential concerns can be satisfied, there is no startling benefit which would accrue from more federal regulation of insider trading in Canada and which could not be accomplished by amendments to existing federal regulation and by the provinces.

The arguments to support federal securities regulation generally apply equally to the area of insider trading. To highlight some of them, a stronger sanction from the federal criminal law power and wider based enforcement may be anticipated, many of the jurisdictional questions raised by interprovincial trading would be answered, a federal regulatory system could be less costly

over the longer term with a fully integrated and strongly sponsored regulatory system, etc. Incidence of abusive insider trading may underscore the weaknesses in a system of securities regulation.[368] But, insider trading itself does not appear to be a significant enough abuse to warrant address from national regulation. Indeed, regulation of the subject is complementary to general securities regulation and the aim of promoting fair dealing in the market.

The regulation of insider trading does emphasize some conceptual problems, inasmuch as there may be an inherent conflict of securities regulation and the corporations law.[369] The *Multiple Access* case,[370] in which provincial regulation of insider trading in the securities of federal companies was struck down, demonstrates the fine line between regulation of this behaviour in the corporations law and at the same time in the securities law when both the federal government and the provinces have authority to regulate the areas. The conceptual problems become more acute when it is remembered that primary regulation of the relationship between a company, its directors and officers and its shareholders is contained in the corporations law and regulation of the market in securities law may involve different considerations. For example, if shareholders ratify the non-disclosure and insider trading, which could be a corporations law method of absolving directors in a conflict case, should an insider remain accountable?[371] Resolution of these fundamental issues in justification of federal securities regulation generally will be responsive to any peculiar question raised by insider trading. But there will remain, nonetheless, the potential for conflicting theories and goals to militate against consistent and effective regulation.

It may be anticipated that additional regulation of insider trading will not be welcomed or popular and more laws to govern already extensively regulated behaviour may not be justifiable. There are limits on how far it is possible to regulate business morality and any such attempt may be futile. Arguments to indicate that the regulation of insider trading is inefficient from the economic point of view should not be ignored entirely.[372] Although most observers would concede the desirability of regulating insid-

368 *See e.g.* COMPANY LAW ADVISORY COMMITTEE, FOURTH INTERIM REPORT TO THE STANDING COMMITTEE OF ATTORNEYS-GENERAL ON MISUSE OF CONFIDENTIAL INFORMATION, DEALINGS IN OPTIONS, DISCLOSURE BY DIRECTORS (Australia 1970).

369 *See e.g.* W. PAINTER, *supra* note 51, ch. VIII.

370 *In re* Multiple Access Ltd., *supra* note 137.

371 *See e.g. Anisman* at 267; in the U.S. consider as examples O'Neill v. Maytag, 339 F.2d 764 (2d Cir. 1964); Ruckle v. Roto American Corp., 339 F.2d 24 (2d Cir. 1964).

372 *See e.g.*, W. PAINTER, *supra* note 51, ch. XI for a summary of arguments.

er trading, the commitment of additional resources to satisfy what may be viewed as technical shortcomings is questionable.

B. RECOMMENDATIONS AND CONCLUSIONS

While the arguments and observations which would indicate that additional federal regulation of insider trading would be undesirable are persuasive, there is justification for federal initiatives in the area. From a historical viewpoint, the regulation of insider trading has developed from individual fiduciary standards to legislative controls on the basis that the setting of a public market justifies broader regulation. It is a logical extension that as the market becomes and is national in scope, the legislative controls and capabilities of local regulation, albeit with extensive cooperation, become less credible. For example, the OSC's investigation of the insiders of a Nova Scotia based company[373] may be justified by the terms of the Ontario Securities Act. However, if the issuer, most of the insiders and the traders are located outside the enforcing province, such regulation can be viewed as an unwarranted intrusion into another province's jurisdiction as well as a questionable commitment of the first province's resources. Since any one province should be committed to regulation primarily within its boundaries, federal regulation is the more desirable method to approach problems where no single province may have the political or logical justification to do so.

Much of the reluctance that would attend new federal initiatives to regulate insider trading stems from a presumption that this would be additional regulation instead of substituted standards. The regulation of insider trading is an ideal subject for federal controls – virtually to the exclusion of provincial initiatives. While additional federal law in the area could be duplicative, may give rise to conflicts and only identify an unregulated problem in few provinces, the attraction of one federal standard which would replace the duplication and conflict which already exists with seven regulatory codes is strong. The inherent conflict of corporations and securities laws would be minimized with one regulatory code since it would not be the effort of one province regulating the internal workings of an entity created by another but a federal umbrella over all such entities carrying on business in Canada. There may be considerable acceptance and popularity of a single legislative standard which operates to replace significant amounts of similar laws and offers the possibility of economically efficient administration. The real justification for and role of

373 Re Harold P. Connor, *supra* note 139.

federal intervention in this area at present is the expectation that the most pragmatic solution has been chosen.

Recommendations to the effect that there should be federal regulation of insider trading and securities trading generally are neither novel nor do they hold the prospect of immediate implementation. It must be conceded that the provinces have made progress in curbing abuses and that their administrators constitute the most experienced personnel to enforce such laws. Insofar as federal regulation must rely on and work from the provincial experience, it is imperative that any implementation of the proposals herein be undertaken following consultation, both as to feasibility and transition, with provincial administrators. It may be that there is a continuing justification for provincial regulation, *i.e.*, with purely local issuers and in closely-held companies, and the division of authority should be clearly stated. It is hoped that further study and negotiation will lead to a more comprehensive and acceptable regulatory environment.

Canadian Financial Institutions

J. Peter Williamson

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Chapter I
Introduction

The transfer of savings from individuals and nonfinancial businesses to the users of capital that include governments, individuals and business is heavily dependent on financial institutions. Chapter I presents a brief and largely statistical picture of financial institutions in Canada.

Chapter II is concerned with the Canadian securities industry. Securities firms are unlike the institutions described in chapter I, which generally accept investment funds from a clientele and then reinvest the funds in stocks, bonds, mortgages and so forth. The securities firms act as agents in bringing buyers and sellers of investment securities together and as dealers, buying and selling securities for their own accounts. Chapter II describes the securities industry, its self-regulatory organizations, and the activities of its members. It goes on to describe competition in the industry, sources and adequacy of capital for securities firms, and foreign ownership of Canadian firms.

Chapter III deals with the commission rates of Canadian stockbrokers, and the economics of the brokerage business. The

The author is grateful for critical reviews of portions of this paper by Professor Calvin C. Potter of Concordia University and wishes to acknowledge the help of his Research Assistant, Paula Eberhardt, in the preparation of this paper.

United States experience in unfixing commission rates is discussed first, and is followed by a review of the Canadian position.

Chapter IV considers the role of banks and trust companies in the securities markets, and compares the U.S. and Canadian situations. In both countries there is disagreement and uncertainty about locating a line of demarcation between activities reserved for the securities industry and those open to banks and trust companies.

Chapter V discusses the roles of institutions and independent individual investors in the stock market. The trend in recent years has been toward increased institutionalization and has led to concern over the quality of securities markets and possible concentration of economic power in institutions.

The principal types of Canadian financial institutions are listed in table 1. The chartered banks are the largest by far. Trust companies, including assets held in trust, are about half the size of the banks. Life insurance companies and trusteed pension plans are about tied in third place and credit unions are fourth. All the others are much smaller.

Table 2 shows the securities holdings of these institutions. Information is not complete, especially for the chartered banks which do not disclose their holdings of corporate stocks. Pension funds, life insurance companies and mutual funds account for almost all of the institutional holdings of stocks, apart from common stock holdings in trust accounts of trust companies (see table 3). Corporate bonds are held principally by life insurance companies, pension funds, banks, provincial and municipal governments, and other insurance companies.

A. CHARTERED BANKS

In Canada the term "bank" refers only to institutions chartered under the federal Bank Act. Table 1 shows banks to be the dominant financial institution in Canada. Table 4 lists the major chartered banks and it is clear that five banks dominate the group.

The Canadian banking system is unusual in its very high degree of concentration and in the large branch networks of the dominant banks. These large branch networks are significant for the purposes of this paper because they could form the vehicle for providing throughout the country a variety of financial services beyond traditional commercial banking. The five major banks operate more than 6,500 branches in all provinces of Canada. At the same time, the existence of this branch system poses a constant competitive threat to financial institutions other than banks. The brokerage and investment dealer industry, in particular, has

Table 1
Total Assets of Canadian Financial Institutions

As of December 31, 1974–76
In millions of dollars

	1974	1975	1976
Chartered banks	87,458	100,380	116,843
Québec savings banks	884	971	1,118
Trust companies (including guaranteed funds)	12,442	14,604	18,335
Assets in trust	28,384	32,332	
Mortgage loan companies	6,743	8,017	9,332
Local credit unions and caisses populaires	10,315	12,791	14,987
Central credit unions	1,920	2,602	2,937[a]
Sales finance and consumer loan companies	9,461	10,336	11,141
Leasing companies	643	806	1,055
Life insurance companies (assets in Canada)	20,540	23,834	
Other insurance companies	4,823	5,556	6,679
Investment dealers	3,459	3,673	4,700
Mortgage investment trust corporations	832	1,052	1,267
Mutual funds	2,368	2,769	2,874
Closed-end funds	801	921	694
Trusteed pension funds			
Industrial	9,223	10,583	25,234 (Industrial and Other combined)
Other	8,861	10,379	
Total	209,157	241,606	

a. Third quarter.
Sources: *Bank of Canada Review;* Statistics Canada, *Financial Institutions*, various issues.

Table 2
Securities Holdings of Canadian Financial Institutions

As of December 31, 1976
In millions of dollars

	Canadian government securities	Provincial and municipal securities
Chartered banks	8,526	1,135
Québec savings banks	32	170
Trust and mortgage loan companies	578	541
Central credit unions and caisses populaires[a]	150	982
Local credit unions and caisses populaires	33	563
Sales finance and consumer loan companies	12	5
Life insurance companies	612	1,825
Other insurance companies	772	1,432
Mutual funds	48	47
Closed-end funds	4	5
Trusteed pension funds		
Industrial	202	941
Other	203	5,246
Provincial and municipal governments	416	4,545
Investment dealers	564	275
Non-residents	1,074	15,155
Residual	1,593[b]	3,857
Total	14,819	36,724

Corporate bonds and debentures	Mortgage loans	Commercial paper	Preferred and common stocks	Foreign securities
2,675	8,681		?	510
52	603			
519	20,718	285	489	37
89	43	305	21	
76	6,649	2	26	
14	890	35	2	
5,447	9,117	5,041	1,950	443
1,409	197		892	128
141	632	64	1,169	486
20		3	371	22
2,348	1,346		3,298	484
1,191	1,124		1,302	242
1,549				
84		1,011	17	19
7,235				
3,060				
25,909	50,000	6,746	9,537	2,371

a. Third quarter.
b. Excludes $15,835 Canada Savings Bonds and $8,621 held by the Bank of Canada and Government Accounts.
Sources: *Bank of Canada Review;* Statistics Canada, *Financial Institutions,* various issues.

Table 3
Securities Holdings of Trust Company Trust Accounts

As of December 31, 1975
In millions of dollars

Bonds	Mortgage loans	Stocks
12,563	4,868	12,104

Source: *Report of the Ontario Registrar of Trust and Loan Companies for 1975.*

Table 4
Total Assets of Canadian Chartered Banks[a]: Outstanding Debentures and Shareholders' Equity

As of October 31, 1974–77
In millions of dollars

	Assets				Out-standing deben-tures 1976	Share-holders' equity 1976
	1974	1975	1976	1977[b]		
The Royal Bank of Canada	21,669	25,211	28,831	35,671	270	731
Canadian Imperial Bank of Commerce	18,946	22,259	26,104	32,782	225	640
Bank of Montreal	17,651	18,243	20,492	25,908	240	541
The Bank of Nova Scotia	13,462	16,006	18,181	22,113	166	606
The Toronto-Dominion Bank	11,857	13,577	16,192	19,467	166	491
Bank Canadian National	4,126	4,872	5,675	6,837	60	132
The Provincial Bank of Canada	2,739	3,059	3,624	4,366	35	81
The Mercantile Bank of Canada	699	1,288	1,708	2,014		62
The Montreal City and District Savings Bank	873	969	1,124	1,232[c]		
Bank of British Columbia	503	625	844	1,144	8	23
Total	92,525	106,109	122,775		1,170	3,307

a. Includes Québec savings bank.
b. As of December 31.
c. As of October 31.
Sources: Annual reports of banks listed.

reason to be fearful of an expansion of the chartered banks into broker-related services.

Of the banks listed in table 4, the first five operate across the country. The Bank Canadian National and The Provincial Bank of Canada limit themselves essentially to the province of Québec. The Bank of British Columbia operates in British Columbia. The Mercantile Bank of Canada, at one time a subsidiary of First National City Bank of New York, specializes in corporate finance in major financial centres.

Foreign currency assets and liabilities of the banks have been growing much faster than Canadian dollar assets and liabilities over the past decade or so. In 1964 foreign currency assets amounted to 21.7% of total assets for the banks and by 1974 this ratio had risen to 29.5%. The Royal Bank of Canada has consistently had the largest foreign currency assets in recent years, with The Bank of Nova Scotia and the Bank of Montreal vying for second place. In recent years, particularly after the imposition of Canadian voluntary capital outflow guidelines in 1968, the percentage of foreign currency assets and liabilities booked outside Canada has increased substantially. In 1976, for the five largest banks, revenue from international activity as a percent of total revenue ranged from 21% (Canadian Imperial Bank of Commerce) to 35% (Bank of Nova Scotia).

The ownership of the chartered banks is somewhat restricted by statute. No single institution or affiliated group of institutions is permitted to own more than 10% of a chartered bank. Aggregate foreign ownership may not amount to more than 25% of a bank. It is not always clear, of course, because of nominee holdings, just who are the ultimate beneficial owners of shares in a bank.

The Bank of Nova Scotia reported that at the end of 1976, 45% of its outstanding shares were held by institutions or corporations, 20% were held by 400 Canadian pension funds, 10% by 75 mutual funds, 7% by 30 Canadian insurance companies, 7% by 130 corporations, and 1% by charitable, educational and religious groups. It did not indicate what percentage might be held by trust company accounts.

In recent years the banks have turned to debentures as well as common stock in raising permanent capital. Table 4 also shows debentures outstanding and shareholders' equity. All but two of the banks were making use of debentures and aggregate outstanding debentures were about one third of shareholders' equity. There are no limits on institutional or foreign ownership of bank debentures and a number of debenture offerings have been made in foreign securities markets.

Financial disclosure by the chartered banks is very limited.

Table 5
Assets of Trust and Loan Companies in Canada

As of December 31, 1975
In thousands of dollars

Trust companies	Company assets	Guaranteed trust funds	Assets of estates, trusts and agencies
Provincial (Ontario) Corporations			
Crown Trust	12,729	229,994	643,614
District Trust	5,445	83,960	16,626
Dominion Trust	1,385	5,365	—
Federal Trust	7,241	110,720	25,093
Hamilton Trust & Savings	11,194	146,903	88,811
Industrial Mortgage & Trust	7,320	—	5,253
Lambton Trust	535	—	14,665
Lincoln Trust & Savings	10,036	156,649	37,143
Metropolitan Trust	19,936	267,949	546,210
National Trust	74,122	1,090,302	3,146,579
Ontario Trust	14,024	227,174	7,733
United Trust	22,463	206,147	68,211
Vanguard Trust of Canada	1,066	—	631
Victoria & Grey Trust	59,771	1,123,684	147,549
	247,267	3,648,847	4,748,118
Other Corporations			
Bankers' Trust	1,076	—	36,545
Canada Permanent Trust*	98,263	1,357,872	2,407,591
Canada Trust*	99,739	1,364,994	3,225,625
City Savings & Trust	19,404	258,312	35,731
Continental Trust*	1,194	—	26,550
Co-operative Trust of Canada*	16,774	234,740	166,046
Eaton Trust*	1,181	14,533	156,690
Equitable Trust*	1,388	16,903	18,988
Farmers & Merchants Trust	16,357	237,060	46,914
Fidelity Trust*	9,144	84,157	215,262
Fort Garry Trust	6,014	60,966	27,379
General Trust of Canada	23,884	336,089	1,438,361
Guaranty Trust of Canada*	60,526	1,025,427	712,677
Income Trust*	2,529	24,024	3,581
International Trust	6,882	62,002	670,495
Investors Group Trust	2,294	—	584,560
Montreal Trust	44,251	714,616	5,450,774
Morguard Trust*	3,075	23,864	608,082
Nelcon Trust*	3,750	6,247	804
Premier Trust*	8,238	64,063	6,919
Royal Trust	139,217	2,759,900	11,390,630
Savings & Investment Trust	4,459	63,979	253,137
Standard Trust*	4,753	81,353	53,160
Sterling Trusts*	8,846	150,486	46,885
	583,238	8,941,587	27,583,386
Total -- 1975	830,505	12,590,434	32,331,504
Comparative figure for 1974	691,899	10,730,558	28,384,003

Loan Companies	Total assets
Provincial (Ontario) Corporations	
Canadian First Mortgage	26,607
Canborough	34,148
Lambton Loan & Investment	117,664
Landmark Savings & Loan	26,538
Municipal Savings & Loan	69,846
Nipissing Mortgage	986
Tordom	361,705
Traders Mortgage	559
	638,053
Other Corporations	
Arteco Mortgage Investment*	20,528
James T. Barnes Mortgage Loan	581
BNS Mortgage*	88,330
Canada Permanent Mortgage*	1,384,182
Crédit-Foncier Franco-Canadien	791,402
Eastern Canada Savings & Loan*	412,493
Fidelity Mortgage & Savings*	68,495
Fidmor Mortgage Investors*	5,923
General Mortgage of Canada*	39,563
Greymac Mortgage*	1,612
Huron & Erie Mortgage*	1,268,067
International Savings & Mortgage*	51,476
Kinross Mortgage*	538,366
Montreal Trust Mortgage	2,764
Morguard Mortgage Investment*	29,114
Nova Scotia Savings & Loan*	288,174
Royal Trust Mortgage	255,068
Roymor	519,811
Seel Mortgage Investment*	6,016
	5,771,965
Total – 1975	6,410,018
Comparative figure for 1974	5,356,927

*Federal Company.
Source: *Report of the Ontario Registrar of Trust and Loan Companies for 1975.*

Table 6
Assets of Trust and Loan Companies Not Doing Business in Ontario

In thousands of dollars

Trust companies	Company assets	Guaranteed trust funds	Assets of estates, trusts and agencies
Federal trust companies			
Commercial Trust (Qué.)	732		209,815
Pioneer Trust (Sask.)	1,934	8,959	1,403
Nova Scotia and Manitoba companies			
Acadia Trust (N.S.)	1,196	327	11,504
Atlantic Trust (N.S.)	1,346	21,467	7,031
Inland Trust & Savings (Man.)	2,722	48,981	3,786
Interior Trust (Man.)	582		
North Canadian Trust (Man.)	210		1,025
Regent Trust (Man.)	484		2,340
Total	9,206	79,734	236,904

Loan companies	Total assets
Federal loan companies	
Bomont Mortgage Investment	632
Evangeline Savings & Mortgage	21,417
Graiville Savings & Mortgage	5,224
James T. Barnes Mortgage Loan	581
League Savings & Mortgage	12,228
Settlers Savings & Mortgage	4,704
Nova Scotia company	
Yarmouth Building & Loan Society (N.S.)	316
Total	45,102

Annual reports contain only simplified and condensed balance sheets and operating statements. Disclosure of bank securities portfolio holdings might be of considerable interest. The Financial Post reported that for the first seven months of 1977 banks took up one third of the estimated $6.61 billion of Canadian corporate financing (not including conventional bank loans);[1] banks were also said to have taken up 14% of corporate equity financing.

B. QUÉBEC SAVINGS BANKS

The Montreal City and District Savings Bank is the only Québec savings bank and has been since the disappearance of the Banque d'Économie de Québec in a merger in 1969 with Les Caisses populaires Desjardins. At that time the Montreal City and District became legally entitled to operate beyond Montréal, throughout the province of Québec. Despite its federal charter, however, it may not operate beyond that province. It has about one hundred branches in the Montréal area.

With assets of more than $1 billion, the Montreal City and District ranks after the eight largest chartered banks. At the end of 1976 the bank had almost 60% of its assets invested in mortgage loans. Personal loans stood at about 12% of mortgage loans but were rising fast. The bank is not permitted to make commercial loans. Trust activities are not allowed either but the bank owns a trust company, the Montreal City and District Trustees Ltd., which had estate, trust and agency accounts of $111 million, guaranteed deposits and certificates of $63 million and company assets of $68 million at October 31, 1976.

C. TRUST AND LOAN COMPANIES

There are at least forty-six trust companies and thirty-five loan companies in Canada. These numbers are the totals of the trust companies and loan companies licensed to do business in Ontario, federal companies not doing business in Ontario, and Nova Scotia and Manitoba companies examined by the federal Superintendent of Insurance and not doing business in Ontario. There are fourteen trust companies incorporated in Ontario and seventeen federally incorporated; and there are eight loan companies incorporated in Ontario and twenty federally incorporated.

Table 5 lists the loan and trust companies doing business in Ontario and filing reports with the Ontario Registrar. Table 6

1 *Are Banks Poaching in Corporate Finance?* The Financial Post (Toronto), October 1, 1977, at 35.

adds the federally incorporated and Nova Scotia and Manitoba companies not doing business in Ontario.

Table 5 shows assets of the trust companies. First are assets owned by the trust companies. Second are assets labeled "guaranteed trust funds" which are assets under the control of the companies but segregated as security for the guaranteed certificates issued by these companies. Unlike the chartered banks or banks and trust companies in the United States, the Canadian trust companies do not issue certificates in the form of ordinary unsecured obligations of the company. They issue "guaranteed trust certificates" and segregate the proceeds of these certificates. Finally, the third class includes assets of estates, trusts and agencies administered by the trust companies. In Canada the chartered banks are forbidden to act as trustees and trust companies operate the entire trust business.

In terms of company assets and guaranteed trust funds, the Royal Trust Company is twice the size of the second largest, and Royal Trust together with the next five companies in size clearly dominate the industry. In terms of trust assets, Royal Trust is again twice the size of the second largest and six companies (but not the same six) dominate the industry.

Of the loan companies, two clearly stand out in size. These are the Canada Permanent Mortgage Corporation and The Huron & Erie Mortgage Corporation.

D. CREDIT UNIONS

Credit unions (and caisses populaires, in Manitoba and Québec) constitute an important financial institution in at least six provinces. All are organized under provincial statutes. Table 7 shows total assets and memberships by province. Primarily savings institutions, with assets consisting chiefly of loans including mortgage loans, credit unions have begun to operate as full service financial institutions. In British Columbia provincial and municipal deposits in credit unions averaged $50 million over the last half of 1976. The B.C. Central Credit Union League reported in 1976 plans to borrow $20 million to $80 million in 1977 through a debenture issue. Credit unions offer chequing accounts, and credit union cheque clearings have recently accounted for about 20% of all cheque clearings in Alberta, British Columbia and Manitoba and 40% in Saskatchewan.

Credit unions have banking and trust company affiliations. In Québec credit unions own 25% of The Provincial Bank of Canada. Western Canadian credit unions organized their own chartered bank in 1976 – the Northland Bank – which operates in Manitoba,

Alberta and Saskatchewan. Co-operative Trust is a federally incorporated trust company, owned entirely by credit unions and cooperatives. Unlike Northland Bank, which is a wholesale institution, Co-operative Trust does a general trust company business in all provinces except Québec.

The provincial associations are owned by their locals, accept deposits from the locals, and make loans to the locals. They function essentially as a central bank for the locals, although they engage at times in quite different activities as we shall see. The federal association, the Canadian Co-operative Credit Society Ltd., which was formed in 1973, serves as a central bank for the provincial associations and in 1978 announced plans to raise funds in the Canadian and international capital markets. Table 8 shows assets and membership of the credit union industry in Canada overall, and the Québec portion of the industry.

There is also a National Association of Canadian Credit Unions which is not itself a financial institution but which serves as a trade association. At the end of 1975 its membership included about 2,500 credit unions with over $7 billion in assets.

Credit unions in Québec numbered approximately 1600 at the end of 1976 – the largest number in any province. Table 8 shows the six central credit unions in Québec to which the locals belong. These credit unions are generally known as "caisses populaires" and the members of the largest central are known as "Caisses Desjardins" after Alphonse Desjardins who established the first caisse populaire at Lévis in 1900, and who persuaded the Québec legislature to adopt a credit union statute in 1906. Other than members of the Québec Credit Union League, the Québec credit unions do not belong to the Canadian Co-operative Credit Society.

The bulk of credit union assets consists of loans. The Caisses d'entraides économique are unique in making local business loans rather than residential mortgage loans. Only the Saskatchewan and Québec locals own significant amounts of common stock. The Québec centrals also hold common stock and not always for purely investment purposes. In March 1977 the president of the Fédération de Québec des Caisses populaires Desjardins (the dominant central, as table 8 shows) disclosed that his central had purchased 228,000 shares of The Montreal City and District Savings Bank (11.4% of the outstanding shares) on the initiative of The Provincial Bank of Canada and with the intention of selling them to Provincial Bank so that the latter could bring about a merger with Montreal City and District. (The caisses own about 25% of Provincial Bank.) Provincial Bank itself had apparently purchased another 200,000 shares (10% of shares outstanding and the maximum permissible holding by one person). The sale, and merger, did not

Table 7
Credit Union Statistics[a]

1975 and 1976
In millions of dollars

	Number of credit unions		Number of members	
	1975	1976	1975	1976
British Columbia	178	176	595,000	668,089
Alberta	200	191	285,000	316,345
Saskatchewan	247	245	426,000	456,381
Manitoba	194	191	292,000	314,000
Ontario	1,260	1,208	1,600,000	1,650,000
Québec	1,583	1,610	3,975,000	4,262,000
Nova Scotia	126	127	134,000	150,000
New Brunswick	146	138	143,000	178,671
Prince Edward Island	13	13	18,000	18,095
Newfoundland	24	14	7,100	7,806
Yukon and Northwest Territories	4	5	2,850	3,100
Total	3,975	3,918	7,477,950	8,024,487

Savings		Loans		Assets	
1975	1976	1975	1976	1975	1976
$ 1,409	$ 1,868	$ 1,280	$ 1,667	$ 1,550	$ 2,034
490	658	431	580	550	730
860	1,392	791	992	1,341	1,553
578	692	481	594	637	943
2,100	2,300	1,550	1,900	2,200	2,700
5,942	7,060	3,780	4,843	6,310	7,516
112	133	99	121	122	150
119	159	106	142	132	174
12	13	14	16	17	19
6	9	5	9	6	10
4	4	5	4	5	4
11,632	14,288	8,542	10,868	12,870	15,833

a. Includes Caisses Populaires.
Source: *The Credit Union Financial System in British Columbia*, published by the B.C. Central Credit Union League Ltd., May 1977.

Table 8
Credit Unions in Canada

Assets as of fiscal year end, 1976
In millions of dollars

	Assets of national and provincial bodies	Number of members	Assets of members
Members of the Canadian Co-operative Credit Society Ltd.			
Canadian Co-operative Credit Society Ltd.	$ 54		
B.C. Central Credit Union League Ltd.	367	176	$2,035
Credit Union Federation of Alberta Ltd.	99	191	730
Co-operative Credit Society of Manitoba Ltd.	111	162[a]	713
Brunswick Credit Union Federation Ltd.	2	138	174
Newfoundland Co-operative Services Ltd.	0.085[b]	16	10
Nova Scotia Credit Union League Ltd.	33	127	150
Ontario Credit Union League Ltd.	246	1,081	2,400
P.E.I. Credit Union League Ltd.		13	19
Quebec Credit Union League Ltd.	15	89	124
Saskatchewan Co-operative Credit Society Ltd.	386	245	1,553
Northwest Territories Credit Union Central		4	2
Whitehorse Credit Union League Ltd.		1	2
Québec[c]			
Fédération de Québec des Caisses populaires Desjardins	25	1,245	6,278
Fédération de Montréal des Caisses Desjardins	56	34	475
Fédération de Caisses d'économie du Québec	46	138	222
Quebec Credit Union League Ltd.	15	89	124
Fédération des Caisses d'établissement du Québec	3[b]	12	77[b]
Fédération de caisses d'entraide économique du Québec	30	55	428[d]

a. About 30 caisses populaires, with assets of $70 million, belong to Centrale des Caisses populaires du Manitoba, with assets of $11 million.

b. As of March 31, 1977.

c. As of December 31, 1976.

d. As of May 1977.

take place. Montreal City and District was able to enlist the support of investors who purchased 30% of the outstanding shares and were prepared to block a merger.

The Canadian government *White Paper on Banking Legislation* proposed in 1976 that credit union holdings of the stock in a chartered bank or Québec savings bank be limited so that the combined holdings of a central, federation or regional unit and its associated credit unions or caisses populaires would not exceed 25%. The Senate Banking, Trade and Commerce Committee recommended a 10% limitation.[2]

E. LIFE INSURANCE COMPANIES

In 1975 there were 166 life insurance companies doing business in Canada, of which 83 were Canadian companies, 65 were U.S. companies, 9 were British and 9 were European. Of the 166, 25 were registered under provincial law and 141 under federal law. The latter accounted for 94% of total life insurance in force. Assets of the federally registered companies were $24,095 million at the end of 1975.

In Ontario in 1975 there were 128 life insurance companies, 6 companies writing both life and casualty insurance, and 38 fraternal societies, all but one of which write life insurance.

In recent years life insurance companies have taken on the management of segregated funds, chiefly pension funds. In this business they compete with trust companies, brokers, and investment counselling and management firms and it is here that growth prospects for life insurance companies seem chiefly to lie.

Table 2 gives a breakdown of the investments by major categories of Canadian life insurance companies. More detailed information is not publicly available. The companies all supply annual lists of all of their investments and of their investment transactions to the superintendents of insurance, but these listings are kept confidential. Some information came to light in the submission to the Royal Commission on Corporate Concentration in 1976 by the Canadian Life Insurance Association. The submission noted the legal limitations on investments of life insurance companies, in particular the prohibition against a Canadian life insurance company investing in more than 30% of the common stock of any one corporation. The submission stated that "a survey of member companies reveals that an individual company owned 10% to 30%

2 *Standing Senate Committee on Banking, Trade and Commerce, Twelfth and Final Proceedings on the White Paper on Canadian Banking Legislation, Report of the Committee,* issue No. 44, at 44:74-44:75 (June 28, 1977).

of a Canadian corporation's common stock at the end of 1974 in twenty-seven cases. Nine were real estate corporations and only eight of all the corporations were listed on a Canadian stock exchange. The twenty-seven cases were spread among fifteen life insurance companies."[3]

F. MUTUAL FUNDS

There are two kinds of investment companies. The so-called "closed-end" funds raise money by offering shares to the public just as any corporation does, and invest that money in a portfolio of securities. The shares of the funds themselves are traded as are shares in any corporation and may even be listed on a stock exchange. The "open-end" funds, or mutual funds, likewise raise money from the public and invest the money in a portfolio of securities. But unlike the closed-end funds, the mutual funds are continuously offering new shares to the public and redeeming shares from shareholders who wish to withdraw their money. There may be a small trading market for mutual fund shares but most individuals buy new shares from a fund when they wish to invest in it and return their shares for redemption when they wish to sell out. The price at which new shares are sold and old shares redeemed is established by the net asset value per share of the fund which is just the net asset value of the entire fund divided by the number of shares outstanding. There may in addition be a sales charge or a redemption charge on the purchase or redemption.

A large number of Canadian mutual funds representing the majority of fund assets are members of The Investment Funds Institute of Canada. Table 9 gives a breakdown of the membership, by size. As of March 30, 1977, the number of member funds stood at seventy-five, with total assets of $1,836 million. There were one hundred non-member funds with total assets of $1,269.1 million. Total assets for the industry were $3,105.7 million.

The bulk of the portfolio assets of the mutual funds consists of stocks and bonds. A few funds, however, specialize in short-term securities. And four members of the Investment Funds Institute specialize in mortgages. The largest of these, Investors Mortgage Fund, had assets of $132.3 million at the end of 1976. The three others had aggregate assets of $22.9 million.

3 Canadian Life Insurance Association, Submission to the Royal Commission on Corporate Concentration (1976), at 19.

Table 9
Investment Companies: Assets and Number of Members of The Investment Funds Institute of Canada

As of December 31, 1976
In millions of dollars

	Number of funds	Total assets
Over $200 million	2	$ 430
$100–199 million	4	512
$50–99 million	2	148.9
$25–49 million	6	209.6
$10–24 million	21	344.8
$5–9 million	15	107.9
$1–4 million	19	53.6
Under $1 million	5	2.9
Total	74	1,809.7

Source: The Investment Funds Institute of Canada.

G. PENSION FUNDS

As of 1970 about 2.8 million Canadian workers were members of over 16,000 pension plans. As table 2 shows, the assets of trusteed pension funds were worth about $18 billion at the end of 1976. Over half the assets – $9.3 billion – were held by government funds, and the balance by private industry funds. The Canada Pension Plan with $9.4 billion in assets, and the Québec Pension Plan with $4 billion, bring total pension fund assets in Canada to over $30 billion.

Private pension funds are significant buyers of Canadian equities. Government funds own a substantial number of equities but are much more heavily invested in bonds, particularly provincial and municipal bonds. The use of public pension funds to finance local government needs is a feature of Canadian and American capital markets.

1. *Canada Pension Plan*

The Canada Pension Plan began operations in January 1966. All Canadian employees are required to contribute 1.8% of contributory earnings which in 1976 meant earnings over $800, up to and including $8,300. Employers are required to make a matching contribution and the self-employed are required to contribute 3.6% of contributory earnings.

A rather small portion of the fund's assets representing working capital is invested in Canadian government securities. The remainder is loaned to the provinces with each province receiving the contributions originating in that province. The loans take the form of twenty-year nonnegotiable bonds bearing interest at the average market yield of twenty-year Government of Canada bonds at the time of issue. (The bonds are, however, callable before maturity to meet benefit payments.) Table 10 shows investment of the funds from 1966 through 1976. The investments in Québec bonds are small because these amounts relate only to federal employees resident in Québec. (Other employees in Québec do not contribute to the Canada Pension Plan; they contribute instead to the Québec Pension Plan.) The interest income for 1976 was about 7.1% of the average balance of the fund during the year.

An interesting review of the investment policy of the Canada Pension Plan, with recommendations for change, was published in 1975.[4] The Advisory Committee of the Canada Pension Plan noted

4 ADVISORY COMMITTEE OF THE CANADA PENSION PLAN, THE RATE OF RETURN ON THE INVESTMENT FUND OF THE CANADA PENSION PLAN (June 1975).

that the plan represented 19.5% of all Canadian personal savings in the five years ended March 31, 1974, and had been a big factor in overall Canadian economic expansion.[5] It considered the possibility of a managed portfolio (as in the case of the Québec Pension Plan, described below), but concluded that automatic loans to the provinces were appropriate. However, the advisory committee recommended an interest charge based on provincial bond rates.[6]

2. *Québec Pension Plan*

The investment operation of the Québec Pension Plan is very different from that of the Canada Pension Plan. The Québec plan is administered by the Régie des rentes de Québec which remits the plan's collections to the Caisse de dépôt for investment.

The Québec Pension Plan began at the same time as the Canada Pension Plan and its assets were $4 billion at the end of 1976. The Caisse de dépôt was established in 1965 to invest funds from a number of government units in Québec. Total assets of the caisse at the end of 1976 were $5.3 billion, of which the Québec Pension Plan accounted for 75%. Workmen's compensation, government employee retirement funds, and construction industry pension funds accounted for another 21%.

The Caisse de dépôt has been highly regarded as a government agency relatively free of political interference and investing in corporate equities as well as corporate and government bonds, much as a private investment company might. As of the end of 1977 the holdings of its "general fund", which is essentially the Québec Pension Fund, were as shown in table 11.

Segregated funds consisted of $478.0 million in bonds, $221.3 million in stocks, $225.0 million in mortgages, and $98.3 million in short-term investments.

H. CONCLUSIONS AND POLICY IMPLICATIONS

Institutional interest in corporate common stocks is a matter of great importance to the Canadian economy. As we shall see in chapter V, individuals have been withdrawing from the stock market in recent years with institutions taking their place. If equity capital is to be available to Canadian industry in future years, it is crucial that institutions be willing and able to furnish it.

Encouraging institutional acquisition of equities, of course,

5 *Id.* at 8.
6 *Id.* at 25.

Table 10
Canada Pension Plan Investment Funds: Investments by Province

Fiscal years 1965–66 to 1975–76
In millions of dollars

	Securities of or guaranteed by					
	Nfld.	P.E.I.	N.S.	N.B.	Qué.	Ont.
1965–66	0.7	0.1	1.2	1.0	—	20.1
1966–67	11.0	1.9	21.4	16.7	0.4	332.6
1967–68	12.0	2.3	25.2	19.3	1.9	375.9
1968–69	14.2	2.9	29.2	21.8	2.4	412.0
1969–70	15.6	3.2	31.6	24.2	3.1	445.8
1970–71	16.8	3.5	34.0	25.8	5.1	476.0
1971–72	17.6	3.6	35.7	26.8	6.6	498.3
1972–73	19.0	3.8	38.6	28.8	8.0	536.4
1973–74	21.7	4.3	43.8	32.8	8.1	606.6
1974–75	25.8	5.3	50.9	38.3	7.9	701.8
1975–76	29.4	6.0	57.3	43.2	8.0	784.1
Total	183.8	36.9	369.0	278.7	51.5	5,189.6

Man.	Sask.	Alta.	B.C.	Canada	Total	Cumulative total
2.1	1.4	3.1	5.0	0.1	34.8	34.8
34.9	24.5	51.1	84.4	1.8	580.7	615.5
39.4	29.7	59.2	96.6	3.8	665.3	1,280.8
42.3	35.9	68.4	107.5	5.6	742.2	2,023.0
47.7	40.4	77.1	117.2	4.1	810.0	2,833.0
51.5	42.9	82.3	125.1	5.4	868.4	3,701.4
53.7	42.7	87.1	131.2	6.5	909.8	4,611.2
57.4	43.2	94.6	141.5	7.1	978.4	5,589.6
64.5	47.8	108.7	161.7	7.9	1,107.9	6,697.5
74.5	55.6	126.6	189.1	9.1	1,284.9	7,982.4
83.4	62.6	143.4	213.9	10.2	1,441.5	9,423.9
551.3	426.7	901.6	1,373.3	61.7	9,423.9	

Source: *Canada Pension Plan, Report for the year ending March 31, 1976*, at 32.

Table 11
Caisse de dépôt General Fund

Assets at market value as of December 1977 In millions of dollars	
Bonds	
Government of Canada	80.5
Government of Québec	2,453.9
Guaranteed by provincial grants	150.9
Municipal and school	292.4
Corporate	438.5
	3,416.2
Equities	671.3
Mortgages	257.4
Real estate	25.4
Short-term	326.9
Total	4,697.2

Source: Caisse de dépôt et placement du Québec.

involves far more than securities regulation. Tax policy and statutory limitations on holdings of institutions are important. So is the relative role of private and public pension plans.[7] There is a growing fear in both Canada and the United States that public pension plans may discourage private saving that is needed for economic growth. Defenders of the Canada Pension Plan would argue, of course, that it finances necessary public sector benefits and reduces the competition for capital between the provinces and the private sector. The Québec Pension Plan perhaps stands as the best example of a government plan that is channeling savings directly into productive private sector investment, although equity investments are less than 15% of the plan's assets.

Within the jurisdiction of a regulatory commission, however, there are also some policy implications. Regulation that makes institutional acquisition of equities difficult or expensive may be harmful to the economy. The use of "exempt purchaser" status to avoid expensive disclosure formalities may be helpful. Decisions on brokers' commission rates, particularly with respect to discrimination in the rate structure between individual and institutional customers, should take into consideration the importance of institutions as stock buyers. The tendency is always to deplore the exit of individual investors from the stock market, and to approve rate structures that will lure them back. The result, unfortunately, may be simply to discourage both individuals and institutions. The same issue arises in connection with possible limitations on institutional ownership and trading of common stocks and again in connection with the provision of market-making services which may be aimed at either institutions or individuals.

To the extent that a regulatory commission or a regulatory statute may affect the securities-related activities of financial institutions, the potential value of the branch network of the larger chartered banks should not be ignored. It may well be that many of the needs of investors could be more efficiently served through bank branches than through the securities industry. In a few provinces credit unions offer the same opportunity. Although the credit unions are not organized as multiple branches of a single organization, the very large groups of local credit unions belonging to the same central credit union offer a potential very similar to that of the bank branch networks.

Finally, a regulatory commission is presented with two policy questions involving disclosure. Should the financial institutions

7 A particularly critical issue is whether private pensions are to be indexed and if so, what effect this might have on pension fund investment in equities. *See* J.

(apart from mutual funds) continue to be free of significant disclosure requirements when they raise capital from the public? And considering the substantial concentration of security holdings in these institutions, should there be some disclosure of institutional holdings, trading and other portfolio practices? This latter question is particularly difficult to answer in view of the need, referred to above, to encourage institutional stock ownership. It is a question we shall come back to in chapter IV.

Chapter II
The Canadian Securities Industry

It is difficult to assemble a complete picture of the securities industry in Canada. Statistics have been compiled at various times, in 1970 by the Moore Committee – which studied the requirements and sources of capital and the implications of nonresident capital for the industry (see note 31) – and in 1975 by Professors D. Shaw and R. Archibald for their study for the Toronto Stock Exchange, but even these either dealt with only a part of the industry or relied a good deal on guesswork.

A. REGISTERED PARTICIPANTS

A list of categories of registrants with the Ontario Securities Commission (OSC) (table 12), as of May 30, 1977, gives an idea of the variety of participants in the Canadian securities industry:

A "broker" is defined in the regulations under the Ontario Securities Act as a member of the Toronto Stock Exchange (TSE), and acts exclusively as an agent. The nine registered brokers carried on no securities trading other than on the exchange, although at least four were closely affiliated with investment dealers. In total, seventy-one firms were registered as members of the TSE, including firms performing more than a broker function.

An "investment dealer" is defined as a member of the Investment Dealers Association of Canada (IDA) and may trade as agent or as dealer. Investment dealers handle most of the bond business in Canada, as well as underwriting industrial equities. There were sixty-one registered investment dealers of which forty-nine were also members of the TSE.

A "broker-dealer" is defined as a member of the Broker-Dealers' Association of Ontario and may trade as a broker or dealer. These firms are not members of IDA, although one in the

PESANDO & S. REA, JR., PUBLIC AND PRIVATE PENSIONS IN CANADA (1977) (especially ch. 4 and app. A.).

Table 12
Various Registrants with the Ontario Securities Commission

As of May 30, 1977

Category	Number registered
Broker (member TSE)	9
Investment dealer (member IDA)	12
Broker-dealer (member BDA)	12
Broker and investment dealer (TSE and IDA)	49
Broker and broker-dealer (TSE and BDA)	1
Broker and securities dealer	12
Securities dealer	10
Mutual fund dealer	19
Scholarship plan dealer	1
Security issuer	13
Underwriter	5
Investment counsel	8
Securities adviser	1
Investment counsel and portfolio manager	41
Total	193

list in table 12 was also a member of the TSE. Broker-dealers for the most part underwrite and deal in new issues of mining and oil stocks. There were thirteen registered as of May 30, 1977.

A "securities dealer" is registered to trade as a broker or dealer but is not a member of any of the three organizations referred to above. Twelve members of the TSE were also registered as securities dealers so that they could carry on a dealer as well as a broker business. About half of the ten firms registered solely as securities dealers were affiliates of foreign securities firms.

A "mutual fund dealer" acts exclusively to sell mutual fund shares and most of the nineteen registrants were mutual fund management companies or affiliates of management companies selling shares in the funds they managed.

A "scholarship plan dealer" is registered exclusively to trade in the securities of scholarship or educational plans or trusts.

A "securities issuer" is registered to trade only in securities of its own issue without acting through a registered broker or dealer. Most of the thirteen registrants were either mutual funds issuing shares directly to investors, or finance companies issuing securities directly.

An "underwriter" is registered to act as either principal or agent in the underwriting process but registration solely as an underwriter does not confer the right to deal directly with the public. Some other class of registrant must carry out this stage of an underwritten offering. Two of the five registered underwriters were affiliates of chartered banks and one was an affiliate of a U.S. investment banking firm.

A "securities adviser" gives general advice on specific securities, usually by means of a market letter, while "investment counsel" serve the particular needs of individual clients. "Portfolio managers" have discretionary authority to manage the portfolios of clients.

A further category of "registrant" that is of some interest, although it is not really part of the securities industry, is the "exempt purchaser", permitted to purchase unregistered new issues of securities so that an offering limited to exempt purchasers does not require a prospectus. Most exempt purchasers are pension funds and mutual funds. Some are foreign insurance companies (domestic insurance companies automatically enjoy the benefits of an exemption). In early 1977 there were fifty-three exempt purchasers registered with the OSC.

Table 13 lists the numbers of registrants in all provinces, the Yukon and the Northwest Territories. The greatest concentration was in Ontario, Québec and British Columbia.

Table 13
Number of Registrants, Registered with Various Provincial and Territorial Authorities

As of spring, 1977

Category	Alta.	B.C.	Man.	N.B.
Members of Toronto, Montreal, Vancouver or Alberta stock exchanges[a]	18	39	18	10
Members of Investment Dealers Association of Canada[a]	25	24	19	12
Members of Broker-Dealers' Association of Ontario[a]				
Broker-dealers (petroleum and natural gas leases)				
Other brokers and dealers	7	3	8	7
Investment counsel and securities advisers	19	23	2	1
Mutual fund broker or dealer	16	19	8	8
Scholarship plan broker or dealer	1	1	1	2
Underwriter		6	2	4
Security issuer	15	29	6	1
Exempt purchaser				
Unidentified		4	13	
Total	101	148	77	45

Nfld.	N.W.T.	N.S.	Ont.	P.E.I.	Qué.	Sask.	Yukon
10	1	16	71	11	57	11	2
10	1	15	61	10	49	11	1
		6	13	2			
						55	
4		8	10	4	14	1	
			59		34	4	
4	1	11	28	7	14	13	
1	1	1	1	1	2		1
2	1	3	7	3		1	
		1	13			2	1
			53[b]				
		4					
31	5	65	316	38	170	98	5

a. There is some overlap among these three memberships.
b. Locations: Ontario 38; Manitoba 7; Québec 5; U.S.A. 3.

Table 14
Value of Trading on Canadian Stock Exchanges

1964–77
In millions of dollars

	Toronto		Montreal		Vancouver	
1964	$3,056.6	69.3%	$1,122.8	25.5%	$219.8	4.9%
1965	3,199.1	67.1	1,252.0	26.3	302.2	6.3
1966	2,877.2	67.9	1,006.4	23.8	319.0	7.5
1967	3,521.3	67.7	1,302.7	25.2	337.6	6.5
1968	5,015.0	69.4	1,550.2	21.4	633.3	8.8
1969	5,765.2	72.5	1,628.2	20.5	477.7	6.0
1970	3,653.8	68.6	1,205.0	22.1	454.4	8.5
1971	4,715.7	69.2	1,598.4	23.4	488.4	7.2
1972	6,258.2	68.7	2,057.3	22.6	782.5	8.6
1973	6,737.1	71.7	2,174.0	23.1	483.3	5.1
1974	4,523.5	68.6	1,598.0	24.2	464.8	7.1
1975	4,089.0	70.4	1,384.7	23.8	314.5	5.4
1976	5,093.0	73.3	1,483.6	21.3	328.3	4.7
1977	6,044.8	76.8	1,374.2	17.5	395.1	5.0

Alberta		Winnipeg		Total
$ 5.9	0.1%	$2.8	—	$4,408
9.5	0.2	3.6	0.1%	4,766
32.0	0.8	2.2	—	4,236
29.3	0.6	2.4	—	5,193
27.8	0.4	2.6	—	7,228
76.6	0.9	5.8	—	7,954
17.0	0.8	0.8	—	5,331
11.8	0.2	0.8	—	6,815
6.5	0.1	0.8	—	9,105
7.1	0.1	0.6	—	9,402
5.7	0.1	0.6	—	6,593
18.3	0.3	1.8	—	5,808
46.8	0.7	1.0	—	6,953
58.5	0.7	0.8	—	7,873

Source: Toronto Stock Exchange.

B. SELF-REGULATORY ORGANIZATIONS

There are seven principal self-regulatory organizations within the Canadian securities industry: the Investment Dealers Association of Canada, the Broker-Dealers' Association of Ontario, and five stock exchanges: Toronto, Montreal, Vancouver, Alberta and Winnipeg. The last two are quite small, and in 1977 accounted for only about 1% of trading on all five exchanges. As table 14 shows, the Toronto Stock Exchange is the dominant market. A minor organization in terms of self-regulation is The Investment Funds Institute of Canada.

As of early 1977, there were 75 Toronto Stock Exchange member firms, of which 30 were also members of the Montreal exchange, 6 were members of the Vancouver exchange, and 15 were members of both the Montreal and Vancouver exchanges. Another 16 firms were members only of the Montreal exchange (plus 3 with limited trading privileges); 22 more were members of the Vancouver exchange alone; and another was a member of both the Montreal and Vancouver exchanges. Of 26 members of the Alberta Stock Exchange (ASE), 23 belonged to other exchanges. In all, these numbers represent 120 different member firms.

The Investment Dealers Association of Canada had 89 members in 1977, of which 78 were members of the Toronto, Montreal or Vancouver exchanges. And the Broker-Dealers' Association of Ontario had 13 members, of which one was a member of the TSE. These two dealer associations bring the total number of brokers and dealers to 143.

In 1975 a joint industry committee provided a tabulation of budgets and staff for the four largest organizations (table 15).

1. *Toronto Stock Exchange*

The Toronto Stock Exchange is the major self-regulatory organization in the Canadian securities industry. There are 126 seats on the exchange, but membership has declined in recent years, from a peak of 100 firms in 1969 to 75 in 1977. The value of a membership has also declined, as shown in table 16. In general, the value of a seat has followed the volume of trading but the relationship has not been quite as close as one might have expected, as is shown in figure 1.

Member firms of the TSE employed 4,404 salespeople (registered representatives) in May 1976, down from a peak of 5,064 in 1973 and up from 2,516 in 1965. The average annual growth from 1965 to 1976 was 5.2% a year. Branch offices grew from 276 in 1965 to 457 in mid-1976 (peaking in 1973 at 483) at an average rate of

Table 15
Budget and Staff of the Four Largest Securities Industry Organizations

1975
In thousands of dollars

	Budget	Staff
Investment Dealers Association of Canada	$ 800	24
Toronto Stock Exchange	4,500	206
Montreal Stock Exchange	2,000	79
Vancouver Stock Exchange	1,500	50

Table 16
Price Range of Seats on the Toronto Stock Exchange

1963–77
In thousands of dollars

	High	Low	Number of transactions
1963	$ 71	$ 60	2
1964	75	70	5
1965	105	90	3
1966	105	90	2
1967	92	65	7
1968	98	98	1
1969	125	125	14
1970	132.5	115	4
1971	95	80	2
1972	90	60	7
1973	90	87	3
1974	nil	nil	nil
1975	39	20	10
1976	30	20	8
1977	20	15	7

Source: Toronto Stock Exchange.

Figure 1
Average Seat Prices and Volume of Trading on the Toronto Stock Exchange

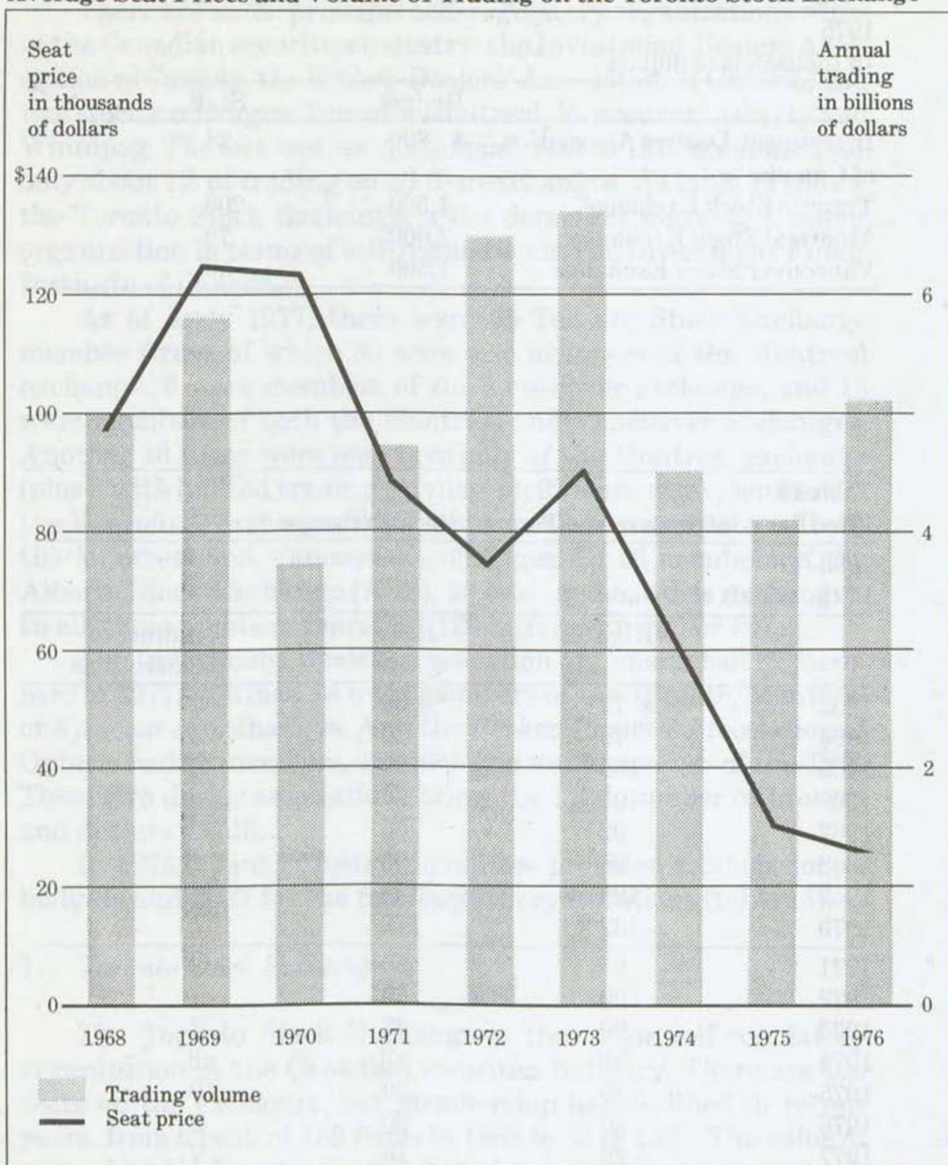

Table 17
Average Profit of Toronto Stock Exchange Members Before Income Tax as a Percent of Capital

As of year ending March 31, 1968–76

1968	20.0%
1969	40.3
1971	16.4
1972	28.0
1973	34.5
1974	12.2
1975	16.4
1976	24.8

4.7% a year. Volume on the exchange measured in value of transactions grew at 2.5% a year from 1965 to 1975. The number of issues listed on the exchange grew by 1% a year over this time but the number of transactions declined by an average 5.6% a year.[8] It seems possible that as of 1977 there were still too many salespeople in the industry. There has been a trend to larger transactions in value and number of shares, probably as the result of increasing institutionalization of the market.[9]

The exchange has been disappointed in the value of trading in recent years but there seems little to support its estimate of what is "normal" trading. In 1975, trading on all exchanges in Canada totalled $5.8 billion. The exchange has said that $15.7 billion would have been consistent with historic trends[10] and would have been 9.7% of Canada's Gross National Product. But volume has reached this percentage of GNP in only two years – 1968 and 1969. While it is true that actual 1975 volume was only 3.6% of GNP, the lowest percentage in at least sixteen years, it is not clear what a "normal" percentage is.

Average profit of members before taxes as a percent of capital is shown in table 17.[11]

These are returns on equity and subordinated debt rather than on equity alone, but for most firms that use it, subordinated debt is very similar to equity provided by owners.

2. *Montreal Stock Exchange*

The Montreal Stock Exchange (MSE), as the volume and budget statistics have shown, is much smaller than the Toronto exchange. It has seen about the same proportionate decline in memberships and in registered representatives. (A seat on the MSE sold for only $2,000 in early 1976.) But as the volume statistics in table 14 indicate, Montreal has been losing its share of the dollar value of trading in Canada. Montreal does somewhat better in senior industrial stocks that are listed on both exchanges (26.7% of volume in 1975) than in interlisted junior industrials (1.5% of volume in 1975).[12]

Competition between the Toronto and Montreal exchanges has extended over the years to a variety of protectionist rules. In

8 H. McKay, Evolution of the Canadian Securities Market with Particular Focus on the Equity Market 120-49 (Toronto Stock Exchange 1976).

9 This trend is discussed in ch. V *infra*.

10 H. McKay, *supra* note 8, at 123.

11 Computed from tables 6 and 7 in H. McKay, *supra* note 8, at 154-55.

12 Quebec Securities Commission Task Force, Commission Rates in the Securities

1969 the Quebec Securities Commission announced Policy Statement No. 4 which required, subject to a broker's duty to obtain the best execution for a customer, that orders originating in Québec in Montreal-listed stocks be executed in Montreal.[13] On its face, the statement was probably not unreasonable, and enforced literally according to its terms, it would probably have made little difference.

Next, the Montreal exchange stopped enforcing its "cross interference" rules. These are contained in section 6169 of rule II of the Montreal exchange and essentially restrict the ability of a member to "cross" a buy order with a sell order at the same price. Under the rules other members bidding or offering at the same price as that for a proposed cross, were entitled to trade at that price up to 15% of the proposed cross. The halt to enforcement of the cross interference rules made the Montreal exchange an attractive place for crosses and drew business from Toronto. The Toronto Stock Exchange responded by suspending section 11.19 of its by-laws, the counterpart of the Montreal section 6169, so that trading conditions were equalized.

Then the Quebec Securities Commission brought proceedings against a Toronto-based member firm under Policy Statement No. 4, indicating that the policy was to be interpreted so as to require Montreal member firms to bring a satisfactory proportion of their Québec-based business to the Montreal floor. The Toronto Stock Exchange was concerned that this interpretation would seriously

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INDUSTRY 65-72 (June 1976). Over 680 stocks are listed on both exchanges, and almost 600 of them are "senior industrials".

13 The text of the policy statement was:

"The Commission under Section 2 of the Securities Act is charged with the supervision and control of the securities business in the Province of Québec.

"In the case of shares quoted on an Exchange recognized by it (*i.e.*, the Montreal Stock Exchange and the Canadian Stock Exchange), the Commission is of the opinion that it is in a better position with respect to the secondary market to exercise a continued supervision of the Securities business in the Province, if at all possible, purchases and sales which originate in the Province of Québec are transacted within the Province.

"On the other hand the Commission is aware that some securities are listed both on an Exchange recognized by it and other Exchanges in Canada or elsewhere and that the first duty of a broker towards his client is to obtain for him the best price possible.

"In order to reconcile these two requirements the Commission has decided that buy or sell orders originating in this Province for shares listed on an Exchange recognized by it should be executed on the floor of such an Exchange, if possible, and that all things being equal and taking into account the broker's duty towards his client to obtain for him the best execution possible, transactions should take place on the floor of that Exchange.

"Brokers must at all times be prepared to explain any failure to conform with this policy."

divert trading. It responded with section 11.19(2) of its by-laws which prohibits a member (acting as principal) from reversing on another exchange any part of a position acquired on the TSE, and from reversing on the TSE any part of a position acquired on another exchange.[14]

The Montreal exchange had derived no net benefit from this contest of rules and in 1977 the Quebec Securities Commission withdrew Policy Statement No. 4.[15] The Montreal exchange clearly hoped that Toronto would abolish section 11.19(2) but the TSE delayed, while awaiting resolution of matters relating to short sale rules and restrictions on the trading of members' accounts operated by traders on the exchange floors. Toronto was particularly concerned about a new category of member on the Montreal exchange, a member trading for himself, free of any specific obligations to serve the quality of the market but adding his capital and trading to the market's apparent benefit. Registered traders on the Toronto exchange are subject to a number of restrictions that would put them at a disadvantage in competition with the Montreal members.[16] Perhaps more important, a Toronto registered trader, absent new rules, might avoid the TSE restrictions by setting up a partner on the MSE floor. In early 1978, section 11.19 was amended to expand the exemptions from the arbitrage prohibitions, which relaxed the competition between the two exchanges.

3. *Vancouver Stock Exchange*

The Vancouver exchange has in recent years become Canada's speculative mining stock market. Its self-regulatory function was substantially restricted in August 1977 when prospectuses for primary offerings through the exchange were transferred from the jurisdiction of the exchange to that of the British Columbia Superintendent of Brokers.

14 Toronto Stock Exchange, by-law 11.19(2), 3 CCH CAN. SEC. L. REP. ¶ 89-409. Except in executing orders for the accounts of customers, members are prohibited from making bids, offers, purchases, or sales of a security on the exchange to reduce, hedge or otherwise offset a position taken on another stock exchange in Canada. Any position resulting from a purchase or sale of a security on the exchange, except in executing orders for the accounts of customers, shall not be reduced, hedged or otherwise offset on another stock exchange in Canada.

15 8 QSC Bull., No. 35 (Decision No. 5316, September 6, 1977).

16 There is apparently not much enthusiasm for restoration of the "cross interference" rules, partly because this might encourage the taking of crosses to the United States.

4. *The Investment Funds Institute of Canada*

This organization was formed in 1962 as the Canadian Mutual Funds Association, and acted as a self-regulatory body until 1976 when it abandoned part of the self-regulation and adopted its present name.

Membership in the institute has never been required by the regulatory commissions as a condition of registration nor is the institute even referred to in any statute or regulations, so that the self-regulatory function has been quite unofficial. In fact, a substantial part of the mutual funds industry does not belong to the institute. Still, the institute prescribes a code of ethics dealing with overreaching, qualifications of salespeople, and insider transactions.

5. *Investment Dealers Association of Canada*

The Investment Dealers Association (IDA) has its head office in Toronto and maintains regional offices in Montréal and Vancouver and a district council in each of seven regions. Its self-regulatory activities take the form chiefly of a set of rules governing capital, insurance, qualification of employees, maintenance of records, and audits of its members. These rules generally parallel the rules of the stock exchanges. Because of overlapping membership, regulation of the total membership of the exchanges and the IDA is allocated among the self-regulatory organizations, so that for the most part a firm is subject to oversight by only one organization.

The association's membership includes the largest firms in the securities business and it may initiate fewer disciplinary actions than the other self-regulatory organizations. It is perhaps as much a trade association as a regulatory body.

The IDA is the organization with responsibility for most of the over-the-counter market in Canada. The Canadian money market operates under IDA rules, and volume in 1976 was $150 billion.[17] The over-the-counter market in stocks is small, and consists chiefly of secondary trading in new issues before the issues are listed. In 1976 this trading totalled $680 million and the rest of the over-the-counter trading in stocks amounted to only $113 million. Regulation consists chiefly of clearing rules and reporting of trades.

Market-makers and quote-makers in the Ontario over-the-counter stock market are designated by the IDA. The former are

17 The money market is discussed *infra*.

Table 18
Sources of Toronto Stock Exchange Member Firm Revenue by Type of Firm

As of years ending March 31, 1975–77

	All types		
	1975[a]	1976[a]	1977[a]
Equity agency income			
Toronto Stock Exchange	30.8%	30.7%	28.5%
Montreal Stock Exchange	8.2	7.4	6.6
Vancouver Stock Exchange	2.4	2.1	2.3
U.S. markets	6.2	7.8	5.8
Over-the-counter	2.8	1.8	1.4
	50.3	49.8	44.6
Underwriting	19.7	25.1	24.1
Trading			
Principal trading stocks	4.7	2.1	2.3
Principal trading bonds	7.9	10.4	14.1
Registered trading stocks	0.6	1.5	1.0
Money market	9.7	4.0	5.3
Other	7.2	7.1	8.6
	30.1	25.1	31.3
Total	100.0	100.0	100.0
Total income by class			

National diversified firms 1977[b]	High value per trade (institutional) 1977[b]	Low value per trade (retail) 1977[b]
23.6%	56.7%	47.5%
4.9	22.8	4.1
1.5	0.7	11.7
5.9	5.6	6.6
1.2	1.8	3.6
37.2	87.5	73.5
28.5	0.5	5.6
2.7	0.4	0.2
15.8	4.1	7.6
0.3	4.5	4.9
6.3	—	0.1
9.2	3.0	8.1
34.3	12.0	20.9
100.0	100.0	100.0
83.0	9.0	8.0

a. Sample representing 78% of Toronto Stock Exchange trading in 1975, 72% in 1976 and 65% in 1977.
b. Sample representing 65% of Toronto Stock Exchange trading in 1977.
Source: Toronto Stock Exchange.

obliged to call "firm markets" – both a bid and an offer good for one round lot – in the stocks for which they make markets. A dealer is required to check with two market-makers before executing a client order and must execute the trade with a market-maker unless a better execution can be obtained elsewhere. A quote-maker simply undertakes a continuing interest in an issue.

All over-the-counter stock transactions in Ontario must be reported daily to the IBM Datacentre in Toronto and a report of all the trading goes to the IDA. Another report is published, showing volume, high and low for each security traded, but it includes only trades between Ontario dealers and other dealers, banks and trust companies.[18]

The over-the-counter market in bonds is much larger, since there is no listed bond market in Canada. Trading and clearing rules are established by the Montreal, Toronto and British Columbia bond traders associations. Statistics on bond trading are hard to find, and in April 1978 the Quebec Securities Commission announced a sampling of trading statistics to measure the breadth of the secondary bond market in Québec.[19]

C. ACTIVITIES OF SECURITIES FIRMS

The Securities Industry Ownership Committee of the Ontario Securities Commission discovered substantial changes in investment dealers' mix of business over the period from 1966 to 1971. Both brokerage and underwriting showed substantial swings in percent of gross income. The committee said: "it is not possible to reach any but the most general conclusions as to the needs for capital and the profitability of specific functions."[20] It appeared that only a few firms kept close enough track of costs to know how profitable the functions were.

Table 18 shows, for members of the TSE, the relative importance of different sources of revenue. Brokerage (equity agency income) accounted for just about half of this revenue in each of 1975, 1976 and 1977. Underwriting was significant, accounting for 20% to 25% of revenue. Dealing in stocks, bonds and money market instruments accounted for another 20%.

Table 18 also shows, for each of three types of TSE member, the importance of these sources for fiscal 1977. The national diversified firms show a much lower dependence on brokerage revenue than either the institutional or retail firms and a substantial

18 The rules and procedures were described in [1975] OSC Bull. 196 (August).

19 9 QSC Bull., No. 15 (Decision No. 5419, April 18, 1978).

20 OSC, REPORT OF THE SECURITIES INDUSTRY OWNERSHIP COMMITTEE 64 (April 1972). The TSE now offers complete and detailed cost analyses to its members.

dependence on underwriting. Indeed, underwriting and money market trading together are as important as brokerage. And bond trading is also a significant activity.

For the institutional firms, brokerage accounted for nearly 90% of revenue. The retail firms were more diversified, with underwriting and bond trading accounting for about 13% of revenue and less than 75% of revenue was from brokerage.

What is more important, perhaps, than sources of revenue is sources of profit. The relative profitability of brokerage and of "other" business was explored by Calvin Potter in an Ontario Securities Commission staff position paper in 1977.[21] Potter concluded that for diversified firms, commission business was marginally unprofitable and other business was marginally profitable. For non-diversified firms, however, particularly institutional firms, the reverse was true. For the diversified firms, of course, the mutual dependence of commission and other business might well make commission business quite worthwhile. For the year ending in March 1977 it appears that commission business was unprofitable for diversified firms but profitable for institutional firms.

1. *Brokerage*

In Canada the stock brokerage function is essentially limited to trading on the stock exchanges and the brokers are all members of the exchanges. The economics of this particular activity and particularly the question of whether commission rates should remain fixed or become competitive are discussed in chapter III. The choice between dealer and broker markets and liability (dealer, as opposed to broker) trading on the exchanges is dealt with in Williamson, *Capital Markets*, in this volume.[22]

The debate over commission rates in 1976 and 1977 raised questions about concentration in the brokerage business and the potential for domination by a few firms. A fairly steady increase in concentration in trading on the Toronto Stock Exchange can be seen from table 19. The 48% of trading accounted for by the top ten firms in 1976 is higher than the corresponding 35% for the New York Stock Exchange.[23] The table was updated by the TSE in a submission to the Ontario Securities Commission; the top ten

21 *See* the discussion in ch. III *infra*.
22 *See, Williamson, Capital Markets*, ch. II, at text accompanying n. 48 and following.
23 The 35% figure comes from *Trends in Concentration in the Securities Industry*, published in SECURITIES INDUSTRY ASSOCIATION, SECURITIES INDUSTRY TRENDS 4 (August 29, 1977).

Table 19
Concentration in Trading on the Toronto Stock Exchange

1968–76
In millions of dollars

	10 top firms		25 top firms	
	Value of trading (both sides)	Percentage of total trading	Value of trading (both sides)	Percentage of total trading
1968	$3,751	38.4%	$7,831	67.9%
1969	4,415	38.5	6,728	66.5
1970	2,727	38.4	4,972	66.2
1971	3,788	40.4	6,343	67.6
1972	4,976	40.6	8,517	69.4
1973	5,804	43.4	9,608	72.0
1974	3,956	44.5	6,428	72.2
1975	3,663	45.3	6,005	74.3
1976[a]	2,410	48.1	3,886	77.5

a. Up to May 31, 1976.
Source: Toronto Stock Exchange, *Evolution of the Canadian Securities Market with Particular Focus on the Equity Market* 147 (June 1976).

Table 20
Canadian Securities Industry: Concentration in Commission Revenue and in Other Business Revenue

As of 12 months ending March 31, 1977

Commission revenue	
Top 5	37%
Top 10	55
Top 20	75
Top 25	81
Top 40	91
All 94	100
Other business revenue	
Top 5	64%
Top 10	86
Top 20	94
Top 25	96
Top 40	98
All 94	100

Source: Data on 94 firms, compiled by the Investment Dealers Association of Canada, and the Toronto and Montreal stock exchanges. *See* note 25 *supra*.

trading firms accounted for over 50% of trading value in the first four months of 1977.[24]

Table 20 shows the degree of concentration of commission revenue for approximately the twelve months ending March 31, 1977.[25] Comparison with table 19 suggests that the trend is up. But what is especially interesting is that concentration in "other revenue", which includes all revenue *except* commission revenue, is much higher. For the whole set of ninety-four firms, aggregate "other revenue" was also higher at $284 million than commission revenue of $212 million. (The ratio of commission revenue to total revenue, 43%, was very close to the corresponding ratio for the United States securities industry. As shown in table 18, the ratio for TSE members has been about 50%.)

For the top ten firms in terms of commission revenue, this revenue was $117 million and "other revenue" was $220 million. So for the firms that dominate the commission business, other revenue is almost twice commission revenue (just as we saw for national diversified firms in table 18), and these firms are even more dominant in other business. They had 55% of commission revenues and these same firms had 78% of other revenues.

These statistics suggest that although the focus of concern has been on concentration in commission business, concentration in other business is much more significant.

In the course of a study of commission rates in the securities industry a task force set up by the Quebec Securities Commission collected information on fifty members of the Montreal Stock Exchange, including the largest securities firms in Canada, and the statistics presented by the task force give some insights into the structure of the industry nationally. (Twenty-three of the firms were controlled in Québec, twenty-three were controlled in other provinces, and four were foreign controlled.)

The task force was able to draw some conclusions about concentration in the various activities of the securities business but since the sample was limited to fifty firms, and much of the analysis was concerned with the position of Québec-owned firms with respect to the rest of the industry, the conclusions are of limited value on a national scale. The analysis of profitability of

24 Toronto Stock Exchange, Submission to the Ontario Securities Commission regarding the Proposed Commission Rate Schedule, at 40 (May 16, 1977). U.S. concentration statistics are shown in table 39 in ch. III *infra*.

25 Data on the 94 firms are collected by the Investment Dealers Association and the Toronto and Montreal stock exchanges. Table 20 is based on data for the year ended March 31, 1977, for about half of the firms, for the year ended December 31, 1976, for about one third, and for years ended on dates between September 30, 1976 and August 31, 1977, for the remainder.

different lines of business was of wider interest but was limited to the year 1975.[26]

2. *Dealing*

The stock market in Canada is almost entirely a market in listed stocks, rather than an over-the-counter (OTC) market. There is a certain amount of dealing, or "liability trading", in listed stocks discussed in Williamson, *Capital Markets*,[27] but nothing like the United States OTC or third markets. Table 18 shows the almost negligible proportion of revenue derived by TSE members from OTC stock trading. Table 21 gives figures for OTC stock trading in Canada in 1976. The bulk of the trading was in new issues, after issuance but before listing on a stock exchange. Trading in genuine "unlisted" issues was very small - $113 million compared to stock exchange volume of nearly $7 billion.

Table 22 shows all the unlisted stocks for which OTC trading, apart from primary distribution, exceeded $500,000 in 1976. The list includes only seven industrial stocks, eight mines and one oil.

The Canadian bond market, on the other hand, is entirely a dealer market. We saw something of its relative importance in table 18. It accounted for 14% of the revenue of TSE members in 1977. Ten securities firms, according to Shaw and Archibald, participate "on a continuous basis, as market intermediaries in the secondary bond market".[28] Table 2 shows the aggregate bond inventory of securities dealers and table 21 gives an idea of the distribution of securities inventories.

Although the secondary bond market is substantial, volume and price information are not publicly disclosed apart from weekly bid and ask prices provided by the IDA, and annual statistics such as those in table 24. Reference has been made to a 1978 data collection in Québec.[29]

Table 24 shows aggregate trading in bond and money markets. The total volume of bond and money market trading in 1976 was about nineteen times the stock trading volume on the stock exchanges in Canada. The bulk of this trading was in money market instruments; bond trading volume alone was three and one-third times stock trading volume.

26 QUEBEC SECURITIES COMMISSION TASK FORCE, *supra* note 12. The conclusions on concentration are discussed *infra*, text accompanying note 170 and following.

27 *See*, *Williamson, Capital Markets*, ch. II.

28 D. SHAW & R. ARCHIBALD, 8 THE MANAGEMENT OF CHANGE IN THE CANADIAN SECURITIES INDUSTRY 51 (1977) (The Canadian Securities Market: A Framework and a Plan).

29 *See* 9 QSC Bull., No. 15 (Decision No. 5419 April 18, 1978).

Table 21
Canadian Securities Industry:
Concentration in Securities Inventories

As of March 31, 1977
In millions of dollars

	Securities inventory	
Top 5	$1,928	63%
Top 10	2,728	90
Top 20	3,009	99
All 94	3,046	100

Source: *See* note 25 *supra*.

Table 22
Over-the-Counter Trading in Canadian Stocks

1976
In thousands of dollars

	Total over-the-counter trading	Primary distribution	Trading in new issues, prior to listing	Trading in unlisted issues
Industrials	655,800	2,341	569,362	84,097
Mines	64,113	10,039	29,173	24,901
Oils	85,884	997	81,251	3,636
Total	805,797	13,377	679,786	112,634

Source: Investment Dealers Association of Canada.

Table 23
Over-the-Counter Trading in Unlisted Canadian Stocks[a]

1976
In thousands of dollars

	Trading
Industrials	
AGF Special	687
Canadian Foremost Ltd.	763
London Life	28,903
Maritime Tel & Tel Co. Ltd.	3,529
Oxford Dev. Group Ltd.	1,062
Oxford Dev. Groups Ltd. Pfd.	42,015
Ready Foods	1,174
Mines	
Abino Gold Mines	953
Aggressive	774
Canuc Mines	7,438
Cavalier Energy	1,930
Dejove Mines	637
Gull Lake Iron Mines Ltd.	549
New Bedford	613
Reactor Ind.	882
Oils	
B.C. Oil Lands	3,153

a. Unlisted stocks for which trading, other than in primary distributions, exceeded $500,000.
Source: Investment Dealers Association of Canada.

Table 24
Money Market and Bond Trading in Canada

1976 and first half of 1977
In millions of dollars

	1976	First half of 1977
Money market trading		
Canada bills	14,355	14,377
Canada bonds due within 3 years	3,573	1,747
Provincial bills	3,732	1,206
Municipal bills	1,238	812
Canadian bankers acceptances	14,444	6,949
Canadian bank paper	20,028	10,977
Foreign bank subs paper due within one year	2,307	1,466
Corporate paper due within one year	28,616	13,065
Finance company paper due within one year	20,630	13,042
Total money market trading	108,923	63,641
Bond trading		
Canada bonds due in more than 3 years	8,339	6,453
Provincial bonds	7,130	3,979
Provincial savings bonds	41	2
Total provincial	7,171	3,981
Municipal bonds	589	522
Corporate paper due in 1–5 years	892	565
Corporate bonds	5,461	3,232
Total corporate	6,353	3,797
Other	833	446
Total bond trading	23,285	15,199
Total bond and money market trading	132,208	78,840

Source: Investment Dealers Association of Canada.

It does not seem possible with available data to make any estimates of the distribution of trading among securities firms or to assess the degree of concentration in trading.

3. *Underwriting*

Underwriting of mining and oil stocks of companies in the development stage is a very specialized business and is not described here.[30] For stock or bond offerings of established companies the underwriting process begins when a "managing underwriter" negotiates with the issuer the terms of the offering. The manager may then organize a "banking group" of underwriters, if the issue is large, and the offering will be sold by the issuer to the manager and by the manager to this group. Some members of the banking group will resell the securities to their institutional or retail customers. Some will allow the manager to sell at least a part of their allocations to members of a "selling group" for resale to their customers.[31]

In North America long-standing relationships between issuing corporations and managing underwriters are common, although there is a growing tendency for issuers to "shop around", and for underwriting firms to seek out issuers who may be willing to change underwriters. The same is true of relationships between governments and underwriters.

Statistics on underwriting participants are maintained by the Investment Dealers Association of Canada as well as by the major underwriting firms but there is a great reluctance to publish them. Shaw and Archibald reported in 1975 that sixty-nine securities firms had acted as managing underwriters for 795 corporate, provincial and municipal offerings in 1971 and 1972. Of the sixty-nine only two were classified as "major" underwriters in all three sectors, having managed at least ten issues in each. Four more were "major" underwriters in one of the three.[32] In 1977 they reported:

> "Four securities firms, operating nationally and internationally, dominate the primary market for Canadian is-

30 *See* J. Williamson at 295-99.

31 For more details, *see* J. Williamson at 282-92; Report of the Committee to Study the Requirements and Sources of Capital and the Implications on Non-Resident Capital for the Canadian Securities Industry 22-23 (May 1970) [hereinafter Moore Committee Report].

32 7 D. Shaw & R. Archibald, *supra* note 28, at 75-76 (The Securities Firm in the Canadian Capital Market).

sues and are active in all phases of the securities market as dealers and brokers."[33]

Shaw and Archibald do not identify any firms but these four would have to be A.E. Ames, Dominion Securities Harris & Partners, McLeod Young Weir, and Wood Gundy.

They go on to say:

"Eight securities firms have national and international operations and are extensively diversified across the market....

"These twelve securities firms (four diversified, dominant underwriters plus eight diversified) undertake a large proportion of the primary market activity for corporate and provincial government issues of commercial paper, long-term debt and equity. In addition, they dominate the secondary dealer market....

"Eight securities firms (the four diversified, dominant underwriters and four of the diversified firms) act as managing underwriters for a large share of the corporate and provincial securities offerings in Canada. These eight firms wield substantial power over the market intermediaries because they control the selection of firms for banking groups, inclusion in which is profitable."[34]

The eight diversified firms are probably Merrill Lynch Royal Securities, Nesbitt Thomson, Greenshields, Crang & Ostiguy (now merged with Greenshields), Pitfield Mackay Ross, Burns Fry, Richardson Securities of Canada, Walwyn Stodgell Cochran Murray. And the first four of these are probably the four referred to in the last paragraph in the quotation above – managing underwriters.

Some more recent statistics are presented in tables 25 and 26.[35] The fourteen firms listed (eleven by the end of 1973 as the result of mergers) were the top underwriters in 1974 and are ranked by volume of debt issue underwriting in 1974.

The two tables reinforce the suggestion in table 18 that the underwriting business is quite concentrated. This is not to say that the concentration is harming anyone, although there is certainly anecdotal evidence on the difficulty experienced by firms at-

33 8 D. Shaw & R. Archibald, *supra* note 28, at 45-46.

34 *Id.* at 46-47.

35 An offering made through more than one underwriter was attributed in full to each underwriter named in the filing. No attempt was made to allocate an offering among participating underwriters because the filings did not include enough information to make this possible.

Table 25
Underwriting in Canada: Corporate Equity Offerings[a]

1970–74
In thousands of dollars

	1970	1971	1972	1973	1974
Wood Gundy	7,005	136,907		68,503	248,786
A. E. Ames	937	110,450	10,112	16,891	176,526
Dominion Securities	4,046	115,259	41,882	51,000	201,526
Harris & Partners		6,900			
McLeod Young Weir		130,431	186,128	63,340	254,026
Greenshields		104,000	14,470	72,200	100,000
Pitfield Mackay Ross	5,520	14,602	33,770	9,606	
Nesbitt Thomson	6,680		167,450	6,961	146,526
Richardson Securities of Canada	20,320	12,525			156,526
Merrill Lynch	4,600	7,887	33,402	30,786	68,526
Royal Securities					
Lévesque Beaubien		59		3,250	100,402
Midland-Osler		6,900	126,456	2,263	25,000
Doherty McQuaig			2,520		

a. Offerings for which a prospectus was filed in Ontario, Québec or British Columbia. Figures shown are the values of total offerings in which the underwriters participated.
Source: Prospectus filings. *See* note 35 *supra*.

Table 26
Underwriting in Canada: Corporate Debt Offerings[a]

1970–74
In thousands of dollars

	1970	1971	1972	1973	1974
Wood Gundy	882,000	782,250	677,000	545,000	887,500
A. E. Ames	568,000	401,000	484,000	265,000	730,000
Dominion Securities	235,500	346,000	400,000	175,000	545,000 (Dominion Securities and Harris & Partners combined)
Harris & Partners	210,000	133,500	135,000	100,000	
McLeod Young Weir	413,000	250,000	346,500	312,000	353,500
Greenshields	120,000	205,000	88,000	20,000	221,500
Pitfield Mackay Ross	112,500	144,500	60,500	130,000	183,500
Nesbitt Thomson	454,500	217,500	155,000	295,500	175,000
Richardson Securities of Canada	196,700	176,500	161,400	40,000	115,000
Merrill Lynch / Royal Securities	108,000	100,300	35,300	27,000	70,000
Lévesque Beaubien	3,100	52,425	42,500	25,450	70,000
Midland-Osler	233,000	56,000	35,000 (Midland-Osler and Doherty McQuaig combined)	175,000 (Midland-Osler and Doherty McQuaig combined)	30,000 (Midland-Osler and Doherty McQuaig combined)
Doherty McQuaig					

a. Offerings for which a prospectus was filed in Ontario, Québec or British Columbia. Figures shown are the values of total offerings in which the underwriters participated.
Source: Prospectus filings. *See* note 35 *supra*.

tempting to break into the business. But there may be legitimate reasons for this difficulty.[36]

The major Canadian underwriters show up well in a North American context. Table 27 shows underwriting volume for the top twenty-five underwriters in the United States market for the first half of 1977. McLeod Young Weir and Wood Gundy appear in the list covering all securities. They are joined by A.E. Ames and Dominion Securities in the list covering only negotiated (as opposed to competitive bid) offerings. A list of the top underwriters of foreign debt would include these four firms and Greenshields. A tabulation of top banks and investment banking firms in arranging private placements of securities in 1976 shows McLeod Young Weir in fourteenth place.[37] Their high rank, of course, reflects one or two major Canadian client relationships.

Underwriting appears to be a rather profitable activity in recent years (although precise measures are not available) particularly when compared to brokerage. So the firms not engaged in underwriting are especially interested in entering the field, while those already in have a reason for wanting to keep it to themselves. At the same time, one of the features of an increasingly competitive underwriting business in the United States is the expansion of brokerage activities by underwriting firms. This expansion is taking place not because brokerage itself is necessarily profitable but because the distribution facilities of a brokerage business are so important to successful underwriting. It is the enormous distribution ability of Merrill Lynch, for example, that is generally supposed to explain the firm's success in rapidly building a major underwriting business.

There seems to be evidence of competitive pressure from U.S. investment bankers for foreign underwriting of Canadian issues. A substantial amount of Canadian provincial, municipal, and industrial financing takes place in the United States and Europe and a good deal of the industrial financing is for Canadian subsidiaries of U.S. companies. According to Canadian dealers, the parent

36 See the discussion of the structure of the investment dealer industry in *Williamson, Capital Markets* at text accompanying n. 87; 8 D. SHAW & R. ARCHIBALD, *supra* note 28, at 47-49. The Securities Industry Ownership Committee of the Ontario Securities Commission reported for 71 Canadian-owned investment dealers responding to a questionnaire in 1971 that the 10 largest resident-owned firms accounted for 62.6% of total underwriting, and 65.2% of industrial underwriting. But these 10 largest had only 49% of total income; OSC REPORT OF THE SECURITIES INDUSTRY OWNERSHIP COMMITTEE, *supra* note 20, at 54, 58, 157 and 159. More conclusions on concentration of underwriting are discussed in text accompanying note 170 *infra*. Underwriting appears to be much more concentrated than commission business.

37 *See* Angermueller & Taylor, *Commercial vs. Investment Bankers*, 55 HARV. BUS. REV. 132 (September-October 1977).

companies sometimes direct the subsidiaries to make use of American dealers in offerings outside Canada.

There has been a good deal of concern in recent years about separation of brokerage from underwriting activities. In the United States there has been some litigation over the use of "inside information" gained from underwriting to assist brokerage clients.[38] As a result, there is usually a separation of the two functions within securities firms, very similar to the "wall" in U.S. banks that separates trust activities from commercial lending.[39] The same separation appears to take place in Canadian firms, although little is said about it.

This kind of conflict has come to the attention of the Council of the London Stock Exchange, which in June 1977 issued "notes of guidance" to member firms acting as brokers to listed companies. The notes called on member firms to effectively separate their corporate finance function from their other activities. The council said "the less definite this separation, the more difficult it will be for partners and employees of a firm to justify having dealt in, or having made a recommendation about, the securities of a company to which the firm acts as broker, if later called upon to do so".

The Toronto Stock Exchange established in 1968 a policy on fiduciary obligations of members as directors or fiduciaries of corporations,[40] which affirms an obligation not to reveal privileged information gained through the directorship or fiduciary relation. The policy goes further, and states that "the ground rules should be substantially the same" for a representative of a member "acting in an advisory capacity to a company and discussing confidential matters". National Policy No. 18 of the provincial securities commissions refers to the TSE policy and cautions representatives of registrants who serve as directors of public companies. But it says nothing about the use of information gained from an underwriting relationship. Section 125 of the Canada Business Corporations Act would impose liability on an underwriter who profited from inside information, but not necessarily on one who passed information to brokerage clients.

4. *Money Market Dealers*

The thirteen investment dealers that are also money market dealers make up a special class of securities firms. All of these firms

38 *See e.g.* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, 495 F.2d 228 (2d Cir. 1974).

39 Discussed in ch. IV *infra*.

40 Toronto Stock Exchange, Policies, pt. V, sec. 5.01, 3 CCH CAN. SEC. L. REP. ¶ 92-036. *See also*, *Connelly* at n. 127 and following.

Table 27
Underwriters of Offerings in the United States

First 6 months of 1977

Total securities: the top 25	Volume in thousands of dollars[a]	Number of issues
1 Morgan Stanley	$2,458,800	36
2 Merrill Lynch	1,920,100	86
3 Salomon Brothers	1,792,100	83
4 First Boston	1,595,500	64
5 Goldman Sachs	1,507,500	49
6 Blyth Eastman Dillon	1,299,200	46
7 Kidder Peabody	697,900	38
8 Lehman Brothers	643,700	30
9 White Weld	566,100	30
10 Bache Halsey Stuart Shields	548,300	37
11 Dillon Read	534,300	19
12 Dean Witter	525,500	31
13 E. F. Hutton	478,200	27
14 Kuhn Loeb	468,400	17
15 Paine Webber Jackson Curtis	387,100	28
16 Loeb Rhoades Hornblower	327,400	21
17 Smith Barney Harris Upham	323,100	27
18 Drexel Burnham Lambert	210,300	21
19 Warburg Paribas Becker	133,300	13
20 McLeod Young Weir[b]	133,300	3
21 Lazard Freres	133,300	6
22 Wood Gundy[b]	95,700	3
23 Shearson Hayden Stone	91,200	10
24 Wertheim	85,400	10
25 Reynolds Securities	67,100	6

Negotiated securities: the top 25	Volume in thousands of dollars[a]	Number of issues
1 Morgan Stanley	$2,072,000	23
2 Merrill Lynch	1,462,600	47
3 Goldman Sachs	1,309,500	35
4 First Boston	1,264,300	34
5 Salomon Brothers	1,161,200	36
6 Blyth Eastman Dillon	975,700	19
7 Lehman Brothers	457,400	15
8 Dillon Read	454,700	12
9 Kidder Peabody	411,100	16
10 Dean Witter	382,600	17
11 Kuhn Loeb	378,300	10
12 White Weld	343,600	10
13 E. F. Hutton	286,000	10
14 Bache Halsey Stuart Shields	261,200	10
15 Paine Webber Jackson Curtis	170,100	9
16 Smith Barney Harris Upham	159,500	11
17 Loeb Rhoades Hornblower	153,300	2
18 McLeod Young Weir[b]	133,300	3
19 Drexel Burnham Lambert	101,300	8
20 Lazard Freres	100,000	5
21 Wood Gundy[b]	95,700	3
22 Warburg Paribas Becker	89,900	6
23 A. E. Ames[b]	58,300	2
24 Nikko Securities	51,700	5
25 Dominion Securities[b]	45,700	3

a. Volume is calculated by allocating an offering equally among managers, with an extra share to the lead manager.
b. Canadian firms.
Source: *Institutional Investor*, September 1977.

have a line of credit with the Bank of Canada, and the bank, as a lender of last resort, will extend credit through securities purchase and resale agreements, buying from the dealers, who agree to repurchase. The rate charged is one-quarter of 1% above the average rate on three-month treasury bills, subject to a minimum of bank rate minus three-quarters of 1%. (The bank rate is the Bank of Canada rate charged to chartered banks.)

Equipped with the Bank of Canada credit facility, the money market dealers can borrow from chartered banks on day-to-day loans using as collateral Canadian government securities and bankers' acceptances.

During the first half of 1977 as much as $266 million of purchase and resale agreements was outstanding. The maximum of day-to-day loans outstanding was $342 million.

The thirteen money market dealers are:

A.E. Ames;
Burns Fry;
Dominion Securities;
Equitable Securities;
Midland Doherty;
Merrill Lynch Royal Securities;
McLeod Young Weir;
Nesbitt Thomson;
Pitfield Mackay Ross;
Richardson Securities of Canada;
Walwyn Stodgell Cochran Murray;
Wood Gundy;
Greenshields Crang Ostiguy.

The last has its head office in Montréal. The others are all Toronto-based. The two largest dealers are Wood Gundy and Dominion Securities, and they are said to control over 40% of the business.

There are apparently about 190 issuers of commercial paper in Canada. The largest, General Motors Acceptance Corporation of Canada, with about $700 million of paper outstanding, announced in the summer of 1977 that it would be placing paper directly with investors, thus bypassing the dealers.

About 75% of the dealers' business takes the form of purchases and sales as principal and 25% is agency business. Issuers ordinarily pay a commission for agency services and offer a discount to dealers buying as principals. Dealers are not allowed to pass on a part of the commission to investors (apparently as a result of IDA regulation) but they may set the price on a resale so as to pass on part of the discount. A principal business, however, requires capital.

The IDA through its Money Market Committee sets some

standards of conduct for money market dealing. There are margin requirements for dealer inventories and members may deal in corporate paper only if the issuer completes a Robert Morris Associates questionnaire or Canadian Sales and Finance (CANSAF) report (the paper is exempt from prospectus requirements).

5. *Money Management*

In February 1975 the Ontario Securities Commission announced it would hold hearings to determine whether registered dealers should be permitted to manage mutual funds. (There was no indication of concern about brokers or dealers exercising discretion over customer accounts.) The Toronto Stock Exchange and Investment Dealers Association filed a joint brief defending the management of funds by dealers. Only sixteen funds, with aggregate assets of $40 million (less than 2% of the mutual fund industry) were dealer-managed. The managers were twelve dealers, one of which did not offer fund shares in Ontario. The other eleven were all members of the IDA; ten were members of the TSE as well. The firms are identified in table 28 taken from appendix A of the brief. The funds were not members of the industry organization – then the Canadian Mutual Funds Association – and did not have "outside" directors.

After the hearings the OSC published Ontario Policy No. 3-32, which prohibits a dealer-managed fund from buying any securities from its manager, acting as principal, and from buying any securities underwritten by the manager within the preceding sixty days. There are no requirements for independent directors and no limits to trading. But the fund must disclose annually both the aggregate commissions and the management fees paid to the dealer-manager.

Although few securities firms are engaged in money management, Shaw and Archibald reported in 1975 that a move to money management was "the major change factor" mentioned by managers in retail firms.[41] This was seen as an important way to reach small investors at low cost.

In the late 1960s and early 1970s institutions in the United States, confronted with fixed, and it appeared to many of them excessive brokerage commission rates, began to press for direct access to stock exchanges. The New York exchange refused to admit financial institutions to membership either directly or

41 7 D. SHAW & R. ARCHIBALD, *supra* note 28, at 68. *See*, *Connelly*, at n. 163, on the general subject of brokers' discretionary management of funds.

Table 28
Registered Dealer-Managed Mutual Funds

1975
In thousands of dollars

	Funds	Net asset value
TSE/IDA members		
Bell Gouinlock	Enterprise Fund	130
Brault Guy O'Brien	Canagex Fund	13,800
	Canagex Bond Fund	4,800
	Canagex International	400
Hodgson	C. J. Hodgson & Co. Ltd. Investment Account	4,920
	Hodgson Pension Investment Account	259
	The Hodgson Retirement Savings Plan Fund	441
Housser	Educators Equity Fund	390
Jones Heward	Jones Heward Fund	2,130
Kingwest Securities	Harvard Growth Fund	2,312
	Pension Mutual Fund	1,560
	Xanadu Fund	1,861
Martens Ball Albrecht	Esto Mutual Fund	132
McEwen Easson	Canadian South African Gold Fund	4,083
Moss Lawson	Mosslaw Growth Fund	412
Walwyn Stodgell & Gairdner	Capital Growth Fund	980
	Capital Income Fund	1,131
		39,741
IDA member only		
Calvin Bullock	Acrofund	5,433
	Canadian Investment Fund	119,057
		164,231
TSE/IDA member[a]		
Pemberton Securities	Pacific Compound/Dividend Fund	5,997
	Pacific Income Fund	850
	Pacific Resource Fund	303
	Pacific Retirement Fund	1,669
	Pacific U.S. Fund	3,074
		11,893
Total		176,124

a. Funds not qualified for sale in Ontario.
Source: Appendix A of the brief submitted to OSC by the TSE and IDA, 1975.

through subsidiaries. But some of the regional exchanges accepted institutions and several joined.

The Securities and Exchange Commission (SEC) was confronted with arguments by member firms that institutions did not belong on exchanges because they were primarily money managers and arguments by institutions that many brokers were also money managers. It attempted to work out rules governing eligibility for membership. The rules called for an "80-20" split of brokerage: a member would have to do at least 80% of its brokerage for public customers and no more than 20% for itself or its affiliates.[42]

The "80-20" rule was one that most member firms could live with comfortably. But when the issue moved from the SEC to congressional hearings, the arguments by the exchanges and member firms against the iniquity of mixing brokerage with money management were more persuasive than they intended and the "80-20" rule became a "100-0" rule.

Blyth Eastman Dillon & Co. Incorporated was in 1972 the largest securities firm not a member of the New York Stock Exchange. The firm resigned its stock exchange membership in January 1970 when it became a wholly-owned subsidiary of INA Corporation. The sale to INA was, according to the president of Blyth, motivated by "a belief that it was necessary to make permanent the capital of people in our business, and private ownership did not assure the permanence of capital".[43] Blyth was quite willing to undertake to do no commission business with its parent and the president commented: "it seems only equitable,...that whatever regulation, in terms of the proportion of business that might be done between a broker-dealer and its parent, should be applied with equal effect to business done by the broker-dealer with what might be deemed to be institutional funds controlled by him."[44]

A representative of Connecticut General Life Insurance commented that in the competition between institutions and member firms for pension fund business the member firms had a competitive advantage in offering both brokerage and advisory services to potential pension fund clients. He said "we believe that it is the practice of these member firms to reduce advisory fees, either

42 Rule 19b-2 became effective in 1973. Floor traders were exempt from any limitations.

43 *Study of the Securities Industry: Hearings before the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce*, 92d Cong. 2d Sess., pt. 8, at 3978 (April and May 1972).

44 *Id.* at 3979.

directly or indirectly, wholly or in part, by the amount of brokerage commissions paid by the managed account."[45]

The managing partner of Salomon Brothers, one of the most heavily capitalized investment banking firms in the U.S., said his firm did not oppose institutional membership for the purpose of entering the general securities business. He commented that widespread entry of insurance companies might pose questions of economic concentration but said: "non-financial institutions, however, could considerably strengthen the securities industry with permanent capital." With respect to brokerage and money management he said: "it would be unfair to permit member firms to manage mutual funds and other pooled investments while prohibiting institutional membership. Uniform standards should be applied to all firms regardless of whether they became brokers or money managers first."[46]

The summary of the principal provisions of the Securities Reform Act of 1975 for the Senate Committee on Banking, Housing and Urban Affairs commented that institutional memberships on stock exchanges had caused impediments to fair competition between investment managers, conflicts of interest, and distortions in the efficient allocation of securities trading. The act was to resolve these problems by prohibiting stock exchange members from effecting *any* transaction on the exchange for accounts in which the member or an associated person had a financial interest or with respect to which the member or associate exercised investment discretion.[47] Section 11(a)(1) of the amended Securities Exchange Act has this effect, subject to exceptions, including the authority of the SEC to make rules permitting transactions for a member's own account or "any other transaction".

The new legislation was not to affect existing members until May 1978, and the SEC began to draft new rules. In March 1977 three new rules were proposed to permit members to trade for their own accounts (yielding priority to nonmembers), to prohibit any transaction charges by member firms to accounts subject to their investment discretion, and to permit a member firm to use another firm for transactions in a managed account.[48]

The Securities Industry Association had difficulty adopting a

45 *Id.* at 3992.

46 *Id.* at 4031-32.

47 *Securities Acts Amendments of 1975: Hearings before Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 94th Cong., 1st Sess. 179 (February 19, 20 and 21, 1975).

48 Securities and Exchange Commission, Securities Exchange Act of 1934 Release No.

position on the separation of brokerage and portfolio management. It supported section 11(a) of the Securities Exchange Act, then asked SEC to relax the ban, then opposed the new rules and apparently prepared to press for repeal of section 11(a). Institutions, which had already achieved the benefits of competitive commission rates and did not feel the formerly strong need to join exchanges, were afraid the new rules might compel them to join to satisfy fiduciary obligations. And some members of Congress apparently felt the proposed rules contradicted section 11(a).

The SEC continued to struggle with the problem, while asking Congress to postpone the May 1978 effectiveness date for section 11(a). In March 1978 it modified the March 1977 proposal so as to (1) permit management of client accounts so long as the client's consent was obtained in advance of every trade, (2) permit management of accounts where transactions are handled by unaffiliated firms, (3) permit transactions for an associated person or a customer of an associated person if the same transaction for a client account would be permitted, and (4) permit members to trade for their own accounts in a variety of ways.[49]

6. *Diversification*

In 1976 a joint industry committee published a set of guidelines for diversification of the Canadian securities industry.[50] It was clear from the publication that the securities industry was uneasy over the growth of banks, trust companies and insurance companies and their diversification into securities-related activities. If developments in the United States were any guide, they suggested that banks in particular could provide stiff competition in the brokerage and underwriting business. The strategy of the joint industry committee seemed to be to draw defensible lines of demarcation between the securities industry and these threatening industries, to justify the demarcation and to restrain the securities industry itself so as not to undercut arguments for the restraint of competitors.

The securities industry in the United States had been undergoing substantial diversification, especially since the unfixing of commission rates in May 1975. There had been a substantial move away from dependence on a commission business, and the immi-

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13388, March 18, 1977, [1976-1977 Transfer Binder] CCH FED. SEC. L. REP. ¶ 81,013 (proposed rules 11a2-1, 11a1-3, 11a2-2).

49 SEC, Securities Exchange Act of 1934 Release No. 14563, March 14, 1978, 2 CCH FED. SEC. L. REP. ¶ 22,808.

50 REPORT OF THE JOINT INDUSTRY COMMITTEE ON GUIDELINES FOR DIVERSIFICATION OF THE SECURITIES INDUSTRY (September 23, 1976).

nence of a National Market System with expected shifts in brokerage business and a very likely rise in dealer as opposed to broker activities has led to more diversification, some through mergers in 1976 and 1977.[51]

The joint committee began with the existing rules of the stock exchanges and the IDA. The by-laws of the Toronto Stock Exchange and Montreal Stock Exchange require that the principal business of a member "shall be that of a broker or dealer in securities and it shall be active in such business to an extent acceptable to the Exchange".[52] The by-laws of the Investment Dealers Association require that for a member "at least 60% of that portion of the total gross profits of the business which arises from its dealing with the public, or if the applicable District Council in its discretion so approves, at least 60% of the total dollar volume of the business, results from or consists of the underwriting, distribution or buying and selling from and to the public in Canada, and either as principal or agent, of investment securities".[53]

The committee divided present and potential activities of brokers and dealers into four general classes: securities-related activities; non-securities-related activities, but financial in nature; nonfinancial; and restricted industries (see table 29). It took the position that brokers and dealers should not enter the restricted industries, including banking, trust and loan business, and life insurance. It raised no objection to diversification into nonfinancial businesses so long as these were conducted through separate legal entities and did not jeopardize the financial strength of the broker or dealer operation. The committee was not explicit but by implication seemed to approve all of the securities-related activities and the financial activities. It was quite explicit in supporting dealer-managed mutual funds.

The Toronto Stock Exchange approved the committee's report in April 1977 and indicated that proposals to diversify should be submitted by members for exchange approval.[54]

While the joint industry committee's table of activities gives some idea of what brokers and dealers in Canada are doing, it provides no indication of the relative importance of these activities. Table 18 provides some insights into sources of revenue for TSE member firms.

51 Plans for a National Market System are discussed in *Williamson, Capital Markets*, ch. IV.

52 TSE by-laws, pt. V, sec. 5.01, 3 CCH CAN. SEC. L. REP. ¶ 89-271; MSE by-laws III, art. 3301, 3 CCH CAN. SEC. L. REP. ¶ 85-301.

53 IDA by-laws, No. 1, s. 1.1(b)(f), IDA, BLUE BOOK 404B (1977); IDA by-laws, No. 2, s. 2.2, *id.* at 406.

54 Toronto Stock Exchange, Notice to Members No. 1465 (April 27, 1977); Notice to Members No. 1538 (September 7, 1977).

Table 29
Present and Potential Activities of Securities Firms

Securities-related activities	
As agent	As principal
Stock trading*	Stock trading*
Bond trading*	Bond trading*
Corporate advisory services*	Underwriting*
Merger and acquisition advice*	Money market*
Execution functions*	Commodity trading*
Research*	Puts and calls*
Custodial services*	Mortgage banking*
Money market*	Federal funds trading*
Federal funds trading*	
Money management (discretionary accounts, investment counseling)*	
Mutual fund sales*	
Mutual fund management*	
Commodity trading*	
Options trading*	
Puts and calls*	
Mortgage brokerage*	
Venture capital*	
Leasing brokerage*	
Foreign exchange*	
Non-securities-related activities but financial in nature	
As agent	As principal
Interbank deposit brokerage*	Leasing as principals
Finance and loan activities	
Performance measurement*	
Income tax advice	
Estate planning	
Life insurance	
Real estate	
Fire, general and casualty insurance	
Non-financial	
This would include any non-financial business venture such as hotels, publishing, management consulting, computer services, etc.	
Restricted industries	
Operation of a bank licensed under the Bank Act.	
Operation of a trust or loan company licensed under the Trust Companies Act (Canada) or the Loan and Trust Corporations Act (Ontario) or other similar provincial legislation.	
Operation of a life insurance company licensed under the Canadian and British Insurance Companies Act (Canada) or similar legislation.	

*Areas where one or more firms are known to be active.
Source: *Report of Joint Industry Committee*, 1976, *supra* note 50.

Diversification clearly has implications for the capital needs of the industry. These needs are discussed later in this chapter. A case can be made that the Canadian securities industry is limited in terms of its present activities, let alone potential activities, because of its present capital and restricted access to further capital.

D. COMPETITION POLICY

1. *The Securities Industry and the Combines Investigation Act*

The Combines Investigation Act[55] prohibits, in general, conspiracies and agreements to limit competition, including agreements to share markets and agreements to maintain prices. Until the 1976 amendments, the statute applied only to the sale of products but in that year it was made to apply as well to the sale of services. So the fixing of minimum commission rates on stock exchanges and the usual practice, in international underwritings of securities of dividing markets (for example, giving the Canadian market to the Canadian underwriters and the United States market to the American underwriters) would appear to be illegal. However, the courts have interpreted the act to exempt conduct that is subject to regulation either by a government body or by certain self-regulatory organizations within an industry.[56] Since the Ontario Securities Commission has taken on the responsibility of direct review and approval of commission rates, it seems likely that the fixing of these rates would be regarded by the courts as exempt from the act. However, this is far from certain, and the Director of Investigation and Research under the act has said:

> "Those activities which are subject to regulation by a public authority, acting under valid and specific legislation are exempt, if the activity is effectively regulated and the regulation covers such matters and is for such purposes as to make the application of the Combines Act incongruous....
>
> "The fixing of minimum commission rates by the Toronto Stock Exchange is, in effect, an exercise of self-regulation by a cartel. (Furthermore, this action, in the absence of proper legislative or regulatory approval, would be in violation of the Combines Investigation Act.)
>
> "If this practice continues it is difficult to see how the

55 R.S.C. 1970, c. C-23, *as amended.*

56 In Reference re the Farm Products Marketing Act, 7 D.L.R. (2d) 257, [1957] S.C.R.

[Ontario Securities] Commission can avoid detailed investigation, amounting to rate setting, to ensure that the public interest is being protected."[57]

The market splitting or price maintenance activities of securities underwriters in both primary and secondary distributions are specifically exempt from the act.[58] This exemption was added to the act at the request of the Investment Dealers Association when the act was extended in 1976 to apply to services.

Bill C-42, introduced in March 1977 (and again, with some revisions, in November 1977, as Bill C-13), would make a substantial change to the status of commission rate fixing and market sharing. First, the bill as originally presented, included no explicit exemption for underwriters or any other part of the securities industry. Second, it offered a specific exemption for "regulated activity" to replace the court interpretations referred to above.[59] The price fixing and market sharing prohibitions would not apply "in respect of regulated conduct" which was defined in terms of three requirements. First, the conduct would have to be expressly required or authorized by a public agency deriving its power from federal or provincial legislation and not appointed or elected by the persons to be regulated; the self-regulatory organizations then – the IDA or the stock exchanges – would not qualify as public agencies, while the Ontario Securities Commission would. Second, the public agency would have to be expressly empowered by legislation to regulate the conduct in the manner in which it was being regulated and the agency would have to have expressly directed its attention to the regulation of the conduct. Third, circumstances would have to be such that attainment of the regulatory objectives under the federal or provincial legislation would conflict seriously with the Combines Investigation Act. If all these conditions were met, then the act would not apply to the conduct. (The third requirement was eliminated by Bill C-13.)

The securities industry immediately objected to the proposals. Even though the Ontario Securities Commission had taken on responsibility for supervising and approving the fixed commission rates, there was considerable doubt that this activity complied with all of the elements described above as necessary to exempt the rate fixing from the act. In addition, nothing the Ontario

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198, the Supreme Court found regulatory schemes based on valid legislation not to be "to the detriment or against the interests of the public".

57 Submission by the Director of Investigation and Research, Combines Investigation Act, to the Ontario Securities Commission regarding Fixed Commission Rates on the Toronto Stock Exchange, July 1976, at 2, 13.

58 Section 4.1 exempts underwriting from ss. 32, 38.

59 In proposed new s. 4.5.

Securities Commission did would seem to confer an exemption on market sharing by underwriters. A variety of less significant regulatory activities by the stock exchanges and the IDA would also be suspect under the act. Finally, the IDA objected to prohibitions on interlocking directorships which might preclude an investment dealer from being a director of an underwriting client. The Combines Investigation Act does permit an arrangement that "relates only to a service and to standards of competence and integrity that are reasonably necessary for the protection of the public".[60] This clause might protect a number of the activities of a self-regulatory organization, but not all of them.

The IDA asked first for an exemption for the securities industry comparable to the exemption for underwriting in the present act.[61] Failing this, it asked for an exemption for the activities of a self-regulatory association if every member of the association were registered with a provincial or federal agency. For the securities industry this exemption would be equivalent to the first exemption requested. As a further alternative, it asked for a provision such that rules of the self-regulatory organization that were approved by a federal agency would be exempt. And as a final alternative, the IDA requested elimination of the explicit exemption for regulated conduct so that the case law would still stand. With respect to the specific prohibitions in Bill C-42 of market sharing in foreign distributions and interlocking directorships,[62] the IDA asked that at least the anticompetitive effects should be weighed against evidence of benefits.[63]

The Senate Banking, Trade and Commerce Committee reported in the summer of 1977 its general dissatisfaction with Bill C-42. Specifically, the committee recommended that industries and professions subject to regulatory agencies remain under the exclusive jurisdiction of those agencies.[64] It appears from the report of the committee that it approved the exclusion of self-regulatory organizations from the definition of a "public agency", but that it would have exempted from the proposed Competition Act *any* conduct authorized or tacitly approved by a public agency.

60 Section 32(G).

61 Submission by the Investment Dealers Association of Canada to the Hon. Anthony G. Abbott, Minister of Consumer and Corporate Affairs, May 17, 1977, at 6, 7, *reprinted in Minutes of Proceedings and Evidence of the Standing Committee on Finance, Trade and Economic Affairs*, issue No. 52, at 52A:36, 37 (June 7, 1977).

62 Sections 32.1, 31.75.

63 Submission by the IDA, *supra* note 61, at 9-10, 12-13, *reprinted in Minutes of Proceedings and Evidence of the Standing Committee on Finance, Trade and Economic Affairs*, *supra* note 61, at 52A:39-40, 42-43.

64 *Proceedings of the Standing Senate Committee on Banking, Trade and Commerce:*

The House Standing Committee on Finance, Trade and Economic Affairs, on the other hand, supported the proposition in the bill that even regulated conduct should be insulated from the free forces of the market only "where there is a clear and demonstrable public purpose to be served, and only then if adequate safeguards are put in place to insure that the public interest is adequately and fully taken into account by appointed bodies responsible for the supervision of those they regulate".[65] More specifically, the House committee supported the proposition that regulated conduct should be exempt from the proposed act, provided that it is being responsibly reviewed by an impartial body. And it expressed the opinion that an agency composed of representatives of the persons regulated is not impartial. But the committee felt that it would be enough to justify an exemption that the regulated conduct would be "required or authorized by a government appointed 'public agency' that is clearly entitled to control such conduct and is, in fact, attentively doing so".[66] The committee also recommended that the proposed Competition Board be given discretion to take into account any gains in efficiency to society.[67] Bill C-13 reflected this recommendation in its definition of restraint or injury as the result of market sharing or price fixing, and also provided an exemption for underwriters of international issues from the ban on market sharing.

2. *The United States Industry and Antitrust Law*

The SEC has had authority under the Securities Exchange Act of 1934 to veto as well as to modify or add to the rules and practices of a stock exchange. Over many decades, the power was exercised only once, in the so-called "multiple trading case".[68] The case arose in 1940, when the New York Stock Exchange issued a ruling barring its members from transactions on regional exchanges in interlisted stocks. The result of the ban would probably have been to put the regional exchanges out of business and to transfer all trading in interlisted stocks to the New York Stock Exchange. The commission instituted a public proceeding and issued an order rescinding the ban.

The application of the antitrust laws to the New York Stock

Fifth Proceeding on Study of the Subject Matter of Bill C-42 (Competition Policy), Interim Report, Issue No. 48, at 21-22 (July 6, 1977).

65 *Report of the Standing Committee on Finance, Trade and Economic Affairs, House of Commons Votes and Proceedings*, August 5, 1977, at 1467.

66 *Id.* at 1476-77.

67 *Id.* at 1519.

68 *In re* Rules of the N.Y. Stock Exchange, 10 SEC 270, 283-84 (1941).

Exchange was tested in *Silver v. New York Stock Exchange*[69] in 1963. The Court of Appeals for the Second Circuit reversed a judgment in favour of Silver, who complained of an exchange ban on private lines from his office to the offices of member firms, and held that the Securities Exchange Act of 1934 gave to the exchange powers in the exercise of which the exchange was not subject to the antitrust laws. The Supreme Court reversed, declaring that exemption from antitrust laws would apply only if necessary to make the Securities Exchange Act work and then only to the minimum extent necessary.

In 1967, however, the U.S. Supreme Court denied *certiorari* in *Kaplan v. Lehman Brothers.*[70] Kaplan had claimed that the fixing of minimum commission rates by the exchange's constitution was in violation of the antitrust laws but the District Court and Court of Appeals concluded that since commission rates were subject to review by the SEC, they were by implication exempt from the antitrust laws. This decision was in effect overruled in 1971, when the Supreme Court denied *certiorari* in *Thill Securities Corporation v. New York Stock Exchange.*[71] Once again, the case concerned fixed commission rates but the Court of Appeals held that SEC oversight did not necessarily imply antitrust immunity. Following *Silver*, anticompetitive conduct would be considered immune only if necessary for the operation of the Securities Exchange Act. Then in 1975, in the *Gordon* case, the Supreme Court unanimously found fixed commission rates on the New York exchange to be exempt from the antitrust laws.[72] The long history of fixed rates (since 1792), the congressional awareness of rate fixing and its delegation of fixed rate oversight to the SEC, and a conclusion that application of the antitrust laws to commission rate fixing would preclude and prevent the operation of the exchange act as intended by Congress, led to an implied immunity.

In June 1975 the Securities Reform Act of 1975 went into effect, just after the SEC had implemented its requirement that commission rates no longer be fixed. The revised Securities Exchange Act gives the SEC specific direction to remove existing burdens on competition and to prevent new burdens that are not necessary to the purposes of the act. The amendments removed

69 Silver v. New York Stock Exchange, 196 F. Supp. 209 (S.D.N.Y. 1961), *rev'd*, 302 F.2d 714 (2d Cir. 1962), *rev'd and remanded*, 373 U.S. 341 (1963).

70 Kaplan v. Lehman Brothers, 250 F. Supp. 562 (N.D. Ill. 1966), *aff'd*, 371 F.2d 409 (7th Cir. 1967), *cert. denied*, 389 U.S. 954 (1967).

71 Thill Securities v. New York Stock Exchange, 433 F.2d 264 (7th Cir. 1970), *cert. denied*, 401 U.S. 994 (1971).

72 Gordon v. New York Stock Exchange, 422 U.S. 659 (1975). *See* Linden, *A Reconciliation of Antitrust Law with Securities Regulation: The Judicial Approach*, 45 GEO. WASH. L. REV. 179 (1977).

section 15A(n) which had stated that section 15A, concerning registered securities associations, should prevail over all other legislation. The Senate committee report declared that this removal was not intended to change the state of the law[73] and it appears that Congress wished to perpetuate the conclusions in the *Silver* and *Thill* cases, to the effect that behaviour necessary to the purposes and operation of the act but no other behaviour would be exempt from the antitrust laws. The *Gordon* case, however, may have frustrated this wish.

E. SOURCES AND ADEQUACY OF CAPITAL IN THE CANADIAN SECURITIES INDUSTRY

When the giant of the United States securities industry – Merrill Lynch, Pierce, Fenner & Smith – purchased Royal Securities in 1969, the Investment Dealers Association and the major stock exchanges promptly established a committee to study sources of capital for the industry and agreed to accept no applications for nonresident capital participation in member firms pending the committee's report. The industry was caught between the threat of an invasion by well-capitalized foreign firms (Merrill Lynch already had far more capital than the entire Canadian industry and the New York Stock Exchange was about to authorize public ownership of member firms)[74] and a policy agreed to by the industry and apparently by the Ontario Securities Commission that sources of outside capital for securities firms be limited to the resources of those engaged in management.

The committee published its report in May 1970 and recom-

73 SECURITIES ACTS AMENDMENTS OF 1975, REPORT OF THE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS, TO ACCOMPANY S. 249, S. REP. No. 75, 94th Cong., 1st Sess. (April 14, 1975).

74 The New York Stock Exchange, under extreme pressure from Donaldson, Lufkin and Jenrette, which had announced that it was "going public" and would leave the exchange if necessary, agreed to public ownership of members in July 1970. NASD firms had for some years been allowed to have public shareholders. Merrill Lynch began operating in Canada in 1925, through an office of one of its predecessors, E.A. Pierce & Co. (a U.S. firm founded in 1820), in Toronto. Offices were subsequently opened in Montréal, Vancouver and Calgary in 1960, 1964 and 1968. Merrill Lynch joined the Investment Dealers Association of Canada in 1952, took over the E.A. Pierce seat on the TSE in 1940, and joined the Montreal and Vancouver exchanges when offices were opened in those cities. In 1969 Merrill Lynch acquired 100% ownership of Royal Securities, a firm with 15 offices located in all the provinces. The Merrill Lynch Canadian operations were subsequently merged with Royal Securities, to form Merrill Lynch, Royal Securities Limited. Merrill Lynch (U.S.) became publicly owned in June 1971; Submission by Merrill Lynch, Pierce, Fenner & Smith Incorporated and Royal Securities Limited to the Ontario Securities Commission Industry Ownership Study Committee, at 2, 3, 16 (September 1971).

mended very limited recourse by securities firms to capital outside management resources and maximum 25% ownership of a Canadian firm by non-resident individuals (but not foreign securities firms), with a grandfather clause to protect existing foreign-owned firms, provided they and their parents did not make use of capital sources forbidden to resident-owned firms.[75]

The committee concluded that the industry's capital was adequate. Brokerage was found to be the activity needing the greatest amount of capital. Dealer activities required less (114 firms used 25% of their capital for this purpose). The capital of 102 firms furnishing data had grown at 7.5% a year in the decade 1959 to 1969, mostly from retained earnings, and the committee concluded that this growth had been sufficient to meet the demands placed on the industry.[76] It went on to say that over the medium term it appeared that current sources of capital would be adequate.[77] However, the committee did recognize a "turnover" problem involving transfer of ownership from older management to younger succession while maintaining firm capital and concluded that a certain amount of outside financing might be appropriate to deal with it.

After reviewing the disadvantage of "outsider" investment in securities firms, including influences that might detract from good faith dealing and possible restrictions on competition, and conflicts inherent in a firm selling and dealing in its own securities, the committee recommended limited recourse to "approved investors" outside the firm. These investors would require approval of the firm's board of directors and by the appropriate "regulatory authorities", the Investment Dealers Association or a stock exchange. Approved investors would be limited to 50% of the capital of a firm and subordinated debt held by them would have to be medium- or long-term debt. No more than 25% of a firm's

75 Moore Committee Report, *supra* note 31, at 10-14, 17-18. A joint industry committee disagreed with the Moore Committee Report on two points: it recommended "Canadianizing" the existing nonresident-controlled firms and it recommended that nonresident securities firms be allowed to hold all or part of the 25% nonresident ownership, with any one firm's holdings limited to 10%; Report of the Joint Industry Committee on the Moore Report (July 1971).

76 Moore Committee Report, *supra* note 31, at 53.

77 *Id.* at 55. Merrill Lynch challenged this conclusion, and suggested probable growth in dealer activity in Canadian stocks; *see* Merrill Lynch submission, *supra* note 74, at 22-23. It was not until 1977, however, that a substantial change in the scope of this activity came about. *See, Williamson, Capital Markets*, ch. II. Merrill Lynch noted that when Goodbody & Co., one of the largest U.S. brokerage firms, failed in 1970, Merrill Lynch was the only firm sufficiently capitalized to take it over; Merrill Lynch submission, *supra* note 74, at 25.

voting or participating (in profits) securities could be held by outsiders and no one outsider could hold over 10%.[78]

It is interesting that the committee recognized that the restrictions it proposed for members of the IDA and the stock exchanges would put these firms at a serious disadvantage with respect to nonmembers, unless the latter were bound by the same restrictions. It is hard to see in this conclusion anything other than a realization that the restrictions would reduce the ability of firms to serve customers efficiently. The committee's report urged the IDA and the stock exchanges to press for government action to impose the restrictions on nonmembers too.[79]

Shortly after the Moore Committee released its report, a committee appointed by the Québec Minister of Financial Institutions, Companies and Cooperatives to consider the same issues published its interim and final reports. The conclusions of the Bouchard Committee differed dramatically from those of the Ontario industry committee. One reason had to do with the ownership of the Québec securities industry. While firms controlled in Québec made up 60% of the number of firms included in a survey of the industry, over 60% of the Québec industry's capital was represented by Ontario-based firms.[80] Some other statistics, including share of total inventories of securities, showed an even clearer domination of the industry by Ontario firms. Of the top fifteen firms, in terms of capital, ten were Ontario firms and only three had head offices in Québec.[81] And it was clear that Ontario firms showed a much greater penetration of the Québec securities market than Québec firms had achieved in the Ontario market.[82]

The Bouchard Committee was also impressed with the importance of capital to a securities firm, concluding that there were important economies of scale. The report went so far as to recommend a minimum total capital of $250,000.[83]

Given this background it is not surprising that the *Bouchard Report* recommended that no purchase or sale of securities by

78 MOORE COMMITTEE REPORT, *supra* note 31, at 100-04, 115-19. The recommendations, as modified by a Joint Industry Committee, are summarized in OSC, REPORT OF THE SECURITIES INDUSTRY OWNERSHIP COMMITTEE, *supra* note 20, at 141-43.

79 MOORE COMMITTEE REPORT, *supra* note 31, at 115. The Joint Industry Committee agreed with the *Moore Committee Report* recommendations as a temporary device, but said that the restrictions on outside capital would place the Canadian securities industry at a disadvantage with respect to the industry in the United States; REPORT OF THE JOINT INDUSTRY COMMITTEE, *supra* note 75.

80 QUÉBEC DEPARTMENT OF FINANCIAL INSTITUTIONS, COMPANIES AND COOPERATIVES, 1 STUDY ON THE SECURITIES INDUSTRY IN QUÉBEC, FINAL REPORT 38 (June 1972) [hereinafter BOUCHARD REPORT].

81 *Id.* at 82.

82 *Id.* at 86.

83 *Id.* at 115.

Québec investors be allowed except through an agent registered with the Quebec Securities Commission[84] and that firms registered with the commission be free to sell up to 49% of their voting capital stock to outsiders.[85] But ownership by a single outsider would be limited to 10% of the voting capital in a firm[86] and at least 25% of the voting stock of any firm operating in Québec would have to be owned by officers and employees resident in that province.[87]

The *Interim Report* of the Bouchard Committee had been published when the Securities Industry Ownership Committee of the Ontario Securities Commission was charged with a study of capital and foreign ownership in the Ontario industry. The Ontario committee was impressed with the difficulties in passing ownership of a securities firm from retiring to new management and at the same time maintaining the firm's capital.[88] The Moore Committee had admitted the problem was a real one but the Securities Industry Ownership Committee followed it up to discover the substantial increase in subordinated loans that, with share capital and surplus, make up the bulk of the capital of the firms. From 1964 to 1971 for 71 investment dealers, subordinated loans rose from 15% to 31% of the sum of share capital and loans.[89] At the same time surplus was probably rising substantially so that loans as a fraction of total capital may have been rising much more slowly. The ratio in 1971 was 16%.[90] For five Canadian-owned brokers (members of the TSE but not the IDA), however, subordinated loans were 37% of total capital in 1971.[91] As a practical matter subordinated loans are for most firms probably the most flexible ownership device. Capital can be inserted and withdrawn quickly and easily, which is convenient for the owners but means that a portion of the industry's capital is subject to rapid withdrawal.

The committee could not find much evidence upon which to base conclusions on capital adequacy. Not only did the "mix" of business show substantial changes over the years but few firms seemed to know how profitable their different activities were.[92] There was a little evidence of business turned away for want of

84 *Id.* at 128. The intention was that Québec investors be required to use Québec brokers and not go to markets outside the province; *see* discussion in note 13 *supra*.
85 Bouchard Report, *supra* note 80, at 130.
86 *Id.* at 132.
87 *Id.* at 134.
88 OSC, Report of the Securities Industry Ownership Committee, *supra* note 20, at 50-51.
89 *Id.* at 157.
90 *Id.* at 156.
91 *Id.* at 161.
92 *Id.* at 64-65.

capital[93] and the committee concluded that additional and more permanent capital was needed by the securities industry if it was to achieve greater efficiency, provide broader advice and more effective service, particularly to attract institutional clients, and if it was to remain competitive in the national and international securities markets.[94]

In considering sources of capital the committee rejected continuation of the existing policy of the commission which was to limit capital to the resources of those managing the firm.[95] It also rejected the Moore Committee's recommended limited use of outside capital from "approved investors" but did not go quite as far as the Bouchard Committee had gone in its *Interim Report* in proposing more or less unlimited access to investor capital. The committee recommended access to outside capital subject to a set of conditions very similar to those of the NYSE and NASD in the United States. A dealer might offer its securities to the public if it were a public company with at least $2 million in equity capital, of which at least $1 million would have to be issued shares, and half of them voting shares. Some criteria having to do with experience and stability would have to be met and any holder of 5% or more of a class of transferable securities, other than an officer or director, would have to be "approved" by the commission.[96]

Table 30 shows the top twenty U.S. securities firms by size of capital, and the capital (equity plus subordinated debt) of ninety-four Canadian firms and sets of these firms.[97] It is clear that capital in the Canadian industry is very small by U.S. standards. The top twenty U.S. firms had capital of $2,503 billion, twelve and a half times the capital of the Canadian industry. The entire United States industry probably had twenty times the capital of the Canadian industry. Even if Merrill Lynch is excluded, the nineteen largest U.S. firms in table 30 had over nine times the capital of the entire Canadian industry. This contrasts sharply with the respectable showing of Canadian firms in lists of top underwriters in the United States.

About a dozen Canadian investment dealers file annual financial statements with the Corporations Branch of Consumer and Corporate Affairs Canada, in Ottawa. Wood Gundy is one of them and almost certainly has the largest capital of any Canadian firm;

93 *Id.* at 66.

94 *Id.* at 77. The committee was also impressed with the criticisms in the "informal" *Gray Report,* leaked to the press in mid-November 1971, of the capital market in Canada.

95 *Id.* at 80.

96 *Id.* at 95-96, 183-87.

97 *See* note 25 *supra,* for details on data source.

Table 30
Capitalization of the United States Securities Industry, Ranked by Group and Size of Firm, with Comparative Canadian Data

As of March 31, 1977
In thousands of dollars

U.S. firms		Capital[a]	Canadian firms
1	Merrill Lynch	640,000	
		200,000	All 94
		192,000	60 largest
2	Salomon Brothers	192,000	
		180,000	40 largest
3	Dean Witter Reynolds	176,000	
		157,000	20 largest
4	Bache Halsey Stuart Shields	152,000	
5	E. F. Hutton	150,000	
	11 major U.S. regional firms	130,000	
		123,000	10 largest
6[b]	Paine Webber Jackson & Curtis	116,000	
7	Goldman Sachs	100,000	
8[b]	Loeb Rhoades	88,796	
9	First Boston	85,912	
10	Blyth Eastman Dillon	85,527	
11[b]	Shearson Hayden Stone	84,112	
12	Stephens	83,831	
		78,000	5 largest
13[b]	Drexel Burnham Lambert	75,000	
14	Donaldson Lufkin & Jenrette	74,000	
15	White Weld	73,000	
16	Allen	70,605	
17	Kidder Peabody	65,068	
18	Smith Barney Harris Upham	65,068	
19	Becker Warburg Paribas	65,000	
20[b]	Lehman Brothers	58,781	

a. Capital includes equity and subordinated debt.
b. Subsequently grown through merger.
Sources: United States data, *Securities Week* (New York), October 17, 1977; Canadian data, *see* note 25 *supra*.

as of December 31, 1976, its capital (equity and subordinated debentures) was about $24 million. This size would have placed Wood Gundy about thirty-seventh in a ranking of U.S. firms. (Wertheim & Co., Inc., with a capital of $24.6 million, ranked thirty-seventh at the end of 1976.) It would come after the major national underwriters, but it would come ahead of the major U.S. regional firms. Piper, Jaffray & Hopwood Incorporated had a capital of $16.5 million, Dain, Kalman & Quail, Inc. had $15.5 million, and Prescott, Ball & Turben had $14.6 million.

The degree of concentration of capital in the Canadian industry (see table 31) is about the same as for commission revenue (as shown in table 20) and is greater than concentration in the United States, where the top twenty-five firms have about 64% of industry capital. The correlation between capital and commission revenue, as shown in table 32, seems to be fairly high, at least for the largest commission firms. These firms, ranked on the basis of commission business, show about the same share of both industry capital and commission revenue.

The correlation between capital and "other revenue" shown in table 33, seems to be somewhat lower for the top "other revenue" firms. A regression analysis for all ninety-four firms showed:

Capital = $470,000 + $.30 per $1 of commission revenue + $.33 per $1 of other revenue.

And:

Capital = $440,000 + $.32 per $1 of total revenue.

These results can be compared with the figures in table 34 which represent the judgment of TSE members on the capital needed for commission business and other business. The membership collectively estimated about 40¢ in capital to support $1 in annual commission income, while the regression above indicated 30¢. But the regression also indicated a "basic" capital of close to $500,000 for a member firm, so the difference is not surprising. The membership estimated about 50¢ of capital to support $1 of total income, while the regression indicated 32¢. Once again, the difference is not surprising, because the regression includes $440,000 of basic minimum capital. Both the membership estimates and the regressions indicate that less capital is required to support a dollar of commission revenue than to support a dollar of "other" revenue.

F, FOREIGN OWNERSHIP

1. *The Canadian Securities Industry*

The *Moore Committee Report* listed fifteen securities firms either controlled or wholly-owned abroad with memberships in

Table 31
Canadian Securities Industry: Concentration in Capital

1976–77

	Capital
Top 5	39%
Top 10	61
Top 20	78
Top 25	82
Top 40	90
All 94	100

Source: *See* note 25 *supra*.

Table 32
Canadian Securities Industry: Concentration in Commission Revenue and Corresponding Capital

1976–77

	Commission revenue	Capital
Top 10	55%	58%
Top 20	75	75
Top 40	91	84
Top 60	98	89
All 94	100	100

Source: *See* note 25 *supra*.

Table 33
Canadian Securities Industry: Concentration in Other Revenue and Corresponding Capital

1976–77

	Other revenue	Capital
Top 10	86%	57%
Top 20	94	72
Top 40	98	83
All 94	100	100

Source: *See* note 25 *supra*.

Table 34
Capital Allocation of Toronto Stock Exchange Member Firms

1976 and 1977
In dollars

	Capital used for agency business[a]		Capital per $100 total income[b]		Capital per $100 security agency income[b]	
	1976	1977	1976	1977	1976	1977
All classes	36.1%	34.1%	$52.3	$49.3	$40.4	$38.7
National diversified firms	30.0	27.2	53.2	49.0	37.9	35.9
High value per trade (institutional)	70.5	70.5	46.0	45.4	40.4	36.6
Low value per trade (retail)	66.9	71.4	52.5	56.1	55.8	56.1

a. As of March 31.
b. Years ending March 31. Some differences in 1976 and 1977 samples of firms.
Source: Toronto Stock Exchange.

one or more of the IDA and the four stock exchanges. Of the fifteen, thirteen were controlled by or were branches of U.S. firms. The brokerage activities of these firms were chiefly in U.S. securities,[98] and they had not been very active in underwritings in Canada until the Merrill Lynch acquisition of Royal Securities suggested a change.[99] (It is not clear from the report whether Canadian underwriting would be a credit to the foreign-controlled firms or would be held against them. This lack of clarity may stem from a belief that if they were active in underwriting they would benefit Canadian industry but would present unwelcome competition to Canadian underwriting firms.)

After lengthy consideration of possible costs and benefits associated with foreign (essentially U.S.) controlled firms operating in Canada, the report concluded that no more such firms should be allowed to join the IDA or the stock exchanges and that no investment by a foreign securities firm should be permitted in any member, but that a grandfather clause should protect existing foreign-controlled members.[100] But even that protection would be precarious, with membership subject to withdrawal of the grandfather clause if control of the firm were transferred or capital were obtained in a manner not open to Canadian-controlled firms.[101]

Again, the fear of the competitive advantages that would accrue to firms able to raise capital from the public led the committee to urge that a foreign firm be denied registration if it obtained

98 For the fiscal year ending March 31, 1969, commissions on transactions in Canadian securities for Canadian residents for the group were given as $10 million, and commissions on transactions in U.S. securities for Canadian residents as $17 million; MOORE COMMITTEE REPORT, *supra* note 31, at 126. Merrill Lynch, however, said that on July 31, 1971, it held $56.5 million in Canadian securities and only $13 million in U.S. securities for Canadian customers. For all of its customers it was holding $265 million in Canadian securities; Merrill Lynch submission, *supra* note 74, at 9, 39. Merrill Lynch also commented on the recent admission of two Canadian firms by the New York Stock Exchange. The *Moore Committee Report* had noted that 15 Canadian firms had offices in the U.S.; Merrill Lynch submission, *supra* note 74, at 47.

99 MOORE COMMITTEE REPORT, *supra* note 31, at 127. Merrill Lynch said frankly that "[it] had in prior years been advised on a number of occasions, privately, that neither Merrill Lynch nor any other American brokerage firm would be invited to participate generally in syndicate or banking groups in Canada"; Merrill Lynch submission, *supra* note 74, at 11. Entry into underwriting in Canada (Merrill Lynch was already underwriting Canadian issues in the U.S.) was a principal objective of the acquisition. Corporate and government securities underwriting by Royal Securities increased substantially after the Merrill Lynch takeover; Merrill Lynch submission, *supra* note 74, at 15.

100 MOORE COMMITTEE REPORT, *supra* note 31, at 139-40. The different view of the joint industry committee was noted in note 75 *supra*.

101 MOORE COMMITTEE REPORT, *supra* note 31, at 143.

capital in a manner different from those permitted to Canadian firms, especially from a public distribution of securities.[102]

The Bouchard Committee took a very different view. While Ontario firms overshadowed Québec-based firms, the report was able to say:

> "[W]e examine non-Canadian firms and find that their share of the market is negligible. There is no danger therefore at the present time of domination of the Canadian market by non-Canadian firms.[103]

And no limitation was proposed for foreign firms beyond the general ownership rules set out above.

A perhaps surprising recommendation was that membership in the MSE or the IDA should be a condition for registration of a firm with the Quebec Securities Commission, given the clear indication that nonresidents would be barred from membership.[104]

In 1971 the Province of Ontario provided by regulation that nonresident ownership of new registrants with the Ontario Securities Commission would be limited to 25% with no single nonresident or associated group of nonresidents holding more than 10%.[105] At that time there were thirty-eight securities firms registered in Ontario that did not comply but were protected by a "grandfather" clause. Of these, eight firms were members of the TSE and IDA, one was a member of the TSE, and three were members of the IDA. The balance were chiefly investment counsellors and mutual fund dealers. Virtually all were subsidiaries of U.S. firms.[106]

The IDA and the TSE had already declared a moratorium on accepting new nonresident-owned members while the Moore Committee was studying the subject and, as we have seen, the Moore Committee came out against foreign-owned firms in the Canadian industry.

The Securities Industry Ownership Committee of the Ontario Securities Commission referred to the regulation as a stopgap, to prevent foreign firms from exploiting the undercapitalized Canadian industry until the resident-owned firms could obtain access

102 *Id.* at 146.

103 Bouchard Report, *supra* note 80, at 82.

104 *Id.* at 125.

105 OSC, Report of the Securities Industry Ownership Committee, *supra* note 20, at 97-98. The Regulation, O. Reg. 296/71, was amended in 1974 twice, by O. Reg. 95/74 and O. Reg. 600/74. The amendments can be found in [1974] OSC Bull. 26 (March), and [1974] OSC Bull. 151 (August). The second amendments brought about what proved to be a critical set of standards governing transfer of ownership or control of a nonresident-owned firm.

106 OSC, Report of the Securities Industry Ownership Committee, *supra* note 20, at 101, 153-54.

to new capital. At that stage, the domestically-owned firms would presumably not need further protection and the issue of foreign influence would have to be resolved at the federal level.[107]

At the same time, the policy in Québec was to register at least some nonresident-owned firms. The *Bouchard Report* had recommended this,[108] and Québec had registered wholly-owned subsidiaries of two U.S. firms after the Ontario government announced its restrictive regulations.[109]

The Ontario committee concluded that the 25%/10% maximum nonresident ownership limits referred to above should apply to nonvoting shares and debt securities as well as to voting shares.[110] It disagreed with the Bouchard conclusion that foreign-owned firms contribute to the Québec economy saying that these firms (at least in Ontario) chiefly facilitate investment by Canadians in foreign securities, and the removal of capital from Canada.[111] However, recognizing that some foreign-owned firms may be beneficial, the committee recommended giving the commission power to relax the 10% rule. Existing foreign-owned firms would be allowed to continue subject to commission approval of any change in ownership and to limitations on growth.[112]

The Securities Industry Ownership Committee saw a "back door" to the Canadian securities market left open by the "exempt purchaser" provision of the Ontario Securities Act[113] and commented with some dismay that:

> "the exemption permits non-registrants to trade without the necessity of Ontario registration with sophisticated classes of the investment public – including banks, loan and trust companies, insurance companies, and 'recognized' exempt purchasers. The exemption was created long before the institutional investor became such a powerful force in the marketplace."[114]

The committee objected strongly to the offering of U.S. securities to Canadian institutions by U.S. dealers not registered in Ontario and said:

> "We view it important that Ontario registrants be used

107 *Id.* at 99.

108 *See* text accompanying note 103, *supra*.

109 OSC, Report of the Securities Industry Ownership Committee, *supra* note 20, at 100.

110 *Id.* at 101.

111 *Id.* at 111-12.

112 *Id.* at 114-16.

113 Section 19(1)(3) of the Ontario Securities Act exempts from registration trades where the purchaser is recognized by the Ontario Securities Commission as an "exempt purchaser".

114 OSC, Report of the Securities Industry Ownership Committee, *supra* note 20, at 46.

by Ontario money managers whether the ultimate decision be to trade in United States or other foreign securities or not."[115]

There have been four significant decisions by the Ontario Securities Commission on applications by nonresident-owned firms for approval of a change in ownership. The first involved Laidlaw Securities Canada Limited and was decided before the 1974 amendments to the Ontario regulations referred to above. Laidlaw Securities was owned by a U.S. firm, Laidlaw Inc., and asked approval of a transfer of ownership to another U.S. firm, Laidlaw Capital Services, Inc. Laidlaw Securities had been American-owned since 1901 and was a member of the IDA and the Montreal and Toronto stock exchanges. The commission found the transfer not to be prejudicial to the public interest and approved it.[116]

The second case involved DuPont Glore Forgan Canada Limited which had become American-owned in 1951; the application was for approval of a sale by the financially troubled U.S. parent, DuPont Glore Forgan Incorporated, to the U.S. firm, Paine Webber Jackson & Curtis Incorporated. The new regulations which were to be announced a couple of months later required a finding before the commission could give its approval that without the approval a unique and beneficial service to Ontario investors would be lost. Without referring to any amendments to the regulations, the Ontario commission applied this standard (implying that it had done the same in the *Laidlaw* case) and rejected the application.[117]

The third case concerned Baker Weeks of Canada Ltd. This firm was a wholly-owned subsidiary of the U.S. firm, Baker Weeks & Co. Inc., which had acquired it in 1955. In 1976, the firm applied to the Ontario Securities Commission for approval of a change in ownership from Baker Weeks & Co. Inc. to Reynolds Securities Inc., another U.S. firm that was absorbing all the assets of the American Baker Weeks.

Baker Weeks of Canada Ltd. was a member of the IDA and both the Toronto and Montreal stock exchanges. The IDA and the Toronto exchange opposed the application but presented no evidence to the commission. The commission interpreted the regulations as permitting it to approve a change in control where it was satisfied that the nonresident-controlled registrant provided ma-

115 *Id.* at 47. *See also id.* at 109–11.

116 *In re* regulation 6a to the Securities Act and Laidlaw Securities Canada Limited, [1973] OSC Bull. 100 (July).

117 *In re* the Securities Act and DuPont Glore Forgan Canada Limited, [1974] OSC Bull. 133 (June).

terial or unique services to Ontario investors not substantially available through other registrants and that continuation of the service was dependent upon continued nonresident control and not against the public interest.[118] Apparently the fact that Reynolds was publicly owned induced the Toronto Stock Exchange to protest strongly but the commission gave its approval subject to a condition that Baker Weeks would engage exclusively in brokerage activities and not participate as a managing underwriter or banking group member in any underwriting.[119]

Two months later, the TSE denied an application by Baker Weeks for approval under an exchange by-law of the transfer of ownership. The position of the board of governors of the exchange was that it was bound by the recommendations of the Moore Committee (as it had declared in a notice to members in 1970). Since those recommendations were that the grandfather clause be withdrawn if the firm's change of ownership would make it a "different organization" and since the board concluded that the transfer did have this effect, approval had to be denied.

Baker Weeks appealed to the OSC for a hearing and review. The exchange defended the board's decision but asked that if it had been in error, the exchange be allowed to put the matter to a membership vote. The commission concluded that the exchange did not have the power to deal with transfers of nonresident ownership, since the province had taken over the regulation of this subject. And in any case the board of governors of the exchange was wrong in concluding that it was bound by the Moore Committee recommendations. Further, the board was wrong in deciding that a "different organization" would result from the change in ownership and it would be an abuse to permit a vote on the matter. The exchange was directed to approve the change in ownership.[120]

The fourth case involved the same firm. The U.S. parent, Reynolds Securities Inc., had merged with Dean Witter to form Dean Witter Reynolds Inc., in 1977. Reynolds Securities (Canada) Ltd., the successor to Baker Weeks, applied to the Montreal Stock Exchange, to the Quebec Securities Commission, and to the Ontario Securities Commission for approval of the change in foreign ownership. The Membership Committee of the Montreal exchange recommended that the change be approved without putting the question to a membership vote. The governors of the exchange,

118 *In re* Baker Weeks of Canada Ltd., [1976] OSC Bull. 284, 287 (October).

119 No reason was given for this limitation. It is particularly significant in view of the apparently substantial concentration in Canada of underwriting (*see* note 36 *supra*) and the probable fear of those in the business that well-capitalized competition would hurt them.

120 *In re* Baker Weeks of Canada Ltd., [1977] OSC Bull. 32 (February).

however, referred the question to the members. Of the fifty-eight members, twenty-five voted to approve the change and fifteen voted against approval. Since the exchange by-laws require a two-thirds majority for approval, the request was turned down. At the same time, the Quebec Securities Commission had consented to the change in ownership for registration purposes, so Reynolds Securities (Canada) appealed to the commission to reverse the exchange's disapproval, which it did.[121] The commission unanimously agreed that the vote of the members was an act of the exchange and subject to review, and that in the absence of specific regulations governing the transfer of foreign ownership (regulations that would be subject to commission review) the exchange had no basis for denying approval to Reynolds Securities (Canada).

The Ontario commission came to a different conclusion. Quoting section 6d(3) of the Ontario Securities Regulations,[122] which requires a material or unique service not substantially available from other registrants, the commission concluded that the requirements were not met, and that approval for the change could not be given. However, the commission did conclude "that it would be in the best interests of Ontario investors and the Canadian capital markets to permit the Applicant to continue its Ontario registration".[123] So it recommended that Reynolds Securities (Canada) apply to the Ontario cabinet for a change in the regulations. It also noted that its denial of approval for the change in

121 9 QSC Bull., No. 9 (Decision 5460, March 7, 1978).

122 Ontario Securities Regulations, s. 6d(3) and (4) reads as follows:

"Upon the application of a non-resident controlled registrant, the Commission, where it is satisfied,

"(a) that the non-resident controlled registrant provides material or unique service to Ontario investors not substantially available to those investors through other registrants; and

"(b) the non-resident and his associates or affiliates have made reasonable efforts without success to obtain resident Canadian purchasers for the equity shares over which they exercise control or direction of the non-resident controlled registrant and that under the control or direction of the proposed non-resident, the non-resident controlled registrant would continue to provide the material or unique service to Ontario investors; or

"(c) the continuation of the material or unique service to Ontario investors is dependent upon continued nonresident control or direction,"

and that to do so would not otherwise be prejudicial to the public interest, may permit a material change in non-resident ownership, control or direction of the non-resident controlled registrant subject to such terms and conditions as it may impose.

"(4) Upon an application of a non-resident controlled registrant, the Commission may exempt the non-resident controlled registrant from the obligation to comply with clause (c) of subsection 1, upon such terms and conditionc as it may impose, where it is satisfied that to do so would not be prejudicial to the public interest."

123 *In re* Reynolds Securities, [1978] OSC Bull. 101, 108 (March). The decision is being appealed to the Ontario Court of Appeal.

ownership did not automatically terminate Reynolds Securities (Canada)'s registration, and indicated that it would give the firm a reasonable time to approach the cabinet before taking any action to terminate.

The initial Baker Weeks case is particularly interesting in that it displays a growing willingness on the part of the OSC to oversee decisions of the TSE with respect to membership. Foreign ownership is part of the more general issue of control of membership and the self-regulatory organizations have generally been left to operate as "private clubs". In 1973, Lafferty, Harwood & Partners Ltd. appealed to the OSC from the TSE's refusal of membership. Questions were raised in the case as to the propriety of past actions of the firm but some language of the OSC decision (affirming the refusal) is most interesting:

> "In the first place no one has the right to be a member of the Exchange in the way that it may be said an individual has a general right to carry on any lawful trade he chooses subject to compliance with whatever regulatory requirements there may be...the fact remains that it (the Exchange) is a private corporation and like any private corporation the existing membership may be given the power to decide who may and may not become members."[124]

The decision did, however, include this statement that suggests less than a completely free hand on the part of the exchange:

> "If their [the Governors'] standards were not consistent with our views of the public interest or their discretion were not exercised fairly, such as an absence of evidence upon which their conclusions could be supported, we would not hesitate to intervene."[125]

There seems to be evidence of some tendency on the part of the Ontario commission to assert jurisdiction over membership decisions, but the privacy of the club is still fairly safe except in the nonresident ownership or control area, where the province and the commission have insisted on their own standards.

2. *U.S. Attitudes on Foreign Broker-Dealers*

Attitudes expressed in the United States on the subject of foreign participation in U.S. securities markets may be useful to

124 *In re* the Securities Act and Lafferty, Harwood & Partners Ltd., [1973] OSC Bull. 26, 36 (February), *appeal dismissed*, Lafferty, Harwood & Partners Ltd. v. The Board of Governors of the Toronto Stock Exchange, 58 D.L.R. (3d) 660 (Ont. Div'l Ct. 1975).

125 [1973] OSC Bull. 26, 45 (February).

Canadian policy-makers. While it is true that Canadian securities firms have more to fear from U.S. competitors than U.S. firms have to fear from Canadian competitors, the United States industry is apprehensive over potential competition from European financial institutions, through broker-dealer affiliates.

One set of recommendations prepared in the United States has made the point that denial of NYSE memberships to European broker-dealers may simply lead to a "Euro-third market" – a European over-the-counter market in NYSE listed stocks.[126] This is a point that will not be lost on Canadians. Competition between U.S. and Canadian securities markets is discussed in detail in another part of this paper,[127] but briefly, there is already a "U.S.-third market" in some Canadian stocks listed on exchanges in Canada and there is a substantial volume of trading on American exchanges in Canadian stocks interlisted on both American and Canadian exchanges.

A New York Stock Exchange committee endorsed a policy of reciprocity for admission of foreigners to U.S. securities markets, saying: "The requirement that U.S. broker-dealers be treated as liberally as domestic firms [in a foreign country] should be a *sine qua non* of U.S. policy on foreign access."[128]

In defining what is meant by "reciprocity" the NYSE committee referred with approval to a policy of "mutual nondiscrimination" endorsed by the Federal Reserve, with respect to banking. This would mean, for banking, that foreign and domestic banks operating in a country would be subject to the same rules.[129] The committee argued that the Glass-Steagall Act which requires a separation of investment and commercial banking should apply to foreigners doing business in the United States. And it was claimed that some foreign banks had interests in U.S. affiliates carrying on both activities.[130] The Treasury has suggested that only foreigners *not* associated with commercial banks be granted direct access to U.S. securities markets.[131] Whether nonbank financial institutions, foreign or domestic, should have direct access to securities markets is still unresolved in the United States.

126 Advisory Committee on International Capital Markets, New York Stock Exchange, Recommendations on Access and Membership by Foreign-Controlled Broker-Dealers to the U.S. Securities Markets (June 1974), *reprinted in*, *Securities Acts Amendments of 1975: Hearings before Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 94th Cong., 1st Sess. 418, 420 (1975).

127 *See* ch. III *infra*.

128 *See* Advisory Committee on International Capital Markets, *supra* note 126, at 425.

129 *Id.* at 420.

130 *Id.* at 421.

131 *Id.* at 422.

Finally, the committee expressed special concern about Canadian attitudes toward foreigners:

> "The Committee would like to direct special attention to recent Canadian policies towards foreign broker-dealers. Canada is one foreign nation where American broker-dealers have a relatively large number of retail outlets. NYSE member firms alone have about 50 branch offices in Canada. The Canadian securities industry has taken an increasingly rigid and severe stance against the operations of foreign broker-dealers in recent years. This is in sharp contrast to the consideration U.S. authorities are now giving to steps to liberalize foreign broker-dealer access to American securities markets.
>
> "In a joint securities industry release late last year, representatives of the Canadian brokerage industry recommended that the activities of new non-Canadian broker-dealers be restricted to selling domestic issues outside Canada, or trading foreign securities with selected institutions only. Moreover, it was recommended that non-Canadian firms not be permitted to transact business in Canada with the general public.
>
> "At first, it appeared that nonresident-controlled brokerage firms existing before July 1971 were granted grandfather status enabling them to continue to engage in a full range of securities activities within Canada. However, it has come to the Committee's attention that Canadian industry authorities now are taking an increasingly hard line on such activities. For example, there is some discussion about whether the grandfather status is transferrable through sale of the business or not. The Committee is concerned about these recent Canadian actions and believes the Canadian situation bears close watching by the securities industry and the U.S. authorities."[132]

G. BROKER FAILURES AND INSURANCE

In Canada there have not been enough failures of brokerage firms to cause alarm and protection of investor-customers has been left almost entirely to the securities industry.[133] The National Contingency Fund was established in 1968 by the Montreal, Canadian, Toronto and Vancouver stock exchanges, and the In-

132 *Id.* at 425.

133 This discussion summarizes *Honsberger*, ch. V, at n. 285.

vestment Dealers Association. The fund and its sponsors have made no promises and undertaken no obligations but the purpose of the fund is to protect customers of members of the sponsors from losses in case of member bankruptcy. A total of $1,895,000 has been paid out in connection with four bankruptcies.

The Quebec Securities Commission has established the Contingency Group Fund for protection of customers of firms not members of one of the sponsors of the National Contingency Fund and a corresponding fund is maintained by the securities industry in Ontario.

In the United States the stock exchanges for some years maintained contingency funds but brokerage failures and financial problems in the late 1960s prompted Congress to enact the Securities Investor Protection Act of 1970. (The New York Stock Exchange Fund paid out about $100 million from 1968 through 1976.) The act established the Securities Investor Protection Corporation (SIPC), a nonprofit organization of which all registered broker-dealers and members of stock exchanges must be members. (At the end of 1976 membership was 5,168.) Assessments are made on members, based on gross securities business, at a rate in 1977 of 0.5%. The fund balance of the corporation had reached $137 million at the end of July 1977. When the balance reaches $150 million, the corporation may reduce the assessment rate. The SIPC protects customers of insolvent members up to a limit of $50,000 per customer with a limit of $20,000 in the case of claims for cash.

Through the end of 1976, 121 members of SIPC had failed, 103,000 customer claims had been satisfied, and $52.8 million had been advanced from the SIPC fund in connection with these liquidations.

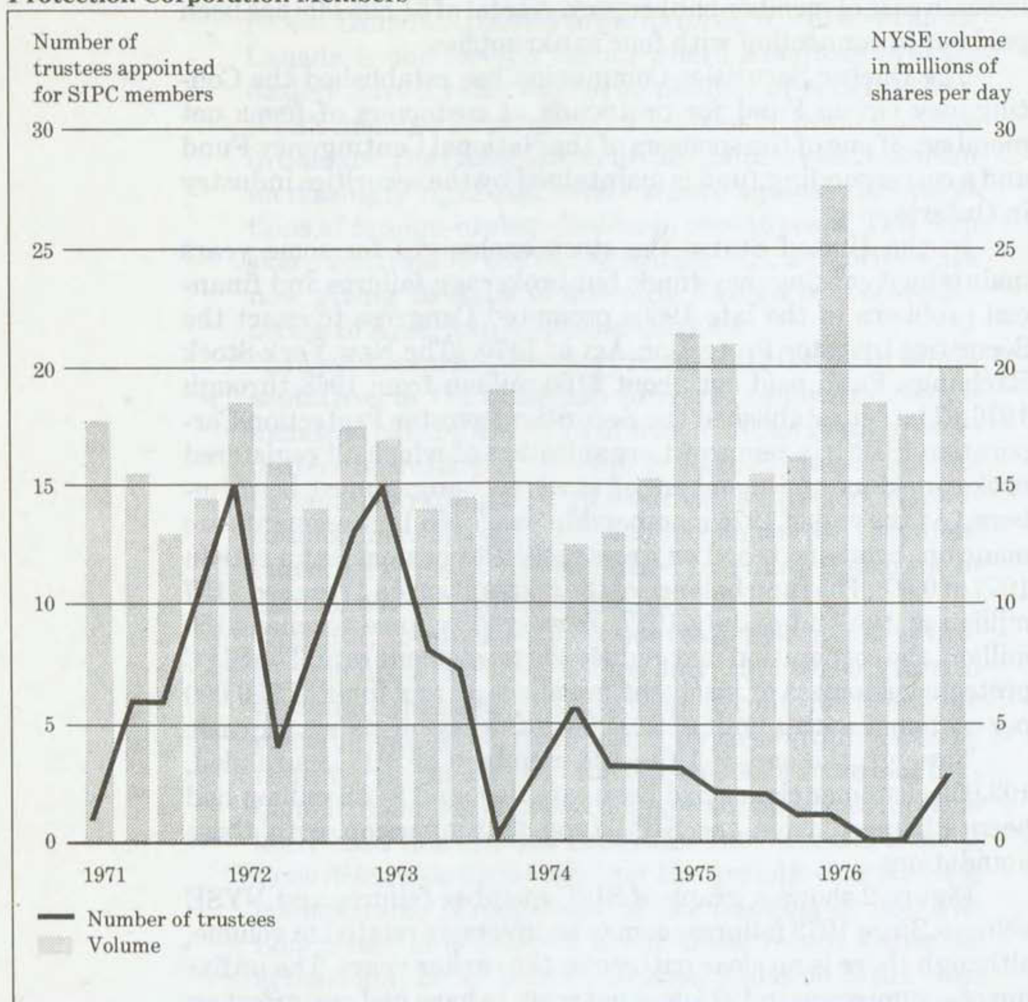
Figure 2 shows a graph of SIPC member failures and NYSE volume. Since 1973 failures seem to be inversely related to volume, although there is no clear pattern in the earlier years. The unfixing of commissions in 1975 does not seem to have had any effect on the number of failures.

H. CONCLUSIONS AND POLICY IMPLICATIONS

Self-regulatory organizations in the securities industry confront a regulatory commission with a number of difficult choices. The first concerns the autonomy of the organizations and the second, closely related to the first, concerns the division of regulatory responsibility between the organizations and the commissions.

The Canadian tradition, like that in the United States, has been to delegate a great deal of regulation to these organizations

Figure 2
New York Stock Exchange Volume and Bankruptcies of Securities Investor Protection Corporation Members



and to give them a great deal of freedom. It was not until the late 1960s that the SEC faced up to the fact that some of the regulatory rules and activities of the stock exchanges in the United States were devoted to investor protection, while others were devoted simply to restraining competition in order to protect the economic interests of the members. Since then both the United States Congress and the SEC have undertaken systematic suppression of anticompetitive activities of the exchanges. Access to membership on an exchange is a matter that has not yet been fully resolved, with the New York Stock Exchange itself in the process of establishing easier and cheaper access for those who are not now members.

In Canada there has been a more subtle recognition of the need to curb anticompetitive self-regulation. The proposed amendments to the Combines Investigation Act and some official commentary on access by foreigners to the Canadian securities market reflect this. But as yet, neither Parliament nor the securities commissions have gone nearly as far as have the United States Congress and the SEC.

As the securities industry in Canada moves closer to a Canada-wide market, access to this market, probably through some self-regulatory organization, will become a critical issue. The regulatory commission with jurisdiction over this market will have to decide whether access is to be controlled by a "private club", or whether it is to be open to all qualified applicants.

With respect to investor protection, substantial delegation of authority to the self-regulatory organizations seems to have worked very well, but there may be some question about leaving the National Contingency Fund and the protection of customers of bankrupt securities firms entirely in the hands of the industry.

A third issue related to self-regulatory organizations concerns competition among them. The current view in the United States seems to be that competition among all marketplaces, exchanges and over-the-counter markets is beneficial. It is not so clear that the form that competition between the Toronto and Montreal Stock Exchanges has taken is beneficial to the securities industry or to its customers. So long as regulation of the stock exchanges remains at the provincial level there is probably not much that can be done to bring about enough uniformity of rules and practices to eliminate unproductive kinds of competition. But a national regulatory commission might want to undertake this.

A fourth issue concerns permissible activities of securities firms, access to these activities and the degree of concentration in them. The range of activities has been left pretty much to the discretion of the self-regulatory organizations, subject, of course,

to statutes limiting entry to a number of activities such as banking. Diversification is an area over which a regulatory commission might want to exercise some jurisdiction. Permissible diversification of firms in the securities industry can hardly be separated from access to the securities industry by firms not outside it. Money management is a good example of this interrelationship. If securities firms are to be permitted to manage money, then should money management firms be permitted to acquire memberships on a stock exchange? This question now confronts the SEC, and has proved to be extraordinarily difficult to answer.

There seems to be some evidence that underwriting is highly concentrated in the Canadian securities industry. Although there may be good reason for this, there may also be some undesirable anticompetitive arrangements that tend to keep the business concentrated. A regulatory commission may wish to take some action here, although the matter can perhaps be left to competition legislation.

Although it appears that concentration is substantial in underwriting, it is hard to be precise simply because the data that would indicate the degree of concentration in all aspects of the securities industry are either nonexistent or treated as highly confidential by the self-regulatory organizations and their members. At the least, a regulatory commission needs to know what the degree of concentration is. And this knowledge is only the beginning of the information gathering that is so crucial to setting policy. The regulatory commissions at present know very little about the economics of the securities industry, something to be discussed in chapter III.

The capital needs of the securities industry constitute one aspect of the economics of the industry that will probably call for some decisions before long. There appears to be evidence that the Canadian securities industry would be stronger and certainly less fearful of foreign competition if it were better capitalized. The rules of the self-regulatory organizations at present stand in the way of substantially increased capitalization and a regulatory commission may simply have to interfere.

Foreign ownership, capitalization, and competitive strength are all closely bound together. Ontario and Québec are the two provinces that have taken some initiative in establishing rules about foreign ownership. The rules, at least in Ontario, have conflicted with the preferences of the Canadian-owned firms. Differences between the attitudes of the two provinces are easily understandable, given the dominance of the Ontario-based firms in the industry. A clear federal policy on this subject, administered by a national regulatory agency, would be very helpful.

Chapter III
Commission Rates and the Economics of the Canadian Brokerage Business

Careful analysis of the economics of the brokerage business began in the United States only in 1968 when the Department of Justice challenged the fixed minimum commission rates of the New York Stock Exchange. In Canada the process began in 1974 when the Quebec Securities Commission asked the Montreal Stock Exchange to explain why its rates should not be competitive. It was intensified in 1976 when the Ontario Securities Commission questioned fixed minimum rates on the Toronto Stock Exchange.

Fixed rates were abolished on the New York exchange in May 1975 and the analysis that preceded that decision has been replaced by evidence on the consequences of the switch to negotiated rates. In Canada the arguments of the stock exchanges persuaded the Ontario commission to continue with fixed minimum rates and the Quebec commission has gone along with that decision. In 1977 the analysis undertaken by the TSE was directed not to continued justification for fixed minimum rates but to support a particular fixed rate structure.

Since the issue of fixed commission rates is still alive in Canada, although it has been settled in the United States, it may be useful to review briefly the economic arguments and analysis that were presented in the United States before the switch to negotiated rates in 1975, as well as the reports on the consequences of abandoning fixed rates there.

A. THE UNFIXING OF COMMISSION RATES IN THE UNITED STATES

In the course of a general review by the SEC in 1968 of commission rates on the New York Stock Exchange, the United States Department of Justice issued a direct challenge to the concept of fixed minimum rates. The rates at that time were those shown in table 35. The New York Stock Exchange responded to the challenge largely by way of an economic study prepared for it in 1970 by the consulting firm National Economic Research Associates.[134] But in August 1968, two years before this report was completed, the exchange published a defence of fixed minimum commission rates in terms of the dire consequences it believed

134 NATIONAL ECONOMIC RESEARCH ASSOCIATES, INC., REASONABLE PUBLIC RATES FOR BROKERAGE COMMISSIONS (2 vols. 1970) (Report to the Cost and Revenue Committee of the New York Stock Exchange).

Table 35
New York Stock Exchange Minimum Brokerage Commissions (Non-Member Rates)

Before May 1, 1975

On first 1,000 shares (per round lot)		On excess over 1,000 shares (per round lot)	
Money involved	Commissions	Money involved	Commissions
First $400	2% plus $3	$100–2,800	1/2% plus $4
Next $2,000	1%	$2,800–3,000	same as $2,800
Next $2,600	1/2%	$3,000–9,000	1/2% plus $3
Above $5,000	1/10%	Above $9,000	1/10% plus $39

Source: New York Stock Exchange.

would follow from competitive rates.[135] The exchange argued that the quality of the central auction market – that is, the New York Stock Exchange market – would deteriorate because of a loss of incentive for brokers to belong to the exchange. Economists not associated with the exchange replied to this argument that there was no reason to believe that the quality of the marketplace itself would deteriorate, but that the value of a seat on the exchange might well decline. This decline would, of course, be unwelcome to the exchange membership, but need not be a matter of concern to the investing public or to a regulatory authority. Indeed, some economists argued that price competition among brokers might well lead to lower commission rates and an increased volume of trading on the NYSE, as it became more competitive with the third market (the over-the-counter market in listed stocks).[136]

The exchange made a second argument to the effect that various services to investors, including research, advisory and communication services would probably decline if commission rates became competitive and fell below the fixed minimum levels. The answer that came from various economists was simply disagreement with this conclusion; if the services mentioned are truly valuable to investors, then investors will buy them one way or another.

A third argument raised by the exchange was to the effect that with competitive rates large investors would probably be treated better than small investors. The economists' reply to this argument was that under fixed commission rates large investors were discriminated against. Their trades were more profitable to brokers than were the trades of individual investors and this discrimination might be expected to disappear with broker price competition. This argument differed somewhat from the first two in that it went to the policy question whether the commission rate structure should be deliberately designed to favour individual investors over institutional investors, as the fixed commission rate

135 NYSE, ECONOMIC EFFECTS OF NEGOTIATED COMMISSION RATES ON THE BROKERAGE INDUSTRY, THE MARKET FOR CORPORATE SECURITIES, AND THE INVESTING PUBLIC (August 1968).

136 Chris McEvoy has discussed the effects of fixed minimum commissions and declining competition among jobbers on the London Stock Exchange. In 1974, financial institutions in the U.K. set up their own computer-based block trading system known as ARIEL (Automated Real-Time Investment Exchange Ltd.). This system is analogous to the Instinet System in the United States, which is largely responsible for the "fourth market" in that country, the institution-to-institution market that makes no use of securities firms. McEvoy suggested that in view of the predictions that in the 1990s, 70% of the equity in U.K. companies will be held by institutions, the ARIEL system may divert substantial trading from the stock exchange. *See* McEvoy, *Economic Efficiency and the Stock Exchange*, 2 MANAGERIAL FINANCE 330 (1976).

structure on the New York Stock Exchange and the old fixed commission structure on the Toronto Stock Exchange almost certainly were. The question of relative value of institutional trading and individual trading to the quality of the marketplace, and whether one should be required to subsidize the other is discussed later.[137] Briefly, there is no clear-cut reason for a subsidy.

Finally, the NYSE raised the argument of probable destructive competition if commission rates were to be unfixed. The exchange predicted that large, diversified firms would cut prices drastically and eliminate their small competitors, regardless of the efficiency of the latter. It was the prospect of destructive competition that the New York exchange seemed to rely on most in its defence of fixed rates. And it was this same argument that the TSE pushed hardest in 1976 in defence of its own fixed rates. In fact the predicted destructive competition has not taken place in the United States in the three years since fixed commission rates were abandoned, but that does not prove that it cannot take place at some time in the future. Volume on the exchange has been substantial since May 1975 and destructive competition would be expected to take place only in periods of very low volume. So it is still worth reviewing briefly the case that was made for its dangers.

First, the very term "destructive competition" suggests something "bad". Indeed, for the victims within the industry – the firms that are forced into failure or mergers – destructive competition is "bad". But it is not so clear that destructive competition is bad for the customers of the industry, or so bad that price-fixing is a preferred alternative. Destructive competition is usually seen as taking the form of price-cutting until all or most of the firms in an industry are selling their product below total cost for an extended period of time, long enough to bring about a number of failures. It may be argued that customers are injured in this process because they are permanently deprived of the services of the firms that fail. This argument has some merit for an industry into which entry is extraordinarily expensive or otherwise difficult. The railroad industry might be an example. Steel or cement might be others. But the brokerage industry is characterized by relative ease of entry. Firms that fail in recessions are easily replaced in better times. The capital needs for starting a brokerage firm are not extraordinary and the employees of firms that fail are probably available to work for new firms. It is unlikely that the disappearance of any firm in the brokerage industry, particularly

137 In ch. V *infra*.

a financially weak firm, will result in a permanent loss of service to the investing public.

A second unattractive consequence of destructive competition may be wide fluctuations in the price of the brokerage service. In times of very low trading volume one might expect drastic price-cutting with substantially higher charges for brokerage services during periods of high volume. The impact of commission costs on the investing public, including the elasticity or response of trading volume to changes in commission rates, is still largely unknown. But both the New York and Toronto stock exchanges have expressed the opinion that the elasticity is quite low and that investors are not very much affected by the level of commission rates.

Finally, it can be argued that destructive competition will lead to the failure of the financially weak firms, even though these firms may be efficient suppliers of services to the investing public, and to increased concentration of the brokerage business in a few well-financed firms. This was the consequence emphasized most by the New York and Toronto exchanges. Neither exchange demonstrated why increased concentration would necessarily be detrimental to the interests of the investing public but it is certainly plausible that this would be the case.

The elements of destructive competition and the conditions under which price-fixing is in the public interest have been carefully set out by F.M. Scherer.[138] Destructive competition begins with fluctuating total demand in an industry where fixed costs are high, and variable costs low. The New York Stock Exchange said that around 50% of the total costs incurred by member firms in their commission business were fixed. Suppose the average cost of handling a brokerage transaction is $60, half of which represents fixed costs (office rent, lease of a computer and so forth), while the other half represents variable cost, the out-of-pocket expense for a transaction. Then as industry volume declines, a firm is tempted to sustain its own volume by reducing price to somewhere between $30 and $60, say $40. At this price the firm will cover its out-of-pocket expense and earn $10 towards fixed costs.

In cutting price, of course, the firm has to consider whether it is more profitable to do a small volume at, say, $50, or a larger volume at $40. But if the cost structure of our firm is characteristic of the entire industry, there will not be much choice. In a fight to stay in business all firms will cut prices to something not much above $30 and there may be virtually no volume available at $50.

138 *See* F. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 192-206 (1970).

It is at least better to earn $10 towards fixed costs than nothing at all. But if these conditions continue for long and the firm is simply unable to cover all of its fixed costs, its resources may be exhausted.

Scherer went a little further to see whether the danger of destructive competition justifies price-fixing. If the securities industry were affected in the manner described above in times of low volume, then we would expect firms to raise their prices in times of high volume to make up for their losses. The question is whether the public is better served by high prices in good times and low prices in bad times or by the same fixed prices at all times.

Scherer concluded, first, that highly inelastic marginal costs argued in favour of fixed prices. Highly inelastic marginal costs mean that as volume declines so does the out-of-pocket expense for each transaction, and Scherer saw this as quite likely to happen in an industry with high costs, operating close to capacity. One might imagine this marginal out-of-pocket cost as including some overtime, and other extraordinary expenses, when the firm is at or close to capacity. As volume subsides so do these extraordinary expenses. The result is that the price can fall even more sharply than in the scenario above. The marginal cost may drop to only $25 from $30. So the price might drop to $35 rather than $40. This price would still leave a $10 contribution to fixed costs, so the firm is no worse off. But Scherer pointed out that in *good times* this firm must raise its prices in order to achieve a satisfactory average profit and that the combination of the high price in good times and the low price in bad times would tend to be *higher* than a constant fixed price. So highly inelastic marginal costs argue in favour of fixed prices.

Next, Scherer pointed out that the elasticity of demand is an important element in a justification of price-fixing. A low elasticity of demand means that customers do not respond to price cuts by increasing their purchases. In the brokerage industry it means that investors and traders do not respond to commission rate cuts by increasing their trading. The result is that as brokerage firms cut their commission rates seeking increased volume, they can only take business away from one another. A low demand elasticity encourages destructive competition. But there is more to it. If elasticity *increases* as volume declines, and some economists argue that this is likely, the combination of high prices in good times and low prices in bad times will be no worse than fixed prices. If the elasticity does not increase, and particularly if it decreases, then fixed prices are more likely to be preferable.

We have already seen that the New York Stock Exchange in making its case for the dangers of destructive competition claimed that about 50% of the costs of commission business are fixed. The

exchange went through two analyses, the first of which simply involved the allocation, as fixed or variable, of all of the member firm costs associated with commission business. The second analysis took the form of a multiple regression in which the dependent variable was total cost of commission business and the independent variables were number of transactions handled by each firm and six categories of firm size. From this analysis the NYSE study concluded that the marginal cost for a transaction was $20.65 and the fixed cost varied from about 25% of total costs for the largest firms to something over 50% for the smallest firms. For most of the firms, fixed cost was about 50% of total cost. H. Michael Mann, applying a better regression analysis to the same data, came up with a marginal cost of $26.76 per transaction and fixed costs ranging from about 20% for the largest firms to a little over 40% for the smallest firms.[139] But as Mann pointed out, the whole exercise is somewhat suspect because the cost of a brokerage transaction varies a great deal from one transaction to another. It just is not plausible that the same marginal cost applies to all transactions of all brokers. In any case, the exchange continued its regression analysis to deduce a long-run marginal cost per transaction of $31.34 – $(2.16 \times 10^{-6}) \times$ the number of transactions per year which is a slightly decreasing function of the number of transactions indicating some economies of scale, that is, large firms have an inherent advantage over small firms. But Mann, performing a similar regression analysis, concluded that the long-run marginal cost was $25.57 and did not change with increased volume.

Harold Demsetz used a slightly different method of analysis to conclude that the average *total* cost per transaction on the New York Stock Exchange declined from about $46 for the firms with the smallest volume (averaging 19,000 transactions per year) to about $28 at a volume of 200,000 transactions per year and then remained fairly constant. His overall conclusion then was very similar to that of Mann, to the effect that economies of scale are not important in the brokerage industry.[140]

A review of the case presented by the New York Stock Exchange and the replies from Mann, Demsetz and other economists, together with the results of some of their own work, convinced R.

139 H. Mann, A Critique of the NYSE's Report on the Economic Effects of Negotiated Commission Rates in the Brokerage Industry, the Market for Corporate Securities and the Investing Public (paper presented to the SEC, 1970). Mann's results are quoted in ch. 5 of R. West & S. Tinic, The Economics of the Stock Market (1971). *See also* Mann, *The New York Stock Exchange: A Cartel at the End of Its Reign*, in Promoting Competition in Regulated Markets 301 (A. Phillips ed. 1975).

140 Statement of Harold Demsetz before the SEC, August 1969, *quoted in* R. West & S. Tinic, *supra* note 139.

West and S. Tinic in 1971, four years before the abolition of fixed minimum commission rates on the NYSE, that negotiated rates would probably lead to a "shake-out" in the brokerage business but not to destructive competition and domination of the industry by a few giant firms. They said "the kinds of economies of scale necessary for this simply do not appear to exist".[141]

1. *Consequences of Negotiated Rates*

Fixed minimum commission rates were abolished in the United States on May 1, 1975, and the SEC monitored the consequences of that event through early 1977. The fifth and concluding report of the commission to Congress[142] answers some of the questions that were raised back in 1968. It does not answer them all. The conditions that might give rise to destructive competition simply have not arisen since May 1975. There has indeed been vigorous price competition but not in the context of very low volume.

Some observations by Greenwich Research Associates in 1977, however, do bear on the question of destructive competition. They reported:

> "In the short run, brokers are striving to build market share by competing simultaneously on two fronts: price and value (or cost). With increasing costs and decreasing revenues, brokers' profits have been under great pressure. So far, most firms have responded solely by striving even harder to increase market share – by increasing costs even more or by reducing the prices of their services even more. And this explains why research and liquidity have both been improving.
>
> "Is it sustainable? Certainly not. Supply cannot long continue to exceed demand, and the supply of research and agency execution services now significantly exceeds the demand for these services. But this anomaly can continue during the near term so long as major firms are fighting for market position and market share....
>
> "Over the next year or so, we expect the number of suppliers to be reduced by several firms merging or closing. The intriguing question is whether this reduction in the number of suppliers will be so great as to create a

141 R. West & S. Tinic, *supra* note 139, at 139.

142 Securities and Exchange Commission, Fifth Report to Congress on the Effect of the Absence of Fixed Rates of Commissions (May 26, 1977). The economic analysis of the brokerage industry was carried forward to the end of 1977 in SEC Staff Report on the Securities Industry in 1977 (May 22, 1978).

situation in which the demand for service exceeds supply, because only then will brokers' prices and margins increase."[143]

The New York Stock Exchange had predicted that brokers and trading would leave the exchange and that the quality of trading would decline. The SEC reported that the share of trading in New York-listed stocks handled on regional exchanges and in the third market showed no significant change following the introduction of negotiated rates. Although these two markets held a slightly smaller fraction of total trading in 1976 than they held in 1974 and earlier years, there was no significant difference between their share early in 1975 when rates were still fixed and in 1976 when rates were competitive. The quality of the exchange market, as measured by stock price volatility, did not change significantly over the period of unfixing commission rates. Liquidity generally improved after rates became negotiable but this was largely the result of an increase in the volume of trading.

The SEC did not report on services to investors,[144] but did discuss the emergence of "discount" brokers offering executions without other traditional services. These firms are generally not members of the exchange, but deal through correspondents. Most have a single office and do not employ registered representatives or solicit orders except through media advertising. A sample of twenty such firms accounted in 1976 for under 0.4% of commission revenue of NYSE members doing a public business. Over 96% of their revenue was from commissions and margin interest and they were quite profitable with average returns on equity of 60.2% and on total capital of 42.6%. (Their capital was 17.2% of total assets compared to 10.2% for NYSE members.)

Commercial advisory services appeared to be flourishing in 1976 and 1977 and the Value Line Investment Survey has directed advertising specifically to investors who have chosen to do business with discount brokers. Banks are also reported to be paying cash for research services.[145]

Greenwich Research Associates commented in 1977:

"Services provided to institutions by brokers have actual-

143 Greenwich Research Associates, Fourth Annual Report on Institutional Brokerage Services at i-ii (1977).

144 But a Quebec Securities Commission Task Force reported in June 1976 that a substantial number of U.S. firms had increased the number of their analysts, although some firms had closed. On the whole, research services seemed unimpaired. Quebec Securities Commission Task Force, Commission Rates in the Securities Industry 25-26 (June 1976). This report was updated in Quebec Securities Commission Task Force, Updated Report on Commission Rates in the Securities Industry (December 1976).

145 Securities Week (New York), April 19, 1976, at 5-6.

ly increased significantly over the past two years. Liquidity has improved in every sector of the stock and bond markets, and the quantity and quality of research services have both increased for the second straight year."[146]

The New York Stock Exchange had predicted that institutions would benefit from competitive rates at the expense of individual investors. The greatest reductions in commission rates have certainly been achieved by institutions. For them, commissions on all trades dropped from an average of 26¢ per share in April 1975, to 13.3¢ per share in December 1977, a decline of 49%. But for individuals there was also a decline, although a smaller one. The average commission on all trades dropped from 30¢ per share to 24.5¢, a decline of 18%. Expressed as a percent of principal value rather than in terms of cents per share, institutional commissions declined from 0.84% in April 1975 to 0.45% in December 1977, a drop of 46%. For individuals the decline from 1.73% to 1.45% was 16%.[147]

For small trades, however, institutions received a more substantial decrease in commission rates than did individuals. For transactions involving less than 200 shares institutional commissions declined from 60¢ per share to 40.4¢, a drop of 33%. For individuals commissions fell from 50¢ per share to 48.7¢, a decline of 3%. For very large transactions on the other hand – 10,000 or more shares – institutional commissions declined from 15¢ per share to 8.9¢ per share, while individual commissions declined from 9¢ per share to 5.7¢ per share.

One discount broker doing business with individuals advertises commission rates of 40¢ per share on odd lots and the first 100-share round lot, plus 30¢ per share on the second 100 shares, plus 20¢ per share on the third 100 shares, plus 10¢ per share on the balance of an order. In addition, the rates guarantee a discount of 30% from the old New York fixed rates, subject to a $25 minimum. Table 36 shows the commissions for different share prices and different order sizes.

Overall then, institutions appear to have derived more benefit from price competition than individual traders. But individual traders saw their commission rates decline. And individuals could achieve substantial savings by turning to discount brokers.

The SEC conclusions are consistent with what can be observed in the securities markets. Commercial banks have increasingly put up their commission business for bids and for large banks these bids appear to have reached 9¢ or 10¢ per share, with a few at 8¢,

146 Greenwich Research Associates, *supra* note 143, at i.

147 SEC Staff Report, *supra* note 142, exhibit 14. The report noted, at 17, that

and some, for index funds, at 4.5¢. (The bids and the rates paid by large banks are regularly reported in *Securities Week.* In November 1977, *Securities Week* also reported pressure by the Comptroller of the Currency on banks in the south, apparently smaller banks, to seek lower commission rates. South Carolina National Bank, with only about $100 million in equity trust assets, put its commission business for orders under 1,000 shares up for bids. Merrill Lynch won, with a rate between 6¢ and 6.4¢ per share.) For large mutual fund groups executions at 5¢ per share seemed feasible in August 1977 when the Fidelity Funds group worked out an arrangement at this rate with Loeb Rhoades and some independent floor brokers. Subsequently, a number of large money management organizations have achieved a 5¢ target. Early 1978, however, saw a halt to the slide in rates, and some firms began to implement small increases, especially on retail business.

For the brokerage industry the period of price competition was one of high volume of trading with a high level of securities commissions and income. Brokerage commission revenue in 1976 was just 2% below revenue under fixed rates in 1972, a very good year, and 1977 revenue was off 11% from 1976. Institutional firms were the ones most affected by price competition. They showed a decline in securities commission revenue in the second quarter of 1975 following the unfixing of commission rates. All other categories of firms experienced an increase in securities commissions during this quarter. But after that second quarter of 1975 through 1977, the institutional firms held their share of commission revenue. These firms were more profitable than the brokerage industry as a whole when commission rates were fixed but since rates became negotiated their profits have trailed the industry average. Table 37 shows a measure of the impact of negotiated rates on the commission revenue of four classes of firms for the fourth quarter of 1976. Rates of return on equity capital for seven categories of firms for 1976 and 1977 are shown in table 38. Interest expense was a major factor in the 1977 decline.

Concentration of trading, as measured by the percent of securities commission revenue accounted for by the ten largest firms, increased somewhat after commission rates became negotiated (see table 39). But there had already been a steady increase in concentration from as far back as 1972. There was no evidence that the abandoning of fixed commission rates changed this trend.

Commission rate competition has been associated with a high rate of mergers among U.S. brokerage firms in the last year or so.

individuals probably paid even lower commissions in 1977, because the figures quoted do not reflect the rates of "discount brokers".

Table 36
Comparison of Stock Commission Rates: Old New York Stock Exchange vs. Shearman, Ralston Inc.

As of January 1978
In dollars

Share price	Number of shares							
	50		100		200		300	
	Old NYSE	S/R	Old NYSE	S/R	Old NYSE	S/R	Old NYSE	S/R
$5	11.17	25.00	19.48	25.00	38.97	27.28	58.45	40.91
$10	17.11	25.00	29.70	25.00	59.40	41.58	79.60	55.72
$15	23.05	25.00	37.42	25.00	72.47	50.73	95.63	66.94
$20	27.32	25.00	45.14	30.00	83.16	58.21	116.75	81.73
$25	31.19	25.00	52.87	38.00	93.85	65.70	113.52	90.00
$30	35.05	25.00	58.21	40.00	109.30	70.00	150.28	90.00
$35	38.91	25.00	63.56	40.00	120.47	70.00	167.05	90.00
$40	42.77	25.00	68.90	40.00	131.65	70.00	183.82	90.00
$45	46.63	25.00	74.25	40.00	142.83	70.00	200.58	90.00
$50	50.49	25.00	77.22	40.00	154.01	70.00	217.35	90.00
$60	55.84	25.00	80.73	40.00	161.45	70.00	242.19	90.00
$70	61.18	25.00	80.73	40.00	161.46	70.00	242.19	90.00
$80	66.53	25.00	80.73	40.00	161.46	70.00	242.19	90.00
$90	71.87	25.00	80.73	40.00	161.46	70.00	242.19	90.00
$100	77.22	25.00	80.73	40.00	161.46	70.00	242.19	90.00
$125	80.73	25.00	80.73	40.00	161.46	70.00	242.19	90.00
$150	80.73	25.00	80.73	40.00	161.46	70.00	242.19	90.00
$200	80.73	25.00	80.73	40.00	161.46	70.00	242.19	90.00
$250	80.73	25.00	80.73	40.00	161.46	70.00	242.19	90.00
$300	80.73	25.00	80.73	40.00	161.46	70.00	242.19	90.00

500		1,000		2,000	
Old NYSE	S/R	Old NYSE	S/R	Old NYSE	S/R
88.51	61.96	150.88	105.62	263.30	184.31
115.24	80.67	213.62	149.53	375.08	260.00
148.42	103.89	269.51	160.00	449.60	260.00
176.36	110.00	325.40	160.00	499.28	260.00
204.31	110.00	362.66	160.00	548.96	260.00
232.25	110.00	399.92	160.00	598.64	260.00
260.20	110.00	424.76	160.00	648.32	260.00
288.14	110.00	449.60	160.00	698.00	260.00
306.77	110.00	474.44	160.00	747.68	260.00
325.40	110.00	499.28	160.00	797.36	260.00
362.66	110.00	548.96	160.00	896.72	260.00
387.50	110.00	598.64	160.00	996.08	260.00
403.65	110.00	648.32	160.00	1,095.44	260.00
403.65	110.00	698.00	160.00	1,194.80	260.00
403.65	110.00	747.68	160.00	1,294.16	260.00
403.65	110.00	807.30	160.00	1,542.56	260.00
403.65	110.00	807.30	160.00	1,614.60	260.00
403.65	110.00	807.30	160.00	1,614.60	260.00
403.65	110.00	807.30	160.00	1,614.60	260.00
403.65	110.00	807.30	160.00	1,614.60	260.00

Table 37
Estimated Revenue Foregone by U.S. Brokerage Industry by Groups of Sampled Firms

Fourth quarter, 1976
In millions of dollars

Group type	Estimated commissions on equity transactions	Estimated percent discount from effective commission rate before May 1, 1975	Revenue foregone	Estimated revenue foregone as a percent of gross revenue
National full-line firms	$221.0	9.6%	$23.6	4.3%
Regional local full-line firms	24.0	11.4	3.1	5.7
Underwriters and general dealers	83.2	20.5	21.0	6.4
Institutional firms	17.5	33.2	8.7	22.1

Source: Securities and Exchange Commission, *Fifth Report to Congress, supra* note 142, Exhibit 19-B.

Table 38
Rates of Return on Equity for U.S. Brokerage Industry

1976 and 1977

	1976	1977
Traders and market-makers	43.1%	12.6%
Underwriters and general dealers	38.4	15.8
Commission introducing firms	31.9	23.2
Regional and local full-line firms	30.8	14.3
Institutional firms	29.6	10.0
National full-line firms	28.0	12.2
Commission firms	22.5	8.8

Source: Securities and Exchange Commission, *Fifth Report to Congress, supra* note 142, at 45, and SEC, *Staff Report, supra* note 142, Exhibit 8.

Table 39
Concentration of Securities Commission Revenue of New York Stock Exchange Member Firms Doing a Public Business

1974–76

	Percent accounted for by 10 largest firms
1974	
First quarter	33.0%
Second quarter	33.6
Third quarter	35.8
Fourth quarter	37.0
1975	
First quarter	37.8
Second quarter	38.7
Third quarter	38.8
Fourth quarter	38.5
1976	
First quarter [a]	42.3
Second quarter [a]	39.8
Third quarter [a]	39.8
Fourth quarter	39.4

a. Revised.
Source: Securities and Exchange Commission, *Fifth Report to Congress*, *supra* note 142, Exhibit 22.

But the mergers have generally been in response to increased competition of all kinds and in anticipation of still more competition to come with a National Market System (discussed in Williamson, *Capital Markets*[148]), rather than as a result of negotiated commission rates as such. A few mergers have been aimed at rescuing failing firms but most have reflected a conviction that the major firm of the future must be well capitalized and strong in three operating areas: underwriting, trading and distribution. Recent years have seen the giant retailer, Merrill Lynch, develop strength in underwriting, and the leading underwriter, Morgan Stanley, build and acquire strong trading and distribution operations. Some of the most significant mergers in late 1977 have involved firms particularly strong in only one or two of these three areas.

B. ONTARIO SECURITIES COMMISSION HEARINGS, 1976

During the summer of 1976 the Ontario Securities Commission held hearings on fixed minimum commission rates on the Toronto Stock Exchange. The TSE brief contained a number of opinions to the effect that fixed rates should continue but offered almost no economic analysis.[149] The exchange expressed fears that commission rate competition would lead to financial institutions overshadowing brokerage firms, to fewer brokerage firms and therefore fewer independent sources of research, to reduced services for small investors, and to lack of uniformity in commission rates charged to institutions and individuals. All but the first of these are certainly quite likely, especially in view of the United States experience. But what is doubtful and unsubstantiated is that they are harmful to the investor or the marketplace.

The exchange also argued, as had the NYSE, that price competition would lead to destructive competition and shrinkage of the industry. The TSE went further, predicting that this shrinkage would particularly affect the financing of small companies in Canada because of a reduction in broker research.

But if the TSE pinned its defence of fixed rates on any one claim, it was the claim that commission rate competition would accelerate a trend toward institutional dominance of the ex-

148 *See, Williamson, Capital Markets*, ch. IV. The SEC reported that for May 1, 1975, through 1977, 93 firms left the New York Stock Exchange and 62 were admitted to memhership. Of the 93, 24 remained in business as NASD members and 36 disappeared in mergers; SEC STAFF REPORT, *supra* note 142, at 13-15 and exhibit 11.

149 TSE, In the Matter of the Securities Act, R.S.O. 1970, ch. 426, and, In the Matter of the Toronto Stock Exchange (June 18, 1976) (submission of the Toronto Stock Exchange to the OSC).

change marketplace. Exactly the same argument had been made by the New York Stock Exchange in defence of fixed commission rates. And as we shall see,[150] institutional participation is far more substantial in New York than it is in Toronto. In both markets the institutional share of trading appears to have leveled off in the last five years or so and what is particularly interesting is a comparison for New York between trading in 1974, when commission rates were fixed, and in 1976, when they were negotiated. Individuals accounted for 23% of total dollar volume on the NYSE in both years, with a slight increase in their proportion of share volume from 31% in 1974 to 33% in 1976. Institutions maintained their proportion of share volume at 44.5% but increased their share of value traded from 51% to 54% at the expense of trading by member firms.[151] This suggests that the shift to negotiated rates on the New York exchange has not led to increased dominance by institutions. Whether such an increase, should it take place, would be detrimental to investors and the marketplace is another question. The answer seems to be no but the question is dealt with in some detail later on.

In the absence of open price competition, service competition is bound to border on price-cutting. This was true in the United States before May 1975 and it appears to be true in Canada. The Quebec Securities Commission Task Force referred to the problems the Montreal Stock Exchange has had with "junkets, payment of subscriptions to business magazines or newspapers, rental of equipment or facilities"[152] and described the allocation of commission business by banks as based on reciprocity.[153] More examples were provided in the task force update of its report.[154] A substantial amount of what looks like price competition makes it likely that open and legitimate price competition would not greatly alter the economics of the industry.

1. *The Potter Submission*

Only three careful analyses of revenues and costs useful for analyzing commission rates in the Canadian brokerage business have appeared to date. One, analogous to the studies described above for the New York Stock Exchange, is that by Calvin Potter. This analysis appeared in his submission to the Ontario Securities

150 In ch. V *infra*.
151 NEW YORK STOCK EXCHANGE, PUBLIC TRANSACTION STUDY, 1976 (January 1977).
152 QSC TASK FORCE REPORT, *supra* note 144, at 18.
153 *Id.* at 80.
154 QSC TASK FORCE UPDATED REPORT, *supra* note 144.

Commission in the course of the 1976 hearings.[155] He dealt specifically with the argument by the exchange that negotiated rates would lead to destructive competition and relied for his Canadian data on the submission of the TSE to the OSC in November 1975 requesting continuance of a 10% surcharge on commission rates.[156] That submission contained fairly extensive cost and revenue data for five classes of members for six- and twelve-month periods through 1973 and 1974 and up to September 30, 1975. He used comparable U.S. data from the first report of the Securities and Exchange Commission to Congress on the effects of the absence of fixed commission rates, covering the period May 1 to August 31, 1975.[157] (The TSE has also published a cost study covering twelve months to March 31, 1975, and twelve months to March 31, 1976,[158] and another covering calendar 1976.[159] Unfortunately, these more recent studies do not provide any breakdown of data by category of member firms.) The categories of firms were those devised by the Toronto Stock Exchange. Potter's definitions are given in table 40.

Potter began with a comparison of the revenue mix of U.S. and Canadian securities firms. His general conclusion was that the two were remarkably similar, at least for the total industry on both sides of the border. For the Canadian industry for April 1 through September 30, 1975, 54.7% of total revenue came from commission income. For the U.S. firms for May 1 through August 31, 1975, commission revenue accounted for 52.3% of total revenue. (The most recent SEC report shows that for the fourth quarter of 1976 the ratio in the United States had dropped to 40%. For twelve months ending March 31, 1976, the ratio for the Canadian firms was down to 50%.)

Potter found that category A, national full-line firms in Canada, were already less dependent on commission revenue than were their U.S. counterparts, but that category B, local firms with a high value per trade (which Potter treated as analogous to American institutional firms) and category D, local firms with medium to low value per trade, derived a very large proportion of their

155 C. Potter, Fixed Minimum Commission Rates versus Competitive Rates for the Toronto Stock Exchange, Submission to the Ontario Securities Commission (May 1976).

156 Toronto Stock Exchange, Submission to the Ontario Securities Commission for the Continuance of the 10% Surcharge on Orders of $5,000 and above (November 14, 1975).

157 SECURITIES AND EXCHANGE COMMISSION, FIRST REPORT TO CONGRESS ON THE EFFECT OF THE ABSENCE OF FIXED RATES OF COMMISSIONS (December 1, 1975).

158 Toronto Stock Exchange, TSE Cost Study (June 18, 1976) (Document No. 3 of Submission to the Ontario Securities Commission).

159 CLARKSON, GORDON & CO., TORONTO STOCK EXCHANGE REPORT ON COST STUDY OF 13 MEMBER FIRMS (May, 1977).

Table 40
Definition of Categories of Firms

Category	United States	Canada
A	National full-line firms; underwriters	National, diversified firms
B	Institutional firms	Local firms with high value per trade
C	Traders and market-makers; introducing firms; other firms	National, primarily agency firms with medium to low value per trade
D	Regional and local commission firms	Local, primarily agency firms with medium to low value per trade
E	Regional and local full-line firms	Local and regional, diversified firms

Source: Calvin Potter, *supra* note 155.

revenues from commissions, over 90% in fact, well above the ratios for the U.S. firms. (A detailed breakdown of revenue sources, based on more recent data, was given in chapter II.)[160]

If the firms most dependent on commission revenue are the most vulnerable to price competition, then these are the local firms.[161] However, Potter went on to calculate commission revenue as a percent of trading and found that for category B, the local institutional firms, this percent was relatively low. So these firms were already, presumably because of the tapered rate structure, charging below-average commission rates.

Potter also found that for all of the Canadian firms the commission as a percent of the value traded was considerably higher than the percent charged on individual trading in the United States and of course far higher than the percent charged on institutional trading in the United States. The average for all of the Canadian firms was 2.2%. (More recent data from the Toronto Stock Exchange give an average rate of 1.45% for the April–June 1976 quarter. For trades under $5,000 the average was 2.25%.)[162] In the United States, as we have seen, by February 1977 the percentage had reached 1.58% for individuals, down a little from the 1.7% quoted by Potter, and the rate for institutions had reached 0.47%, down from the 0.6% quoted by Potter. Canadian rates were apparently well above American rates.

Potter drew some conclusions with respect to percentage profit margins in Canada compared with those in the United States. For the six months from April to September 1975 Canadian firms showed a lower margin than U.S. firms but for the three fiscal years ending March 31, 1973, 1974 and 1975 the Canadian firms were considerably more profitable. The more recent data indicate that for the twelve months ended March 31, 1976, the margin for American firms was 15.1% while the margin for Canadian firms was 13.3%. For the twelve months to March 31, 1976, the return on capital before income tax was 29% for the American firms and 25% for the Canadian firms. The "profit" measure is a doubtful one at best, since it is calculated *after* salaries to partners

160 *See* table 18 in ch. II *supra*.

161 The Commission Rate Committee of The Toronto Stock Exchange predicted that half of the category B firms would close if commission rates were unfixed. TSE Commission Rate Committee, Paper No. 3, Consensus of Views of the Commission Rate Committee as to the Likely Consequences of a Move to Unfixed Commission Rates in Canada, at 2 (February 3, 1976).

162 Toronto Stock Exchange, *RAMA [Revenue and Market Analysis] Results for the April–June 1976 Quarter*, Notice to Members No. 1387 (October 21, 1976). The average rates in the RAMA studies are generally lower than the rates given by the cost studies, such as that cited in note 158 *supra*. The exchange relies on the RAMA studies.

and directors. The report of the Securities Ownership Committee of the Ontario Securities Commission describes the dramatic effect on reported profits of substantial changes in partners and directors' compensation.[163] Data are included in the SEC's fifth report to permit adjustment for this compensation.

The most interesting of Potter's conclusions is probably that presented in table 41. Fixed costs range from 27% of total costs for category D, to 53% for category C, to over 70% for the other three categories.

These ratios of fixed costs are high by U.S. standards but lower than the TSE's own estimates which are shown in table 42. Potter found, when he allowed for different types of firms, that the marginal cost was $\$30.29 - (65.58 \times 10^{-6}) \times$ the number of transactions per year.[164] This result differs from the New York results and particularly from Mann's results by demonstrating a much greater increase in economy of scale with transaction volume. (This difference could, of course, be due to inaccuracies in estimating transaction volume.) The allocations of fixed and variable costs derived by Potter were for the most part not very different from the Toronto Stock Exchange allocations.

For the industry as a whole Potter found high fixed costs but constant returns to scale. The latter meant that large firms did not enjoy lower marginal costs than small firms. But taking account of categories of firms, he found that within these categories there were increasing returns to scale, that is, larger firms did have an advantage. His explanation for the apparently conflicting conclusions was that there are distinct markets for different kinds of brokerage. As table 41 shows, relative advantages in the form of low total cost, low marginal cost, and high margin between revenue and cost tend to offset one another. So it is not surprising that different categories of firms have developed different products or sets of services within the brokerage business that coexist at different costs and revenues.[165] Potter went on to justify the expectation that this coexistence would continue under competitive rates. And this coexistence appears to be about what has happened in the United States, with some shifting in the costs,

163 OSC, REPORT OF THE SECURITIES INDUSTRY OWNERSHIP COMMITTEE, *supra* note 20, at 55-56, 61-62.

164 Shaw and Archibald asked 16 firms what was the minimum commission that returned a profit to the firm. The median response was $26. The range was from $9 to $65. 7 D. SHAW & R. ARCHIBALD, *supra* note 28, at 46 (The Securities Firm in the Canadian Capital Market).

165 This is borne out by the estimates of profitable commissions referred to in note 164 *supra*. Two of the three highest estimates came from institutional firms and the three lowest came from retail firms.

Table 41
Average and Marginal Agency Revenue, Long-Run Average and Marginal Transaction Costs, and Related Margins, by Category of Firm

1976
In dollars

Category	Estimated number of annual transactions	Annual variable cost	Annual fixed cost
D	14,000	$ 411,320	$ 151,870
E	16,000	179,168	556,350
B	15,300	448,137	1,193,470
C	60,900	1,603,000	1,825,970
A	89,900	2,193,200	5,242,700

Table 42
Agency Business Expenses of Toronto Stock Exchange Firms

12 months to March 31, 1973–75
In thousands of dollars

Category	1973 cost [a]				1974 cost [a]
	Total	Variable		Fixed	Total
A	$ 64,729	$12,955	20%	$51,734	$ 83,587
B	20,556	6,524	32	14,032	29,429
C	27,668	10,728	39	16,940	12,611
D	8,374	3,659	44	4,715	11,021
E	18,681	7,149	38	11,532	9,753
Total	140,008	41,055	29	98,953	146,401

Average revenue per transaction	Marginal revenue per transaction	Marginal cost per transaction	Unit cost per transaction	Potential discrimination margin
$ 71.29	$36.15	$29.38	$ 50.23	0.728
61.62	35.75	29.24	46.42	0.525
115.03	33.98	29.29	107.29	0.745
59.25	27.76	26.28	56.21	0.556
75.16	22.22	24.40	82.62	0.675

Source: Calvin Potter, table XIX, *supra* note 155.

			1975 cost[b]			
Variable		Fixed	Total	Variable		Fixed
$16,798	20%	$ 66,789	$ 80,602	$13,358	17%	$ 67,244
7,651	35	21,778	23,729	4,273	22	19,456
5,028	40	7,583	12,817	4,001	31	8,816
4,708	43	6,313	4,236	1,572	37	2,664
3,981	41	5,772	6,061	1,887	30	4,174
38,166	26	108,235	127,445	25,091	20	102,354

a. 57 TSE firms.
b. 46 TSE firms.
Source: Toronto Stock Exchange, Submission to the Ontario Securities Commission, *supra* note 156, Appendix E.

prices and sets of services (including the innovation of the execution-only service).

2. *The Ontario Securities Commission Decision in 1976*

In a split decision the Ontario Securities Commission approved in 1976 the continuation of fixed rates with a requirement that the TSE submit a new schedule of rates. There was little reasoning in the majority opinion; about all it conveys is a message that the majority did not feel compelled to take an uncomfortable step.[166]

C. THE QUEBEC SECURITIES COMMISSION TASK FORCE REPORT

Reference has already been made to the Quebec Securities Commission Task Force report[167] and the appendix to this paper reproduces chapter II of the report, which describes the U.S. and Canadian commission rate structures up to early 1976. The task force collected data on fifty brokers registered with the Quebec commission and responsible for 96% of the 1975 value of trading on the Montreal exchange. For the whole group, 1975 commission revenue ($139.9 million) was 44% of total revenue ($320 million). This fraction compares with 54.7% for the TSE firms in the TSE and Potter analyses.

Of a total of $140 million in brokerage commissions, 35% was from institutions and 65% from retail customers. For the seven firms deriving over half their commission revenue from institutions[168] institutional commissions were over 80% of the total but these specialized firms accounted for only 17% of institutional commissions. The nine firms deriving over half their commissions from retail customers[169] averaged 60% retail business but still did twice the volume of institutional business done by the seven institutional firms.

Total underwriting revenue for the fifty firms was $67.6 million. The seven firms for which over half of total revenue was derived from underwriting[170] earned 42% of this amount. So

166 *In re* pt. XV of the by-laws of the Toronto Stock Exchange, [1976] OSC Bull. 289 (November). The decision is carefully reviewed in Connelly, *Fixed Versus Negotiated Commission Rates on The Toronto Stock Exchange*, 2 CAN. BUS. L.J. 244 (1977).

167 *See* note 144 *supra*.

168 Alfred Bunting & Co., Gordon Securities, Institutional Securities, Lafferty Harwood & Partners, Loewen Ondaatje McCutcheon, Maison Placements Canada, Research Securities of Canada.

169 Bache Halsey Stuart Canada, Bongard Leslie, Davidson Partners, Dominick Canada, Draper Dobie, Geoffrion Robert & Gélinas, W.D. Latimer, Midland Doherty, Turcot Wood Power & Cundill, Yorkton Securities.

170 A.E. Ames, Grenier Ruel & Cie., René T. Leclerc, Lévesque Beaubien, Molson Rousseau & Co., Tassé & Associés, Wood Gundy.

underwriting was a good deal more concentrated than institutional commission business.

Revenues of all firms fluctuated substantially from month to month in 1975 but apparently the fluctuations were not significantly greater for the firms most dependent on commissions (twenty-six firms derived over half their total revenues from commissions). These firms, however, showed more months of losses. The analysis concluded that fixed costs are substantial but did not attempt to quantify this conclusion.

It appeared that the institutional firms were consistently more profitable than the retail commission firms through 1975, confirming the TSE and Potter conclusions. The underwriting firms were much more profitable than those dependent on commission revenue and this, too, confirmed the other studies' conclusions. Profitability declined steadily for the commission firms over the four quarters of 1975 but the report suggested no reason for this. Figure 3 shows the relationship between MSE volume and rate of return on capital for three classes of firms for 1975.

Table 43 applies U.S. experience to the Canadian industry to forecast the revenue reductions that might result from competitive commission rates.

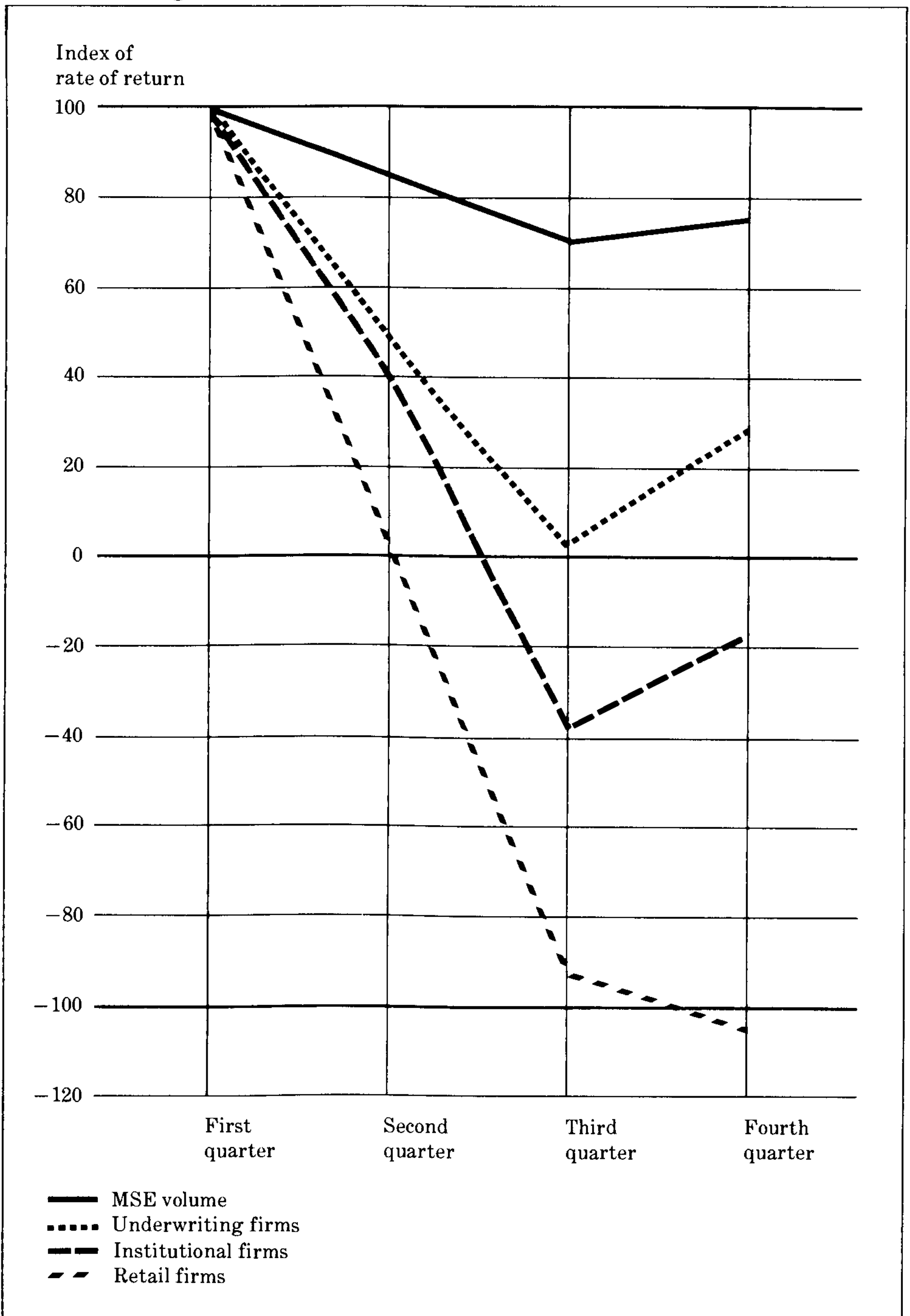
A good deal of the QSC task force analysis was directed at the differences between Québec-controlled and other brokerage firms. (The seven firms with the largest total revenue, aggregating 45% of revenues of all fifty firms, were controlled outside Québec.) Concentration was another element of interest. Figure 4 shows concentration by various kinds of revenue. Underwriting shows relatively large concentration, while institutional commission business shows relatively little (half as much as underwriting) and retail commission business lies between. Concentration in underwriting revenue correlated highly with concentration in capital; but the heavily capitalized firms did not dominate the commission business.

D. COMPETITION BETWEEN U.S. AND CANADIAN MARKETS

As we have seen, one of the issues raised in the U.S. deliberations over fixed or competitive commission rates was the competition among the New York Stock Exchange, the regional stock exchanges, and the "third market". The New York exchange had hoped that Congress or the SEC might eliminate the third market by legislation or by rule but that wish was not granted.

In Canada no significant "third market" has ever developed and although there is competition between Toronto and Montreal, the commission rates are identical on the Toronto and Montreal

Figure 3
Montreal Stock Exchange Volume for 1975, and Rates of Return on Capital for Three Categories of Firms



Source: *Quebec Securities Commission Task Force* (1976).

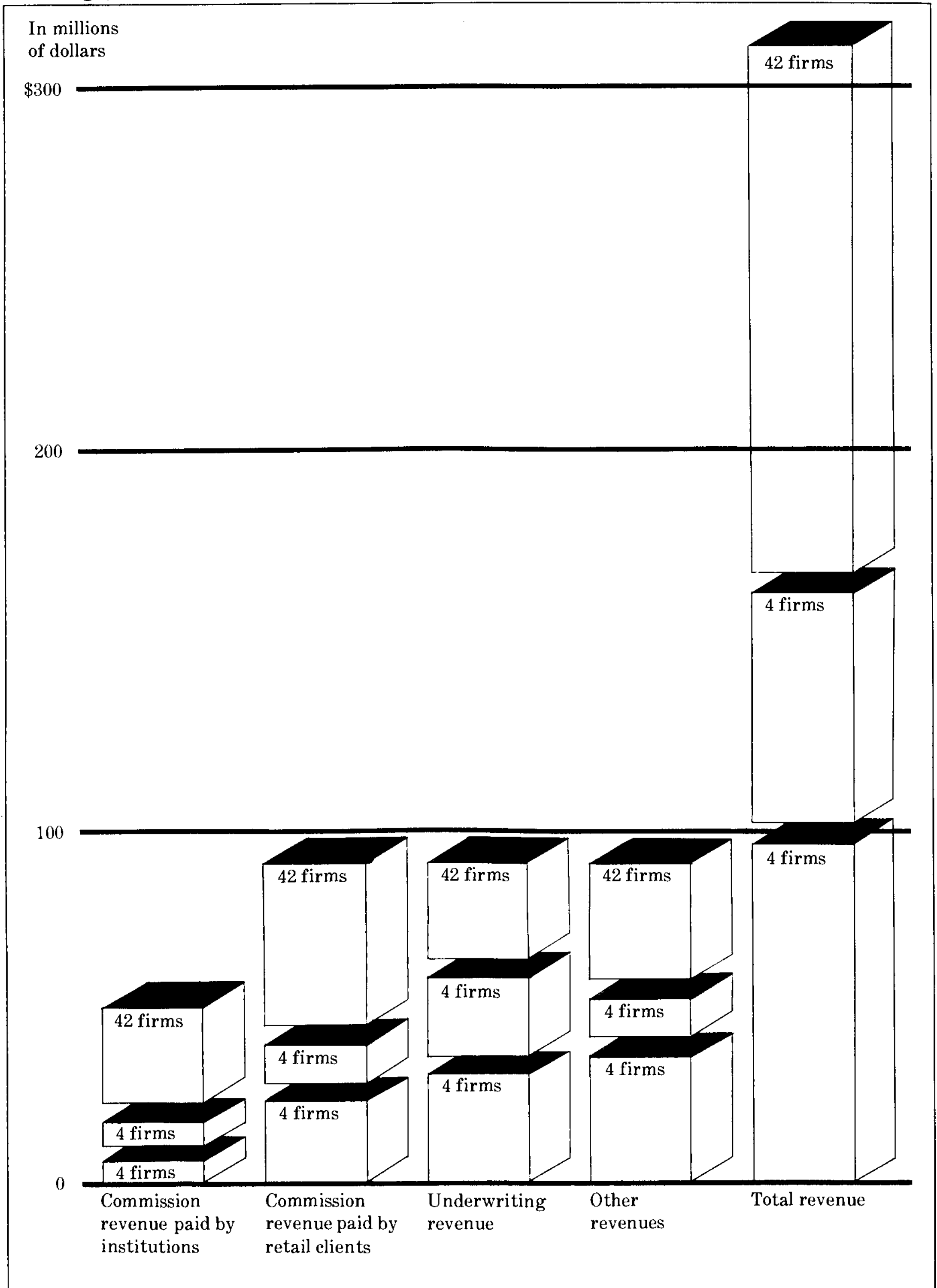
Table 43
Hypothetical Reduction in Revenues and Brokerage Rates Based on United States Experience[a]

In thousands of dollars

Category	Number of firms	Reduction of commission revenue		Reduction of total revenue
Institutional	7	$ 3,300	35.9%	33.0%
Retail	10	1,500	5.3	3.6
Underwriting	7	3,000	17.7	4.4
Others	26	11,800	13.8	5.9
Total	50	19,600	14.0	6.1
50% or more of total revenues originate from stock exchange commissions	26	9,500	15.5	11.0
50% or more of total revenues originate from other sources	24	10,100	12.9	4.3
25–50% of total revenues originate from institutional commissions	11	4,600	19.1	12.3
Largest firms	8	6,300	11.7	3.9

a. Assumes a 40% decrease in the average institutional brokerage rate.
Source: *Quebec Securities Commission Task Force, supra* note 144, table VIII-1.

Figure 4
Categories of Revenue for 50 Largest Firms on the Montreal Stock Exchange, 1975



Source: *Quebec Securities Commission Task Force* (1976).

exchanges. But there is vigorous competition between Canadian and U.S. markets in interlisted stocks. The shares of about seventy-nine Canadian corporations are listed for trading on stock exchanges or on NASDAQ in the United States as well as in Canada. Eighteen are listed on the NYSE, forty-two on the AMEX, sixteen on NASDAQ and three on the Pacific Coast Exchange. These stocks present an unusual opportunity for a Canadian investor to seek better trading conditions in the United States. They are also important stocks in terms of the Canadian marketplace. Forty percent of the value of trading on the TSE in the first five months of 1977 was in these interlisted issues.

The Toronto Stock Exchange has said that "there is an active dealer market in the U.S. in a significant number of TSE stocks which are *not* listed in the U.S., but trade via NASDAQ and the U.S. OTC market – in effect a 'third market' in TSE stocks....In certain stocks, including Moore Corporation, Denison Mines, Falconbridge Nickel Mines, such trading is substantial".[171]

Tables 44 and 45 show a rough comparison between U.S. and Canadian commission rates at mid-1976.[172] (The appendix to this paper contains graphical comparisons for institution size orders taken from the Quebec Securities Commission Task Force report.)

The SEC presents data for different sizes of orders broken down by number of shares rather than by value, while the TSE breaks down orders by value. Table 44 shows the SEC statistics with size of order estimated by assuming an average price of $25 per share. It seems safe to say that for Canadian trading, institutions account for almost all of the orders from $100,000 up, and the 0.73% rate of commission was high compared to the American institutional rates on large trades. (As of the end of 1977 the U.S. institutional rate was down from the 0.4% shown in table 44 to about 0.3%.) Since even on the smallest orders the average American institutional rate was only 1.05%, it seems clear that in general the U.S. trading was cheaper for institutions.

An interesting comparison of commission rates in Canada and in other countries, as of mid-1976, is shown in table 46 taken from a submission to the Ontario Securities Commission by Swiss Corporation for Canadian Investments Ltd.[173] Tables 47 and 48 from the

171 Toronto Stock Exchange, Background Memorandum concerning Principal Transactions, at 39 (May 23, 1977). The memorandum was part of a submission to the Ontario Securities Commission.

172 SECURITIES AND EXCHANGE COMMISSION, FIFTH REPORT, *supra* note 142; Toronto Stock Exchange, *RAMA Results for the April-June 1976 Quarter*, Notice to Members No. 1387 (October 21, 1976).

173 Swiss Corporation for Canadian Investments Ltd., Fixed or Negotiated Rates? (May 14, 1976) (brief submitted to the Ontario Securities Commission).

Table 44
United States Data, Commission in Cents per Share and Percent of Value

April 1975 (old) and June 1976 (new)

Total value of order	Commission							
	Institutions				Individuals			
	Old		New		Old		New	
	Cents per share	Rate of commission	Cents per share	Rate of commission	Cents per share	Rate of commission	Cents per share	Rate of commission
Under 200 shares (under $5,000)	60¢	1.50%	50¢	1.05%	50¢	2.04%	53¢	2.00%
200–999 shares ($5,000–25,000)	46	1.28	33	0.90	33	1.86	32	1.80
1,000–9,999 shares ($25,000–250,000)	28	0.89	20	0.50	20	1.38	19	1.25
Over 10,000 shares (over $250,000)	15	0.57	11	0.40	9	0.76	7	0.50

Source: Securities and Exchange Commission, *Fifth Report*, *supra* note 142.

Table 45
Canadian Data, Commission in Cents per Share and Percent of Value

April–June 1976

Total value of order	Commission		
	Cents per share	Rate of commission	Average order value
Under $5,000	5.2¢	2.25%	$ 1,507
$5,000–9,999	14.7	2.03	6,949
$10,000–19,999	19.2	1.90	13,754
$20,000–99,999	21.1	1.42	37,964
Over $100,000	14.1	0.73	235,267
Total	10.4	1.45	6,574

Source: Toronto Stock Exchange, *RAMA Results*, *supra* note 172.

submission of Burns Fry Limited, give a more direct Canada-United States comparison.[174]

The submissions to the Ontario Securities Commission in the summer of 1976 reflected an awareness of the competitive threat of U.S. markets with some confidence that there was little to worry about. In its submission, the Montreal Stock Exchange reported that for interlisted issues, total 1975 U.S. volume was about 43.9% of the total Canada and American trading. There had been a downward trend in the percentage trading in the United States, from a high of 70.5% in 1969 to a low of 43.9% in 1975, although throughout this period Canadian commission rates were somewhat higher than rates in the United States. There had been, however, a wide variety among the stocks in terms of the percent of trading done in the United States and the trend in that percent.[175]

The Montreal exchange reported some evidence that Canadian financial institutions had shifted orders for some stocks to the United States market and the shift was particularly noticeable in the case of the stocks of four widely-held corporations: Alcan, Canadian Pacific, International Nickel, and Massey-Ferguson. For Alcan and International Nickel most of the total trading is done in the United States while for the other two most is done in Canada. The exchange concluded that the trading statistics, particularly those reflecting the American and Canadian shares of trading following the freeing of commission rates in the United States on May 1, 1975, indicated that a differential in commission rates between the United States and Canada was not likely to lead to a substantial outflow in trading in interlisted issues.[176] But the exchange was sufficiently concerned about such a shift that it advocated that Canadian brokers be forbidden to pass on to Canadian customers the benefits of lower commissions on U.S. transactions in interlisted stocks.[177]

Some Canadian institutions indicated in their briefs to the OSC that they had shifted trading from Canada to the United States to take advantage of lower commission rates there.[178] Other

174 Burns Fry Limited, A Case for Negotiated Commission Rates in Canada (June 1, 1976) (submission to the Ontario Securities Commission).

175 Montreal Stock Exchange, Brief Presented to the Ontario Securities Commission in the Matter of the System of Fixed Minimum Rates of Commission for Exchange Transactions, at I-3-I-17 (June 10, 1976). Most of this U.S. trading is carried out by Canadian, not American brokers; *id.* at IV-8.

176 The Report of the Quebec Securities Commission Task Force was less optimistic; QSC Task Force, *supra* note 144, at 29, 81.

177 Montreal Stock Exchange, brief, *supra* note 175, at IV-6. In its submission of June 1, 1976, Burns Fry Limited suggested that such a prohibition might come about.

178 For example, Mutual Life Assurance Company of Canada and Canada Permanent Trust Company.

Table 46
Comparison of Stock Exchange Commissions on Various Markets of the World

1976
Per 100 share order, in Canadian dollars

Price per share	Canada		New York		Paris	
$5.00	$ 12.50	2.50%	$12.86	2.57%	$ 5.00	1.00%
$10.00	25.00	2.50	19.60	1.96	10.00	1.00
$25.00	44.76	1.79	34.89	1.40	25.00	1.00
$50.00	82.00	1.64	50.96	1.02	50.00	1.00
$75.00	123.00	1.64	50.96	0.68	75.00	1.00
$100.00	164.00	1.64	50.96	0.51	100.00	1.00

Frankfurt		London		Tokyo		Zurich	
$ 3.00	0.60%	$ 12.59	2.52%	$ 8.00	1.600%	$ 5.15	1.03%
6.00	0.60	15.00	1.50	10.34	1.034	10.25	1.03
15.00	0.60	37.50	1.50	17.34	0.694	16.25	0.65
30.00	0.60	75.00	1.50	35.34	0.707	32.50	0.65
45.00	0.60	112.50	1.50	52.68	0.702	48.75	0.65
60.00	0.60	150.00	1.50	65.68	0.657	65.00	0.65

New York: Figures based on commission tariff in force prior to May 1, 1975, with 20% discount. Price per share and commission converted into Can $ at 98.
Paris: Commission is based on the total amount of the order, regardless of share price. Commission includes stamp duty. Conversion rate 0.2105.
Frankfurt: Commission is based on the total amount of the order, regardless of share price. Tariff used for transactions between banks. Conversion rate 0.3870.
London: Commission is based on the total amount of the order, regardless of share price. Conversion rate 1.7980.
Tokyo: The average share price is far below the one in Canada. A share price of 1,000 Yen ($3.27) is unusual. To obtain a meaningful comparison, we applied a share price ratio of 1:30. Conversion rate 0.003275. A 1.018 share order was used.
Zurich: The average share price is far above the one in Canada. To obtain a meaningful comparison, we applied a share price ratio of 1:10. Conversion rate 0.3996. Commission is based on the total amount of the order, regardless of share price. Commission includes federal and cantonal tax.
Source: *Fixed or Negotiated Rates? A Brief on the Subject of Stock Exchange Commissions in Canada*, submission by Swiss Corporation for Canadian Investments Ltd., May 14, 1976.

Table 47
Approximate Commissions Charged by Full-Service Firms in the United States One Year after "Mayday" and Discount from Prior Fixed Rates[a]

As of May 1, 1976

Total value of order	Price per share $10		$20		$30		$40		$50		$60	
$50,000	10¢	29%	16¢	30%	23¢	28%	29¢	31%	35¢	30%	42¢	31%
$100,000	8	33	13	32	18	31	23	30	28	30	33	31
$200,000	7	36	11	35	15	35	19	34	24	31	28	33
$300,000	7	36	10	37	14	36	18	36	21	36	25	36
$400,000	6	N/A	10	N/A	14	N/A	18	N/A	21	N/A	25	N/A
$500,000	5	N/A	9	N/A	12	N/A	16	N/A	18	N/A	22	N/A

a. Expressed in cents per share with percentage discount from old fixed rates. Discounts on large transactions not applicable (N/A), since rates on transactions over $300,000 were negotiable prior to May 1, 1975.
Source: Burns Fry Limited.

Table 48
Fixed Minimum Commission Rates in Canada[a]

As of May 1, 1976

Total value of order	Price per share $10	$20	$30	$40	$50	$60
$50,000	19.50¢	31.45¢	38.37¢	51.17¢	63.96¢	76.75¢
$100,000	14.00	22.58	27.55	36.74	45.92	55.10
$200,000	10.75	17.34	21.16	28.21	35.26	42.31
$300,000	9.67	15.59	19.02	25.37	31.71	38.05
$400,000	9.16	14.72	17.96	23.94	29.93	35.92
$500,000	8.80	14.19	17.32	23.09	28.86	34.64

a. Expressed in cents per share.
Source: Burns Fry Limited, using Toronto Stock Exchange figures.

institutions indicated that they were content with the Canadian marketplace, while still others expressed some surprise that Canadian institutions had not pursued the lower rates available in the United States more aggressively. One submission noted that Canadian bank stocks trade over-the-counter in the United States at somewhat lower transaction costs than are found in Canada.[179]

In discussing the potential for a shift of trading from Canada to the United States, some of the submissions stressed the importance of the quality of the market, particularly its liquidity, observing that a lower commission rate might well be offset by the disadvantage of a poorer market. However, no evidence was presented to indicate that the U.S. market for any of the interlisted stocks was significantly lower in quality than the Canadian market.

In early 1977 the complacency disappeared and the Toronto Stock Exchange became alarmed at the shift of trading from Canada to the United States. Two committees of the exchange, the Market Functions Committee and the Joint Industry Commission Rate Committee, brought some distressing statistics to the attention of the membership and the public. Table 49 shows the percentages of total agency trading and total principal transactions of members of the TSE in interlisted Canadian stocks that were executed in the United States. There was a significant increase in agency trading in the United States, but the actual "slippage" could have been even greater since these figures do not include transactions for Canadian customers by U.S. brokers who are not members of the TSE. Nor do they include American trading over-the-counter in stocks that are not interlisted. In 1977, however, U.S. agency trading dropped a little, principal trading was up a little, and total U.S. trading seemed to have leveled off.

The Market Functions Committee acted first, recommending a reduction from $400,000 to $100,000 in the minimum size trade that may be handled by a member firm as a principal transaction. The proposal was accepted by the membership and ultimately by the Ontario Securities Commission.[180] The committee produced a rather more detailed analysis than is shown in table 49 in order to show that trading in interlisted issues is more concentrated in large orders than is trading in all issues and that a high percentage of large orders (over $50,000) are transacted in the United States. The commission rate proposal came next.

179 Brief of the Investment Counsel Association of Quebec (July 22, 1976) (submission to the Ontario Securities Commission).

180 *See* the discussion in *Williamson, Capital Markets*, ch. II.

Table 49
Slippage in Percentages of Agency and Principal Transactions to U.S. Markets

May 1975–September 1977

Month	Agency	Principal	Total transactions
May 1975	6.94%	33.21%	17.16%
November 1975	10.77	33.07	18.35
March 1976	12.93	36.93	22.93
June 1976	12.87	38.75	23.70
September 1976	15.34	37.99	24.46
October 1976	13.63	35.73	23.55
November 1976	12.47	32.92	21.11
December 1976	16.40	35.95	24.75
January 1977	13.70	38.80	26.10
April 1977	15.70	36.80	24.40
June 1977	14.80	39.90	24.90
September 1977	14.20	40.20	23.90

Source: Toronto Stock Exchange. Data through December 1976 appeared in: Joint Industry Commission Rate Committee, *Presentation of Proposed Commission Rates* (April 4, 1977).

E. THE 1977 COMMISSION RATE PROPOSAL

The Joint Industry Commission Rate Committee proposed a new fixed commission rate structure based on the value of each 100 share lot traded. Commissions would be 3% of the first $500, 2% of the next $1,000 and 1% of the balance, with a discount for large transactions - nothing off the first $5,000, 10% off the next $15,000 and 20% off the next $20,000. On amounts beyond $40,000, the commission would differ according to whether the stock price was less than or greater than $10. Below $10 the rate would be 1% of value; above $10 it would be 10¢ per share. Beyond $1 million rates would be negotiable. (Under the existing rate schedule, negotiation began at $500,000.) Individual traders would be given a 50% discount on "reversal" sales, at the broker's discretion where the purchase and sale of the same stock were executed through the same broker within forty-five calendar days. (This rule has apparently introduced some rate competition.) Finally, a five-day accumulation rule would allow consolidation, for purposes of determining the commission, of orders filled within five consecutive trading days where the total value is at least $100,000. The membership approved on April 19, 1977 (by a vote of seventy-eight to fifteen), and this rate scale was put before the Ontario Securities Commission in June 1977.

The exchange's 1977 submission disclosed the dilemma in which the industry found itself. On the one hand, the recession of 1973–74 had reduced profits and led to attrition in the number of salespeople employed so that firms were eager to increase commission rates. On the other hand, the substantially lower commission rates in the United States were taking institutional trading in Canadian interlisted stocks away from the Toronto market. The task was to produce a rate scale that was attractive to member firms, yet competitive with U.S. rates. These conditions precluded a "flat" rate, one based solely on the value of a transaction. That rate would have to be either too low to satisfy the members or too high to be competitive, and since costs of executing a transaction are almost certainly not directly proportional to the value of the transaction, there is little reason to aim at a flat rate.

In defending the proposed rates the exchange said that "there is a relatively high cost per trade which must be met, regardless of the trade value, and the incremental costs arising from the value of the trade or the number of shares involved is a smaller percentage of the total cost".[181] This conclusion follows

181 Toronto Stock Exchange, Submission to the Ontario Securities Commission regarding the Proposed Commission Rate Schedule, at 20 (May 16, 1977).

from the 1976 data described above and from Potter's analysis. But the cost study commissioned by the TSE for the 1977 hearings provided little support.[182] Clarkson,Gordon & Co. explicitly disclaimed any attempt to separate fixed from variable costs, and in fact expressed doubt that a separation was even practical.[183] We can be fairly sure from the earlier data, discussed above, that fixed costs are substantial (although, as Clarkson Gordon suggested, it is very hard to say just how "fixed" these costs are – leases, after all, can be terminated, computers relinquished, research staffs cut back). And there almost certainly is some minimum marginal cost for a transaction. But how these costs may vary from firm to firm and from category to category of firm the exchange did not say.

Institutional trading was expected by the exchange to involve chiefly shares priced above $10, which was chosen as the dividing point for rates on the portion of a transaction beyond $40,000. For higher priced shares these large transactions were expected to be competitive with trading in the United States. Table 50 compares old and proposed TSE rates with old NYSE rates. Since institutional brokerage firms in the United States were on average charging rates 33% below the "old" New York rates in the fourth quarter of 1976 and institutional customers were achieving discounts of 30% to 40%,[184] the current NYSE commissions can probably be taken to be about two-thirds of the "old" rates. The TSE rates do appear competitive on these very large trades.

1. *The Clarkson Gordon Cost Study*

The Clarkson Gordon study is disappointing in that it makes no attempt to separate fixed and variable costs or at least to identify the minimum cost that might be associated with an execution. Even though this identification is difficult, the proposed rate structure is based on the proposition that there is such a minimum cost and that rates should at least approximately reflect it. The study is also disappointing in that it identifies very different average total costs per transaction for different categories of firm, as did Potter, but makes no attempt to explain the differences. The TSE proposal offers only a distinction between "retail" and "institutional" trades but there must be much more significant differences.

Table 51 analyzes transaction costs for commission transac-

182 Clarkson, Gordon & Co., *supra* note 159.

183 *Id.* at 32.

184 Securities and Exchange Commission, Fifth Report, *supra* note 142.

Table 50
Commissions on Large Transactions[a]

As of May 16, 1977

Total value of order	Price per share				
	$10	$20	$30	$40	$50
$100,000					
Present TSE	14.0¢	22.6¢	27.6¢	36.7¢	45.9¢
Proposed TSE	14.6	19.8	23.2	26.7	30.1
Old NYSE	11.9	18.9	26.3	32.9	39.9
2/3 of Old NYSE	—	12.6	17.5	21.9	26.6
$200,000					
Present TSE	10.7	17.3	21.2	28.2	35.3
Proposed TSE	12.3	14.9	16.6	18.3	20.1
Old NYSE	10.9	16.9	23.0	28.9	34.8
2/3 of Old NYSE	—	11.3	15.3	19.3	23.2
$500,000					
Present TSE	8.8	14.2	17.3	23.1	28.9
Proposed TSE	10.9	12.0	12.6	13.3	14.0
Old NYSE	10.3	15.7	21.1	26.4	31.8
2/3 of Old NYSE	—	10.5	14.1	17.6	21.2

a. Expressed in cents per share.
Source: Toronto Stock Exchange, *Submission to the Ontario Securities Commission*, *supra* note 181, with 2/3 of old NYSE rates added.

Table 51
Analysis of Transaction Costs per Agency Transaction

1976
In dollars

	All firms in survey (13 firms)	Retail (3 firms)	National retail (2 firms)	Diversified (5 firms)	Institutional (3 firms)
Total cost before interest, compensation to producers and bonuses to shareholders	61.59	36.50	43.81	87.32	192.66
Implied compensation to producers at 33-1/3% rate	30.80	18.25	21.90	43.66	N/A
Calculated value of commission revenue from "break-even trade"	92.39	54.75	65.71	130.98	N/A
Average commission revenue from TSE trades	79.62	66.94[a]	53.47	91.53	235.70
From all agency trades	69.40	51.89[a]	43.26	86.34	244.67

a. Excludes one retail firm with a large volume of institutional business.
Source: *Clarkson Gordon Cost Study*, schedule 19, *supra* note 182.

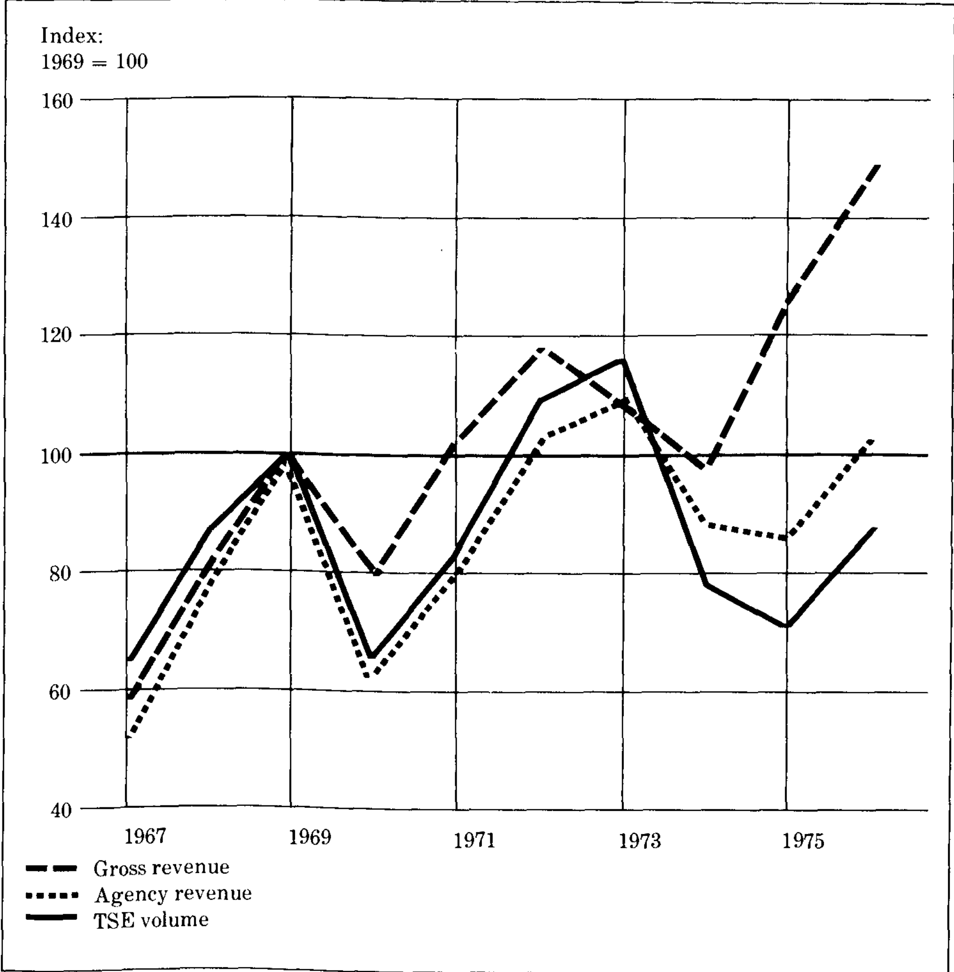
Table 52
Rate of Return on Capital of 12 Toronto Stock Exchange Firms

1967–76 and 1976

	1976	Average 1967–76
5 diversified firms	17.0%	17.1%
2 small institutional firms	6.0	10.4
5 retail and national retail firms	(1.0)	6.4

Source: *Clarkson Gordon Cost Study*, schedules 8, 9, 10, *supra* note 182.

Figure 5
Gross Revenue, Agency Revenue and Volume on the Toronto Stock Exchange, 1967–77



Source: *Clarkson Gordon Cost Study*, *supra* note 182.

tions. The thirteen firms whose data are represented handled 30.5% of the value of TSE trading in 1976.

The substantial differences among the categories of firm in average cost and average profitability suggest significant differences among the products offered. Bearing in mind that for the thirteen firms commission revenue was only 39.4% of total revenue in 1976, we can easily surmise that joint products and joint costs may differ greatly among the firms. (This percentage is low even for diversified firms. See table 18.) So for decision-making purposes – whether management decisions within firms or rate structure decisions by the commission – the data in table 51 are probably not very helpful.

The study traces total revenue and commission revenue for the sample of thirteen firms over a decade. Figure 5 shows the close correlation between exchange volume and commission revenue. (The commission rate structure was modified in 1973 and a 10% surcharge was in effect for 1975.) The study furnished data on rates of return for the total business (including commission business) of the diversified, retail and institutional firms. These do not tell us much about the commission business except to suggest that despite the costs of non-price competition, the institutional firms have been more profitable than the retail firms and probably this difference reflects the commission rate structure. Table 52 summarizes some comparisons of the study.

On June 30, 1977, the Ontario Securities Commission accepted the TSE proposed rate schedule (after the exchange modified it to restore the $500,000 level at which rates become negotiable rather than moving to $1 million) to be effective September 1, 1977, and to continue for two years. The OSC had the benefit of its own staff position paper, which had estimated rates of return for different segments of the industry under the proposed schedule. It concluded that the rates would not produce unreasonable profits, at least from agency business, and approved them for a two-year period.[185]

The Quebec Securities Commission, which had already given notice of a preference for competitive rates and of its intention to ask for legislation to make rates competitive,[186] tacitly agreed to go along with the Ontario decision, as did the Vancouver exchange.

185 *In re* the Securities Act and Part XV of the By-Laws of The Toronto Stock Exchange, [1977] OSC Bull. 157 (July).

186 8 QSC Bull., No. 16 (April 26, 1977).

2. *The Ontario Securities Commission Staff Position Paper, 1977*

The third of the three careful analyses of revenues and costs in the Canadian industry was the Ontario Securities Commission staff position paper[187] prepared for the commission in the summer of 1977 during proceedings on the TSE proposal for a new set of rates. The author of the paper was Calvin Potter and its conclusions are significant not simply in terms of a particular rate structure (one that was approved by the OSC) but in terms of the whole logic behind rate structures – the purposes they are to serve and the means to achieve those purposes. It seems all too clear that throughout the 1976 and 1977 deliberations the industry and the commission had no very clear set of purposes in mind but were guided by a vague objective of "fair and reasonable" rates, subject to fear of the effects of competition.

Potter points out early in his paper the unsatisfactory nature of a "fair and reasonable" standard without much more specific tests.[188] In effect, the OSC was taking a few faltering steps toward a public utility rate regulation standard. But the standards for this kind of regulation go far beyond "fair and reasonable". They go to cost of capital of the regulated institution and determination of a reasonable rate of return. The commission was unwilling to take this step, yet it agreed with the principle of fixed rates, subject to its approval.

It is interesting that, as Potter noted, the TSE implicitly endorsed competitive commission rates as "fair and reasonable", since its justification for the new fixed rates on both large and small trades was that these rates were comparable to or lower than the competitively established New York rates.[189] In fact, what the TSE had done in large part was to construct a set of fixed rates that roughly matched the New York rates. Potter observed that if the match were a close one, he would have to conclude as an economist that the result was bound to be "fair and reasonable" since it simply duplicated the effects of free competition.

But the match was not perfect and the TSE rates presented two major difficulties. First, as the exchange conceded, since its rates were to be fixed while the New York rates were not, even though the two sets of rates were close, those firms dealing in the New York market would have some flexibility to underprice the Toronto competition. Second, as Potter pointed out, in trying to meet New York competition and at the same time keep revenues

187 Ontario Securities Commission, Toronto Stock Exchange Commission Rate Schedule Hearing, staff position paper (June 7, 1977) (prepared by C.C. Potter).

188 *Id.* at 5 (summary).

189 *Id.* at 5-7.

as high as possible the exchange had come up with a structure that was internally inconsistent.

The exchange had said that there is a substantial fixed cost associated with a trade (although it offered no evidence on this because the Clarkson Gordon study furnished none). This conclusion is undoubtedly correct. The exchange also said that "it does not cost substantially more to trade high-priced shares than low-priced ones".[190] This conclusion is almost certainly correct as well, although there are no data available to prove the point. But the new rate structure follows these principles only for large transactions where NYSE competition is most significant. It does not follow them for small transactions.

Consider the commission on a $60,000 trade compared to the commission on a $40,000 trade. Both are essentially large "institutional" trades. The commission on the $40,000 trade should have covered the fixed costs and so the extra commission in moving to a $60,000 trade should reflect only the extra, or marginal cost, of handling more shares. And if it costs no more to handle 100 shares of a $40 stock than it does to handle 100 shares of a $20 stock, the extra commission should be strictly a function of the number of shares required to bring the trade from $40,000 to $60,000. This is in fact exactly the case. The extra commission is 10¢ per share, regardless of share price, if the price is at least $10. In fact, as the description of the rate schedule easily shows, once a trade exceeds $40,000, the commission for every extra round lot is $10 for any share price above $10.

But for small trades the relationship is very different. Consider the extra commission in going from a $10,000 trade to a $20,000 trade. For a $10 stock the extra charge is 22.5¢ per share. For a $20 stock it is 36¢ per share. And for a $40 stock it is 56.8¢ per share. Potter pointed out that this pricing is not consistent with the exchange's own statement about costs and imposes a discrimination against individual trading of high-priced, "quality" stocks. This discrimination is particularly surprising, since the exchange itself had expressed fears that competitive rates would favour institutions. We seem to have found a fixed rate structure that emphatically favours institutions just in terms of the extra commission charged for each extra round lot traded!

There is a third defect in the new set of Toronto rates. They fail to reflect differences in the kinds of brokerage services offered by different firms and the kinds of services wanted by different customers. We have already seen the emergence of discount bro-

190 TSE, Submission to the OSC regarding the Proposed Commission Rate Schedule, *supra* note 181, at 27.

kers in New York offering a no-frills, execution-only service to individuals many of whom may prefer to obtain their investment advice from a commercial adviser. These low-rate firms exist side-by-side with the long-established retail wire houses that charge significantly higher rates and offer the traditional line of services. The TSE rates were claimed to be below the U.S. wire house rates on individual trades but although the TSE was well aware of the discounted rates, it did not expect that Canadian brokers would meet them.[191] The investor in the Toronto market, then, is simply not given the choice of buying only executions from a broker at a low rate and obtaining investment advice elsewhere.

But quite apart from execution-only service is the matter of accommodation to the variety of services already offered. The exchange itself refers to this variety[192] but makes only limited provision in the rate structure for variations in commissions to accompany variations in service. Instead, brokers are left to adapt service to fit price, something that has long been an unattractive feature of the institutional market; it continues in the individual market in Toronto. Since the extra commission per round lot rises steeply with share price, brokers will find it profitable to encourage individuals to trade in high-priced stocks. Probably the encouragement will take the form of a research emphasis on these stocks, precisely the opposite to the emphasis the TSE has said is needed by the economy.

The staff position paper drew some important conclusions on the profitability of brokerage and "other" activities of member firms. The TSE had said that brokerage was not sufficiently profitable and that retail firms, in particular, needed higher rates. What Potter found was that for the industry as a whole (represented by forty-four firms) brokerage was marginally unprofitable and "other business" was profitable. That is, the marginal cost of increasing brokerage revenue was greater than the revenue itself, while the marginal cost of increased other business was lower than the increased revenue. But for the nondiversified firms, those doing a primarily commission business, the opposite was true for both institutional and retail firms. This conclusion did not prove the firms were profitable, since the analysis did not incorporate fixed costs. But it showed that for these firms commission business at a sufficiently high volume was profitable.[193] It seemed quite possible that the supply of brokerage services was simply too large for the demand – that the industry was too large

191 *Id.* at 33-34.
192 *Id.*
193 *Id.* at 47-55.

to be profitable. This conclusion for the U.S. industry was suggested above.[194]

F. CONCLUSIONS AND POLICY IMPLICATIONS

A fundamental policy issue, of course, is whether commission rates are to be fixed or competitively determined. The United States experience can only lend support to competitive rates but one may argue that something can still go wrong.

Fixed rates that duplicate competitive rates – rates established in a comparable market that does allow competition – will have almost the same effect as competitive rates and are almost automatically "fair and reasonable". But since these rates cannot reflect all possible kinds and levels of services, they deny to both broker and customer the opportunity to match rates and services that exist in a free market. The new (1977) TSE rates do differentiate between low-value and high-value trades and between speculative and investment quality stocks. But even these differentiations can have perverse results. We have seen that small transactions in investment quality stocks have been made expensive for customers and therefore profitable for brokers. The fixed rates also penalize the Canadian industry relative to the U.S. industry, since firms in a competitive market can always cut rates, or "repackage" services and rates to attract business.

If the fixed rates do not duplicate competitive rates, then the regulatory commission will have to assume the powers and responsibilities of a public utility rate regulator – something neither the SEC nor the OSC has ever wanted to do. This kind of regulation calls for a set of standards, almost inevitably involving cost of capital or the "appropriate" rate of return for a brokerage firm. And this in turn calls for cost and revenue allocations that go far beyond anything that the OSC has demanded or that the TSE has provided.

It is difficult to achieve even a fixed and variable cost allocation, although the TSE studies used to do just that. But as Potter has pointed out, the real difficulties arise because of joint costs. The same expenses support both underwriting and commission business. And revenues may be joint too. Success in underwriting may call for a substantial retail operation. Together, the two activities may be profitable. Taken separately, one may appear profitable and the other unprofitable, but this is of no particular importance to the firm which undertakes both together.

We still do not have the cost studies that could demonstrate

194 In the quotation in text accompanying note 143 *supra*.

whether price-fixing is justified and if so, what the appropriate rates would be. The case for destructive competition has not been proven, although the data may exist that would prove it. The TSE suggests that with variable rates the large firms would drive out the small. Potter's analysis, on the other hand, indicates that for the large, diversified firms brokerage is marginally unprofitable, while for the smaller commission-oriented firm it is marginally profitable.

The TSE actually has and collects on a regular basis a substantial amount of cost and revenue data. It should be possible to analyze these data to establish, first, whether rates should be fixed or competitive. If they are to remain fixed, then it should be possible to monitor the industry to see that the fixed rates are kept appropriate. If they are to become competitive, it should be possible to monitor the industry to see that competition is, indeed, working.

But there are further reasons for collecting and analyzing data. So long as self-regulation is considered an important part of a regulatory scheme, the adequacy of incentives and capability for self-regulation is worth continued study. Adequacy of capital in the securities industry and access to capital beyond the resources of employees is a matter of concern at present and calls for continuing economic analysis. The extent to which foreign competition should be encouraged or discouraged, the importance of centralizing trading in a single marketplace, the choice between agency trading and principal trading, and the value of individual trading as opposed to institutional trading all involve policy choices that a regulatory commission will have to deal with sooner or later and all require economic analysis of the brokerage business.

Experience in the United States may be useful here as a guide to what to avoid, as well as to what to do. The SEC has undertaken an enormous amount of data gathering, far more than has ever been attempted in Canada where the work has been left to self-regulatory organizations whose tendency is to keep data highly confidential and who, understandably, prefer to use the data in their own best interests. However, relatively little economic analysis has emerged from the SEC and some testimony given in early 1977 suggested that the agency was completely overwhelmed by data. The moral is that without a clear idea of what is to be done with the data, its collection may be an expensive and unproductive exercise.

From the analysis that has been done it seems almost inevitable that Canadian commission rates will become competitive or substantially competitive. Just how the change is brought about may be important to the securities industry and the capital mar-

ket. The diversified firms have the least to fear because most of their business is other than commission business and this other business appears to be quite profitable. If the firms that are not diversified have a cost advantage, as Potter suggests they have, and if they believe they have this advantage, then they have every reason to continue specializing, realizing that competition may become more intense but that they are in the best position to compete.

If, on the other hand, the nondiversified firms believe they are threatened by diversified firms, they may seek diversification. To do so is not necessarily sound, since the diversification event itself – the entry into new fields – may be very expensive. Many U.S. firms seem to be caught in the same dilemma. The largest have chosen the fully diversified route and are using mergers as probably the least risky and least expensive method to achieve it. The smaller firms (the major regional firms, for example) are looking for ways to remain somewhat specialized and profitable.

Which way firms in the industry move and whether their moves are in their own best interests and the best interests of the industry and the market may depend on the signals given by regulatory commissions.

Chapter IV
Securities-Related Activities of Banks and Trust Companies

There are significant parallels between the debates in the United States – in Congress, the courts and the marketplace – over the appropriate role of banks in securities markets, and the debates taking place in Canada largely involved in the decennial revision of the Bank Act but also as a part of the whole process of regulation of securities markets. The U.S. debate is informative so far as Canada is concerned, partly because of obvious similarities between American and Canadian financial institutions and securities markets and partly because American practices frequently find their way into Canada. In addition, a fair amount of research has been done in the United States and the results can be useful for Canadian planning purposes. Further, some policies and practices that have been proposed for Canada have already been tried out in the United States, and it may be possible to draw some conclusions as to their probable effects in a Canadian setting.

Competition between the banking and brokerage industry in Canada and in the United States has so far consisted almost entirely of banks engaging in activities traditionally associated with investment banking or brokerage. But in June 1977 Merrill Lynch (in the United States) announced a plan that appeared to be

the first venture by a brokerage firm into deposit taking. Merrill Lynch would offer customers automatic investment of their cash balances in a money-market mutual fund with daily interest. At the same time customers would be able to use these balances through VISA cards and cheques on the City National Bank & Trust of Columbus, Ohio. Since the interest rate charged by Merrill Lynch on securities loans was to be lower than rates charged on usual credit card borrowing, the plan offered significant competition to bank-sponsored credit cards.

The competition between commercial banking and investment banking has also become more intense in the United Kingdom, although it is difficult to document just what has happened. The commercial banks – "clearing banks" in British terms – seem to be replacing the investment banking firms – "merchant banks" or "accepting banks" – in underwriting syndicates in both the British domestic market and the Euro-currency market.

The following discussion deals with a number of activities of banks and trust companies in the securities markets including what they do, what they are forbidden to do, what they would like to do, and what others would like them to cease doing. Canadian banks and trust companies are discussed first, followed by American banks. Since banks in the United States are permitted to conduct a trust business, while Canada has separated commercial lending from trust activities giving the first to the chartered banks and the second to the trust companies, we must compare American banks to both Canadian banks and trust companies.

In recent years commercial banks in the United States have found a number of profitable ways in which to expand their securities-related activities. Already equipped with substantial money management facilities in their trust departments, they have looked for ways in which to reach a wider clientele for these services. Their extensive data processing facilities have suggested an opportunity to serve small investors through such things as dividend reinvestment plans that are simply not available from securities firms.

Before turning to the detailed activities of the banks, it may be worth reviewing the attitudes of some of the regulatory authorities with respect to this expansion of bank activities. Jeffrey M. Bucher, a member of the Board of Governors of the Federal Reserve System, testified in December 1975 before Senator Harrison Williams' Subcommittee on Securities. He said:

> "As a general matter, the Board believes that, within limits, commercial banks in securities-related activities can play a constructive role in serving the public, strengthening competitive forces, helping to enhance

individual participation in capital markets, and insuring efficiency in the allocation of investible funds. At the same time, the need for adequate safeguards for the public and the banks must be given appropriate attention. Each securities-related activity will tend to raise issues of its own, but an overview of the nature of the benefits and risks of the services will help provide a perspective of the Board's position on bank involvement in new service areas."[195]

Bucher described a number of public benefits from the offering of securities-related services by banks. First, banks are already offering a number of services not readily available elsewhere, such as automatic investment plans and dividend reinvestment plans, beneficial chiefly to small investors and generally not available from brokerage firms because of the high cost. The banks through their data processing facilities are able to achieve substantial economies in handling these transactions. Bank services have also drawn new investors into the equity markets which should be helpful in providing necessary equity financing to industry. (Charles W. Buek, president of U.S. Trust Co., also appeared before the subcommittee and stressed the importance of bank data processing equipment in making services available.)[196]

Bucher identified three risks related to bank participation in securities-related activities. The principal one involves the potential for conflicts of interest, but he suggested that bank examiners should be able to take care of this. A second is the potential exposure of bank capital, something that will inevitably accompany any extension of securities underwriting by banks. A third risk concerns the possible concentration of securities activities in banks and ultimate reduction of competition. Bucher was doubtful that this risk posed a real danger.

Specifically, he said the board believed that dividend reinvestment services and automatic investment services are appropriate activities for commercial banks. The board also believes that the potential benefits of investment advisory services outweigh foreseeable risks. However, he commented that the board had not yet reached a judgment as to whether to recommend amendment of the Glass-Steagall Act to permit commingled managed agency accounts, an activity now forbidden to commercial banks by a Supreme Court interpretation of the act.[197] The board is also

195 *Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 94th Cong., 1st Sess. 5 (December 9 and 10, 1975).

196 *Id.* at 332.

197 Discussed in the text accompanying note 318, *infra*.

apparently satisfied to have banks or affiliates of bank holding companies serve as advisers to real estate investment trusts and closed-end investment companies. Bucher noted that the board has since 1967 supported a change in legislation to permit commercial banks to underwrite municipal revenue bonds. But he said that the board would not reaffirm its position on this subject until it had reviewed recent developments in the municipal securities markets.

Edwin H. Yeo, testifying before the same committee on behalf of the Department of the Treasury, expressed a general approval from the Treasury for the securities activities of commercial banks.[198] He said that appropriate legislation and supervision by bank authorities should take care of conflicts of interest in money management, and he concluded that agency and brokerage-oriented services would benefit investors and capital markets by providing convenient, low-cost services to investors and encouraging greater participation by small individual investors in securities markets. He did, however, express some concern about the possibility of concentration of investment in a few favoured stocks.

Roderick M. Hills, then chairman of the Securities and Exchange Commission, restated the advantages and risks that had already been discussed by the previous two witnesses[199] and suggested a further risk, that banks might be able to tie securities services to banking services, something that competing securities firms would be unable to do. By and large, Hills did not support or oppose the securities-related activities of commercial banks; he indicated that the SEC was studying their potential.

James E. Smith, Comptroller of the Currency, also testified before the Senate committee. He not only was enthusiastic about the present securities-related activities of commercial banks but supported two specific changes in legislation, to permit banks to offer commingled agency accounts and to permit them to underwrite revenue bonds.[200]

As one might perhaps expect, the bank regulators are generally enthusiastic about expansion of banks into profitable activi-

198 *Securities Activities of Commercial Banks, supra* note 195, at 16-21.

199 *Id.* at 88-168.

200 *Id.* at 168. According to the Investment Company Institute, the growth of bank securities and money management activities has been particularly rapid since Congress transferred regulation of fiduciary activities of national banks from the Federal Reserve Board to the Comptroller of the Currency in 1962; *id.* at 307. *See also Financial Institutions and the Nation's Economy (FINE) "Discussion Principles": Hearings before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Currency and Housing,* 94th Cong., 1st and 2d Sess., pt. 3, at 2436-38 (December 1975 and January 1976).

ties, while the SEC is concerned about the survival of the securities industry.

A. TRUST ACTIVITIES

1. *Canada*

There is a strong tradition in Canada against permitting any single institution to offer trustee services and simultaneously engage in commercial lending. The chartered banks engage in commercial lending but are not permitted to operate trust departments. The trust companies are not permitted to engage in commercial lending, although the chartered banks have complained that some trust company commercial lending is going on.[201] The reason for the separation of activities is essentially the threat of a potential conflict of interest between an institution that on the one hand is lending money to a business and on the other hand is in a position to invest funds in that business. Commercial loans might be made to unsound corporations to support the market for their securities or trust assets might be invested so as to protect the loans. The 1976 federal government *White Paper*,[202] the banks and trust companies, and the Economic Council of Canada[203] have all endorsed the principle and recommended continued separation of the two functions. The president of one trust company, however, has suggested that the conflict problem could be resolved and trust companies allowed to enter banking.[204]

There is little information available on the details of trust activities within the trust companies. The Economic Council of Canada commented that "few statistical data are available on the fiduciary operations of trust companies".[205] The report of the Registrar of Loan and Trust Corporations for the province of Ontario shows that the thirty-eight reporting trust companies were administering a little over $32 billion in assets at the end of 1975.[206] And a breakdown of this total by cash, bonds, stocks, mortgages, guaranteed fund deposits, and real estate is available

201 CANADIAN BANKERS' ASSOCIATION, BANK ACT 77, THE INDUSTRY'S BRIEF 15 (No. 2 1975).

202 HONOURABLE DONALD S. MACDONALD, MINISTER OF FINANCE, WHITE PAPER ON THE REVISION OF CANADIAN BANKING LEGISLATION, PROPOSALS ISSUED ON BEHALF OF THE GOVERNMENT OF CANADA 29 (August 1976).

203 ECONOMIC COUNCIL OF CANADA, EFFICIENCY AND REGULATION, A STUDY OF DEPOSIT INSTITUTIONS 79-81 (1976).

204 Comments by Eric J. Brown, Q.C., President of Canada Permanent Trust Co., to the *Winnipeg Society of Financial Analysts* (October 27, 1976), on the White Paper on the Revision of Canadian Banking Legislation.

205 ECONOMIC COUNCIL OF CANADA, *supra* note 203, at 20.

206 REPORT OF THE REGISTRAR OF LOAN AND TRUST CORPORATIONS FOR THE PROVINCE OF ONTARIO 95-96 (1975). This subject is discussed in more detail in ch. I *supra*.

for the aggregate of the thirty-eight companies and for each of them. No information is available, however, on specific holdings in trust accounts and it is not possible to draw any conclusions on the extent of control or potential control over Canadian industry. This lack of information has been of great concern in the United States, as we shall see, and has led to quite detailed reporting requirements in recent years. W. Grover and J. Baillie, in their paper in this volume, suggest that similar requirements may be appropriate in Canada.[207]

In the course of submissions to the Ontario Securities Commission in 1976 on the subject of fixed commission rates much was made of the concentration of stock ownership in the trust holdings of a few trust companies. This subject is discussed in chapter V.[208] It appears that the percentage of common stocks owned through trust companies in Canada is not very different from the percentage owned by commercial bank trust departments in the United States. Trust ownership in the United States, however, is spread over something like 1,500 commercial banks with one or two hundred holding a substantial portion of the total assets. In Canada the ownership is spread over fewer than fifty trust companies with a half-dozen managing about 90% of total trust assets.

Trust companies are exempt from registration as investment advisers in Ontario,[209] and the exemption would continue in the new legislation contained in Ontario Bill 30,[210] although Bill 30 would require a trust company to register as a management company in order to manage a mutual fund for compensation under a contract.[211]

Trust companies are "exempt" purchasers of securities, and the issuer of securities sold exclusively to exempt purchasers need not register under the Ontario Securities Act and no prospectus is required. Furthermore, trust companies are "exempt" purchasers even when purchasing on behalf of trust accounts.[212] The implication of this specific statutory provision is that other financial institutions do not qualify a purchase as exempt when they are buying for a managed account, and Grover and Baillie suggest that other institutions should have the same opportunity. [213] The

207 *Grover & Baillie* at n. 318.

208 In text accompanying note 460 and following.

209 Ontario Securities Act, s. 18(a). In any case, the definition of "advising" probably does not cover the management of trust accounts. The other provinces grant the same exemption.

210 Ontario Bill 30, s. 33(a).

211 Ontario Bill 30, s. 24(I)(e).

212 Ontario Securities Act, s. 58(1a) says that a trust company is "deemed to be acting as principal when it trades as trustee for accounts fully managed by it".

213 *Grover & Baillie*, text following n. 362.

trust companies may have an advantage over investment counsel under the Ontario Act, since a substantial amount of new issue financing is done by way of the exempt purchaser route. (A second advantage, so long as broker commission rates are fixed, lies in the ability of trust companies but not investment counsel to pool purchases for several accounts in order to take advantage of reduced commission rates.)[214] Professor L. Loss, in his notes to the American Law Institute's draft Federal Securities Code, says of an exemption for purchases by "institutional investors":

> "It is implicit...that banks and insurance companies are institutional investors whether buying for their own accounts or for accounts under their investment managements. This would have been made explicit, except that it might have created a negative implication with respect to the clients of certain investment advisers. Obviously it would not be realistic to treat all clients of all investment advisers as institutional investors...it is contemplated that rules...will make appropriate distinctions among investment advisers, and will not discriminate, so far as clients are concerned, between banks and insurance companies on the one hand and those investment advisers that deserve similar treatment on the other hand."[215]

Ontario Bill 30 does not alter the exemption for purchases by trust companies on behalf of trust accounts[216] but it does alter the ability of a trust company to dispose of securities acquired in an exempt purchase. Under the present Ontario Securities Act, no formalities accompany such a resale (although the trust company must have purchased the securities originally "for investment only and not with a view to resale or distribution" which implies some restraints on turnover), because a prospectus is required only for a "distribution to the public",[217] and distribution to the public is defined to include sales by controlling shareholders and sales to the public of securities "not previously distributed to the public".[218] The Ontario Securities Commission has taken the position that securities acquired by an institution in an exempt purchase have been distributed to the public (the institution being part of the "public") and therefore the trust company (unless it happens to be a controlling shareholder or could be considered to be an underwriter) is free to resell without a prospectus.[219]

214 Commission rates are discussed in ch. III *supra*.

215 ALI Federal Securities Code, Tent. Draft No. 1, at 29-30.

216 Ontario Bill 30, s. 73(2).

217 Ontario Securities Act, s. 35.

218 *Id.* s. 1(1)6b.

219 *Grover & Baillie* at n. 288. Baillie has argued that this interpretation is wrong.

But Bill 30 puts some limits on resales. The issuer of the securities will have to be a "reporting issuer", the trust company will have to have held the securities for six, twelve, or eighteen months depending on whether they are legal for life insurance companies or listed stocks, and a report must be filed with the commission.[220] This limitation may introduce some difficulty in terms of a tradeoff between the opportunities for trust accounts in exempt purchases and the "lock-in" or expense of a prospectus on resale.

Grover and Baillie point out the "all or nothing" resale provisions of Bill 30 mean that the trust company may sell its entire holding free of a prospectus if it meets the conditions described above but not one share if it does not. They recommend the same "trading transaction exemption" they would give issuers for a small volume of resales with the full prospectus requirement for large sales.[221] But a trust company, having decided that an issue is no longer appropriate for some accounts, may well decide it is inappropriate for any, and want to sell out completely. And there may be unfair treatment of accounts vis-à-vis one another at the time of sale, if only a small portion of total holdings may be sold. The Bill 30 proposal is somewhat similar to proposals in the United States for limitations on sales by institutions, and raises some of the same objections.[222]

2. *United States*

The Comptroller of the Currency reported to Senator Lee Metcalf's subcommittee in 1974 that of the 4,600 national banks in the country, 1,900 were authorized to exercise trust powers and 1,600 actually exercised them. There are at least 300 commercial bank trust departments managing assets of $100 million or more.[223] In 1975 United States commercial banks managed approximately $400 billion in trust assets,[224] 41% of them in employee trust and agency accounts.[225]

220 Ontario Bill 30, s. 73(4).

221 *Grover & Baillie* at nn. 343, 377.

222 *See* ch. V *infra*.

223 *Corporate Disclosure: Hearings before Subcomm. on Budgeting Management and Expenditures of the Senate Comm. on Government Operations*, 93d Cong., 2d Sess. 56, pt. 3 (June and August 1974); FEDERAL DEPOSIT INSURANCE CORPORATION, TRUST ASSETS OF INSURED COMMERCIAL BANKS - 1974 (1975). The FINE discussion principles proposed extending trust powers to savings and loan associations, credit unions and mutual savings banks; *see* HOUSE COMM. ON BANKING, CURRENCY AND HOUSING, 94TH CONG., 2D SESS., 1 FINE: FINANCIAL INSTITUTIONS AND THE NATION'S ECONOMY 9 (1976) (compendium of papers).

224 FEDERAL DEPOSIT INSURANCE CORPORATION, TRUST ASSETS OF INSURED COMMERCIAL BANKS - 1975, table I (1976).

225 SEC, FINAL REPORT ON BANK TRUST ACTIVITIES 125 (July 1977).

As already noted, Canada has taken the position that there is an inherent conflict of interest if one financial institution carries on both a commercial lending and a trust business. There is an awareness of this conflict in the United States and there has been a good deal of testimony on the subject before congressional committees in recent years.

The *Hunt Commission Report,* in dealing with bank trust departments, recommended that there be a "wall" between the commercial banking and trust departments of banks with trust assets over $200 million, that brokerage commissions not be used to attract deposit or loan business, that inside information not be used in the trust department, and that banks establish procedures to review the uninvested cash in trust accounts.[226] The Comptroller of the Currency has been sufficiently sensitive to the issue to insist that the commercial banks set up some sort of system to ensure that commercial lending departments do not communicate with trust departments and the result has been what some bankers call a "Chinese wall" between commercial lending and trust activities, and the comptroller has proposed explicit regulations to prohibit the use of inside information in making investment decisions for trust accounts.

There are those who are not satisfied by the comptroller's action or by the apparent responses of the banks, and who argue that commercial lending and trust activities should be separated as they are in Canada.[227] But there does not seem to be very much support for this position and there certainly seems to be no disposition on the part of Congress to dismember commercial banks, although there are proposals before Congress to give trust powers to other institutions.

An interesting discussion of conflicts in trust departments appears in the record of congressional hearings on financial institutions in December 1975. Professor Edward S. Herman, who had prepared a study on the subject for the Twentieth Century Fund, observed that abuse of inside information is not the principal difficulty and indeed in their efforts not to use inside information trust departments may be failing to use public information and therefore failing to do their best for trust accounts. (Apparently

226 REPORT OF THE PRESIDENT'S COMMISSION ON FINANCIAL STRUCTURE AND REGULATION (December 1971) [hereinafter HUNT COMMISSION REPORT].

227 A former member of the Federal Reserve Board has suggested that some banks might find it advantageous to separate the two activities into two institutions; *Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities, supra* note 195, at 9.

sales of Penn Central stock as the company was failing were unfortunately inhibited.)[228] The more important conflicts involve the use of trust cash balances and unequal treatment of trust accounts. Herman also argued that bank regulatory authorities were much more concerned with depositor protection than with the protection of trust clients.[229]

It is interesting that some congressional committees in asking bank trust departments about commercial lending to companies whose stocks are held in trust accounts have perhaps unintentionally brought about breaches in the "wall". Indeed, some bank trust departments declined to respond to a congressional questionnaire for just this reason.[230] At the same time, it is hard to understand how a bank trust department could do a thorough security analysis of a company and not discover that the bank's commercial department was a major lender to the company. Some trust departments simply steer clear of companies for which their bank is a major lender, and some simply avoid stock interests in any but the soundest companies.

Another area of conflict has to do with the use of brokerage commissions, paid ultimately by the beneficiaries of trusts, to purchase services that may be of considerable benefit to the bank trust department. Until brokerage commission rates became competitive on May 1, 1975, the issue was somewhat academic. Bank trust departments were generally unable to obtain executions for less than the fixed minimum commissions (although there were some opportunities to do so in the so-called "third market"), so that

228 It would be interesting to know what bank trust departments were doing with New York City bonds in 1974 and 1975. One report suggests the banks were selling the bonds out of *their own* portfolios on the basis of inside information; *see* NEW YORK STATE ASSEMBLY OFFICE OF LEGISLATIVE OVERSIGHT, THE BANK AND THE MUNICIPAL CRISIS: PUBLIC RESPONSIBILITY AND PRIVATE PROFIT (November 15, 1976). The SEC confirmed this suggestion in August 1977, but at least one bank claimed the SEC was wrong; *see* SUBCOMM. ON ECONOMIC STABILIZATION OF THE HOUSE COMM. ON BANKING, FINANCE AND URBAN AFFAIRS, 95TH CONG., 1ST SESS., SEC STAFF REPORT ON TRANSACTIONS IN SECURITIES OF THE CITY OF NEW YORK (Comm. Print 1977); and *see e.g.* Morgan Guaranty Trust Co., *Morgan Guaranty Trust Reports on "Transactions in Securities of the City of New York"*, The Wall Street Journal, September 12, 1977, at 9, col. 1 (advertisement).

229 *Financial Institutions, Hearings before Subcomm. on Financial Institutions, supra* note 200, pt. 1, at 329-35 (December 1975). *And see* E. HERMAN, CONFLICTS OF INTEREST: COMMERCIAL BANK TRUST DEPARTMENTS (the Twentieth Century Fund 1975).

230 SUBCOMM. ON FINANCIAL MARKETS, SENATE COMM. ON FINANCE, 94TH CONG., 2D SESS., BANK TRUST STOCK HOLDINGS: RESPONSES TO FINANCIAL MARKETS SUBCOMMITTEE QUESTIONNAIRE (June 1976). It was reported in 1975 that most banks prohibit disclosure of broker deposits to trust departments or traders, so that choice of broker cannot be a function of deposits. *See* STANFORD RESEARCH INSTITUTE FOR THE TRUSTEES OF THE BANKING RESEARCH FUND, ASSOCIATION OF RESERVE BANKERS, THE TRUST ACTIVITIES OF THE BANKING INDUSTRY 11, 50 (1975).

if commissions purchased not only the executions required by the trust accounts but also research services that were of value to the trust department itself, the beneficiaries could hardly complain. But with the unfixing of commission rates it is not quite so clear that bank trust departments are entitled to use commissions paid by the trusts to purchase research services. Congress anticipated the problem, and included in the Securities Reform Act of 1975 a new section 28(e) of the Securities Exchange Act of 1934, which provides:

> "No person...in the exercise of investment discretion with respect to an account shall be deemed to have acted unlawfully or to have breached a fiduciary duty under State or Federal Law unless expressly provided to the contrary by a law...solely by reason of his having caused the account to pay a member of an exchange, broker, or dealer an amount of commission for effecting a securities transaction in excess of the amount of commission another member of an exchange, broker, or dealer would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided...viewed in terms of either that particular transaction or his over-all responsibilities with respect to the accounts as to which he exercises investment discretion."

This section authorizes what is known as "paying up", that is, paying more than the minimum going rate for transaction services alone, in order to obtain further services, generally research services. The conflict of interest issue arises because the bank trust department already has an obligation to provide management for trust accounts and the research necessary for this management might well be regarded as the responsibility of the trust department paid for by trust department fees charged to the individual trust accounts.

Section 28(e) has been subject to a good deal of criticism. The Securities and Exchange Commission has warned that the section does not authorize "paying up" for services that are generally available for public purchase.[231] And the commission has promulgated proposed regulations calling for the disclosure of broker selection policies and the use of commissions to purchase re-

231 *See* Commissioner J.R. Evans address before the *National Trust Conference, American Bankers Association* (February 7, 1977) ("An SEC Perspective on Bank Trust Departments"). On this topic *see also, Connelly.*

search.[232] Since the SEC does not have jurisdiction over bank trust departments, however, the proposed regulations would not apply to them. The position is that account beneficiaries should know what benefits, if any, they are receiving in addition to executions for the brokerage commissions their accounts are being charged.

Apart from the conflict issue, the chief concern in the United States has been with possibly excessive concentration of corporate control in bank trust departments. The Hunt Commission recommended that banks publish annual reports showing the twenty largest stock holdings, excluding any holdings worth less than $10 million and not constituting 1% of outstanding voting shares of the issuer, reporting holdings that constitute 5% or more of an outstanding registered voting stock issue, dollar values with respect to listed holdings broken down by sole, shared and no voting responsibility, interlocking directors, officers or senior employees and cases in which the bank voted against management or against a management recommendation.[233]

There has been considerable concern in recent years in Congress about the need for fuller disclosure of the ownership and particularly voting power in U.S. corporations. Senator Metcalf, whose subcommittee held extensive hearings on the subject in 1974,[234] has stressed a special need to know who owns and controls regulated corporations. And he has spoken of the dangers of foreign influence on major American corporations including defence contractors. Finally, he has talked of the dangers of economic concentration through institutional control of corporations and industries.

A representative of a large New York bank testifying before Senator Metcalf's subcommittee in 1974 suggested that the disclosure form used by federal agencies in the United States could be substantially improved and that nominees and corporations could be required to provide more useful information.[235] He suggested that ownership reporting would be improved if nominees were required to make it easy for an issuer to identify multiple nominees of a single institutional investor and that corporations in their own reporting should be required to aggregate and treat as one all the various nominee holdings of a single institution. All of this pertains to ownership but not necessarily to voting power. The wit-

232 SEC, Securities Exchange Act of 1934 Release No. 13024, November 30, 1976, [1976-1977 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,815.

233 HUNT COMMISSION REPORT, *supra* note 226.

234 *Corporate Disclosure: Hearings before Senate Subcomm. on Budgeting, Management and Expenditure, supra* note 223, pts. 1, 2, 3 (March 1974, April and May 1974, June and August 1974).

235 *Id.* pt. 1, at 34-117.

ness suggested that separate disclosure of voting power could be required but that some standard definitions would be needed to account for different kinds of voting power possessed by institutions.

Professor David L. Ratner, another witness before Senator Metcalf's subcommittee, stressed the need to have information available in consistent form in a single place.[236] Many kinds of corporations, particularly regulated corporations, already report significant holdings of their shares. But apart from the use of nominees, which makes much of this reporting useless, the fact that they report to different agencies on different forms makes it difficult to pull together ownership patterns. And from the institutional investors' side, bank trust departments did not report anything.

In general, there seemed to be no reporting at all that would indicate the concentration of ownership of *debt* securities in financial institutions. The subcommittee itself had solicited information from twenty-five institutions with assets of $5 billion or more. The Interstate Commerce Commission produced some figures showing that about 25% of the composite debt of the fifteen largest railroads in the United States was held by banks in 1973.[237] The chairman of the Federal Power Commission expressed his regret to the committee that he could not tabulate by lender the major debt holdings in electric utilities and natural gas pipeline companies,[238] and he conceded that bond holders may have a significant influence over management.

A representative of the General Accounting Office reported that his office was reviewing the gathering of information by federal regulatory agencies and had proposed regulations for uniform and more useful data.[239]

The chairman of the Federal Trade Commission testified on a study by the commission's Bureau of Competition of the financial relationship between institutions, particularly banks, and energy corporations.[240] The concern was that the interlock between the institutions and the corporations might lead to an indirect interlock between corporations competing in the energy industry.

A.A. Sommer, a commissioner of the Securities and Exchange Commission, testified on the impact of institutional trading on the securities market.[241] He referred to the proposals of Senator Lloyd

236 *Id.* pt. 1, at 119.
237 *Id.* pt. 2, at 641-59.
238 *Id.* at 733-34.
239 *Id.* at 854-75.
240 *Id.* at 898, 913-28.
241 *Id.* at 943-44.

Bentsen that would restrict the holdings of some institutions,[242] but these comments were incidental to his discussion of the issue that concerned the committee, concentration of ownership and voting power. Sommer discussed the disclosure of ownership that is required by the SEC and the problems the commission had encountered in trying to discover ownership behind nominee names.

The Comptroller of the Currency had recently required for national bank common trust funds and for pooled funds annual reporting of portfolio assets, including identification of equities by issue. Proposed regulations would require annual reporting for trust departments administering assets in excess of $100 million on all trust assets, including identification of equity issuers for all holdings in excess of 10,000 shares. The 10,000-share cutoff corresponds to approximately $500,000 on average. The regulations were still being commented on in August 1974. He reported that the same proposed regulations included provisions requiring all national banks operating trust departments to establish policy procedures designed to assure that trust department investments do not utilize nonpublic financial information.[243]

In anticipation of the hearings data were gathered by the staff of Senator Metcalf's subcommittee on some trust department holdings of large banks.[244] For example, as of 1972 the Chase Manhattan Bank held 2% or more of the stock of forty-six of eighty-nine corporations that had furnished data to the committee. Morgan Guaranty Trust and First National City Bank held 2% or more of the stock in twenty-nine and twenty-eight of the corporations, while Bankers Trust held 2% or more in twenty-one corporations. Holdings in certain industries were more concentrated. The Chase Manhattan Bank trust department held between 9% and 6.9% of the stock in each of four airlines and between 8.3% and 5.3% of the stock in each of six railroads. The combined holdings of several banks were quite substantial. The trust departments of six banks plus one brokerage firm and the New York Stock Exchange Clearing Corporation together held 20% or more of the stock of a number of corporations.

These statistics reflected ownership rather than voting power. It was impossible to translate them into voting power

242 *See, Stockholders Investment Act of 1974: Hearings on S. 2787 and S. 2842 before Subcomm. on Financial Markets of the Senate Comm. on Finance*, 93d Cong., 2d Sess. (February 5 and 6, 1974).

243 *Corporate Disclosure: Hearings before Senate Subcomm. on Budgeting, Management and Expenditure*, *supra* note 223, pt. 3, at 56–69.

244 Subcomm. on Intergovernmental Relations, and Budgeting, Management and

because the right of a bank trust department to vote shares held by it varied among trust accounts and the right of the stock clearing corporation and of a brokerage to vote shares depends upon client arrangements. For certain industries, including broadcasting corporations, details on voting power held by institutional investors were available because they are collected by the Federal Communications Commission. As of 1972 the ownership of broadcasting companies by the trust departments of large New York City banks ran as high as 14%; eleven banks combined had 38% of the voting rights in Columbia Broadcasting System, Inc. and eight banks held in the aggregate 34% of the voting rights in American Broadcasting Companies Inc.[245]

Some of these statistics apparently gave rise to alarm but none of the testimony demonstrated that harm had actually been done through institutional ownership or voting power. There simply seemed to be a rather vague fear of what trust departments might do.

Fresh statistics on stock holdings of institutions were reported to Senator Metcalf's subcommittee in the spring of 1976.[246] The first part of the report was prepared by Professor Robert M. Soldofsky and was largely based on stock holdings as of the end of 1974 reported by national banks to the Comptroller of the Currency. The comptroller had initiated this reporting as of December 31, 1974,[247] and required classification of all holdings according to whether the bank held full voting rights, partial voting rights or no voting rights. Soldofsky made use of commercially published data on investment company and insurance company stock holdings but was unable to obtain information on pension fund holdings. His report covered common stock holdings by bank trust departments, investment companies, and insurance companies in 146 corporations. For 1974 the New York Stock Exchange estimated institutional holdings in the aggregate at 33% of the value of all listed stocks. For the 146 corporations there was more than 40% institutional ownership in eight cases and 30%

EXPENDITURES OF THE SENATE COMM. ON GOVERNMENT OPERATIONS, 93D CONG., 2D SESS., DISCLOSURE OF CORPORATE OWNERSHIP 6-8 (March 4, 1974).

245 *Id.* at 169-70.

246 SUBCOMM. ON REPORTS, ACCOUNTING AND MANAGEMENT OF THE SENATE COMM. ON GOVERNMENT OPERATIONS, 94TH CONG., 2D SESS., INSTITUTIONAL INVESTORS' COMMON STOCK HOLDINGS AND VOTING RIGHTS (May 1976). Further statistics on the holdings of the 28 largest trust departments were published in SUBCOMM. ON FINANCIAL MARKETS, BANK TRUST STOCK HOLDINGS: RESPONSES TO FINANCIAL MARKETS SUBCOMMITTEE QUESTIONNAIRE, *supra* note 230.

247 12 C.F.R. 9.102 (1977) (Annual Report of Equity Securities - Form CC 7510-03). The report requires an annual report of holdings of 10,000 or more shares of any issue of common stock classified by voting rights.

to 40% ownership in twenty-seven cases.[248] Where institutional ownership was high, regulated investment companies generally accounted for at least 50% of this ownership.[249] Bank trust departments held up to 25% of the voting power of a few corporations.[250]

The second part of the report to Senator Metcalf's subcommittee was prepared by the Library of Congress and was based on a survey of sixty-six banks, including custodial, corporate trust and corporate agency accounts. Holdings reported were as of the end of 1974. The banks were those that reported trust assets in excess of $1 billion as of the end of 1973. The chief finding of the report was the great difficulty banks had in responding to requests for specific information. Data were compiled, however, for holdings in trust accounts, custodial accounts, and corporate trust and agency accounts classified by voting rights and some analysis was offered.[251]

One outcome of the hearings in 1974 was a significant change in public reporting requirements. The Securities Reform Act of 1975 added section 13(f) to the Securities Exchange Act of 1934. This new subsection requires reporting by all institutional investment managers (including bank trust departments) exercising discretion over accounts holding stocks aggregating more than $100 million. The SEC is authorized to reduce this value cutoff to as little as $10 million. The SEC may also establish the reporting period which may not be less than one quarter or more than one year. The report must show for each listed stock held at the end of the reporting period the name of the issuer, the class of the stock, the CUSIP identification number, the number of shares held and the aggregate fair market value. The SEC is authorized to require a separate listing of the number of shares held with respect to which the manager possesses sole or shared voting authority, the aggregate purchases and aggregate sales during the reporting period of each security, and rather more substantial disclosure for any transaction or series of transactions having a market value of $500,000 or a lower cutoff value established by the SEC. The SEC estimated that this reporting requirement will apply to about 300 institutions holding approximately 75% of all institutional equity securities.[252]

When the reporting requirement was first proposed in 1974,

248 SUBCOMM. ON REPORTS, ACCOUNTING AND MANAGEMENT, INSTITUTIONAL INVESTORS' COMMON STOCK HOLDINGS AND VOTING RIGHTS, *supra* note 246, at 4.

249 *Id.* at 12-13.

250 *Id.* at 14-15.

251 *Id.* at 418-45.

252 *Institutional Investors Full Disclosure Act: Hearings before Subcomm. on Securities*

the Treasury Department strongly opposed the reporting of institutional transactions. The general counsel to the Treasury said that such reporting would introduce unfairness by placing at a disadvantage investors who use institutions to manage their funds. The Treasury also saw as one purpose for the disclosure the provision of information to the SEC so that the commission could decide whether there should be statutory restrictions on institutional trading. The Treasury Department said it "firmly believes that regulation of institutional trading is unnecessary and also contrary to the public interest". Serious proposals had been made to restrict both the extent of institutional ownership of securities and institutional trading in them.[253]

Despite enthusiasm for disclosure from almost every part of the securities and investment industry and of course from the SEC and Congress, few sensible suggestions were offered as to just how the information might be used. Proposals that trust department clients would be better able to judge which bank to go to were quickly discarded as implausible. There was, however, general agreement that investor "confidence" would be enhanced by the disclosure.

The chairman of the SEC said that he saw two chief reasons for continued study and analysis based on a good flow of data from institutional investors. One was simply the need for a continuous review of securities markets and the second was the need for verifying or disproving claims that institutions are interfering with the proper operation of the markets. He described the kinds of studies that could be made if the disclosure statute were enacted. One category would deal with effects of institutional holdings and trading and would include parallel trading of institutions and related price effects, block trading and market liquidity, competition in the brokerage community, and so on. The second general category would have to do with performance of different investment managers.[254]

Enthusiasm for disclosure was not unanimous. The comments of Dean Miller, Deputy Comptroller of the Currency for Trusts, are interesting:

"I think it should be recognized that the only way we are

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of the Senate Comm. on Banking, Housing, and Urban Affairs, 93d Cong., 2d Sess. 22 (August 13 and 14, 1974).

253 *Institutional Disclosure and Sales of Investment Company Advisers: Hearing on H.R. 10570 and H.R. 13986 before Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 94th Cong., 1st Sess. 22-23 (September 13, 1975). The proposals are discussed in ch. V *infra*, in connection with the impact of institutional trading.

254 *Institutional Investors Full Disclosure Act*, *supra* note 252, at 21.

going to get this man of modest means into the stock market is through the device of the no-load mutual fund – that and indirectly through his pension fund.

"Our governmental concern should be toward the effectuation of a system which permits as many as possible choices of such funds to him, including some administered by banks. He is not going to invest directly in the stock market more if he knows that there is a massive bin somewhere in this country containing detailed minutia of the investments and transactions of everybody who has more money than he.

"To be more specific, increased disclosure of bank trust department holdings is going to be of no benefit at all to him. Neither will the implementation of a few more government agencies and a few additional cost burdens upon banks. They will only redound to his detriment."[255]

As of late 1977, at least one congressional subcommittee was impatient not only with the SEC's slowness in implementing the data collection but also with the lack of progress in deciding what to do with it.[256]

Grover and Baillie, who suggest that section 13(f) disclosure might be appropriate in Canada, offer a number of purposes to be served. Probably the best is "to reinforce the public acceptability of existing societal institutions by providing the information to refute charges of unacceptable behaviour".[257] One might add that the data disclosed may require substantial analysis – such as correlating institutional sales and holdings with market behaviour – to establish the refutation.

Banks in the United States, as in Canada, are generally subject to banking laws and not to securities legislation even with respect to securities-related activities. Trust activities of banks are generally exempt from federal securities laws but regulation 9 of the Comptroller of the Currency provides for licensing of trust departments of national banks and deals with bonding, fiduciary records, audits, restrictions on holding trust assets uninvested, prohibitions on self-dealing activities, segregation of assets and public disclosure of trust assets. Regulation 9 permits "crossing" orders for both agency and trust accounts, and requires that the

255 Address of Dean Miller to the *Iowa Trust Association, reprinted in Financial Markets: Hearings before Subcomm. on Financial Markets of the Senate Comm. on Finance*, 93d Cong., 1st Sess., pt. 2, at 125 (September 1973).

256 REPORT OF THE SUBCOMM. ON OVERSIGHT AND INVESTIGATIONS AND THE SUBCOMM. ON CONSUMER PROTECTION AND FINANCE, OF THE HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, OVERSIGHT OF THE FUNCTIONING AND ADMINISTRATION OF THE SECURITIES ACTS AMENDMENTS OF 1975 15-17 (Comm. Print 1977).

257 *Grover & Baillie*, text following n. 139.

trade be "fair to both accounts".[258] Banks may be found liable under Rule 10b-5 of the Securities Exchange Act of 1934 for misuse of inside information in managing portfolios.[259]

The securities industry says record-keeping and audit requirements under the federal securities laws are stricter.[260] And the SEC says regulation 9 is not as comprehensive or protective of investors as the Investment Company Act.[261] The banks are rather defensive about this. Citibank inaugurated its Investment Management Group annual report in 1970 as a device to insure public disclosure of trust activities. A review by Arthur Young and Company of the bank's policies and procedures was published in the 1975 hearings before Senator Williams' Subcommittee on Securities and dealt with commissions, executions, use of "inside" information, uninvested cash, voting of proxies, allocation of purchases and sales among trust accounts and independence of trust and lending activities.[262] BankAmerica Corporation, the holding company for the Bank of America, the largest U.S. commercial bank, published a voluntary disclosure code in 1976.[263]

The SEC has said that trading personnel in bank trust departments are often ignorant of federal securities laws and that this ignorance leads to recurring violations.[264]

B. BANK UNDERWRITING OF SECURITIES

1. *Canada*

Canadian chartered banks are permitted to "deal in" securities and they have traditionally engaged in some aspects of underwriting. The Bank Act prohibits the naming of a chartered bank in a prospectus for corporate securities[265] perhaps because of a potential conflict of interest between the bank's possible position as a lender to the corporation and its promotion of the corporation's securities or perhaps just because of a fear that *any* reference to a bank inspires too much confidence. A few banks have partici-

258 *See Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities*, *supra* note 195, at 104-05. The First National Bank of Chicago has said that it does not "cross" trades between fiduciary accounts; *id.* at 122.

259 *Id.* at 107, 152. *Id.* at 157 refers to SEC, THE FINANCIAL COLLAPSE OF THE PENN CENTRAL COMPANY (1972), analyzing sales by three major banks of Penn Central Stock prior to the bankruptcy.

260 *Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities*, *supra* note 105, at 110.

261 *Id.* at 165.

262 *Id.* at 302.

263 BANKAMERICA CORPORATION, VOLUNTARY DISCLOSURE CODE (November 1976).

264 SEC, FINAL REPORT, *supra* note 225, at 16.

265 Bank Act, s. 157(2).

pated in corporate underwriting banking groups but most banks participating in new issues of corporate securities have acted as agents, only taking orders for the securities. At the same time chartered banks have traditionally participated in the underwriting of new issues of the Government of Canada, provinces, municipalities and some international agencies.

The underwriting function seems to have originated in bank loans to finance investment-dealer underwriting with banks subsequently becoming regular participants in underwritings for all provinces, some municipalities and some corporations. Underwriting in Canada still reflects long-standing relationships among issuers and members of an underwriting group, including bank members, and the investment dealers are somewhat ambivalent about the banks' role. On the one hand, a traditional relationship with an issuer may be strengthened by the presence of a bank in the group. In the case of a municipal issuer, for example, the traditional willingness of the bank to take up the short maturities helps to reduce risk in the underwriting. On the other hand, there is a real fear of the bank as a true competitor rather than an ally and the dealers would be most comfortable with the status quo – no expansion of bank underwriting. The "official" view of the Investment Dealers Association, however, is opposed to the banks underwriting any but Canadian government issues.

It seems probable that the banks have a cost advantage over the investment dealers and brokers in distributing new issues of securities to individuals and quite likely to institutions as well, and probably the capital markets would be best served by allowing them to exploit that advantage. But the securities industry argues that the result would be to squeeze out the brokers and dealers, to lessen competition and in the end to reduce the efficiency of the market. It also argues that banks do not offer sufficient protection and expertise to customers who presumably do not recognize this deficiency or if they do, do not care about it.

The government *White Paper on the Revision of Canadian Banking Legislation* proposed that banks could be named in corporate prospectuses, but would not be permitted to participate in the underwriting of corporate issues.[266] Nor would they be permitted to participate as agents in the arrangement of private placements. The potential conflict of interest referred to above was given as the reason for both of the new rules. However, banks would be explicitly authorized to participate in selling groups for new issues and would be allowed to advertise their participation. The *White*

266 White Paper on the Revision of Canadian Banking Legislation, *supra* note 202, at 34-35.

Paper concluded that these rules would adequately protect investment dealers from the competition of chartered banks but would also give purchasers of corporate securities access to new issues through chartered banks without their having to pay a commission on top of the offering price. The reaction of the securities industry has been enthusiasm for the prohibition on corporate underwriting but protests over the permitted selling group activities.[267]

The *White Paper* proposals would continue chartered bank underwriting of government issues, including issues of provinces, municipalities and some international agencies. The securities industry has urged a ban on provincial and municipal underwriting by chartered banks.[268]

In its report on the government's proposals, the Senate Banking, Trade and Commerce Committee approved putting specific provisions in the act to define permitted securities activities of the chartered banks. But it did not clearly state its preferences for which activities should be permitted and which prohibited. It merely suggested that banks should not be permitted to underwrite corporate securities or to act as agents for private placements and that banks should be allowed to underwrite federal, provincial, municipal, and international agency securities and to distribute corporate securities as members of a selling group.[269]

Until 1966 the Ontario Securities Act (and the acts of six other provinces) provided an exemption from prospectus requirements for securities issues underwritten by banks. In 1966 Ontario eliminated this exemption and a number of provinces have followed.[270] But Grover and Baillie suggest that some financial institutions at least have in effect underwritten public distributions by purchasing by way of an "isolated purchaser" exemption and then reselling to the public so that no prospectus was ever filed.[271]

Although a bank underwriting cannot confer an exemption on an issue not otherwise exempt, the bank itself need not register as an underwriter under the Ontario Securities Act.[272] A member of a selling group (as opposed to a banking group) does not seem to

267 Joint Committee of the Canadian Securities Industry, Memorandum on the Securities-Related Aspects of the White Paper on Canadian Banking Legislation, at 13-15 (October 14, 1976). The industry was particularly alarmed at the prospect of banks distributing securities to institutional investors; *id.* at 14.

268 *Id.* at 10-11.

269 *Standing Senate Comm. on Banking, Trade and Commerce*, *supra* note 2, at 44:12, 44:68.

270 *See* J. WILLIAMSON, SUPP. at 141-43.

271 *See*, *Grover & Baillie*, text following n. 286.

272 Ontario Securities Act, s. 6(1)(d).

be an "underwriter" within the meaning of the act[273] but in any case banks and trust companies are not required to register to trade in securities generally.[274] Ontario Bill 30 would narrow the underwriter exemption for banks. "Underwriters" seem to include selling group members, and banks would be exempt from registration only with respect to issues of government or municipal bonds, securities guaranteed by a bank, loan or trust company or insurance company, or securities issued by a trust company pooled fund or common trust fund.[275]

2. *United States*

Section 16 of the Glass-Steagall Act of 1933 prohibits commercial banks in the United States from underwriting securities, except for obligations of the United States and general obligations of any state or political subdivision.[276] This prohibition reflected a very strong policy decision to separate commercial from investment banking. But the exception for general obligation state and municipal bonds is quite important, and there is a substantial amount of bank underwriting of these bonds. What has been of great interest in recent years is the question of whether commercial banks should be permitted to underwrite municipal revenue bonds, which are not backed by the full faith and credit of a state or municipality.

For a variety of reasons, sometimes having to do with general obligation debt limits and sometimes having to do with the tax advantages of municipal bonds, there has been a substantial increase in recent years in the issue of municipal revenue bonds. Representatives of the banking industry have urged that banks should be permitted to underwrite these bonds. And indeed, there are some exceptions in the Glass-Steagall Act to permit bank

273 *Id.* s. 1(1)25.

274 *Id.* s. 19(1)3. The same is true in the other provinces.

275 Ontario Bill 30, ss. 1(1)41(iv) and 35(2)1.

276 Banking Act of 1933, 12 U.S.C. s. 24 (1970). The act does not apply to foreign activities of United States banks, however, and underwriting in the Eurobond market is substantial for some United States banks (as it is for some Canadian banks). The act defines the powers of national (federally incorporated) banks. A number of the largest United States banks are state chartered and not directly subject to the act. But almost all of these are subsidiaries of bank holding companies which in turn are subject to the federal Bank Holding Company Act of 1956. The Federal Reserve Board has interpreted this act as imposing on subsidiary banks the limitations of the Glass-Steagall Act; *see* 12 C.F.R. s. 225.125(b)(1977).

The Securities Industry Association would like Congress to restrict the securities activities in the United States of organizations affiliated with foreign banks, just as it would like the activities of United States banks curtailed. *See* Securities

underwriting of public housing authority bonds and obligations issued by a state or municipality for housing, university or dormitory purposes which are at the same time eligible for purchase by a national bank for its own account. At one time the Comptroller of the Currency classified a number of bond issues that had been regarded as revenue bonds as eligible for bank underwriting. But this classification was later reversed.[277]

Representatives of the investment banking industry are of course bitterly opposed to the underwriting of revenue bonds by commercial banks.[278] There is some evidence, based upon careful research, that the participation of commercial banks in the underwriting of general obligation state and municipal bonds, and the exclusion of the banks from the underwriting of general revenue bonds, has reduced the cost to issuers of the general obligation bonds relative to the revenue bonds. In other words, the increased competition in underwriting general obligation bonds because commercial banks as well as investment bankers are eligible has benefitted issuing states and municipalities and these benefits are not present for revenue bonds.

In a 1971 article[279] Reuben Kessel analyzed spreads and reoffering yields for tax exempt general obligation bonds, revenue bonds, and so-called Saxon general obligation bonds (bonds that were reclassified from revenue to general obligations by Saxon when he was Comptroller of the Currency). The overall conclusion was that the prohibition of bank competition in the underwriting of revenue bonds has led to fewer bids for these bonds and higher underwriting costs. The revenue bonds that were of high quality, short maturity, and offered when business conditions were poor (all conditions that favour bank participation) were particularly disadvantaged.

An increased number of bids had two effects, both a higher reoffering price and a lower spread. The saving due to bank

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Industry Association, Memorandum for Study and Discussion on Bank Securities Activities, at 4 (August 1976).

277 *See* Kessel, *A Study of the Effects of Competition in the Tax-Exempt Bond Market*, 79 J. POL. ECON. 709 (July-August 1971).

278 *See e.g. Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities*, *supra* note 195, at 268. The Investment Company institute supports this position, too; *id.* at 323-34. Further arguments can be found in *Financial Institutions: Hearings before Subcomm. on Financial Institutions*, *supra* note 200, pt. 3, at 2010-14, 2050, 2068-73 (December 1975-January 1976); *id.* pt. 4, 222-27, 585-87 (1976) (apps. A, B). Underwriting by affiliates of foreign banks was objected to (and statistics were cited) by New York Stock Exchange representatives in *The Financial Reform Act of 1976: Hearings before Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Currency and Housing*, 94th Cong., 2d Sess., pt. 2, at 671-74 (March 1976).

279 *See* Kessel, *supra* note 277.

underwriting effects on reoffering yields might be around thirteen basis points, while a saving of about 48¢ in underwriting spread might be achieved. Kessel argued that each bidder brings some unique information about his customers and therefore the greater the number of bidders the greater the representation of customers who will pay a high price for the new issue. In effect, the issuer is buying information about purchasers when it solicits bids.

Kessel explains why the absence of banks as underwriters is significant in view of the fact that no other financial entities are barred from the underwriting of revenue bonds. Commercial banks do bring some unique characteristics as underwriters, and investment and commercial bankers are complementary resources that benefit the issuers of general obligation bonds, but not the issuers of revenue bonds.

Legislation to allow banks to underwrite state and municipal revenue bonds was introduced in the House of Representatives as early as 1955. Further bills were discussed in 1963, 1965 and 1967.[280] In 1968 legislation was enacted authorizing commercial banks to underwrite and deal in investment quality housing, university, and dormitory revenue bonds. In 1974 the Senate Committee on Banking, Housing and Urban Affairs reported Bill S. 3838 which would have allowed banks to underwrite revenue bond issues eligible for purchase by national banks, subject to a number of conditions: underwritten bonds could not be sold to trust accounts; disclosure of underwriter status would have to accompany sales to depositors, borrowers or correspondent banks; and there would be limits to the size of positions taken and on transfers from underwriting to investment accounts.[281]

In its report, the committee noted that in 1940 only 12.6% of all new municipal bonds were in the revenue bond category and amounted to $188 million. By 1973 the percentage had grown to 44.1% and the dollar amount to $10 billion. The committee was impressed at the quality record of revenue bonds and the evidence that the competition from commercial banks in underwriting might be expected to reduce the cost to the issuing governments.

The Comptroller of the Currency testified in 1975 before Senator Williams' Subcommittee on Securities and Representative St. Germain's Subcommittee on Financial Institutions in favour of a change in the Glass-Steagall Act to permit bank underwriting of

280 *See Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities, supra* note 195, at 211.

281 FINANCIAL AMENDMENTS ACT OF 1974, REPORT OF THE SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, TO ACCOMPANY S. 3838, S. REP. No. 93-1120, 93d Cong., 2d Sess. (August 21, 1974).

municipal revenue bonds.[282] The American Bankers Association has urged the change and so has the Bank Commissioner of the State of Connecticut and the ad hoc Rhode Island Financial Institutions Committee.[283]

With respect to the supervision of bank securities activities by state securities regulatory authorities, the Bank Commissioner of the State of Connecticut offered some rather interesting testimony in 1976 before Senator Williams' subcommittee.[284] The Connecticut banking commissioner not only regulates banks but is responsible for the supervision of investment advisers and broker-dealers. He said that in Connecticut any banks engaging in the underwriting of municipal securities are required to register as broker-dealers. Personnel are required to take the same examination given by the National Association of Securities Dealers (NASD) and they are supposed to benefit from the same training. He said four banks were registered in Connecticut as broker-dealers of which one was a national bank. In commenting on the statement that it would be difficult to have bank employees register, as broker-dealer employees do, he said "I don't believe our experience indicates that at all". With respect to municipal underwriting he said that his office was in the process of revising its procedures to coincide with the new rules promulgated by the Municipal Securities Rule Making Board and the Securities and Exchange Commission.

The commissioner also noted that American banks undertake the underwriting of corporate securities on a very large scale overseas, and he could not see that this was doing any harm to the U.S. commercial banking industry. He questioned the argument that underwriting within the United States is too risky for commercial banks, when it does not appear to be too risky overseas. He also said that he regarded the entry of commercial banks into the dividend reinvestment area as an extension of their corporate trust activities. He said that he could see no harm to the public.

Some opinions of bank customers on the subject of commercial bank participation in underwriting may be of interest. Greenwich Research Associates reported in 1976 that most corporate execu-

282 *Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities, supra* note 195, at 168; *Financial Institutions: Hearings before Subcomm. on Financial Institutions, supra* note 200, pt. 3, at 2418, 2456-57; HOUSE COMM. ON BANKING, FINE, *supra* note 223, at 417.

283 *Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities, supra* note 195, at 293-94; *Financial Institutions: Hearings before Subcomm. on Financial Institutions, supra* note 200, pt. 1, at 667-78; *id.* pt. 4, at 372 (apps. A, B).

284 *Brokerage and Related Commercial Banks Services: Hearings before Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs,* 94th Cong., 2d Sess. 718-36 (August and September 1976).

tives (60% of those interviewed) do not think that their banks should be allowed to offer investment banking services. However, the executives were evenly divided on the question of whether investment bankers were more able to handle their company's sophisticated financial needs then were their bankers.[285]

No legislation has been enacted to permit banks to underwrite revenue bonds but in 1975 Congress did remove the exemption from registration with the SEC of banks underwriting general obligation municipal bonds. These banks must now register as "municipal securities dealers".[286]

C. MONEY MANAGEMENT SERVICES OF BANKS AND TRUST COMPANIES

1. *Canada*

Canadian chartered banks are not permitted to operate trust departments. Some, however, do manage mutual funds, generally through a subsidiary. The 1976 government *White Paper* proposed[287] changes to prohibit this practice, but banks would be permitted to continue to act as sales agents for mutual funds managed by others. The reason for the proposed prohibition is the potential conflict of interest between the bank as lender to a corporation and as manager of a fund able to purchase the corporation's securities. The banks did not seem to object and the Senate Committee on Banking, Trade and Commerce approved the prohibition.[288]

Some banks also serve as advisers to real estate investment trusts (REITS) and to mortgage investment companies (MICS), which are very similar to mutual funds but invest primarily or exclusively in mortgages. Since banks are not permitted to operate trusts directly, the three banks that have established REITS have set up trusts with individual bank officers acting as trustees and the bank itself has served as adviser. The *White Paper* recognized the same potential for conflicts here as in the case of bank-managed mutual funds but it also saw the bank-managed REITS

285 GREENWICH RESEARCH ASSOCIATES, FOURTH ANNUAL REPORT ON LARGE CORPORATE BANKING 1976 (1976). The report was based on interviews with over 1,300 executives representing more than 900 companies during May and June of 1976.

286 Securities Exchange Act of 1934, ss. 3(a)(30), 15B. And *see*, *Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities*, *supra* note 195, at 160. Another recommendation for bank underwriting of municipal revenue bonds was put forward in 1976; *see* HOUSE COMM. ON BANKING, "FINE", *supra* note 223, at 10.

287 WHITE PAPER ON THE REVISION OF CANADIAN BANKING LEGISLATION, *supra* note 202, at 36.

288 *Standing Senate Comm. on Banking, Trade and Commerce*, *supra* note 2, at 44:13,

and MICS as important vehicles for providing residential mortgage loans.[289] So the proposal was to continue to allow chartered banks to serve as advisers to REITS and MICS.

Bank-managed REITS do not enjoy any immunity from provincial securities regulation, at least in Ontario. In 1972 following the filing of preliminary prospectuses by Ontario's first two REITS, policy 3-25 was published by the Ontario Securities Commission setting out the conditions under which REITS (which were classified as "finance companies") would be permitted to issue securities.[290]

The bank as adviser is free of a registration requirement because banks need not register as advisers.[291] With respect to conflict of interest, the policy states:

> "[N]either the adviser nor any affiliate of the adviser shall engage in any business that would bring it in real or apparent conflict with the interests of the issuer [REIT]....[292]
>
> "[This] requirement may be waived in whole or in part by the Director where the adviser is a well established federal or provincial government supervised financial institution, *e.g.*, a bank, insurance company, loan or trust company."[293]

The waiver is critical since banks are in the mortgage business. Furthermore, mortgage funds organized by banks purchase their mortgages from the sponsoring bank and the transaction is hardly at "arms length". At the same time there is no significant secondary market in conventional mortgages in Canada that might serve to identify a "fair" price. The Ontario Securities Commission has had some difficulty with this conflict situation agreeing in one case that a spread up to 1/4% between the lending bank's yield and the investor fund's yield was reasonable but indicating that the subject was under review.[294]

44:69. The committee did favour permitting banks to act as advisers to mortgage-based mutual funds.

289 WHITE PAPER ON THE REVISION OF CANADIAN BANKING LEGISLATION, *supra* note 202, at 37.

290 Ontario Securities Commission Policy No. 3-25, first published in [1972] OSC Bull. 172 (September), 2 CCH CAN. SEC. L. REP. ¶¶ 54-919, 54-920 and amended subsequently.

291 Ontario Securities Act, s. 18(a). The same is true in other provinces.

292 OSC, Policy No. 3-25(F)(2), *supra* note 290.

293 OSC, Policy No. 3-25(F)(4), *supra* note 290.

294 *In re* s. 28 of the Securities Act and Scotiafund Mortgage and Income Trust, [1976] OSC Bull. 184 (July). The 1/4% spread, with some modifications, was made part of a formal policy in June 1977, when National Policy No. 29 was published; [1977] OSC Bull. 145-52 (July), 2 CCH CAN. SEC. L. REP. ¶ 54-867.

Registered Retirement Savings Plans and Registered Home Ownership Savings Plans are tax deferral arrangements designed to promote individual saving for retirement and home ownership. In both cases a trust is required and of course chartered banks may not manage trusts. However, banks may and do handle the sales and administration for these plans and some banks have set up mutual funds to serve as an investment vehicle for the trusts. The *White Paper* concluded that there is no reason why these plans should not be able to maintain deposits in banks and recommended that the trust requirement be abandoned. But the same potential for conflict of interest is present where banks invest money from these plans in bond and stock portfolios. So the *White Paper* proposed[295] that the banks not be permitted to accept any new clients for funds invested in stocks and bonds except where the management of the fund is independent of the bank. The securities industry has protested that the banks should not be permitted even to continue operating mutual funds for existing plan clients.[296]

So far as general portfolio management, investment counseling and securities advising activities are concerned, the *White Paper* proposed that only the management of REITS and MICS be allowed, plus casual securities advising in the course of serving bank customers.[297] The securities industry has expressed enthusiasm for the limitation but objects to the banks being able to offer casual securities advice.[298]

Under the present Ontario Securities Act, banks and trust companies are exempt from registration as advisers[299] which permits them to manage mutual funds without registration. There is no exemption from the Ontario prospectus requirements for mutual funds managed by banks or trust companies, although a fund offering only obligations guaranteed by a bank or trust company is exempt.[300] Bill 30 would continue the exemption for bank and trust company advisers[301] but would introduce the need to register as a management company in order to provide investment

295 WHITE PAPER ON THE REVISION OF CANADIAN BANKING LEGISLATION, *supra* note 202, at 39.

296 Joint Committee of the Canadian Securities Industry, Memorandum, *supra* note 267, at 18.

297 WHITE PAPER ON THE REVISION OF CANADIAN BANKING LEGISLATION, *supra* note 202, at 37. The banks have urged that they be allowed to advise mortgage-based mutual funds; *see* CANADIAN BANKERS' ASSOCIATION, BANK ACT 77, WHITE PAPER: THE BANKS' ASSESSMENT 10 (No. 4, 1976).

298 Joint Committee of the Canadian Securities Industry, Memorandum, *supra* note 267, at 12.

299 Ontario Securities Act, s. 18(a). The same is true in other provinces.

300 *Id.* ss. 19(2)1(c), 19(2)2.

301 Ontario Bill 30, s. 33(a).

advice to a mutual fund for compensation under a management contract.[302] The "contract" suggests that the management company and the mutual fund must be separate legal entities and therefore a bank or trust company would not have to register to manage a mutual fund that is part of the same bank or trust company. Mutual funds, however, will require registration under Bill 30,[303] except for trust companies offering securities of an account solely to service a Registered Retirement Savings Plan, a common trust fund, or a pooled account for which they do not solicit participations.[304] Banks do not qualify for this exemption which would not be necessary if the *White Paper* proposals are implemented. Grover and Baillie approve the exemption for trust companies because they are subject, in managing RRSPS, to the Ontario Pension Benefits Act.[305]

In acquiring securities for a pooled trust account a trust company presumably has the advantages of its exempt purchaser status and the potential problems under Bill 30, discussed above for regular trust accounts,[306] will apply.

The exemption for common trust funds will cover trust funds set up to service regular trust accounts but not the mutual funds operated by trust companies. Regular mutual funds operated by trust companies do not enjoy any exemptions from prospectus requirements nor would they under Ontario Bill 30. It appears that a fund set up entirely within the trust company would require the company to register as a management company. Trust company mutual funds are all "no-load" funds, so there is no "underwriting" and therefore no need even under Bill 30 for underwriter registration. Banks selling mutual fund shares would be subject to the underwriter registration requirement described above[307] but would not have to register to sell securities issued by a trust company for an RRSP account or a pooled account with no solicitation.[308]

Banks also offer miscellaneous administrative services that have to do with portfolios. These include the collecting of interest and dividends, custody of certificates, and periodic reports on portfolios. The *White Paper* saw nothing wrong in these activities because they do not pose any potential for conflicts of interest.[309]

302 *Id.* ss. 24(1)(e), 1(1)20, 1(1)21.
303 *Id.* s. 24(1)(d).
304 *Id.* s. 34(b).
305 *Grover & Baillie* at n. 268.
306 *Id.* at n. 216.
307 *Id.* at n. 275.
308 Ontario Bill 30, s. 35(2)4.
309 WHITE PAPER ON THE REVISION OF CANADIAN BANKING LEGISLATION, *supra* note 202, at 37

2. *United States*

We have already seen the substantial nature of the trust and agency activities carried on by U.S. banks. In managing a trust account a bank is managing funds to which it has legal title. An agency account involves the bank in money management or investment advisory activities with respect to assets that are not placed "in trust". Sometimes these advisory activities are carried out by subsidiaries of a parent bank holding company rather than by the bank itself. This form of money management is usually only practical for rather large accounts and a great deal of private pension fund money is managed in this way. Some banks have begun offering portfolio management services to small accounts (under $100,000). Charles Buek, president of U.S. Trust Co., described the economics of portfolio management to Senator Williams' subcommittee suggesting $200,000 as the minimum size for a separately managed account. But some "automatic" plans are feasible for much smaller accounts and of course commingled accounts offer economies for small accounts.[310] (The SEC found that 54% of the 290,000 separately managed personal trust accounts of the top 115 banks were under $100,000.)[311]

Individual Portfolio Management Service is an advisory service offered by some banks to individuals with portfolios as small as $10,000. Recommendations are sent by the bank to the customer who, if he accepts the recommendations, signs the form and sends it to his broker. Accounts are not pooled; the assets of an account may be held by the customer, the broker or the bank. At least one bank executes trades itself, thus offering some commission saving.[312]

Pension funds qualified under section 401 of the Internal Revenue Code, including Keogh plans for the self-employed and Individual Retirement Accounts under section 408, require trusts or custodial accounts with commercial banks, although the Secretary of the Treasury is authorized to designate non-bank trustees or custodians for IRAS.[313] Some Keogh plans and IRAS simply involve savings accounts but others give investment discretion to the bank. The section 401 pension plans and Keogh plan trusts are exempt from registration under the Securities Exchange Act of 1934 and Investment Company Act of 1940 and so are collective

310 *Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities*, *supra* note 195, at 331-33.

311 SEC, FINAL REPORT, *supra* note 225, at 131.

312 *Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities*, *supra* note 195, at 359-61.

313 *Id.* at 202-06.

trusts for these plans.[314] Keogh plans, however, and collective trust funds for Keogh plans are subject to the registration requirement of the Securities Act of 1933. The SEC may grant an exemption from this requirement and has done so by way of "no action" letters where the funds are invested in mutual funds for which a prospectus has been issued.[315] In many cases the bank makes use of the intrastate offering exemption under the Securities Act.[316]

IRAS are a little different. As in the case of the section 401 pension and Keogh plans, banks are authorized by the Internal Revenue Code to pool these accounts but there is no exemption from the registration requirements of the Investment Company Act of 1940 or the Securities Act of 1933. The SEC has issued "no action" letters contingent on there being no pooling of IRA accounts and the assets of an account being invested either in a savings account or in specific mutual funds, with no discretion on the part of the bank.[317]

Banks are permitted to pool regular trust accounts in so-called common trust funds, which can make it more economical to manage on a day-to-day basis the assets of fairly small trust accounts. (Pooled funds at the end of 1975 amounted to $18 billion.)[318] And these pooled funds are exempt from the Investment Company Act of 1940. But for investment management accounts, those that are not trust accounts, pooling is forbidden. At one time the Comptroller of the Currency authorized commingled agency accounts, which were in effect mutual funds. The SEC insisted that the common fund be registered as an investment company. But in 1971 the United States Supreme Court said that this practice constituted underwriting in violation of the Glass-Steagall Act.[319] Many commercial banks would like this decision changed by legislation and in fact the two legislative changes the American Bankers Association has been pushing hard for (and which the Comp-

314 Section 3(c)(11) of the Investment Company Act of 1940 exempts any collective trust maintained by a bank, consisting solely of assets of pension, bonus, and profit-sharing trusts qualified under s. 401 of the Internal Revenue Code.

315 *Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities, supra* note 195, at 161.

316 *Id.* at 151.

317 *Id.* at 150-51, 204. The Comptroller of the Currency has said that bank examiners treat IRA accounts as regular trust accounts for purposes of supervision; *id* at 176.

318 SEC, FINAL REPORT, *supra* note 225, at 149.

319 Investment Company Institute v. Camp, 401 U.S. 617 (1971). The decision affirmed, however, the right of a national bank to manage the portfolio of an individual customer. The SEC position is that a commingled agency fund would not be exempt under the Investment Company Act of 1940; *see, Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities, supra* note 195, at 154, 165. For a discussion of the events leading to the decision, *see* 2 INSTITUTIONAL INVESTOR REPORT at 447-50.

troller of the Currency endorses)[320] would give banks the power to operate commingled agency accounts and the power to underwrite revenue bonds.

In addition to offering financial advisory services to individual non-trust accounts, a number of banks have begun to serve as investment advisers to both open-end and closed-end investment companies.[321] Sometimes the bank serves as the adviser but in most cases bank holding companies form separate investment advisory subsidiaries.

Banks themselves are exempt from registration under the Investment Advisers Act of 1940 but they are not excluded from the definition of "investment adviser" in the Investment Company Act of 1940. So they must register under the latter in order to manage investment companies.[322] And advisory subsidiaries of bank holding companies are not exempt from either act.[323] The SEC has raised a number of conflict of interest questions concerning banks that serve as custodian and transfer agent for closed-end investment companies that they also sponsor and manage but no action has ever been taken.[324]

The Board of Governors of the Federal Reserve System amended regulation Y in 1972 to allow bank holding companies and their affiliates to serve as advisers to registered closed-end investment companies and real estate investment trusts. The Investment Company Institute filed a petition with the Federal Reserve Board for reconsideration of this regulation. The request was denied and the institute filed a lawsuit which has not yet been decided on the merits.[325] While regulation Y does permit banks to advise investment companies, there are some restrictions imposed by the Federal Reserve Board of Governors that limit the activities of the banks to something less than what nonbank investment

320 *See, Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities, supra* note 195, at 168-69 and 170-74; and further references at note 278 *supra*. And *see, Financial Institutions: Hearings before Subcomm. on Financial Institutions, supra* note 200, at 2437-38. The mutual fund industry of course argued strenuously against any such change; *id.* pt. 4, at 595, 601-03 (apps. A, B).

321 U.S. DEPARTMENT OF THE TREASURY, PUBLIC POLICY ASPECTS OF BANK SECURITIES ACTIVITIES 8 (November 1975); *Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities, supra* note 195, at 98-99; and *Financial Institutions: Hearings before Subcomm. on Financial Institutions, supra* note 200, pt. 4, at 594-97, 601 (apps. A, B).

322 Banks advise over $2 billion in investment company assets; SEC, FINAL REPORT, *supra* note 225, at 147-48.

323 *Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities, supra* note 195, at 152-53 and 199-202.

324 *Id.* at 200.

325 ICI v. Board of Governors, Civil No. 74-697 (D.D.C. 1974). *See, Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities, supra* note 195, at 114-15, 129-30, 201.

advisers may do. And bank holding companies are prohibited from sponsoring, organizing or controlling an open-end investment company or mutual fund.

The significant issue here is whether banks should be permitted to organize their own mutual funds. Many banks have substantial investment management staffs handling trust accounts and performing advisory services for large nontrust accounts. The kind of investor for whom mutual funds are likely to be most beneficial is probably foreclosed from making use of bank talent because it is not economical to open a trust account for a small investor. Besides, the banks are forbidden to solicit trust accounts in the expectation that the trust assets will be placed in a pooled trust fund.

Although investment companies are subject to the Investment Company Act of 1940, there is no comparable statute covering REITS. A bank holding company may organize a REIT investment management company as a wholly-owned subsidiary and the subsidiary will in turn organize the REIT as a separate company that offers shares to the public.[326] The SEC says it has no authority to regulate transactions between REITS and creditor banks but that federal disclosure requirements for bank holding companies and REITS apply to these "loan swaps".[327]

D. FINANCIAL ADVISORY SERVICES AND PRIVATE PLACEMENTS

In the preceding section we dealt with the provision of investment advice or investment advisory services by banks. Here we are concerned with financial advice to corporate customers.

1. *Canada*

The government *White Paper* of 1976 did not mention advisory activities of chartered banks, but proposed that the right of a bank to act as an agent in the private placement of corporate securities would be withdrawn.[328] The securities industry appar-

326 *Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities, supra* note 195, at 201-02; and *see id.* at 140, 144, 153.

327 *Id.* at 165-66. There are those who argue that a serious regulatory gap exists here or at least that the relationship between the bank and the REIT poses serious risk to the bank; *see, Financial Institutions: Hearings before Subcomm. on Financial Institutions, supra* note 200, pt. 1, at 496-99, 507-16 (December 1975).

328 WHITE PAPER ON THE REVISION OF CANADIAN BANKING LEGISLATION, *supra* note 202, at 35. The banks have generally accepted a proposed prohibition of underwriting corporate activities but do want to continue private placements; CANADIAN BANKERS' ASSOCIATION, *supra* note 297, at 10.

ently feels there may still be too much freedom for banks to help their customers arrange private placements.[329]

Even if the bank's role as agent in a private placement constitutes "trading" within the meaning of the Ontario Securities Act, there is an exemption from registration.[330] Bill 30 would remove this exemption but almost certainly the placement would be to "exempt purchasers" and therefore exempt.[331]

2. *United States*

Financial advisory services are essentially management consulting services and are usually provided through a separate nonbank subsidiary of a bank or its holding company. The service may be on the basis of a long-term contract or may be provided to customers for specific projects.[332]

There seems to be no claim that these services are prohibited by the Glass-Steagall Act. However, there is apparently some uncertainty about giving advice to corporate clients in mergers and acquisitions and with respect to private placements which may involve the issue of securities.[333] At some point the advisory services may become underwriting. The Securities Industry Association claims that even syndicating long-term bank loans is suspect.[334] The Comptroller of the Currency is concerned that the penalties for violation of the Glass-Steagall Act may inhibit legitimate financial advisory services and would like to see those penalties removed.[335]

Rendering advice on private placements of long-term securities is an activity that has sparked an especially sharp debate

329 Joint Committee of the Canadian Securities Industry, Memorandum, *supra* note 267, at 7.

330 Ontario Securities Act, s. 19(1)3. The other provinces provide the same exemption.

331 Ontario Bill 30, ss. 35(1)3, 4.

332 U.S. DEPT. OF THE TREASURY, PUBLIC POLICY ASPECTS OF BANK SECURITIES ACTIVITIES, *supra* note 321, at 9, *reprinted in Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities*, *supra* note 195, at 33.

333 Two letters from the Deputy Comptroller of the Currency in 1974 and 1975 describing permissible private placement activities are reproduced as apps. IIA and IIB, in Securities Industry Association, Memorandum for Study and Discussion on Bank Securities Activities (August 1976).

334 *Id.* at 10.

335 U.S. DEPT. OF THE TREASURY, *supra* note 321, at 24-25, *reprinted in Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities*, *supra* note 195, at 172. There was a brief flurry over private placements in early 1977 when the Federal Reserve Board ordered First Arabian Corp., a bank holding company, to divest its interest in Bates North America, a broker-dealer, because of the latter's activity in private placements. The Federal Reserve replied to inquiries that this decision was quite unrelated to questions of bank activities under the Glass-Steagall Act.

between the banks and the securities industry. Representative Henry Ruess, chairman of the House Banking, Currency and Housing Committee, asked the Federal Reserve Board in December 1976 for a study of private placement activities of commercial banks. The Securities Industry Association prepared a memorandum to the board[336] arguing that commercial banks are prohibited by the Glass-Steagall Act from advising on private placements and that dangers of reciprocal practices and conflicts of interest make the banks' activities undesirable. The New York Clearing House Association also prepared a memorandum[337] defending the legality and propriety of the activities.

The Federal Reserve Board *Staff Study* concluded that there was "no evidence of significant legal or public policy problems associated with commercial bank private placement activities".[338] The study reported (quoting the SEC) that there were twenty-two commercial banks that in the five years from 1972 to 1976 had assisted in more than an incidental way in private placements; there were eighteen banks active in private placements in 1976 and five banks accounting for almost 90% of the bank advisory activity.[339] All of the banks accounted for 7% of $16 billion of assisted private placements in 1976 and although the percentage was up from 2% in 1972, it had remained fairly constant for 1975 and 1976.[340]

The study saw little chance of banks displacing investment bankers as the dominant intermediaries (the top ten investment banks in terms of private placement activities had 67% of the advisory business in 1976 and the leading commercial bank was in thirteenth place).[341] Commercial banks did tend to specialize in lease financings, a field of U.S. bank expertise, and in 1976 participated in 15% of assisted lease financings.[342] On the other hand, banks participated in relatively few of the very large private placements (such as those of Hydro Québec, Ontario Hydro and B.C. Hydro).[343] Bank assisted private placements seemed to be of

336 Securities Industry Association, Private Placement Activities of Commercial Banks; Memorandum to the Federal Reserve Board (May 1977).

337 New York Clearing House Association, *Commercial Bank Private Placement Advisory Services: An Analysis of the Public Policy and Legal Issues* (April 1977), *reprinted in* 95 BANKING L.J. 333 (1978).

338 STAFF OF FEDERAL RESERVE BOARD, COMMERCIAL BANK PRIVATE PLACEMENT ACTIVITIES 5 (June 1977).

339 *Id.* at 66, 32, 33.

340 *Id.* at 26, 31. More detailed statistics appear in SEC, FINAL REPORT, *supra* note 225, at 61-74.

341 STAFF OF FEDERAL RESERVE BOARD, *supra* note 338, at 59.

342 *Id.* at 35-36. SEC, FINAL REPORT, *supra* note 225, at 75-89, deals extensively with lease-related placements.

343 STAFF OF FEDERAL RESERVE BOARD, *supra* note 338, at 32-34.

generally high quality and the average fee charged in 1976 was 0.8%.[344]

If the bank makes use of a subsidiary to provide financial advisory services, then the Comptroller of the Currency must approve the creation of that subsidiary. The comptroller has explicitly authorized national banks to provide such advisory services.[345]

Investment banking firms see the bank activity as competitive and frequently unwelcome. There is also a claim that the banks through their commercial lending activities are already direct competitors with underwriters who might handle public offerings. If they also provide the advice that might help a client choose between bank loans and publicly offered securities, the banks may be in a very powerful position and there are possibilities for conflicts of interest.[346] The SEC says that provision of these financial services would call for registration as a broker-dealer were it not for the exclusion of banks from the definitions of "broker" and "dealer" in the Securities Exchange Act.[347] The commission does not argue against this exclusion but it has argued that bank personnel engaged in corporate financing services should be required to pass tests of competence.[348]

A number of banks offer advice on mergers, acquisitions and divestitures. Thirty-three banks responding to the SEC questionnaire indicated that they were engaged in this activity during 1972 to 1976, although seven had discontinued it and only seventeen reported fees or collections for the first nine months of 1976.[349] The number of transactions reported by banks never exceeded 3% of the total number of transactions reported by the Federal Trade Commission for 1972 to 1975.[350]

E. AGENCY AND BROKER SERVICES

1. *Canada*

Canadian chartered banks appear to be free to offer brokerage services but none of the banks hold stock exchange member-

344 *Id.* at 54. An excellent description of the private placement process is given in IRVING TRUST COMPANY, GUIDELINES FOR THE PRIVATE PLACEMENT OF DEBT SECURITIES (New York 1976).

345 U.S. DEPARTMENT OF THE TREASURY, *supra* note 321, at 35.

346 *Id.* at 24; *Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities*, *supra* note 195, at 260-63, 277.

347 SEC, INITIAL REPORT ON BANK SECURITIES ACTIVITIES 5 (January 1977).

348 SEC, FINAL REPORT, *supra* note 225, at 5, 18-19.

349 *Id.* at 94-95.

350 *Id.* at 99.

ships or own broker-dealer firms. Apart from transactions that can be completed among their own customers, they appear to make use of regular broker-dealers even when they serve as brokers. However, they do serve as agents in the sale of commercial paper for corporate customers. The *White Paper* proposals would leave the banks free to act as brokers and also to advertise this function. The securities industry has protested and urged a ban on the solicitation of brokerage business by banks. The securities industry would also like to see a requirement that the banks would be required to use a registered securities firm even for unsolicited orders.[351] And the industry has urged that banks be prohibited from soliciting sales of corporate commercial paper.[352] The banks, on the other hand, would like their right to deal in securities to be made clearer, and they oppose any requirement that they be subject to provincial registration requirements.[353]

Although chartered banks act as market-makers in some bonds, usually those on the head office "approved list", there is apparently not much interest in equity market-making.

Banks and trust companies are not required to register under the Ontario Securities Act in order to act as brokers or dealers[354] but Bill 30 would drastically narrow this exemption. Registration would not be required for a trade involving only the placing of an unsolicited order to purchase or sell with a bank for execution through a registered dealer.[355] The handling of unsolicited orders, of course, is precisely the kind of bank activity of which the securities industry approves and is what makes up almost all the bank brokerage function according to the banks' own testimony.

Like anyone else, of course, the banks are free to act as brokers and dealers without registration in government and municipal securities and securities guaranteed by banks, trust and loan

351 Joint Committee of the Canadian Securities Industry, memorandum, *supra* note 267, at 20.

352 *Id.* at 21-23.

353 CANADIAN BANKERS' ASSOCIATION, *supra* note 201, at 28.

354 Ontario Securities Act, s. 19(1)(3). The other provincial acts contain the same exemption. In a puzzling decision in 1974, however, the Ontario Securities Commission made an order that the registration requirements of the act would not apply to banks that might act as selling group members in a nation-wide offering by the Canada Development Corporation. The commission does not refer to the statutory exemption and suggests that the activity it is authorizing is quite unusual. This particular underwriting aroused rather strong feelings within the investment industry which did not welcome bank participation (and in the end the banks did not participate). The order was granted at the request of CDC and it seems likely it was requested to head off any attempt to have the commission deny use of the exemption which it was empowered to do under section 19(5); *In re* Canada Development Corporation, [1974] OSC Bull. 76-80 (April).

355 Ontario Bill. 30, s. 35(1)10(b).

companies and insurance companies.[356] Ontario Bill 30 preserves this exemption.[357]

2. *United States*

Banks in the United States offer a number of agency services giving customers access to securities markets. So far banks have not undertaken to conduct a retail brokerage business on a significant scale, although it is not entirely clear whether they are permitted to do so under the Glass-Steagall Act.[358] But there is evidence that banks are seeking closer relations with particular brokerage firms and these relationships coupled with the unfixing of commission rates in the United States can probably accomplish anything that a bank might seek to accomplish through providing brokerage services directly.

Banks provide customers with custodial services; indeed the usual custodian of an institutional portfolio will be a commercial bank. The custodial account differs from the trust account in that custodianship simply involves safekeeping and the transfer of securities into and out of the custodial account. There is no investment management on the part of the bank. A custodial account can involve collection of income by the bank and quite possibly reinvestment of this income in short-term funds. The bank may simply deliver and accept securities on the customer's instructions or it may buy and sell securities at the direction of the customer or his investment adviser. The purchases and sales will be undertaken by the bank acting as an intermediary between the customer and a broker or dealer. Custodial arrangements do to some extent involve competition with the securities industry but there appears to be little resentment over them on the part of brokers and dealers and there have been no obvious efforts to have them curtailed.

At least one bank has provided a voluntary investment plan. A broker-dealer would refer customers with small accounts to the bank. The bank would establish a custodial account for each customer and arrange for a monthly purchase of securities chosen by the customer from a list of recommendations from the broker-dealer. The customer would pay a fee based on the size of his

356 Ontario Securities Act, s. 19(2).

357 Ontario Bill 30, s. 35(2)1.

358 *Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities, supra* note 195, at 114, 124-29, 152. The Securities Industry Association has complained about banks dealing directly with third market makers as agents for customers. Securities Industry Association, Memorandum for Study and Discussion on Bank Securities Activities, at 5 (August 1976).

investment account, and the fee would cover all commissions and bank service charges. Part of the fee would be rebated to the broker-dealer.[359]

Automatic investment plans are a somewhat similar service offered by banks but in this case the bank rather than the broker-dealer takes the initiative in soliciting customers and it is the bank that offers a list of the stocks of the twenty-five largest corporations in Standard & Poors Industrial Index from which the customer makes a selection. The plan involves monthly purchases through transfers from the customer's checking account and a service fee is charged for each transaction. The bank is able to pool customer orders to reduce commission costs. The monthly service charge is 5% of the amount invested with a maximum of $2 or $3 a month per stock purchased plus brokerage. Usually there is no custodial account; securities are held in a bank nominee name and are transferred to the customer on request.[360]

Automatic investment plans have generally been regarded by the SEC as not requiring registration under the Investment Company Act of 1940 or the Securities Act of 1933,[361] and the Comptroller of the Currency has said they do not violate the Glass-Steagall Act.[362] The New York Stock Exchange and the Investment Company Institute failed in an attempt to have automatic investment plans declared in violation of the Glass-Steagall Act.[363] Legislation was introduced in 1974 to bring these plans under SEC regulation but nothing was enacted.[364] The number of banks and customers participating in these plans has declined since 1974 and in late 1976 only eighteen banks were offering plans with some 4,500 participants.[365]

Another service offered by many banks is the dividend reinvestment plan. Through this plan shareholders of a participating corporation direct that their dividends be paid to a bank which aggregates all the dividends received and purchases shares of the corporation's common stock, sometimes directly from the corporation but more often in the market. (Direct purchases sometimes benefit by a discount from market price.) Such plans have apparently grown substantially in recent years, as corporations have

359 SEC, INITIAL REPORT, *supra* note 347, at 72.

360 Operation of the plans is described in detail, *id.* at 55-71.

361 *Id.* at 194-95.

362 *Id.* at 195.

363 NYSE v. Smith, 404 F. Supp. 1091 (D.D.C. 1975). For discussion *see, Financial Institutions: Hearings before Subcomm. on Financial Institutions, supra* note 200, at 2077-79, 2083-84; and *see id.* pt. 4, at 588-91 (apps. A, B).

364 *Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities, supra* note 195, at 195.

365 SEC, INITIAL REPORT, *supra* note 347, at 54, 63.

become enthusiastic. The SEC reported in 1977 that sixty-eight banks offered these plans with over 1.8 million participating shareholders in 727 corporations and assets of $1.2 billion.[366] It is also possible in most of these plans for the shareholder to add additional funds to purchase more shares and the additions commonly amount to about five times the reinvested dividends. Service fees usually range from 4% to 5% of the investment but are sometimes less and there is usually a maximum of $2 to $3.[367] Sometimes the corporation pays both the service fee and commissions.[368] The plans are apparently not profitable for the banks offering them nor for Merrill Lynch which also offers them.[369]

Dividend reinvestment plans, whether offered by banks or by others, have generally been considered by the SEC as not subject to registration under the Investment Company Act of 1940 or the Securities Act of 1933 because they do not involve separate securities.[370]

Employee stock purchase plans (ESPPS) are a further bank service. They operate much as do dividend reinvestment plans with a pooling of participants' funds to purchase shares in large quantities. Although they were first offered by banks before dividend reinvestment plans, they are much smaller in the aggregate. The SEC reported in 1977 that fifty-nine banks were offering 105 ESPPS with 165,000 participants and $121 million in assets.[371] Some brokers also offer ESPP services and the SEC concluded that large banks and brokerages have a competitive edge over small banks and brokerages. But banks in general do not have the competitive advantage over brokerages that they enjoy with respect to dividend reinvestment plans.[372] Total direct costs of bank administered ESPPS were probably a little under 3%, while the cost of the plans administered by Merrill Lynch was 1.87%.[373]

The banks argue that in operating dividend reinvestment plans and automatic investment plans they simply function as

366 *Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities*, *supra* note 195, at 93-97; SEC, INITIAL REPORT, *supra* note 347, at 15, 37.

367 *Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities*, *supra* note 195, at 353-55; SEC, INITIAL REPORT, *supra* note 347, at 15-35 describes the plans in detail.

368 SEC, INITIAL REPORT, *supra* note 347, at 34.

369 *See*, *Brokerage and Related Commercial Bank Services: Hearings before Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 94th Cong., 2d Sess. 87, 215 (August and September 1976).

370 SEC, INITIAL REPORT, *supra* note 347, at 106, 192-93. The conditions under which exemptions are granted are described *id.* at 151-52. Automatic investment services are not so easily exempted; *see also id.* at 162.

371 *Id.* at 27.

372 *Id.* at 43-45.

373 *Id.* at 53.

agents of their customers, while the securities industry claims they go beyond permissible dealing "and may violate the ban on underwriting".[374] The securities industry also argues that customers of dividend reinvestment plans and automatic investment plans are not protected by the "suitability requirement", and that neither Securities Investor Protection Corporation, nor Federal Deposit Insurance Corporation insurance applies.[375] Of course, the so-called "discount" brokerage firms offer customers an execution-only service with no recommendations or assurance of suitability. The witnesses representing the brokerage community before congressional committees have generally expressed no opinion about the propriety of this kind of operation.

Bank personnel are not required to demonstrate knowledge of securities laws or be registered by the NASD or SEC.[376] Standards of record-keeping, executions, and confirmations are less strict for banks. And advertising is said to be subject to less control.[377]

The voluntary investment plan, automatic investment plan, and dividend reinvestment plan have been subject to a great deal of criticism from the brokerage industry. The real fear seems to have been that this channeling of transactions through banks will lead to reduced commissions to regular brokers. But it also appears that these services are not widely available to small investors through brokers so that the banks are serving a genuine need.[378] The arguments advanced against these bank practices and in favour of legislation to prohibit them include the familiar claim that investment will be concentrated in a few favourite stocks with the others left to languish. The conflict of interest argument that has been raised in connection with trust activities of commercial banks has also been raised in connection with these three investment and reinvestment plans. It has also been argued that the handling of customer accounts in these plans is not necessarily in the best interest of the customer; the use of cash balances may not be in the customer's best interest; he may or may not get the best execution available; and there may be conflicts involving

374 *Id.* at 126-28. A wish to avoid obvious competition with brokers apparently is the source of upper limits of $1,000 per month or $3,000 per quarter usually imposed by the banks on optional additional cash payments from customers; *id.* at 19. In any case, 90% of the secondary market purchases were executed by brokers; *id.* at 28.

375 *Id.* at 109, 152, 162-63.

376 *Id.* at 110.

377 *Id.* at 111-13.

378 There is some difference of opinion here. Some say bank-sponsored dividend reinvestment plans have been very successful because brokers do not offer the same service. Merrill Lynch has argued the banks enjoy unfair competitive advantages;

those very executions when the bank has many customers to consider including its own trust department clientele. There is also the argument that the securities business, if it becomes substantial for the banks involved, may significantly increase the risk of the entire banking operation.[379] It seems unlikely that any commercial banks are anywhere near this point at the present time but some critics clearly fear that so long as banks are engaging in these securities activities it may be increasingly difficult to keep them out of underwriting and ultimately a full-scale securities business.

There seems to be some evidence that these plans are channeling savings into common stock investments[380] and that genuine cost savings are being achieved by the individual investors, particularly with respect to the reinvestments of dividends; without these plans the cost of reinvestment might be almost prohibitive. However, the total value of orders effected by banks for these services is estimated by the SEC as only 0.9% of all transactions on national stock exchanges and new equity raised is estimated at only 4.4% of new equity financing.[381] Overall, the SEC has concluded:

> "Banks dominate the DRP [dividend reinvestment plan] market and have achieved rapid growth in this area in recent years. Banks have a secondary role in the administration of ESPPS [employee stock purchase plans]; moreover, growth of this service has been relatively modest. Banks offering the AIS [automatic investment service] have declined in absolute terms from twenty banks in 1974 to eighteen banks in 1976, reflecting a lack of demand for this type of service whether offered by banks or broker-dealers. Information obtained from staff interviews with a number of bankers involved in the CTS [brokerage services for customers] suggests little or no growth of this informal service over the past two years."[382]

Table 53 shows the magnitude of the bank activities.

Banks are explicitly excluded from the definition of "broker"

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id. at 93-102. Merrill Lynch is one of only two brokerage firms offering dividend reinvestment plans; *id.* at 15.

379 *Id.* at 96, 100-04, 116-21, 241-44, 266-70, 313-16.

380 *Id.* at 5, 138. The New York Stock Exchange disputes this decision, but does not claim that comparable services are available from brokers; *see*, *Financial Institutions: Hearings before Subcomm. on Financial Institutions*, *supra* note 200, at 2085-86.

381 SEC, INITIAL REPORT, *supra* note 347, at 10. Dividend Reinvestment Plans account for almost all the new equity.

382 *Id.* at 11-12.

Table 53
Scope of Bank Brokerage-Type Plans in the United States

	Approximate number of banks currently offering service	Estimated number of individual participants	Average investment by participants per quarter	Estimated market value of transactions as percentage of all transactions on national stock exchanges	Estimated market value of new equity capital raised as percentage of all new capital raised
Dividend reinvestment plan	68	1,900,000	$ 72	0.1%	4.3%
Employee stock purchase plan [a]	59	165,403	84	0.014	0.1
Automatic investment service	18	4,543	225	0.006	N/A
Customer transaction service	4,300	[b]	[b]	0.8	N/A
Total	N/A	N/A	N/A	0.9	4.4

a. Not projected to the universe of banks; based on data compiled from 255 banks out of 261 surveyed.
b. 10,348 orders were placed through banks in the survey sample in October 1976; average order size was $11,516.
Source: Securities and Exchange Commission, *Initial Report*, p. 13, *supra* note 347.

and "dealer" in sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934 and therefore need not register as such. Section 16 of the Glass-Steagall Act permits national banks to deal in securities upon the order and for the account of customers. There appears to be substantial doubt as to the precise limits of the permissible dealing. The securities industry believes the intent of the act was to permit banks to "accommodate" regular customers. The banks, on the other hand, contend that section 16 was intended to facilitate such activities as automatic investment services.[383]

Banks have traditionally offered an agency service to customers buying or selling securities by transmitting their orders to a broker-dealer. The SEC study said of this service:

> "Customer transaction service is not, however, a formal bank service like the bank services discussed in earlier chapters [dividend reinvestment, employee stock purchase, automatic investment plans]. Indeed, with the exception of a service presently being tested by Chemical Bank, discussed below, customer transaction service is a distinctly informal service provided as an accommodation to bank customers...is rarely mentioned in bank literature, and, viewed separately, is uniformly unprofitable to the bank. Nonetheless, the responses to the Bank Study Questionnaire show that more banks offer this informal service than all of the formal bank services combined."[384]

Bank service fees ranged from $15 to $25 per transaction but may be reduced or even waived for regular banking customers. Small transactions may cost less when placed through a bank than when placed directly with a broker-dealer.[385]

In September 1976, the Chemical Bank announced that it would offer to its customers a stock brokerage service at cut-rate commissions. Customers would be able to buy and sell listed securities and most unlisted securities at commission rates well below those being charged to individual investors by major brokerage houses. Chemical would act as agent with the actual execution of orders handled by Pershing & Company,[386] a widely known execu-

383 *Id.* at 124-26. And *see*, *Financial Institutions: Hearings before Subcomm. on Financial Institutions*, *supra* note 200, at 2079-83; and *see id.* pt. 5, at 226-27, 588-91 (apps. A, B).

384 SEC, INITIAL REPORT, *supra* note 347, at 78.

385 *Id.* at 87-88.

386 Chemical Bank stressed the use of a member firm. Neff, testifying on behalf of the bank before Senator Williams' subcommittee, said that "[t]he bank will not be executing brokerage transactions or in any way usurping the traditional broker-

tion firm, able since the change in the fixed minimum commission rule in May 1976 to negotiate inter-broker transaction costs. The relationship between Pershing and Chemical was probably an "omnibus" account which means that Pershing would treat Chemical as a single customer. Customers joining the program would be charged a flat $30 annual membership fee. Each purchase or sale up to 500 shares of any price stock would carry a $35 commission. Trades beyond 500 and up to 1,000 shares would carry a $55 charge. Trades above 1,000 shares would be subject to negotiation. The saving would be greatest on higher-priced shares and the Chemical Bank service would be more expensive for small orders of low-priced shares. The fees would not include safekeeping and research.

The Securities Industry Association reacted to the Chemical Bank plan with public denunciation and apparently undertook to approach the Federal Reserve for help in stopping the new plan. At the same time SEC commissioner John Evans said that the best way for the individual investor to achieve significant discounts in execution costs is through grouping arrangements like the proposed Chemical Bank plan where the broker-dealer is guaranteed a substantial flow of small orders. He said the cost savings did not depend on individual orders being held to make up block transactions but that the guarantee of a flow of small orders was enough to achieve the low commission rate.

The combination of the Chemical Bank and Pershing & Company put executions in the hands of a member firm that had an excellent reputation for good executions at low cost and the processing and reporting in the hands of a bank that could use monthly checking account statements to report all aspects of securities transactions. Custodial services would of course be available to customers at some fee. There was at least the potential here for a very efficient brokerage service.

The plan was apparently not successful enough in attracting business to justify the political struggle it precipitated and it was dropped in February 1977. In the fall of 1977, however, Citicorp, the holding company for the First National City Bank (and the largest bank holding company in New York city) disclosed the formation of a broker-dealer affiliate. Initially this firm was to sell Citicorp securities to investors but it was apparent that a broker activity was planned.

The securities industry has steadily maintained that bank securities activities present unfair competition to broker-dealers

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dealer function"; *Brokerage and Related Commercial Bank Service: Hearings before Subcomm. on Securities*, *supra* note 369, at 217.

because the banks are subject to less strict regulation and that bank regulation does not provide adequate investor protection. In its second report to Congress on bank securities activities, in February 1977, the Securities and Exchange Commission compared the regulation of banks offering money management services with the regulation of broker-dealers.[387] Both banks and broker-dealers are subject to the anti-fraud provisions of the federal securities laws, in particular the provisions of the Securities Exchange Act of 1934. By and large these provisions deal with fraud in the purchase and sale or offering of securities and not with the offering of securities-related services. Periodic investment plans that involve the issue of new securities will be subject to the Securities Act of 1933 including its limitations on advertising and sales literature. Apart from these requirements, however, banks are free from the regulation of advertising that is imposed on broker-dealers.

The stock exchanges require that members submit advertising for approval before publication and that market letters and research reports be cleared in advance by a qualified employee of a member firm. Literature of member firms must also comply with specific standards of truthfulness and good taste established by the exchanges.[388] The NASD has its own rules applying to the publication of advertising material and market letters and requires that they be approved by a qualified supervisor in the firm and comply with substantive standards relating to their content.[389] The SEC still has not established rules for broker-dealers who are not members of an exchange or the NASD and the SEC does not review their advertising apart from the sales literature of investment companies. The SEC has said, however, that they too should comply with all of the NASD substantive guidelines.[390]

Banks are subject to very little regulation with respect to advertising their services. Regulations of the Comptroller of the Currency prevent banks from promoting collective investment funds to attract new business and the Federal Reserve Board prohibits bank holding companies from distributing advertising materials for investment company shares.[391] There is also a difference between the regulation of banks and the regulation of broker-dealers with respect to the "know your customer" or "suitability" rule. Within the broker-dealer community the rule is not

387 Securities and Exchange Commission, Second Report on Bank Securities Activities (February 3, 1977).

388 *Id.* at 13-14.

389 *Id.* at 15-17.

390 *Id.* at 18.

391 *Id.* at 20.

uniform. The stock exchanges impose an obligation on members to know their customers but have not adopted the detailed suitability requirements that are imposed by the NASD on its members (except for transactions on stock exchanges) and by the SEC on broker-dealers who are neither NASD nor stock exchange members. The NASD and SEC rules both require that the broker-dealer take pains to determine that a recommendation be suitable for a customer.[392] There is some question whether the periodic investment plans, whether sponsored by banks or by broker-dealers, involve any "recommendation". And there is certainly a question whether it makes sense to demand the suitability investigation in connection with these services. In any case, these suitability rules are not applied to banks in the operation of their periodic investment plans. The Comptroller of the Currency has expressed the opinion that the suitability requirement probably does not mean much anyway and in any event should not apply to periodic investment plans.[393]

There are some differences between the treatment of broker-dealers and banks with respect to regulation concerning the character, competence and supervision of employees handling securities-related activities. In both cases there are checks on honesty and good character. For the broker-dealers these are found in the Securities Exchange Act and the policies of the exchanges and the NASD.[394] For the banks the Federal Deposit Insurance Corporation (FDIC) prohibits the employment by an insured bank of any person who has been convicted of a criminal offence involving dishonesty or a breach of trust.[395] Broker-dealers seem to be somewhat more tightly regulated than banks in terms of responsibility for the supervision of employees engaged in securities activities. The Securities Exchange Act of 1934 spells out a responsibility to supervise; the exchanges also require that appropriate personnel be designated to exercise supervisory responsibility; and the NASD not only requires the designation of supervisory officers but also requires written supervisory procedures and specific periodic review of the work of registered representatives.[396] The Comptroller of the Currency, the Federal Reserve Board, and the FDIC all direct examiners to look generally at personnel policies, adequacy of staff, and adequacy of supervision but there appears to be nothing analogous in their regulation to the specific direc-

392 *Id.* at 27. Securities Exchange Act of 1934, rule 15b10-3. The NYSE proposed in 1977 to relax its rules but met with SEC opposition.

393 *Id.* at 34.

394 *Id.* at 37-45.

395 *Id.* at 45.

396 *Id.* at 43.

tions of the Securities Exchange Act, the stock exchanges and the NASD.[397]

On the subject of competence of employees the NASD requires that principals and representatives pass appropriate qualifying examinations; the New York Stock Exchange and American Stock Exchange require experience, training, and examinations; and the staff of the SEC is currently considering what uniform minimum standards should be established for the entire broker-dealer industry in compliance with the 1975 revision to section 15(b) of the Securities Exchange Act.[398] Banks do not appear to be subject to any specific regulation with respect to the competence of employees engaged in securities activities and the SEC has said that it does not believe that specific competency and examination standards should apply to bank officers and employees dealing with the public.[399]

The Securities Exchange Act rules on record keeping are much more specific than any banking laws or rules, but as a practical matter bank examination procedures appear to call for record keeping that the SEC would regard as adequate for securities-related activities.[400] Broker-dealers are subject to more specific rules with respect to fidelity bonding of employees than are banks, but bank employees are covered by bonding.

A broker-dealer is able to use customer cash balances to finance transactions in customer margin accounts, to finance fail-to-delivers, and to finance short sales by customers.[401] Banks may be able to hold such balances as regular deposits but can do no more with them.[402] Broker-dealers are in many instances able to pledge as security for their own borrowing securities purchased by their customers on margin. Banks, on the other hand, are not free to pledge or otherwise use customer securities.[403]

The SEC report concluded that with respect to the execution of customer orders the standards imposed by regulation on banks do not differ from the standards imposed on the broker-dealers, except that stock exchange rules prohibit broker-dealers from completing a transaction in listed securities as an in-house cross. Banks are permitted to cross orders in formal brokerage plans in accordance with customer agreements.[404]

397 *Id.* at 50.
398 *Id.* at 40-45.
399 SEC, FINAL REPORT, *supra* note 225, at 21. Other activities, including trading, however, may require such standards.
400 SEC, SECOND REPORT, *supra* note 387, at 56.
401 *Id.* at 83.
402 *Id.* at 85-86.
403 *Id.* at 88, 89-90.
404 *Id.* at 107.

Confirmations of transactions to customers by banks include brokerage commissions as part of the price per share, so that customers cannot identify the commission paid and compare it with commissions charged by brokers, whereas confirmations from broker-dealers show separately the brokerage commissions paid. Otherwise, the SEC study found no significant difference between broker-dealer confirmations and bank confirmations.[405] The SEC has urged more complete disclosure in bank confirmations so that customers can compare transaction costs.[406]

In September 1977 the commission completed proposed legislation to implement its recommendations. The legislation would not bring bank securities activities under SEC jurisdiction but would require the bank regulatory agencies to establish rules and regulations.[407]

F. CONCLUSIONS AND POLICY IMPLICATIONS

In both Canada and the United States the question of the participation of financial institutions in the securities markets is complicated by divided jurisdiction. Financial institutions and the securities industry are governed by different statutes and regulated by different agencies. In Canada the picture is further complicated by a significant division between federal and provincial regulation. In the United States, banking is substantially under federal control and so is regulation of the securities markets and the securities industry.

The Bank Act determines essentially the permissible activities of the Canadian chartered banks. The policies underlying this act are heavily influenced by the Department of Finance. The securities industry and securities markets are at present regulated under provincial statutes and by provincial securities commissions. So while the Bank Act establishes *what* banks may do with respect to securities activities, *how* they do it is left to provincial regulation. Yet even this distinction is not entirely clear, and the banks argue that the provinces do not have jurisdiction to regulate their activities. A federal regulatory commission having jurisdiction over securities markets and the securities industry might help to clarify the position of the banks and might offer some hope for a consistent position on what banks are permitted to do and how they are to do it.

Whether bank securities activities including underwriting,

405 *Id.* at 112-13.

406 SEC, FINAL REPORT, *supra* note 225, at 32-33.

407 Letter from the SEC to the Speaker of the House of Representatives (September 20, 1977).

brokerage, and dealing in bonds should come under the direct regulation of a federal securities agency or whether they should remain under the jurisdiction of the Department of Finance is another question. In the United States even the SEC has recommended that all regulation of banks remain with the bank regulatory authorities rather than with the SEC. And this recommendation was made despite evidence that the banking authorities had never been particularly interested in the kind of regulation that is appropriate to a securities business.

The trust companies present still a different case. Some are provincially incorporated and some come under federal regulation. So far no serious conflicts seem to have emerged between trust company legislation and the regulation of the securities markets and the securities industry.

A difficult policy choice, one that has appeared before in this paper, is the choice between open competition and regulation. On the one hand, substantial participation by banks in the securities industry has a good deal to offer to the efficiency of Canadian capital markets and to economic growth. Banks in Canada have been successful in underwriting, in providing a secondary bond market, and in furnishing incidental brokerage services to customers. They have both the talent and the widespread branch network that should be able to provide more efficiently than anyone else a number of securities market services. We have evidence from the United States that the participation of commercial banks in underwriting tends to make that underwriting more efficient and reduces the cost to issuers.

On the other hand, the Canadian banking industry is highly concentrated so there may be dangers in giving it free rein in the securities market. The trend in recent years in the United States has clearly been toward greater competition and a lowering of barriers that have divided the activities of different kinds of institutions. The same policy is evidenced in the proposed amendments to the Canadian Bank Act, although Canada has not gone nearly as far as the United States.

There is already, of course, a fair degree of concentration in the Canadian securities industry, particularly in underwriting, and there is a question whether the danger of concentrating underwriting in the hands of chartered banks is any greater than the danger of concentrating it in a few major investment dealers. The number of dominant underwriting investment dealers is not very different from the number of major chartered banks.

It would be much easier to reach some of these policy decisions if more information were available. In particular some information on the portfolio holdings of trust companies would be helpful.

The trust and agency accounts of these companies hold some $12 billion in Canadian equities and virtually nothing is known outside the trust companies themselves about these portfolios. There is probably no need to undertake the vast amount of reporting and data collection that has been implemented in the United States but some steps should be taken toward disclosure.

Chapter V
Institutions and Independent Individual Investors in the Stock Market

It is quite clear that in both Canada and the United States a substantial proportion of stock ownership and stock trading has shifted from independent individuals to institutions. The extent of the shift is discussed later in some detail but briefly the most recent data show individuals accounting for 49% of the value of public trading on the Toronto Stock Exchange and 31% on the New York Stock Exchange.

A. REASONS FOR CONCERN ABOUT INSTITUTIONALIZATION

The consequences of institutionalization are important and indeed critical to some basic policy choices among regulatory procedures and ways of structuring the stock market. Regulation and structure have developed over the years in the context of a stock market dominated by individual investors or, more precisely, by investors whose orders are generally for a modest number of shares. The stock exchange auction market and the fixed brokerage commission rates were devised to deal with individual trading. The regulatory system with its concern for investor protection and its allocation of functions among brokers, dealers, banks, trust companies and other financial institutions and intermediaries has evolved over the years to deal with a marketplace of individuals.

In recent years we have begun to find the regulatory system and the structure are not well suited to a market dominated by institutions. One policy course is to adapt the regulation to the market structure. Another is to reverse the institutionalization and try to restore an individual marketplace.

Canada is beginning to experience the contest between these two policies, a contest that began in the United States in the late 1960s and that is still far from over, although the final outcome is probably quite foreseeable. The controversy over fixed commission rates beginning in 1968 was the first stage of the contest. The fixed rates on the New York Stock Exchange were simply quite unreasonable for large institutional transactions. At the same

time and for the same reason a struggle broke out over admission of financial institutions to stock exchange membership that would have given them direct access to trading without paying the fixed commission rates. The stock exchange membership fought long and hard for their fixed rates and against institutional memberships, largely on the ground that it was crucial for the health of the marketplace to encourage and service the trading of individuals even if this meant rules that imposed expense and inconvenience on institutions. The commission rate dispute was resolved with the unfixing of rates charged to the public on May 1, 1975, and the unfixing of intermember rates a year later. The institutional membership issue is still unresolved.

The contest continues, in terms of market structure. The role of the market-maker – the specialist on the New York Stock Exchange and the dealer market-maker in the over-the-counter market and the third market (the U.S. over-the-counter market in listed stocks) – is a current focal point in the argument over the proper form of a national market system. The basic issue is whether the system is to be geared to the many small trades of individuals or to the large transactions of institutions. West and Tinic said in 1974: "The growth of the institutions and the concomitant decline in the relative importance of individual investors have created virtually insurmountable problems for the traditional continuous auction market."[408] They cited data from the SEC *Institutional Investor Report* as evidence that specialist participation decreases with increasing size of institutional transactions.[409] They concluded that the marketplace of the future will feature enhanced competition in the auction market and a close tie between the auction market and a dealer or even institution-to-institution market. That is, the present exchange market with its specialists will become more competitive and will be linked more closely to the third and fourth markets (the dealer market in listed stocks and the institution-to-institution market).

In Canada the Ontario Securities Commission held hearings in 1976 on the fixed commission rate structure of the Toronto Stock Exchange and heard most of the arguments that had been offered to the Securities and Exchange Commission eight years before. The Canadian institutions, however, were less inclined than

408 West & Tinic, *Institutionalization: Its Impact on the Provision of Marketability Services and the Individual Investor*, [1974] J. CONTEMPORARY BUS. 25, 30 (winter).

409 The specialist's role is discussed in *Williamson, Capital Markets*, ch. II. A recent review of the literature and report on empirical work concludes, however, that specialists could be making money on block positioning; *see* F. Reilly & J. Nielson, Specialists and Large Block Trades on the NYSE (Research Paper No. 61, College of Commerce and Industry, University of Wyoming, January 1975).

American institutions had been to press for unfixed rates (just as they had shown less interest in a third market and no interest in institutional membership). The OSC, with two dissents, decided to let the commission rates remain fixed but with a directive to the TSE to come up with an improved set of rates. A new set of fixed rates was approved in 1977.[410]

The market-making function has not yet become a burning issue in Canada, although it is a troublesome one and may call for hard choices if and when the Canada-Wide Trading System is implemented.

Legislators in both Canada and the United States are faced with controversy over the appropriate powers of financial institutions and intermediaries. In Canada revisions to the Bank Act involve questions of bank participation in securities markets and the consequences in terms of the quality of those markets in serving individuals and institutions. At the same time Ontario is still debating amendments to the Ontario Securities Act that would alter the extent of regulation over securities-related activities of financial institutions and the attractiveness of stock markets to institutions and individuals.

So it makes a great deal of difference in planning or modifying a regulatory scheme whether we accept institutionalization of the stock market and work out a system that serves institutions well or whether we try to shift stock ownership and trading back to individuals, perhaps in part by discouraging or penalizing or simply limiting institutional ownership or trading.

B. EFFECTS ON THE QUALITY OF SECONDARY STOCK MARKETS

The economic growth of the nation depends on primary financing – the flow of savings into corporation and government treasuries for investment in real productive assets. But the secondary market – the market in which owners of securities trade them back and forth – is indirectly important because it facilitates a primary market and offers some independent benefits. So we begin with an examination of the *effects* of institutional and individual trading in the secondary market, where they are most obvious, and then turn to consider the primary market.

1. *Opinion on the Effects of Institutional Trading*

One can turn to two sources of information on these effects. The first is a vast body of opinion, conjecture, hypothesis and

410 Commission rates are discussed in ch. III *supra*.

logical reasoning. The second represents empirical research and is quite small.

In 1973, a year of sharp stock market decline, a number of witnesses appeared before the United States Senate Subcommittee on Financial Markets, chaired by Senator Bentsen, to testify on the effects of institutional investment activity.[411] The witnesses could be divided essentially into two groups. One group came from the stock exchanges and from brokerage firms apprehensive about the power of institutions to either drive down commission rates or take over the brokerage function themselves, as well as from corporations whose executives were dismayed at the declining prices of their stocks and saw institutions as the villains. The other group came, of course, from the institutions.

Witness after witness reaffirmed the importance of individual participation in the securities markets. A decline in the number of individual shareholders in the United States was deplored, as was the decline in the percentage of shares owned by individuals and in the percentage of trading on the New York Stock Exchange carried on by individuals. At the same time some mention was made of the increasing dollar value of shares held and traded by individuals. It never became clear in the hearings which statistics were the most significant: dollar value of individual holdings, dollar value of individual trading, number of individual shareholders or traders, or percentage of stock ownership or trading by individuals. No specific evidence was ever presented to demonstrate the contribution made by individual ownership of stocks or trading of stocks to the quality of the securities markets.

James J. Needham, chairman of the board of the New York Stock Exchange, listed a number of benefits one might expect to flow from individual trading: the provision of breadth to trading in many stocks that are not generally purchased by institutions, liquidity that comes from many orders from individuals, and the supply of new equity capital to small and growing companies. And he stressed the advantage of widespread ownership by individual investors in reducing the danger of undue concentration of power in the hands of large institutions.[412]

Needham and others urged the apparent disadvantages of substantial institutional trading, again with almost no evidence of specific harmful effects. The third market and the growth of the regional stock exchanges were substantially due to institutional investors and these markets fragmented the primary market (the

411 *Financial Markets: Hearings before Subcomm. on Financial Markets of the Senate Comm. on Finance*, 93d Cong., 1st Sess., pts. 1, 2 and app. (July and September 1973).

412 *Id.* pt. 1, at 106–07, 127.

New York Stock Exchange) to the apparent disadvantage of individual investors.[413] He and other witnesses claimed that institutions generally acquire stock positions slowly over time but sometimes "dump" their positions in a very short period of time driving down prices to the disadvantage of individuals. A number of specific cases of apparent "dumping" by institutions were described but it was clear that in many if not all of the cases unexpected bad news had led to a rapid decline in price and there was no evidence that institutions drove the prices down further than they should have gone.[414]

The cry of the corporate executives was essentially that the stocks of their corporations were undervalued and that something should be done to force or at least induce investors to put more money into those stocks and bid the prices up.[415] There was a suggestion that institutions had conspired to ignore the stocks of less than first-rate quality. The practical consequences of depressed stock prices, it was explained, are an inability or unwillingness to raise more equity capital for growth, disappointment on the part of recipients of stock options, and attractive opportunities for foreigners to purchase U.S. corporations because they place a higher value on the stocks than do United States investors.[416]

In the course of the hearings a number of interesting suggestions were made for the encouragement of individual ownership and trading of stocks and the discouragement of institutional ownership and trading, particularly in the heavily capitalized corporations. The proposals with respect to institutions had to do with limiting stock ownership and the speed of sale of equities by institutions. (No witness suggested that there should be any limitations on the speed of purchase by an institution.) Among the proposals were a statutory limit on the percentage of stock outstanding of any one corporation that might be held by an institutional investor;[417] a limit on the fraction of the outstanding shares of any particular corporation that an institution would be permitted to sell in a thirty-day period;[418] and increased commission rates to discourage institutions from selling stock.[419] It was also suggested that an improved options market may provide opportunities for institutions to dispose of holdings with less impact on the market through the writing of covered call options.[420]

413 *Id.* at 129.
414 *Id.* at 158, 187, 225-29.
415 *Id.* at 195.
416 *Id.* at 165-67.
417 *Id.* at 6-7, 159.
418 *Id.* at 142-43, 189.
419 *Id.* at 163.
420 *Id.* at 130.

Witnesses from institutions by and large took refuge in supporting increased disclosure of institutional holdings and trading activities pointing out that they have a substantial fiduciary obligation to do the best for their beneficiaries and in some cases arguing that they were making increased efforts to invest in medium-sized if not small companies.[421]

In testimony presented before a congressional committee in 1976, Professor Roy A. Schotland offered an array of statistics on the percentage of total trading in a number of common stocks accounted for by Morgan Guaranty Trust from 1973 through 1975 and from these figures drew the conclusion that institutional trading, particularly the trading of Morgan Guaranty Trust and a few other very large trust departments, must have a significant and unfortunate effect on stock prices.[422] He offered no evidence to this effect, simply stating that "it defies belief" that the trading would not have at least significant impact and asking "can anyone doubt" that the trading of Morgan is a price-setter?[423] Schotland also argued that large institutions like Morgan are able to create their own superior investment performance records by accounting for a substantial proportion of trading in a number of stocks. He did not explain how it is possible for an institution to bid up the price of a stock beyond any reasonable value and to continue to raise it year after year in order to maintain a superior long-run performance record.[424]

Schotland did not recommend any direct limitations on trading, but he did recommend that a trust department should not be permitted to hold in the aggregate more than 5% of the outstanding shares of any single large corporation.[425]

Professor David W. Miller prepared for Morgan Guaranty Trust, in the summer of 1977, an analysis of Morgan's trading that refuted virtually all of Schotland's conclusions. Much of the testimony in the hearings referred to above was concerned with the "two-tier" market, a phenomenon much discussed in the early 1970s, particularly in 1973 when the stock market had declined but the "top tier" had held up rather well. The theory was that the top tier consisted of the favourites of institutional investors who sup-

421 *Id.* at 61-63, 81-82.

422 STAFF OF HOUSE COMM. ON BANKING, CURRENCY AND HOUSING, 94TH CONG., 1ST SESS., 1 FINE: FINANCIAL INSTITUTIONS AND THE NATION'S ECONOMY, COMPENDIUM OF PAPERS PREPARED FOR THE FINE STUDY 211-27 (1975).

423 *Id.* at 212, 214.

424 *Id.* at 219.

425 *Id.* at 221.

ported the prices of these stocks and thereby achieved superior investment performances. The lower tier consisted of stocks that did not have institutional support and therefore declined in price.[426] The theory appealed chiefly to those who saw something diabolical in institutional concentration of investments. With the decline of even the top tier in 1974 and the recovery of many lower tier stocks in 1975 and 1976 the theory was temporarily shelved. And some evidence has been brought forward to show that there have always been "favourites" with changes from time to time in the stocks included in this category.[427]

An interesting variation on the two-tier theory was published in 1975. Frank Reilly suggested that a marketability need, rather than performance manipulation, will inevitably lead institutions to favour a narrow list of stocks.[428] He suggested that of some 9,500 corporations in the United States with publicly traded stock, fewer than 400 have a market value of $400 million and therefore offer the marketability needed by an institution with $1 billion or more to invest in equities (as is the case for the top seventy or so institutional investors). A middle tier, consisting of corporations with a market value from $200 to $400 million, would offer sufficient marketability for most institutions and large individual investors. Reilly estimated that this tier would include about 300 stocks. The bottom tier, then, would contain some 8,800 stocks.

The argument based on marketability is certainly more plausible than one based on performance strategies but there is evidence that casts some doubt on it. In responding to a questionnaire from the Senate Finance Committee in 1976 some of the twenty-nine largest bank trust departments in the United States described investments in companies in Reilly's middle and bottom tier. Morgan Guaranty Trust, which manages over $9 billion of common stocks in employee benefit funds alone, reported a special situation-equities commingled fund with half a billion dollars invested in the stocks of 190 companies with capitalizations below $100 million. A second commingled fund had another half billion dollars invested in 117 companies with capitalizations between $100 million and $500 million.[429] First National City Bank, with

426 The Miller analysis was transmitted to Senator Lloyd Bentsen, chairman of the Subcommittee on Private Pension Plans and Employee Fringe Benefits, of the Senate Finance Committee, by Harrison V. Smith of Morgan Guaranty Trust on August 4, 1977.

427 Blume, *Two Tiers - But How Many Decisions?*, 2 J. PORTFOLIO MANAGEMENT 5 (Spring 1976).

428 Reilly, *A Three-Tier Stock Market and Corporate Finance*, 4 FINANCIAL MANAGEMENT 7 (Autumn 1975).

429 SUBCOMM. ON FINANCIAL MARKETS, *supra* note 230, at 6.

over $4 billion in equities in employee benefit funds, also reported two commingled funds, one with half a billion dollars apparently aimed at medium-sized and large companies and a smaller fund directed to small, expanding companies.[430] Harris Trust and Savings (over $1 billion in employee benefit fund common stocks) also reported a collective fund with $103 million invested in seventy small companies,[431] and Crocker National (over $900 million in employee benefit fund equities) referred to investments in companies with market capitalizations as low as $25 million.[432]

All of this does not disprove the likelihood that there will be continued institutional *preferences* following Reilly's logic. But it does seem clear that the largest institutions can accommodate substantial holdings of middle and lower tier stocks. Indeed, many of the responses to the questionnaire indicated increasing diversification in common stock holdings and one might argue that the largest institutional investors are in the best position to assemble thoroughly diversified portfolios of small and relatively high risk companies. And as we shall see, this ability may be important to the primary financing of these companies.

In Canada, too, it has been argued that there is a two-tier market and we do have some evidence of the extent to which institutions, in contrast to individuals, concentrate their trading in "top traded" stocks. The Toronto Stock Exchange has reported as part of the findings of the Revenue and Market Analysis Study (RAMA) that for the quarter April–June 1976 institutions accounted for 43.9% of the dollar value of all trading on the exchange and 55.3% of trading in the "top traders".[433] (The "top traders" were the one hundred stocks most traded in 1974. By 1976 this list had declined to about ninety-five stocks.) However, as of the end of 1975 this set of stocks accounted for 66% of the market value of Canadian stocks on the TSE ($34.0 billion of $51.7 billion),[434] and in 1975 trading in these stocks constituted 66% of total trading in Canadian stocks on the exchange ($2.60 billion of $3.96 billion).[435] So it appears that at least for 1975 trading in the "top traders" was proportional to market value outstanding and small and medium-sized companies do not appear to have been neglected in the secondary market.

430 *Id.* at 10, 11.

431 *Id.* at 27.

432 *Id.* at 46.

433 Toronto Stock Exchange, *RAMA Results for the April–June 1976 Quarter*, Notice to Members No. 1387 (October 21, 1976).

434 The numbers were computed from a list of values for 1975 of all TSE stocks. The values of all U.S. stocks were eliminated from the total.

435 The numbers were computed from a list of trading values for 1975 of all TSE stocks. Trading in U.S. stocks was eliminated from the total.

Table 54
Distribution of Equity Agency Trading between Top Traded Stocks and Other Stocks on the Toronto Stock Exchange

April–June 1976

	Institutions	Individuals	Inter-mediaries	Total
Number of orders				
Top traded stocks	6.01%	17.27%	1.26%	24.54%
Other stocks	8.84	61.30	5.32	75.46
Dollar value				
Top traded stocks	25.69	18.26	2.52	46.47
Other stocks	18.19	31.33	4.01	53.53
Number of shares				
Top traded stocks	7.99	7.07	0.87	15.93
Other stocks	11.66	64.09	8.32	84.07
Commissions				
Top traded stocks	18.29	19.98	1.58	39.85
Other stocks	15.49	41.84	2.82	60.15

Source: Toronto Stock Exchange, *RAMA Study*, Notice to Members No. 1387, table 6, October 21, 1976.

2. *Empirical Testing*

A number of empirical studies have explored the impact of institutional trading on the quality of the stock market.[436] One of the first was a part of the *Institutional Investor Report* by the SEC published in 1971, two years before the hearings discussed above. In its overall conclusions, the SEC reported:

> "The preponderance of data collected by the Study on monthly net institutional trade imbalances, on institutional position changes, on block trades and on day-to-day price changes analyzed in Chapters X, XI, XII indicate that institutional trading in the aggregate is related to or coincident with relatively few of the large price changes that occur in the securities market....Other analyses of random large position changes by institutions indicate that, even on an inter-day basis, institutional trading appeared to offset price movements about as frequently as it appeared to contribute to them. Furthermore, from the data on market-makers it appears that during stock months in which institutions were more active, large close-to-close price changes were less frequent....Thus, the Study has not discovered any basis in terms of price stability for imposing generalized limitations on the volume of institutional trading or on the size of institutional transactions."[437]

In 1977 Frank Reilly reported empirical testing using the SEC statistics for stock transactions of major financial institutions annually for 1962 to 1974 and quarterly for 1964 to 1975. He found no evidence of a strong positive relationship between institutional trading and stock price volatility.[438] Other research has found a *negative* relation between block trading (characteristic of institutions) and price volatility.[439]

There have been studies specifically of mutual fund investment behaviour reporting the effects on the market of trading by the funds. In 1970 Friend, Blume and Crockett reported their research on mutual fund investment performance and the appar-

436 The Quebec Securities Commission Task Force cited a number of articles in reaching its conclusion that there is no proof that the leading role played by institutions in European markets has reduced their efficiency; QSC TASK FORCE, *supra* note 144, at 19-20.

437 INSTITUTIONAL INVESTOR REPORT, Summary Volume, at xxi.

438 Reilly, *Institutions on Trial: Not Guilty!*, 3 J. PORTFOLIO MANAGEMENT 5 (winter 1977).

439 Grier & Albin, *Nonrandom Price Charges in Association with Trading Large Blocks*, 46 J. BUS. 425 (July 1973); and F. Reilly, Block Trades and Stock Price Volatility (October 1975) (Faculty Working Paper No. 279, University of Illinois).

ent impact of mutual fund purchases and sales on the stock market.[440] They found that in the late 1950s through most of the 1960s stock buying by mutual funds did seem to accompany a substantial price rise in the stocks purchased, while price declines accompanied stock sales. This pattern could have been due to the ability of mutual fund managers to correctly predict stock price movements and to make use of their predictions or it could have been due simply to the effect on prices of substantial institutional purchases and sales. The authors had already uncovered evidence casting suspicion on the ability of managers to profit from evaluations of common stocks any more than anyone else. And some features of the price performance, notably the recovery of stock prices after a decline that accompanied mutual fund sales, suggested that it was the trading rather than the correct prediction of the market that accounted for the results observed. Overall, however, these three authors were unable to conclude that institutional trading had any significant impact on the efficiency of the stock market.

John Evans reported in a 1975 paper his analysis of the impact of mutual fund trading on the Canadian stock market.[441] He concluded that mutual fund trading over the period from 1965 to 1971 did exert substantial price pressure on the stocks of small companies (those with fewer than ten million shares outstanding). Substantial buying by mutual funds appeared to push up stock prices which subsequently declined as the mutual fund buying slowed or ceased. Selling by mutual funds appeared to push down stock prices and these prices tended not to recover subsequently. Evans attributed this price behaviour to a two-tier market effect with mutual funds simply disposing of their holdings in some small companies and leaving the stocks to languish in a non-institutional market.

An analysis of mutual funds in Spain concluded that funds had increased the efficiency of the Spanish stock market. Mutual funds are the only financial institutions participating in the Spanish stock market and during the period preceding 1966, when funds began operating, the market was noticeably less efficient than in the post-1966 period.[442] It seems likely, however, that it was not the trading activities of the funds but their demands for hitherto unavailable corporate information that led to a better market. This conclusion is not to deprecate the usefulness of insti-

440 I. Friend, M. Blume & J. Crockett, Mutual Funds and Other Institutional Investors: A New Perspective (1970).

441 J. Evans, Mutual Fund Trading and the Efficiency of Canadian Equity Markets (1975) (Working Paper No. 214, Faculty of Commerce and Business Administration, University of British Columbia).

442 Palacios, *The Stock Market in Spain: Tests of Efficiency and Capital Market Theory*.

tutional participation in the market; it means that institutional investors can contribute to market quality by forcing better disclosure than individual investors are able to obtain.

There have been a few studies of the effects of large transactions – the kind one would expect for institutions – on stock prices. If there is an impact on the price of a stock, it could be due to price pressure or to information. That is, it may take a price reduction to sell a large block or one may have to pay a premium to buy a large one, or the person initiating a large trade may have inside information and the price adjustment accompanying the trade will simply reflect the information. Some of these studies were reviewed in a paper by Reilly and Drzycimski in 1975.[443]

In a study of the effects of 7,000 block trades (over $1 million each) on the New York Stock Exchange in 1968 and 1969, Kraus and Stoll concluded that for block trades initiated by buyers there were upward adjustments of price due to information and a true increase in the value of the stock.[444] They concluded, however, that most block trades are originated by sellers and that these showed some price pressure effects.[445] Prices would be depressed by the sale, but would recover, usually by about the magnitude of one commission, by the end of the day. They also found that block trades did not lead to increased price volatility. Indeed, another study concluded that block trades reduced price variability.[446]

Analysis has also been carried out on parallel trading by institutions – trading in which several institutions are simultaneously buying or selling. Presumably parallel trading can be significant only if there are individuals on the other side of the transaction – to buy when institutions are selling and to sell when institutions are buying. Parallel trading conflicts with the concept of a tiered market with institutions operating in one tier and individuals in another. Kraus and Stoll, using data gathered for the SEC *Institutional Investor Report* for 1968–69, found that institutions tend to be active in the same stock at the same time but not necessarily on the same side.[447] Banks and investment companies showed evidence of parallel trading in heavily traded NYSE stocks but the two kinds of institution were generally on opposite sides of the market. Bank trust departments were buying

443 F. Reilly & E. Drzycimski, Institutional Trading and Stock Price Volatility (January 1975) (Research Paper No. 60, College of Commerce and Industry, University of Wyoming).

444 Kraus & Stoll, *Price Impacts of Block Trading on the New York Stock Exchange*, 27 J. FIN. 569 (June 1972).

445 1,199 trades were classified as seller initiated and 366 as buyer initiated.

446 Grier & Albin, *supra* note 439.

447 Kraus & Stoll, *Parallel Trading by Institutional Investors*, 7 J. FIN. & QUANTITATIVE ANALYSIS 2107 (December 1972).

when investment companies were selling and vice versa. On the whole institutions tended to offset each other's trading more than one would expect from pure chance. There were, of course, instances of parallel trading and an imbalance of institutional supply and demand which led to price pressure effects.[448]

An interesting analysis of the effect of large trades in the Canadian stock market was reported in 1975. Nicholas Close used data on secondary offerings and transactions large enough to qualify for volume discounts on brokerage on the Toronto and Montreal Stock Exchanges in 1970 and 1971. He was able to classify accurately the trades as buyer or seller initiated because the classification was noted on the volume discount reports from brokers.[449] The data covered 1,541 buyer-initiated and 1,092 seller-initiated transactions. The price effect of the buys was described as:

> "For buys, days −15 to −1 (the 15 days preceding the trade) indicate that prices preceding block purchases tend to be slightly higher than at any other time in this first period immediately before the block. Days 0 to +4 – the five-day period of actual trading – feature rapid price appreciation of about 1.8 percent, most of which occurs on day 0. From +4 to +15 the index does not drop, indicating that the price changes associated with block purchases are "permanent" in nature, supporting the information effect explanation.
>
> "For sales, the most striking feature is the lack of any impact. Prices are relatively strong from day −15 to −1. Then there is a drop of about 0.5 percent during days 0 and +1. After a seven-day period of no movement, prices tend to recover and by day +15 they are slightly higher than on day −1. These results best support the substitution hypothesis, which predicts little or no impact."[450]

Price impact was found not to be related to the value of a trade which tends to refute a hypothesis of price pressure effects. Perhaps of more interest in the Canadian context where the volume discount is available for aggregate trades over five consecutive trading days, the price impact of sells (which we have seen was virtually non-existent on average) did not differ as the trade was spread over one to five days. But for buys, spreading the trade over

448 Specifically, parallel buying in a $50 stock that produces a $5 million excess of institutional purchases over sales in a month could be expected to bring about a 75¢ increase in the stock price that month with a 53¢ reversal the next month.

449 Close, *Price Reaction to Large Transactions in the Canadian Equity Markets*, 31 FIN. ANALYSTS J. 50 (November-December 1975).

450 *Id.* at 51, 53.

several days did drive up the price temporarily – there was a price pressure effect.

Some further interesting results came from separating the trades in stocks with a high institutional following from those with a low institutional following. For the former (the top ten) there was almost no price impact for buys and for sales a steady price decrease up to and including the trade days, steadying at day +8 at about a 2% discount.

For the stocks with a low institutional following (the bottom fifty), the buys showed a substantial and mostly lasting price increase suggesting information effects. The sells were *also* associated with a permanent price increase of about 6%. Close's explanation is that a price increase triggers block sales and that the sales simply halt the increase. In any case, there seems to be little in the way of price pressure effects, for buys or sells, for institutional or non-institutional stocks.

Further tests of the impact of institutional trading have considered correlation between volatility of stock prices and institutional activity. Reilly and Drzycimski found an increase in volatility from 1965–67 to 1970–73, a period of increasing institutional share of trading.[451] But they also analyzed the variability in a number of economic variables and concluded that "several of these could explain the increase in stock price volatility distinct from any increase caused by institutional trading".[452]

3. *Comparison of Institutional and Individual Trading*

There have been very few studies of individual investor behaviour, largely because it is so difficult to obtain data on individual holdings and trading. One particularly interesting study on the relative merits of institutional and individual trading took the form of a test involving New York listed stocks, of the Capital Asset Pricing Model. A brief description of the model is necessary before reporting the results of the research. According to the model, in an efficient stock market investors will anticipate a rate of return on a particular stock that is proportional to its "market risk" but independent of its "unique risk". The perceived total risk in a stock is thought of as consisting of these two components. The market risk simply reflects the fact that all stocks move more or less with the stock market; some respond sharply to market moves and have a high market risk; others respond less and have a low market risk. But the movement of the

451 F. Reilly & E. Drzycimski, *supra* note 443.
452 *Id.* at 20.

market as a whole does not explain all of the movement in individual stock prices; so each stock has its own unique risk. An investor can anticipate that a stock will move to some extent with the market and he can estimate the market risk. He can also anticipate that there will be independent movement in the price of the stock arising from factors affecting that stock uniquely. And he can make an estimate of the unique risk. The capital asset pricing model assumes that an investor will take risks only if he expects to be paid for them. Hence the greater the expected risk, the greater the expected return the investor will demand when he purchases a stock. But the model also assumes that investors are capable of putting together fully diversified portfolios. And in a fully diversified portfolio the unique risks of individual stocks will cancel out. So for an investor who holds a fully diversified portfolio, the only risk that matters is the market risk. The prices of securities should be such that they offer an expected rate of return that is just proportional to market risk. For an investor whose portfolio is *not* fully diversified, the unique risk in the stocks he owns will *not* be diversified away and he will hope to be compensated for this risk in the expected rate of return on his stocks. If all the investors in a market have poorly diversified portfolios, one would expect securities to be priced in such a way that the expected return on a stock will be proportional to the total risk in that stock, the market risk plus the unique risk.

Now if it turns out that institutional investors tend to hold fully diversified portfolios while individual investors tend to hold poorly diversified portfolios and if there is a class of stocks that might be called "institutional" and another class of stocks that are predominantly held by individuals, then one might anticipate that the institutional stocks will be priced in such a way that their expected return is proportional to their market risk, while the non-institutional stocks will be priced in such a way that their expected return is proportional to their total risk.

Barnea and Logue tested this hypothesis for New York Stock Exchange stocks over the period July 1966 through June 1971.[453] The data used were for 160 stocks, fifty of which were treated as institutional stocks because institutions held anywhere from 20% to 50% of total shares outstanding. The remaining 110 stocks were regarded as non-institutional. Correlations between return and market and unique risk verified the hypothesis put forward above. For the institutional stocks expected return was apparently proportional to market risk, while for the non-institutional stocks

453 A. Barnea & D. Logue, Diversification Costs and Market Equilibrium (unpublished paper, 1975).

expected return was proportional to the sum of market and unique risk. The implications of these results are quite important because they mean that the cost of equity to corporations that are held by institutions is lower than the cost to corporations that are not held by institutions. And this result has nothing to do with the possibility that institutions are deliberately bidding up the prices of their favourites in order to achieve superior performance. It simply has to do with the likelihood that institutions achieve fully diversified portfolios, while individual investors do not.

There does not appear to have been any directly corresponding research on the stock market in Canada. Two authors who examined stocks listed on the Toronto Stock Exchange over the period from 1959 to 1971 concluded that expected returns for the stocks were not proportional to market risk and were presumably dependent on the sum of market and unique risk. However, they made no attempt to distinguish between institutional and non-institutional stocks.[454]

C. EFFECTS ON THE QUALITY OF THE PRIMARY STOCK MARKET

So far as economic activity is concerned the primary securities markets, rather than secondary markets, are what matter. It is by way of primary markets that new capital is supplied to business and government for investment in real, productive assets.

It is generally assumed that the quality of primary markets – the success with which governments and businesses can raise capital at reasonable cost – is closely related to the quality of secondary markets, although there appears to be no empirical research on this point. At the least the secondary market serves to price securities, and we have seen that there is evidence that stocks held by institutions are priced to offer a lower rate of return than stocks not held by institutions.

Much of the alarm expressed over the institutionalization of the secondary market has concerned the concentration of institutional investment in the largest companies. A number of the submissions to the Ontario Securities Commission in the summer of 1976 on the subject of fixed minimum brokerage rates commented that the existence of active secondary markets in a company's stock is critical in enabling that company to raise new equity capital and that institutions are generally not interested in the stock of small and medium-sized companies. Against this we have seen evidence that some very large bank trust departments in the

454 Findlay & Danan, *A Free Lunch on the Toronto Stock Exchange*, 6 J. BUS. ADMIN. 31 (spring 1975).

United States have formed pooled funds to invest in small and medium-sized companies.

D. THE EXTENT OF INSTITUTIONALIZATION

The submissions to the Ontario Securities Commission in the summer of 1976 on the subject of fixed minimum commission rates reflected sharp disagreement over the extent to which the Canadian equity market has actually been institutionalized. The Montreal Stock Exchange, in a report by P. Lortie, presented statistics suggesting extraordinary concentration of equity ownership and trading by Canadian institutions, particularly a few Canadian trust companies.[455] Many of the other submissions accepted the statistics presented in this report and argued from them, generally expressing great concern over institutional concentration. Some submissions, however, challenged the Lortie statistics, arguing that the threat is not nearly as great as he suggested.[456] The *Quebec Securities Commission Task Force Report* also disagreed with Lortie.[457] It is extraordinarily difficult to calculate the percentage ownership by different kinds of investors of the equities *available for trading* in the Canadian marketplace. It is a good deal easier to identify the proportion of the trading itself that is conducted by different classes of investors. Table 55 compares institutional and individual stock trading in the United States[458] and Canada.[459] The table indicates that so far as equity trading is concerned individuals play a much greater role in the Canadian listed stock market than they do in the United States listed stock market. Table 56 shows some institutionalization of the Canadian market over time but also a leveling off of this trend. (The same leveling off has been observed for the New York Stock Exchange.)

Trust companies constitute a special case. The submissions to the OSC, especially those of the stock exchanges, stressed the extraordinary concentration of stock ownership and trading in Canadian trust companies. This concentration was cited as a factor differentiating Canadian from United States securities markets and suggesting special dangers to Canadian markets should trust

455 P. Lortie, The Case for Fixed Commission Rates in Canada, (April 1975) (report prepared for the Montreal Stock Exchange). This report was prepared in response to a request by the Quebec Securities Commission for justification of fixed rates.

456 *See* especially The Royal Trust Co., Comments by The Royal Trust Co. on a Brief by the Montreal Stock Exchange entitled, The Case for Fixed Commission Rates in Canada (March, 1976).

457 QUEBEC SECURITIES COMMISSION TASK FORCE, *supra* note 144, at 21-23.

458 NEW YORK STOCK EXCHANGE, PUBLIC TRANSACTION STUDY, 1976 (January 1977).

459 Toronto Stock Exchange, *RAMA Study Reports on 12 Months of Agency Trading*, Notice to Members No. 1370 (August 17, 1976).

Table 55
Institutional and Individual Stock Trading, the United States (NYSE Members) and Canada (TSE Members)

1976

	Individuals	Institutions	Inter-mediaries[a]	Members
All trading in the U.S.[b]				
Volume in shares	33%	45%		22%
Value of shares traded	23	55		22
Public trading in the U.S.[b]				
Volume in shares	43	57		
Value of shares traded	30	70		
Canada[c]				
Volume in orders	77	14	8	
Volume in shares	70	20	10	
Value of shares traded	49	43	8	

a. Intermediaries are securities firms other than member firms.
b. First quarter, 1976.
c. 12 months to March 31, 1976.
Source: *See* notes 458 and 459 *supra*.

Table 56
Agency Business Completed by Toronto Stock Exchange Members, Based on Value of Trading

1965–75

	Individuals	Institutions	Intermediaries
1965	54.6%	27.3%	18.1%
1968	54.1	33.5	12.4
1970	45.9	41.3	12.8
1975	47.3	43.9	8.8

Source: Toronto Stock Exchange, Notice to Members No. 1344, April 14, 1976.

companies be free to use their full strength in bargaining over commission rates.

The Toronto Stock Exchange *RAMA Study* reporting trading over the twelve months ending in March 1976 showed trust companies accounting for 12% of all TSE trading.[460] The 1975 *Report of the Registrar of Loan and Trust Corporations for the Province of Ontario* showed trust company estate, trust and agency holdings of common stocks at $12,104 million as of the end of 1975.[461] On the same date the value of all Canadian stocks listed on the TSE was $51,566 million. Trading on the TSE in 1975 was about 70% of trading on all exchanges in Canada and if we assume that TSE listings were worth at least 70% of total listings, then trust company stock holdings were at least 16% of total listed stocks.[462] We can at least say they were between 16% and 23%.[463]

In the U.S., 1974 statistics for bank trust departments show them holding about 21% of all common and preferred stock in trust and agency accounts.[464] So in the aggregate, concentration of holdings in trust departments does not seem very different as between the two countries.

Canadian trust company holdings are quite concentrated in a few companies. Royal Trust, with $5,541 million in stocks at the end of 1974, held 46% of all trust company stock holdings. The top five trust companies, in stock holdings, held 86% of all trust company holdings.[465] In the United States, Morgan Guaranty Trust held 5% of all bank trust assets and the top five banks in trust assets held 21%.[466] But there are 4,000 banks reporting trust assets in the United States and only thirty-eight trust companies reporting to the Ontario Registrar.

Some of the submissions to the OSC expressed the opinion that it is inevitable that independent investors will gradually abandon the stock market to institutions. And representatives of the secur-

460 Toronto Stock Exchange, *RAMA Study Reports on 12 Months of Agency Trading*, Notice to Members No. 1370 (August 17, 1976). The report covering April-June 1976, TSE, Notice to Members No. 1387 (October 21, 1976), showed 12.5% of trading accounted for by trust companies.

461 REPORT OF THE REGISTRAR OF LOAN AND TRUST CORPORATIONS FOR THE PROVINCE OF ONTARIO, 1975, at 96 (1975).

462 $(12{,}104/51{,}566) \times 70\% = 16\%$.

463 $12{,}104/51{,}566 = 23\%$.

464 Trust assets of commercial banks at year end 1974 included $171,348 million in common and preferred stocks; FEDERAL DEPOSIT INSURANCE CORPORATION, TRUST ASSETS OF INSURED COMMERCIAL BANKS - 1974 (Washington, D.C. 1975). Salomon Brothers estimated total common and preferred stocks outstanding at that date of $810,000 million; SALOMON BROTHERS, SUPPLY AND DEMAND FOR CREDIT IN 1976 (1977) (both figures are market values.)

465 REPORT OF THE REGISTRAR OF LOAN AND TRUST CORPORATIONS, *supra* note 461, at 96.

466 FDIC REPORT, *supra* note 464.

ities industry itself commented that for many individuals it makes more sense to purchase equities through a mutual fund than to purchase them independently through a broker. (Most of the theoretical literature supports this position simply because the diversification opportunities are so much greater in mutual funds than they are in an individual portfolio.) Some of the submissions indicated an expectation that a reduction in commission rates charged to independent investors or at least a reduction in the gap between the commission rates paid by institutions (on large trades) and those paid by independent investors would encourage the latter to trade more or to refrain from turning their savings over to institutions.[467] On the other hand, some of the submissions indicated that the level of commission rates probably has very little to do with the amount of trading done by individual investors.[468] Several submissions, including some supporting the existing fixed commission rate structure, accepted the proposition that under the existing system institutional trading was subsidizing the trading of independent investors.[469] At least one institution[470] stated that it was perfectly willing to pay the subsidy in order to obtain the benefits of the contribution of the independent investor to market liquidity.

Many of the submissions stressed the importance of services apart from low commission rates to independent investors. Many felt that providing research to independent investors has much to do with encouraging them to trade. Others felt that the number of registered representatives employed by brokerages in the aggregate has a lot to do with the extent of independent investor trading. These conclusions were generally part of an argument for a commission structure that tends to lead to large quantities of brokerage research and the employment of large numbers of registered representatives.

Almost all of the submissions predicted that abandoning fixed commission rates would lead to significant reductions in commission rates for institutions and very little reduction, if any, for independent investors. Some regarded this result as quite appropriate on the grounds that institutions were currently subsidizing independent investors. Others regarded it as entirely inappropri-

467 Several submissions called for lower commission rates and some said that reduced rates would lead to more trading by both individuals and institutions; *see e.g.* Lindsay, McKelvey & Co. Limited, submission to the OSC (May 1976). International Trust Co., submission to the OSC (April 30, 1976), predicted little increased institutional trading if rates were lowered but some increase in trading by individuals.

468 *See e.g.* Canada Permanent Trust Co., brief to the OSC (June 18, 1976).

469 *See e.g.* Vancouver Stock Exchange, brief to the OSC (June 1976); Toronto Stock Exchange, brief to the OSC (June 18, 1976).

470 *See* Manufacturers Life Insurance Co., brief to the OSC (June 28, 1976).

ate because of a perceived need for greater and not lesser participation by independent investors in the marketplace. It is interesting that none of the submissions considered the possibility that freely negotiated commissions might lead to arrangements providing for significantly reduced rates to independent investors. And yet precisely this result is reflected in the discount broker services available in 1977 in the United States.

The New York Stock Exchange in 1972 undertook some research on the importance of commission rates to individual stock investors.[471] In general, investors did not think an increase in rates would reduce their trading. Most did not even know what the rates were; many overestimated the rates; and a large majority had no quarrel with the rates.

In a series of United States hearings in 1976 the New York Stock Exchange contended that the pooling of small orders by commercial banks offering some type of brokerage service would further increase the percentage of volume in large orders and diminish the number of individual small orders which are necessary to provide depth and liquidity. The exchange added the comment that savings in commissions to individual investors brought about by this pooling will drain brokerage revenues from the securities firms that maintain the mechanism and regulation of the auction market.[472]

The rules of the Toronto Stock Exchange deny the benefits of quantity discounts to independent investment counsel who are able to pool transactions for a number of clients, and seem clearly aimed at denying reduced commission rates to investors who have chosen to remain independent. It is interesting that the Ontario Securities Commission endorsed the rule in question on the grounds that if independent investment counsel were able to pool the orders of their clients this might lead to excessive trading by those clients.[473] All of these rules seem to contradict most of the reasoning in the submissions supporting the need for greater independent investor trading.

We are left with conflicting opinions as to the effect of commission rates on individual trading. Those defending fixed rates have argued that high rates do not discourage trading and that there is no need to bring rates down. But then they have argued that competitive rates will draw business to the discounters and

471 A report on the results appears in *Financial Markets: Hearings before Subcomm. on Financial Markets*, *supra* note 41, pt. 1, at 121-22 (July 24-26, 1973).

472 *Financial Institutions: Hearings before Subcomm. on Financial Institutions*, *supra* note 200, pt. 3, at 2084 (December 1975, January 1976).

473 *In re* the Securities Act and the Toronto Stock Exchange and Fiscal Consultants Limited, [1974] OSC Bull. 139 (June).

away from firms offering traditional services. Implicit in this argument is a claim that the services are more valuable than commission savings but that individuals do not realize this.

It is hard to avoid the conclusion that only a free market, one in which brokers can compete freely on a price and service basis, will show what customers really want and what they are willing to pay. In such a market it may become evident that independent individual investors are not willing to pay what brokers must charge to stay in business or it may be that some brokers at least can offer very attractive rates to individuals and still operate profitably. They seem to be able to do so in the United States in 1978.

E. INSTITUTIONAL CONTROL OVER PORTFOLIO COMPANIES

Institutional control is an issue that has been of considerable concern to the United States Congress, as we have seen in connection with bank trust department holdings.[474] It has not been of as much concern in Canada, probably because almost nothing is known about trust company holdings. Other institutions do not seem to interfere much with the companies they hold.[475]

The argument has been advanced in Britain that institutions *should* play an active role. Dobbins and McRae reported that in the United Kingdom institutional investors own 45% of the common stock in quoted companies, and estimated that they will own 50% by 1977.[476] These two authors complained of unwillingness on the part of the institutions to act collectively in the use of their voting strength to influence corporate management. The British institutions appeared to behave much like the American institutions, occasionally exerting some private influence on management but generally simply selling their shares in cases of dissatisfaction. Dobbins and McRae predicted that there would be a change and a consequent improvement in the performance of British companies.

Four kinds of institutional shareholders – insurance companies, pension funds, investment trust companies, and unit trusts – all have their own associations and in 1973 these associations formed the Institutional Shareholders' Committee with the objective of improving the efficiency of industrial and commercial

474 *See* ch. IV *supra*.

475 PORTER REPORT at 194 expressed the opinion that trust companies exert no dangerous influence over portfolio companies.

476 R. DOBBINS & T. MCRAE, INSTITUTIONAL SHAREHOLDERS AND CORPORATE MANAGEMENT (MCB Monograph 1975). And *see* Dobbins, *The Institutional Shareholder*, 2 MANAGERIAL FINANCE 341 (1976).

companies in Britain. The committee was formed with the support of the Bank of England and apparently the purpose was the concerted and effective use of voting power.

While Dobbins and McRae would like to see increasing institutional participation, they do point out that the interests of small shareholders may suffer and that some devices, perhaps the two-tier structure in use in some European countries, may be necessary to preserve true shareholder democracy. They say that the direct intervention by financial institutions in the decision-making processes of industrial organizations is commonplace in Europe. In Germany and France banks in particular have substantial equity holdings in individual companies and are the main source of external financing. While British banks are the main source of external finance for British industrial and commercial companies, they have simply not undertaken to influence company management as have German banks.

F. CONCLUSIONS AND POLICY IMPLICATIONS

A first policy choice for securities legislation or the rules of a regulatory commission has to do with the relative importance of institutions and individual investors. There is a widespread belief that institutional ownership of equities and trading should be restrained and that we should try to entice individuals back into the marketplace. But there appears to be little evidence to favour the contribution of individual trading over that of institutional trading. We have seen in chapter I the importance of institutional holdings of common stocks in Canada. If the institutionalization of portfolio holdings is inevitable, then it may be very damaging to the Canadian economy to attempt a regulatory structure that discourages institutions from buying common stocks.

But the argument remains that institutions favour the stocks of the large, well capitalized companies and that the small and medium-sized companies will not obtain the capital they need in a market dominated by institutions.

The economic case for the small and medium-sized companies has really never been carefully established. Whether the economy benefits more from a dollar of capital invested in a small company than from a dollar invested in a large company is still an open question. But there is such widespread opinion that noneconomic, social factors demand the encouragement of small business that perhaps we can ignore the purely economic question.

Next, there is the question whether small business is at a disadvantage in raising capital because of the structure of the capital marketplace. Many suppliers of capital to small business

claim that there is plenty of capital available but that few small businesses can justify an investment. Essentially, this amounts to a claim that investors, on the one hand, and small business owners, on the other hand, can rarely agree on the terms for financing. The investors, perceiving a high risk in a small business, demand a high expected rate of return and hence a low purchase price for stock. The owners, less impressed with the risk and more optimistic about success demand a high price. In a free market some bargains are struck but many businesses go unfinanced. No deficiency in the market structure, however, stands in the way of financing. There is simply a conflict among judgments and a failure to agree on financing terms.

But we have seen that there are three features of the marketplace that seem to put small companies at a disadvantage. One is the fact that an investor with a well diversified portfolio will find a small company less risky (or perhaps it would be more accurate to say less objectionable on the grounds of risk) than will an investor with a poorly diversified portfolio. Second, the indications are that institutions generally have well diversified portfolios, while individual investors tend to have poorly diversified portfolios. The result is that companies that rely on individuals to buy their stock have a higher cost of capital than those that can sell stock to institutions. Finally, we saw that institutions, for good reason, favour stocks that are marketable – stocks for which there is an active secondary market.

All of this suggests two avenues to reducing the cost and increasing the quantity of financing for small business. One would encourage individual investors to form well diversified portfolios; the other would enhance the marketability of stocks of small companies.

The first might mean bringing down transaction costs to the point where an investor with modest assets is able to spread those assets over a large number of stocks as cheaply as he can invest them in only a few stocks. This might be done by deliberately subsidizing the trading of individual investors. The second might mean easier stock exchange listings for small companies, bringing onto the exchange companies that do not qualify at present.

It is also possible that even for institutions with fully diversified portfolios unique risk is still a matter of concern. Institutions subject to a "prudent man" rule, if that rule is interpreted as requiring that each stock be evaluated on the basis of its total risk, may fear turning to what has hitherto been the non-institutional set of stocks. A change in standards of prudence reflecting the increased tolerance for unique risk in a stock that goes with diversification of a portfolio may be called for.

Whatever the policy choice, it is very difficult to make a case for discouraging institutional investment in stocks. And encouragement of individual investment is only one way and not necessarily the best to deal with structural obstacles to small company financing.

Appendix

This appendix reproduces the text of Chapter II from the Quebec Securities Commission Task Force Study of June, 1976: *Commission Rates in the Securities Industry*. It describes the rates in Canada and the United States, up to 1976, with particular emphasis on the spreads between rates in the two countries.

Chapter II
History and Characteristics of Commission Rates

Fixed commission rates for stock exchange transactions are not recent. In the United States fixed commissions go back to the so-called Buttonwood Tree Agreement of 1792, which provided

> "We, the Subscribers, Brokers for the Purchase and Sale of Public Stock, do hereby solemnly promise and pledge ourselves to each other, that we will not buy or sell from this day for any person whatsoever, any kind of Public Stock at a less rate than one-quarter percent (1/4%) Commission on the Specie value, and that we will give a preference to each other in our Negotiations . . ." (New York, May 17, 1792).

Until 1920 stock exchanges catered to a limited number of individuals. The general public was not involved to any significant extent in exchange trading in equity securities.

After the end of World War I, the public participated with increased frequency in exchange trading in equity securities and the stock market assumed unprecedented importance in the functioning of the economy.

The disastrous events of 1929 gave rise to a movement of reform in the United States which culminated in the enactment of the Act of 1934 and the regulatory authority given to the Securities and Exchange Commission (SEC).

After World War II, the public flocked into the securities markets, and financial institutions increasingly participated in those markets. These circumstances resulted in Congressional and SEC concern as to the adequacy of investor protection.

A first major study was conducted under the auspices of the SEC: "Special Study of Securities Markets", H.R. Doc. No. 95, 88th Congress, 1st Session (1963).

This study included, among other things, probably the first reasonably comprehensive analysis of the nature and structure of commission rates. It pointed out that:

a) the commission rate schedule covered a great variety of services performed by brokers in addition to the execution and clearance of transactions;

b) that the foregoing characteristic (a) of the rate structure induced service competition rather than price competition which resulted in complex and irrational distinctions between

permissible ancillary services and prohibited rebates of the minimum commission;

c) reciprocal arrangements were prevalent;

d) all the foregoing factors proved that the nature of the securities commission business was such that traditional principles of rate regulation could hardly be applied to it.

In January 1968, the New York Stock Exchange (NYSE) in response to the SEC's concern with respect to the operation of the commission rates schedules then in effect, submitted to the SEC a proposal for certain revisions in the structure of its commission rates schedule. The proposal provided for:

a) volume discounts;

b) economic access to the NYSE for non-member broker-dealers through a discount;

c) limited recognition of 'customer-directed give-ups'[1], and

d) prohibitions on procedures then used by institutions to recapture commissions.

Note: The SEC Release No. 8239, January 26, 1968, described in some detail the give-up and reciprocal business practices[2] which had been adopted in order to evade the fixed commission structure.

The NYSE proposal initiated the first major hearings with respect to rate structures[3] which were held from 1968 to 1971. For the first time the question was directly raised as to whether fixed rates of commission should be replaced by competitive rates. In December 1968, in the midst of the hearings, the NYSE and other exchanges adopted volume discounts and banned customer-directed give-ups.

The second major study was transmitted to the Congress by the SEC on March 19, 1971. It was entitled "Institutional Investor Study"[4] and covered the years 1969 and 1970. It was basically an economic study which included an examination of the impact of institutional investment on the securities markets. In a letter attached to the study report, the SEC concluded, among other things:

"The fixed minimum stock exchange commission on large orders had led to the growth of complex reciprocal relation-

1 The customer-directed give-up was a payment by the executing broker of a part of the minimum commission it was required to charge its customer, to other broker-dealers designated by the customer or his investment adviser. The amount of the payment was negotiated.

2 These are practices by which executing brokers provide compensation to other brokers at the direction of institutional investors, permitting such other brokers to participate in the commission generated from execution, in the over-the-counter market or on regional exchanges, of orders which the institutional broker has received from other customers.

3 Securities and Exchange Commission, "In the Matter of the Commission Rate Structure of Registered National Securities Exchanges", SEC File No. 4-144 (1968–71).

4 SEC, "Institutional Investor Study Report", H.R. Doc. No. 92-64, 92nd Cong., 1st Sess. (1971).

ships between, on the one hand, institutions (particularly mutual fund managers and banks) and, on the other, broker-dealers. This has had the effect of making commission rates for institutions negotiable but limiting the extent to which the ultimate investor rather than the money manager has benefited from such negotiation . . . These relationships tend to aggravate potential conflicts of interest. . . ."

In April 1971, at the direction of the SEC, American exchanges provided that commissions on the portion of exchange orders involving $500,000 or more were to be competitively determined.

The "Market Structure Statement",[5] issued on February 2, 1972, by the SEC, concluded that a reduction to $300,000 was called for in the breakpoint above which commission rates on exchange transactions should be competitively determined. In response to the SEC's conclusions, the breakpoint on fixed commission rate schedules was lowered to $300,000 in April 1972.

Finally, in its Release No. 10383 (Sept. 11, 1973), the SEC indicated that it would act promptly to terminate the fixing of commission rates after April 30, 1975, if the exchanges did not, on their own initiative, adopt rule changes achieving that result.

One of the major reasons underlying that decision by the SEC was that, for institutional investors, the commission rates were in fact negotiated. The numerous interventions of the SEC and to a lesser extent of the exchanges to abolish the customer-directed give-ups and the reciprocal business practices were unsuccessful. In fact, institutions and the brokerage community were able to split minimum commission by devices which achieved the same results as "give-ups", such as "mirror transactions"; the "step-outs", the "four-way tickets"; the "eight-way tickets"[6] and all kinds of soft-dollar deals.

The history of the Canadian securities markets parallels that of the United States markets. The Canadian securities commissions and self-regulatory bodies have followed with great interest the evolution of this situation in the United States. This is to be expected because the Canadian and United States economic systems are so closely linked.

If we consider, for instance, the commission rate structure in Canada and in the United States, the similarity is remarkable. In fact, one of the arguments often used by the Canadian exchanges in requesting changes in commission rates was their comparison with the rates on United States exchanges (mainly the NYSE). The purpose of those comparisons was to show that the Canadian exchanges should be able to compete with the United States exchanges with respect to commission rates in order to prevent "the movement of sizeable portions of trading

5 SEC, "Statement on the Future Structure of the Securities Market", 37 Fed. Reg. 5266 (March 14, 1972).

6 Securities Industry Study, "Report of the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce", H.R. Doc. No. 92-1519, 92nd Cong., 2d Session, at 133 (1972).

in interlisted issues of the United States (since) such an event would be injurious to the liquidity of the Canadian markets".[6a]

That relation between the two countries is made evident by the dates on which the recent changes in commission rates took place:

New York Stock Exchange	*Montreal Stock Exchange*
September 25, 1973	November 28, 1973
November 19, 1974	November 19, 1974
May 1, 1975	—
	January 1, 1976

Furthermore, it seemed important to point out certain features of the commission rate schedules and the evolution of those schedules in Canada and the United States.

1. COMMISSION RATES ARE A FUNCTION OF THE TOTAL AMOUNT OF THE TRANSACTION AND OF THE PRICE PER SHARE

Table II-1
Commission Rates in Canada Since January 1, 1976

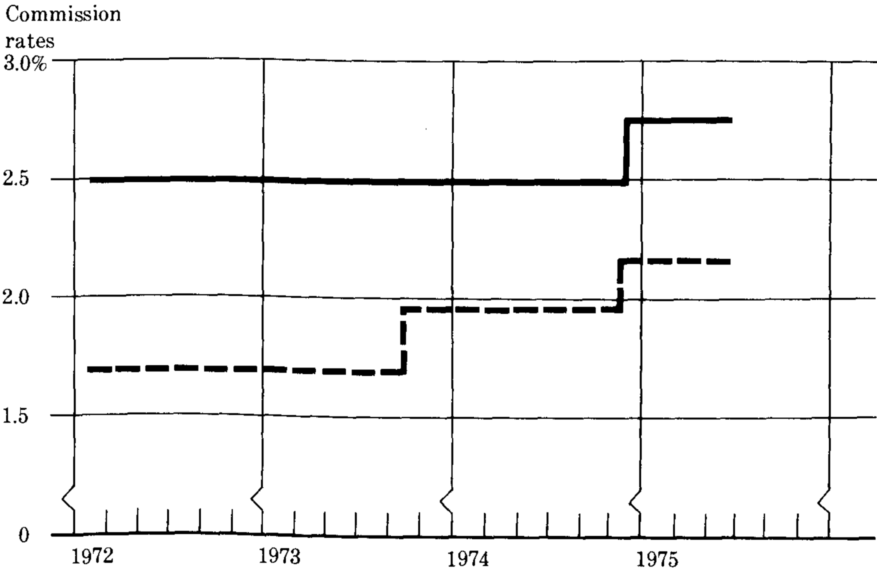
Total amount of the transaction (000's)	Rate of commission on shares of		Spread ((a-b)/a)
	$10 (a)	$30 (b)	
10	2.50%	1.64%	34%
30	2.25	1.48	34
50	1.95	1.28	34
100	1.40	0.92	34
150	1.18	0.78	34
200	1.08	0.71	32
300	0.97	0.63	35

a) According to the total amount of the transaction:
Table II-1 shows that since January 1976, if the price per share is $10, the commission rate on a $10,000 transaction is 2.5% and it is 1.40% on a $100,000 transaction. Likewise, if the price per share is $30, the commission rate on a $10,000 transaction is 1.64% and it is 0.92% on a $100,000 transaction. Thus, there is a spread of 44% in both cases.

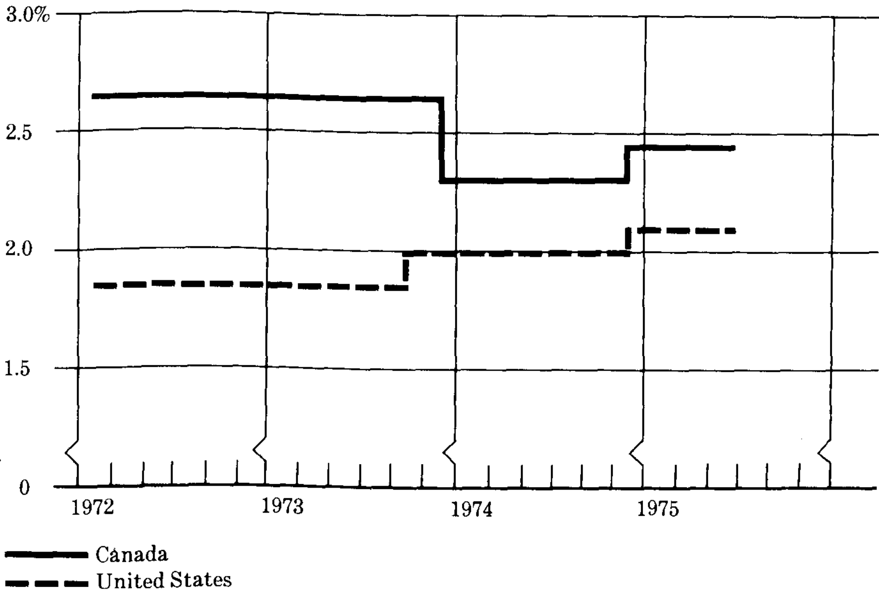
b) According to the price per share:
From the same table one can see that on a $10,000 transaction, the commission rate is 2.5% on a $10 stock, and it is 1.64% on a $30 stock. Likewise, on a $100,000 transaction, the commission rate is 1.40% if the price per share is $10 and 0.92% if the price per share is $30. In both cases there is a 34% spread.

6a MSE, "Presentation of the Proposed Commission Rates to the Members of the Montreal and Canadian Stock Exchanges", April 27, 1972, p. 17. A similar argument has also been invoked at the OSC hearings on commission rates (October 30 and 31, 1974).

Graph II-2
Changes in the commission rates in Canada and the United States from March 1972 to April 1975 on a 1,000 share transaction in a $10 Stock ($10,000)



Graph II-3
Changes in the commission rates in Canada and the United States from March 1972 to April 1975 on a 10,000 share transaction in a $10 Stock ($100,000)



Canada
United States

The above remarks suggest that it is less expensive for a client, to make a $30,000 trade in a $30 stock than in a $10 stock. We don't see how this could be justified since it is probably not much more costly for a brokerage firm to execute an order of 1,000 shares at $30 than an order of 3,000 shares at $10.

2. GENERALLY SPEAKING, BETWEEN FEBRUARY 1972 AND APRIL 1975, THE SPREAD BETWEEN THE CANADIAN AND UNITED STATES COMMISSION RATES HAS BEEN REDUCED

Graphs II-2 and II-3 show that, on a transaction totalling $10,000 in a $10 stock, the spread went from 45% in April 1972 to 29% in April 1975. On a $100,000 trade in a $10 stock, the spread went down from 82% to 29% during the same period.

3. IN APRIL 1975, WHEN THE AMOUNT OF THE TRANSACTION WENT UP, THE SPREAD BETWEEN CANADIAN AND UNITED STATES COMMISSION RATES INCREASED, THEN DECREASED TO ZERO AND INCREASED IN THE OPPOSITE DIRECTION

Graphs II-4 and II-5 show that for a $10 stock, the spread was 28% on a $10,000 transaction, 54% on a $50,000 transaction and 0% on a $300,000 transaction (*i.e.*, the United States and Canadian rates were equal). For a $30 stock, the spread was 15% on a $10,000 transaction, 32% on a $50,000 transaction and −4% on a $300,000 transaction.

4. IN JANUARY 1976, THE SPREAD INCREASED BETWEEN CANADIAN AND UNITED STATES COMMISSION RATES IN THE CASE OF INSTITUTIONAL TRADING ONLY

To reach that conclusion, we had to make different hypotheses, since no one knows the exact average rate structure at the New York Stock Exchange. These hypotheses were based on the following facts:

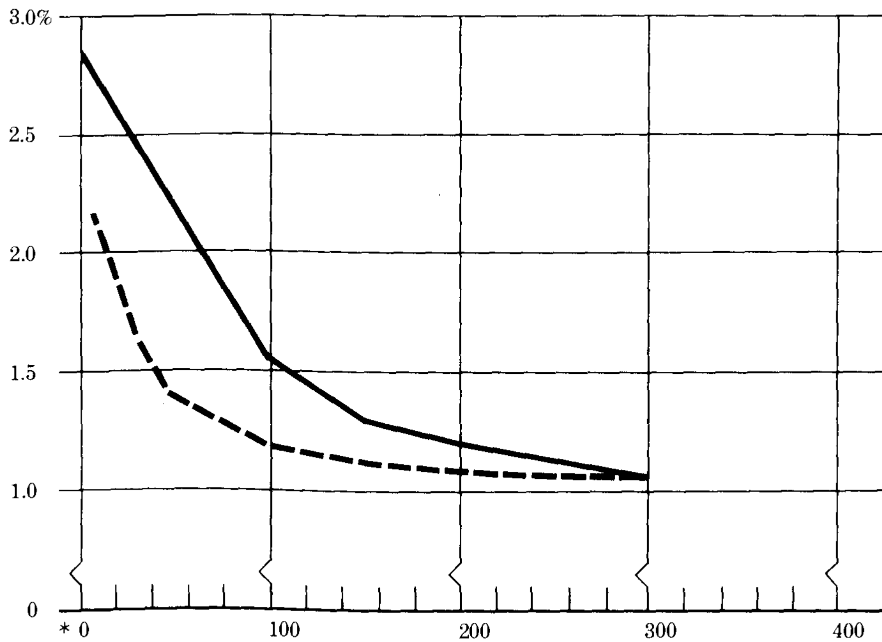
a) The average price per share traded at the NYSE by institutions was $31.38 on August 31, 1975.[7]
b) The average size of institutional (and intermediaries) orders were[8]
205 shares in 1961
644 shares in 1969
713 shares in 1971.

7 SEC, "Report to Congress on the Effect of the Absence of Fixed Rates of Commissions", December 1, 1975, p. II-4.

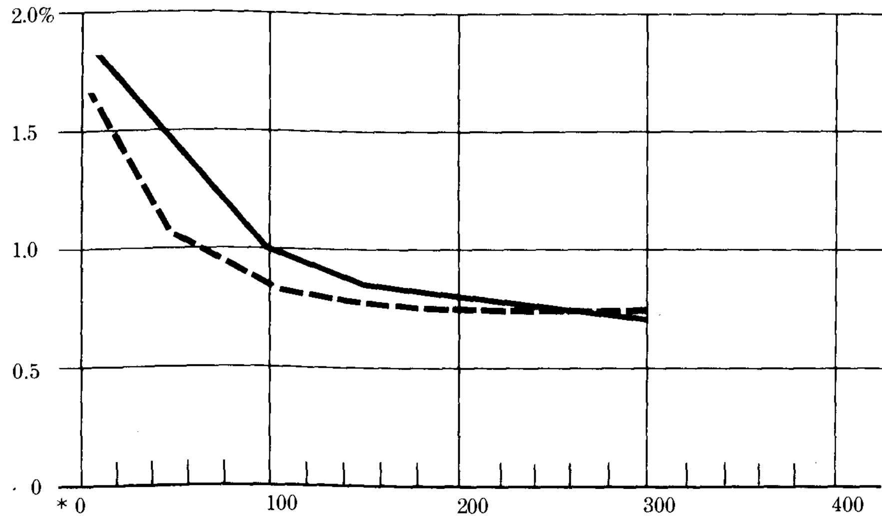
8 NYSE Research Department, "Public Transaction Study", New York Stock Exchange, Inc., April 1972, p. 16.

Graph II-4
Changes in the commission rates in Canada and the United States on a $10 stock as per the amount of the transaction in April 1975

Commission rates



Graph II-5
Changes in the commission rates in Canada and the United States on a $30 stock as per the amount of the transaction in April 1975



Amount of the transaction $(000)
Canada
United States

c) About 74% of all transactions at the NYSE in 1974 were made in blocks of 200 to 9,999 shares[9]
(*i.e.*, 200–999 shares: 36%
1,000–9,999 shares: 38%).
and the average shares per tape print was 438.[10]

d) From May 1, to December 31, 1975, the commission rates at the NYSE for institutions decreased by[11]
23% on transactions of 200 to 999 shares
31% on transactions of 1,000 to 9,999 shares
32% on transactions of 10,000 or more shares
30% on all institutional trades.

Taking these facts into account, we have made the following hypotheses for institutional transactions:

a) An average price per share of $30
b) An average order of 1,000 shares
c) Commission rates reduced by the following percentages:

Amount of the transaction (000's)	Reduction as a percent of commission rates in effect in April 1975
$ 10	20%
30	29
50	30
100	30
150	30
200	30
300	30

d) The above percentages of reduction also apply to the commission rates on $10 shares.

Given the acceptance of those hypotheses, we find out from Graphs II-6 and II-7 that, in the case of shares at $10, the spread between Canadian and United States rates was

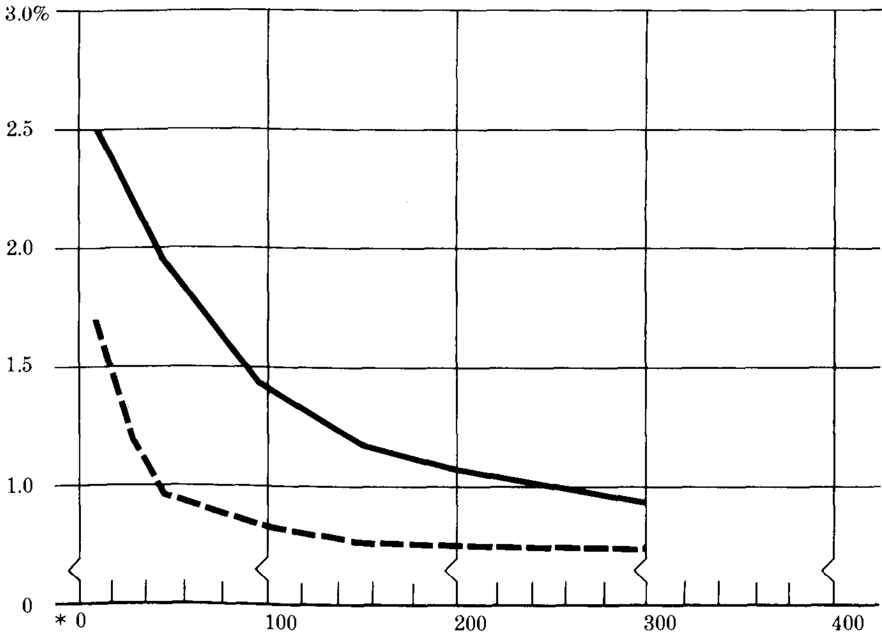
46% on a $ 10,000 trade
99% on a $ 50,000 trade
31% on a $300,000 trade.

Likewise in the case of shares at $30, the spread was

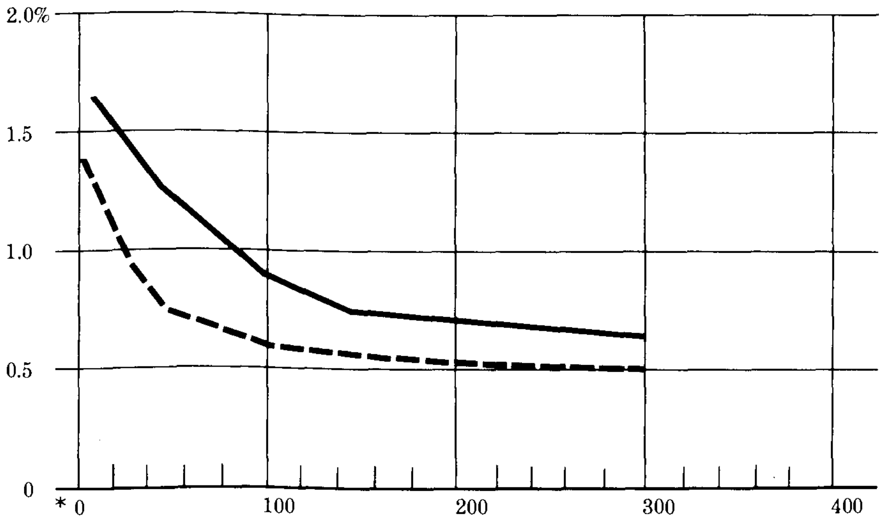
25% on a $ 10,000 trade
57% on a $ 50,000 trade
24% on a $300,000 trade.

9 NYSE, "1975 Fact Book", pp. 10–12.
10 *Ibid.* p. 11.
11 SEC, "Second Report to Congress on the Effect of the Absence of Fixed Rates of Commissions", March 29, 1976, Exhibits 4 and 5.

Graph II-6
Changes in the commission rates in Canada and the United States on a $10 stock as per the amount of the transaction in January 1976



Graph II-7
Changes in the commission rates in Canada and the United States on a $30 stock as per the amount of the transaction in January 1976



Amount of the transaction $(000)
Canada
United States

Thus, even after the elimination of the 10% surcharge in Canada, the spread increased between Canadian and United States rates. Table II-8 summarizes characteristics 3 and 4 above.

Table II-8
Spreads Between Canadian and United States Commission Rates in April 1975 and in January 1976

Price per share	Amount of the transaction (000's)	Spread as a percentage of the United States rate	
		April 1975	January 1976
$10	$ 10	28%	46%
10	50	54	99
10	300	0	31
30	10	15	25
30	50	32	57
30	300	−4	24

These spreads between Canadian and United States commission rates are theoretical since they are based on hypotheses and also because they do not take into account the soft dollar deals between certain brokers and clients.

We don't know to what extent these practices have diminished in the United States since May 1, 1975. However, we know that they are wide-spread in Canada.

These practices take many forms and the MSE classified them in two categories:[12]

a) "low grade type of abuses": junkets, payment of subscription to business magazines or newspapers, rental of equipment or facilities, etc. . . .

b) "sophisticated services": those which are considered by some as a normal extension of brokerage research facilities.

Whatever the category, these practices are nothing but a rebate on commissions for which the amount varies along with the institutions and the broker-dealers. In one case we have estimated the amount of soft dollars received by one institution in 1975 to approximately 10% of the yearly commissions paid by that institution.

Thus, agreements between broker-dealers and institutions do exist and are negotiated in order to establish the price that the institution will pay for the services it receives.

12 Letter from the President of the Montreal Stock Exchange, January 29, 1975.

Applications of Automation in the Canadian Securities Industry: Present and Projected

Hugh J. Cleland

October 1975 and July 1978

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Chapter I
Introduction

In the early nineteenth century, Samuel Morse invented the telegraph. The first intercity line (Washington to Baltimore) was put up in 1844. In 1867, with the development of the stock ticker at the New York Stock Exchange, the telegraph was introduced to the United States securities industry.

This paper was prepared as part of the draft working documents for the meeting of the Securities Market Study group in November 1975. Papers were not completed in final form until 1978. Circumstances prevented a thorough updating of this paper and it should be regarded as a status report as of mid-1975. Certain items of statistical information have, however, been updated and short "1978 update reports" have been written to supplement certain sections of the paper which deal with the major automation programs.

The writer is grateful both to the Toronto Stock Exchange and to the Canadian Depository for Securities Ltd. for their willingness to allow him to use material developed on their behalf. Special thanks are due to Mat Ardron, Director of Systems Planning and Development at the TSE (until November 1977), and to Stan Deudney, General Manager of CDS, for their assistance, and for providing constructive criticism of the approach and substance of the paper. The writer also acknowledges, with thanks, the cooperation of the TSE in permitting him to update materials prepared for the original (1975) draft of this paper.

[*In December 1977, Hugh Cleland joined the staff of the Toronto Stock Exchange as vice president, Policy Development and External Relations. I wish to acknowledge the cooperation of the exchange in permitting Mr. Cleland to update this paper prior to publication – Philip Anisman.*]

Over the succeeding years "the wire" brought about a revolution in the securities industry. Whereas before the telegraph communications between cities by courier or pony express had taken a matter of days, with the wire, return messages became possible in hours. For brokers this not only sped up the sending and receiving of important messages like sale and purchase orders, but it also made possible the economic exchange of a much wider variety of messages (rumours, research reports) and the dissemination of transaction data to a much wider audience.

Thus from a decentralized industry with a stock exchange in virtually every major population centre serving a multitude of brokers, the securities industry was transformed into one dominated by a single focal point – New York. Where formerly distance had made local trading facilities necessary, the telegraph meant that local brokers could send their transactions to New York for execution in the primary market.[1] Not only could local firms now deal in New York, the new technology also made it feasible for the New York houses to open branches in the lesser centres. Many mergers and takeovers resulted, largely due to the potential released by the new technology.

A further revolution was launched in the early twentieth century with the addition of the telephone to the tools of the securities industry. Personal meetings were no longer necessary to obtain instructions. Brokers could sit at a desk and talk to dozens of people in one day. The retail salesman was invented, and securities investment became available to a much wider range of people. In the 1920s, "playing the stock market" became a national pastime in the U.S., and in Canada as well. Regulation of credit and market practices, however, operated more to the benefit of the Rockefellers than to the Smiths and Joneses, and the market collapsed.

In the 1950s and 1960s the technology of mass communication (TV and newspapers), supported again by the salesman with a telephone, brought about a resurgence of public interest in investment. At this juncture, the fate of the campaign for "people's capitalism"[2] and the surge of public involvement in securities

1 Interestingly enough, while early technology virtually eliminated local stock exchanges in the late nineteenth and early twentieth century, its further development in the mid-twentieth century was significant in the rebirth of the U.S. regional exchanges. Because it became so simple and inexpensive to route orders to almost any locale, regional exchanges were able to create convenient trading and commission/access rules, thus avoiding certain New York Stock Exchange standards. They could then solicit brokers and investing institutions to move their trades to the regional floors in order to avoid NYSE rules.

2 *See* various speeches by Keith Funston, president, New York Stock Exchange 1951-66, *cited in* R. SOBEL, THE BIG BOARD 346 (1965).

investment which it helped bring about is still too recent to be read.

What is clear is that the development of technology has played a major role in changing the securities industry. This has brought new opportunities and competitive forces which have significantly affected the level of service, profitability, corporate structure and regulatory framework.

Indeed, at the present time, the securities industry is struggling with the likelihood that technological developments have released another revolution through the introduction of the digital computer. Although the focus of industry news and distress cries may be on commission rates and institutional investment, the computer and computer-based communications networks are playing a major role as forces for change in the 1970s. Key questions relate to the impact which computers can have on order processing costs, potential marketing strategies and even the structure and organization of the markets themselves. Will computers impact on the industry to the same extent as the telegraph and telephone? What will be the pace of impact?

Although this paper does not purport to answer these questions, it does set out the background of an integrated securities market system[3] and describes some major computer-based projects both in Canada and the United States, the outcome of which will in large measure determine the shape and pace of change.

This background material and the information on operational mechanics are provided on the oft-voiced, but seldom practised theory, that any regulatory proposals should be based on a sound understanding of the operating environment in which they will be applied.

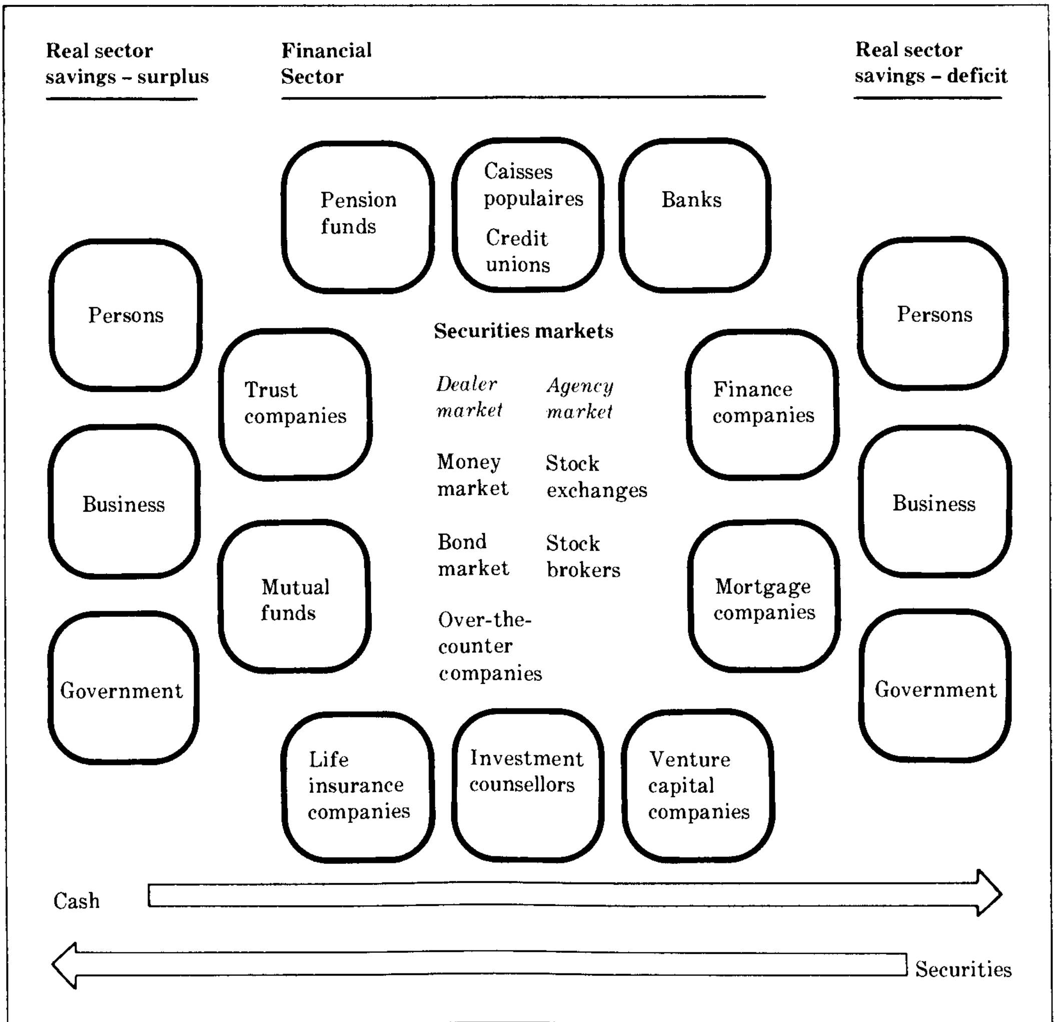
Chapter II
The Securities Market System: Economic Function and Participants

Many articles and books have been written describing the various participants in the financial markets and the flows of funds and securities between them. One such useful description is contained in a recent report of D. Shaw and R.A. Archibald.[4] The following pages from their text outline the fundamentals of the

3 WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY defines "system" as "a complex unit formed of many diverse parts subject to a common plan or serving a common purpose".

4 D. SHAW & R. ARCHIBALD, 1 THE MANAGEMENT OF CHANGE IN THE CANADIAN SECURITIES INDUSTRY 2-7 (1972) (Canada's Capital Market).

Figure 1
Securities Markets



financial system's function and purpose. Their graphic representation of the securities markets is shown in figure 1.

A. DESCRIPTION OF THE CAPITAL MARKETS

"For the purposes of defining and describing the capital market it will be useful to divide the economy into two sectors, the *real* sector and the *financial* sector. Included in the real sector are three classes: persons, non-financial business and government. Within this sector, decisions are made by some economic units to save, consume or spend less than current income, while at the same time other units decide to spend more than their current income using the savings of the former group to finance their deficiency.

"The financial sector or capital market exists to accommodate the transfer of funds from savings-surplus units to savings-deficit units within the real sector. The relationship of the financial sector to the real sector is set out in figure 1. In the diagram, cash flows from left to right, securities from right to left. The real sector is placed on both sides of the diagram, on the left as savers and on the right as spenders. The capital market in the middle provides the means whereby the deficit-units (spenders) in the real sector on the right hand side can exchange contracts (securities) for cash from savers on the left hand side. The capital market function is to match these demands for cash from the deficit units with the supply of cash available from surplus units. This may be accomplished *directly* by offering securities issued by the deficit units to the surplus units. It is accomplished *indirectly* by financial institutions acquiring the claims of deficit units and then issuing new claims on themselves which are tailored more closely to the requirements of savings-surplus units. Financial institutions earn profits on the 'spread', the difference between the rate earned on the direct securities they acquire and the rate paid on the securities they issue. This process whereby financial institutions attract savings by issuing claims on themselves which are more liquid, less risky or of shorter term or some combination of these qualities than the direct securities in which they invest the proceeds is known as *intermediation.*

"Economies of scale provide one major reason for the existence of financial intermediaries. Financial institu-

tions accumulate information, develop sophistication in their personnel and have available funds which permit them to operate in the financial markets in a continuous manner which could not be duplicated at the same cost by individuals or business firms acting in an *ad hoc* manner. In addition, financial institutions benefit from the risk reduction associated with efficient diversification of securities portfolios which an individual investor may not be able to accomplish because of his limited resources.

"II Role of the Capital Markets

"The channeling of savings

"The primary role of the capital market is to channel funds from surplus units to deficit units. Expenditures on consumption goods and on new investment in real assets, such as plant and equipment, generate incomes and employment. The term 'savings' refers to the annual amount withheld from consumption not to the accumulated wealth resulting from past savings. Saving is a withholding of spending. In order that these funds are not lost to the expenditure system the capital market exists to facilitate the flow from those who save to spenders who have projects which they want to undertake but do not have the necessary funds. Spending generates incomes; savings result from having income and not spending all of it. Savings finance the additions to the stock of capital in the economy.

"Reward for saving

"A person's decision to save is a decision to postpone consumption. This involves deferring present satisfaction for anticipated future satisfaction. Future dollars are greater than present dollars by the return earned on the savings, thus the capital market establishes the rate of exchange between present dollars and future dollars, present satisfaction and future satisfaction. The decision to consume presently or save and consume later hinges on the tradeoff between present and future dollars. By providing a means of accommodating such decisions, the capital market may affect the amount of savings within the economy.

"*Cost of financing*

"A second important purpose of the financial market is to establish the cost of financing for the borrower and the rate of return on these financing vehicles for the lender. Knowing the cost of funds permits the borrower to make an investment decision on the basis of comparing the expected returns and perceived riskiness of the project on which he intends to spend the funds with the direct costs of obtaining the funds. A corporate decision to invest in capital projects must be made in light of all the opportunities available at the time of the decision. Even though the corporation may not require external funds to finance the project under consideration, nevertheless, the corporate decision-makers must compare the available returns on similar-risk opportunities in the capital market to the return on their proposed project and choose the higher one if they want to maximize the wealth position of the shareholders. This *opportunity cost of financing* calculation used in the evaluation of capital projects is referred to in business finance as the *cost of capital*. The decision rule is to accept a capital investment proposal if its anticipated rate of return is greater than, or at the margin just equal to, the firm's cost of capital, *i.e.*, the opportunity cost of investing in similar-risk ventures in the capital market. Under these conditions, the capital market can be thought of as playing a major role in the determination and the allocation of a country's private resources. This is accomplished by providing opportunity rates of return for all investment and saving decisions. Given this role, it is critical that this market operates rationally and efficiently in setting prices and yields for risk alternatives.

"*Liquidity*

"Securities markets provide liquidity for holders of securities. Liquidity may be defined as the ability to convert securities into cash quickly at minimum cost and without a significant decrease in price caused by the transaction. A major attribute of liquidity is that it permits a 'transformation process' whereby short-term funds become available for long-term use. As long as an investor believes that he can sell his holding quickly without his transaction adversely affecting price, he may invest funds, which he considers to be short-term, in securities of a long-term nature.

"This transformation process permits a much larger flow

of savings to be made available for long-term investment than would otherwise be the case. Financial institutions facilitate this transformation process by intermediation, offering shorter term securities such as savings accounts and debentures, and investing the funds in longer term securities such as mortgages and bonds. The ability of a financial system to provide liquidity in secondary markets for investors in new security offerings is critical to the efficiency of the market, to the cost of an issue by a borrower and to this transformation process. The degree to which the market can provide liquidity is referred to as the 'depth' of market.

"*Valuation basis*

"The final role of the financial market is to establish a basis for valuation. Market prices of securities establish the basis of their value for the courts and for estate and income taxation purposes. Market prices of securities may influence directly almost all situations with financial consideration, *i.e.*, individual decisions about retirement, vacation and leisure, etc. Collectively these individual decisions have significant impact on society.

"III A Review of Canadian Financial Markets

"Financial markets are classified as *primary and secondary*. The primary market deals in securities issued by a unit seeking funds to units possessing surplus funds. Proceeds from the offering go to the issuing unit. For example, a corporation which issues securities, bonds or common stock to finance new plant and equipment raises funds in the primary market usually by selling the offering to an underwriter who, in turn, sells it to investors.

"The secondary market exists to permit a holder of securities to convert his holdings into cash and as a means of acquiring previously-issued securities for those who want to do so. As implied by the name, it is a secondhand market. Proceeds flow from the person acquiring the securities to the previous holder. Stock exchanges are the best known secondary markets but secondary markets exist for bonds, mortgages and consumer credit as well. The ability to convert a security-holding to cash quickly and without a significant reduction in value in a secondary market transaction adds liquidity to the instrument

for the purchaser and consequently reduces the overall cost of financing to the issuer.

"The capital market in Canada is made up of many submarkets. In a sense, a market is located in every part of the country where there is a bargain for funds. However, certain markets dominate, and it is in these markets that the prevailing structure of rates in the country is established. Three dominant markets are described briefly in the following paragraphs.

"The money market handles short-term debt securities, usually of one year and less to maturity, issued by governments and both non-financial and financial corporations. This is a *dealer* market; that is, an underwriting investment dealer or financial institution buys the offering from the issuing unit and then sells the securities (commonly referred to as 'paper') in parts to financial institutions, corporations and other institutions such as universities, or holds some of the issue itself. In this function it is a primary market; however, there is trading of these instruments in the secondary market as well, usually through the same set of underwriting dealers.

"The bond market has distinct primary and secondary operations. Investment dealers in their role as underwriters buy the primary issue and distribute it to financial institutions and the public. The secondary market involves dealers buying bonds for and selling bonds from their own inventory, making a profit on the spread between cost and selling price. Most underwriters are active in the secondary market, especially in the issues they originally brought to the market; however, other investment dealers and financial institutions also make secondary markets for bonds.

"The primary section of the equity or stock market involves dealers underwriting corporate issues and distributing them to financial institutions and individual investors. The secondary equity markets in Canada are mainly auction markets where bids and offers are made by brokers for their clients on listed stocks on a stock exchange. Brokers are paid for their services by a commission fee since they act in an agency relationship with their customers. Markets for some stocks not listed on a stock exchange are maintained by dealers buying for and selling from their inventory. Dealers in this market are compensated for their efforts by the price spread. This over-the-counter dealer market for equities is a small

component of the total secondary market for equities in Canada relative to stock exchange trading. Another type of secondary market transaction occurs when an underwriter acquires a block of stock from a stockholder and distributes it in much the same way as a primary issue in order to avoid putting stress on the secondary market by selling such a large transaction. These are referred to as *secondary offerings*."[4a]

B. INTERMEDIATION

It is necessary to differentiate the two aspects of intermediary activities brought out in the Shaw and Archibald report: investment (*i.e.*, financial) intermediation and transaction (*i.e.*, market) intermediation. In the process of intermediation, a financial organization interjects itself between savings surplus and savings deficit units in the real sector.

In *investment* intermediation, the intermediary *issues* its own obligations to savings surplus units in return for cash, while *accepting* the obligations of savings deficit units.[5] To successfully interpose themselves, investment intermediaries create and issue instruments which are more attractive to savers than are the obligations which the savings deficit units are able or willing to offer. Features of the instruments issued by these intermediaries which make them attractive to savers are: liquidity/redeemability, tax sheltered status, convenience of purchase (amount, location of sales office, etc.), safety (debt obligations are guaranteed by the capital of the issuing institution, often by government-backed insurance schemes). Examples of such instruments are bank and trust company savings accounts, deposit receipts and certificates, whole-life insurance policies and mutual fund shares.

It is important to note that in their securities market activities these intermediaries are not always acting for their own accounts but often also act as transaction intermediaries. Branch banks and trust companies are particularly active as handling agents and/or investment managers wherein for a fee they act as order routers and custodians of securities investments on behalf of their customers.

In *transaction* intermediation, brokers and dealers act as agents or dealers in the buying and selling of the securities of third party issuers. Under the major heading "Securities Markets" in figure 1 are the principal transaction intermediaries – stock bro-

4a *Id.*

5 *Id.* at 2.

kers/dealers and the markets which they have organized. Neither they nor their markets issue their own obligations[6] but simply act as agents or traders in the exchange of the obligations of others. Although the investment intermediaries' marketing ploy is to offer liquidity to surplus holders in the real sector by issuing guaranteed or participating claims of a short-term or demand nature on themselves, the transaction intermediaries seek to attract the funds of surplus holders by pointing to the potentially greater gains available through direct investment. They also emphasize the liquidity provided by the securities markets which they have organized.

The services of transaction intermediaries and investing intermediaries are not generally substitutes one for the other. In fact, a significant part of the transaction intermediaries' business is as a supplier of transaction service to investment intermediaries acting as agents or for their own investment purposes. A second and more important source of business is individual investors who seek to do their own investing directly in the market, rather than holding the instruments of intermediaries or delegating asset management responsibility to such intermediaries. Another portion of their business is in securities which are unsuited for ownership by trustees and other investment intermediaries with guaranteed obligations. The proportions of business vary from time to time depending on legislation affecting tax positions of individuals compared to institutions and the extent to which individual investors are in a speculative mood.[7]

It is of course possible for investment intermediaries or for savings surplus and deficit units in the real sector to deal directly with each other without involving transaction intermediaries. However, the principal services offered by brokers and dealers such as guarantees of title, credit and closing, an organized market for the economical handling of a high volume of transactions, market coverage through coordination of buying and selling interest as well as investment advice and trading expertise, favour their use by both investment intermediaries and individuals.

6 Some major U.S. brokers have "gone public" in that they have sold their own common shares to investors in order to obtain a permanent capital base; *see* ch. III.F *infra*. However, none except Merrill Lynch have issued money market paper or other investment instruments to the investment public as an investment intermediary would do; *see* The Wall Street Journal, October 3, 1975.

7 *See* ch. III.D *infra*.

Chapter III
Organization of Canadian Securities Markets[8]

The preceding chapter briefly described the various players in the capital markets and outlined the basic economic *raison d'être* for securities markets.[9] It also drew a distinction between investment intermediation (such as that provided by banks, trust companies, insurance companies, mutual funds and pension funds) and transaction intermediation such as that provided by brokers and investment dealers in connection with trading markets.

As the excerpt from the Shaw and Archibald report notes, there are primary and secondary markets for virtually all financial instruments. The main trading markets and instruments however, are the money market, the bond market and the equity market – the last being divided into listed and unlisted categories.[10] This chapter describes how these various markets are organized in Canada. To put this review in perspective, comparison is made to the organization of securities markets in the United States.

A. THE MONEY MARKET

In Canada, the money market[11] is centred around the thirteen to fifteen members of the Investment Dealers Association of Canada (IDA) which have been granted special borrowing (rediscounting) privileges at the Bank of Canada. The IDA is a national self-regulatory body composed of most dealers who are involved in underwriting and distributing the securities of governments and well-established corporations. The main users of the money market are financial institutions and corporations with short-term cash needs or short-term cash surpluses. The amounts involved are often very large and few issuers tailor instruments for transactions of less than $50,000.

The money market has no formal organization. It exists wherever its users and dealers are willing to deal. Since most of its users

8 This chapter is based on several sources: REPORT OF THE OPERATIONS COMMITTEE OF THE CANADIAN DEPOSITORY FOR SECURITIES (March 1972); Toronto Stock Exchange, Planning Report (July 1971) (unpublished); TORONTO STOCK EXCHANGE, COST STUDY REPORTS (1971-75) (Study of TSE member costs in relation to operational efficiency and also to the OSC's hearings on commission rates).
Specific references are made only where statistical information is given.

9 Ch. II.A *supra*.

10 *Id.*

11 The money market is defined as the market for federal and provincial government bonds of less than three years to maturity (including Treasury bills), bankers' acceptances and commercial paper.

are highly sophisticated organizations there is little need for regulation aimed at protection of investors.[12] Though the Bank of Canada collects and publishes statistics on outstanding money market obligations, no trading volume and price range figures are published and there is little, if any, control of selling or trading practice.

Oversight of the money market is maintained by the Money Market Committee of the Investment Dealers Association. Liaison is maintained with the Bank of Canada and Department of Finance. This committee establishes standard settlement rules and, in an informal manner, recommends any disciplinary necessities to the National Executive of the IDA. The committee has tried from time to time to recommend certain policies on spreads and commission reallowances to lenders but competitive practice among the dealers tends to nullify such policies.

B. THE BOND MARKET – PRIMARY AND SECONDARY TRADING

To discuss the bond and equity markets it is necessary to separate primary issues and secondary trading. On so-called primary issues, a detailed prospectus is filed with the securities commission or equivalent authority in each province in which it is intended to sell the securities. Upon acceptance of the prospectus, the bonds or stocks are then sold directly to the customers of the underwriting/selling group of dealers.[13]

On primary issues of bonds and equities, the Investment Dealers Association of Canada[14] exercises some authority. The vehicle of control is the IDA's code of ethics and by-laws dealing with pricing practice by members of a banking/selling group, delivery procedures and the syndicate manager's accounting for distribution of syndicate profits. Full statistics on primary issues are published monthly by the Bank of Canada.

Coincident with and subsequent to the direct selling effort, some dealers may "make a (secondary) market" in the issue. If the issue is a bond, then the trading simply carries on in the between-

12 Generally speaking, no prospectus need be filed on money market issues (due to the exemption given by s. 19(2)3 in the Ontario Securities Act). However, all corporate issuers of such paper are required to complete a Robert Morris Associates Questionnaire or a CANSAF report of standard financial data and signed by their independent auditor, if they wish their paper to be handled by an IDA member. In addition, IDA regulations strictly specify margin requirements for money market paper held in dealers' inventories.

13 The method described here pertains to the great majority of the bond and stock issues of governments and major corporations. However, another method, "primary distribution through a stock exchange", is often practised with some speculative equities.

14 *See* ch. III.E.2 *infra*.

dealer, over-the-counter (so-called) bond market. If it is an equity, the usual situation which pertains is that arrangements have been made by the underwriters to have it listed and called for trading on a stock exchange within a few weeks of completion of the distribution.

The bond market in Canada, like the money market and the over-the-counter equity market,[15] is rather loosely structured. It exists wherever dealers and to some extent chartered banks find it profitable to call markets and settle transactions. Toronto is by far the money market and bond trading centre for Canada. However, there is active trading in Montréal and, to a lesser degree, Vancouver.

There is no effective central data collection on prices bid and offered for Canadian bonds, much less of price ranges or volume of trading.[16] Once or twice a week "representative" quotations for most federal and provincial government issues, as well as a selection of corporation bonds, appear in the financial press.[17]

Responsibility for necessary trading and clearing rules in secondary bond trading in each bond market city has been assumed by the local bond traders association – a loosely knit affiliate of the regional IDA. Except for informal exclusion from trades and information exchange, few sanctions exist to discipline a wayward bond trader who is careless of interdealer ethics and practice. Unethical conduct in dealings with a customer, however, would draw the interest of the IDA's Disciplinary Committee or of the provincial securities commission.

C. THE EQUITY MARKETS

The organization of Canadian equity markets for both primary issues and secondary trading is relatively complex. There are two ways of effecting primary issues. Direct sale following upon filing and acceptance of a detailed prospectus is the most important in terms of dollar value and was described above along with primary issues of bonds. The second type of primary issues is

15 *See* ch. III.C *infra*.

16 Financial Research Institute (*see* ch. IV.C.1 *infra*) tried in 1973-74 to raise funding for a proposed "Bondata System" which would have provided full prospectus information on all extant Canadian bonds and also collected and disseminated quotes on them from dealers and other participants. The effort failed due to lack of interest on the part of some of the larger dealers who, it is said, preferred to keep their quotation information away from their competitors and already had an adequate file of prospectus data for their own purposes.

17 The Globe and Mail (Toronto) "Report on Business" carries quotes every Tuesday. The Financial Post (Toronto) every Saturday and The Financial Times (Toronto) every Monday.

"through the facilities of a stock exchange". This method has been generally used for selling the securities of companies with few or no certain assets but a speculative property with much-vaunted potential, and a promoter who organized the market for the distribution. The technique received much criticism.

> "The recommendation that primary distribution of speculative mining shares be removed from the Toronto Stock Exchange was made from the conviction that such primary distribution was not properly within the function of a major national security exchange."[18]

Financing by primary distribution on a stock exchange has been severely restricted on the Toronto Stock Exchange since 1967 and on the Montreal Stock Exchange since 1974.[19] It is still, however, a popular method on the Vancouver Stock Exchange.

Secondary trading in Canadian equities is done both over-the-counter (OTC) and on stock exchanges. The latter method predominates. Like the bond market, the OTC stock market exists wherever dealers are willing to make quotations. However, there are few companies of any substance whose securities are traded OTC. This is not only because it is generally believed that an exchange listing brings with it a better market, wider exposure to investors and considerable prestige, but also because most publicly held companies can meet the modest listing requirements of Canadian exchanges.[20] With listed status being so easy to achieve in Canada, it

18 WINDFALL REPORT at 113.

19 Passage of the Securities Act, 1966, S.O. 1966, c. 142 reduced exchange primary distributions in Ontario. The Quebec Securities Commission announced for comment a proposed revision of its Policy No. 8 which would make Québec rules more nearly uniform with the Ontario pattern; *see* 5 QSC Bull., No. 10 (March 12, 1974). The comments received were not encouraging and the proposed revisions were withdrawn. Subsequently, an administrative decision of the commission to deal with primary distribution proposals on an ad hoc basis put an almost complete stop to primary distributions on stock exchanges in Québec; *see* 5 QSC Bull., No. 42 (Decision No. 4463, October 22, 1974).

20 Basic requirements for an "industrial" listing on the Toronto Stock Exchange (the highest in Canada) are:
Net tangible assets - $1,000,000 (minimum);
Earnings - before tax income of at least $200,000 and a minimum three-year average income of $200,000;
Public distribution - minimum of 200,000 of the issued shares shall be held by at least 300 public shareholders, each holding a board lot or more;
Market value of issued shares in the hands of the public-minimum of $1,000,000.
The Montreal Stock Exchange has the same standards for most of its companies but also has a "junior industrial" list with somewhat lesser requirements. (The Vancouver Stock Exchange standards are slightly lower again.)
By contrast, a New York Stock Exchange listing requires:
2,000 shareholders (100 shares or more);
Market value of publicly held shares - $16,000,000;
Earning power before taxes - last fiscal year - $2,500,000 and each of preceding two years - $2,000,000.

is only logical that most companies have little investor interest.[21]

The principal action in Canadian equity markets is in listed securities on the Vancouver, Montreal and Toronto stock exchanges. The Toronto Stock Exchange (TSE) has about 1,250 issues listed for 885 different companies, and accounts for about 77% of the dollar value of trading in listed equities in Canada. The Montreal Stock Exchange (MSE) has 832 listings for 522 different companies accounting for 18% of dollar value of trading, and the Vancouver Stock Exchange (VSE) accounts for 5% of trading with 616 listings plus an interim "curb market" for 183 issues. The Alberta Stock Exchange (ASE) and the Winnipeg Stock Exchange (WSE) are the remaining exchanges operating in Canada.

Many of these listings and companies overlap. Tables 1 and 2 show the degree of overlap in 1977 and the dollar value of trading in each category.

Table 1 is constructed to highlight the concentration of multilisted stocks on the TSE. That is, 749 TSE-listed stocks are *also* listed on at least one of the other exchanges; ten MSE stocks which are not listed on the TSE are listed on one or more of the VSE, ASE or WSE; twenty-seven VSE stocks, which are neither on the TSE or MSE, are on the ASE or WSE; and two ASE stocks are listed on the WSE. The bracketed number in the multilisted column indicates the total number of multilisted issues on that exchange. The essence of table 1 is that of 2,093 companies interlisted on stock exchanges in Canada 1,267 are listed on the TSE.

Table 2 indicates the extent to which trading in Canada is concentrated in the issues that are listed on the TSE – though as shown in the table, some of the trading takes place elsewhere.

Table 2 shows that in 1977, nearly 94% of the dollar value of listed trading done in Canada was done in companies listed on the TSE – that is, total TSE trading plus MSE, VSE, ASE and WSE trading in stocks which are also listed on the TSE.

It is worth noting that the top ten issues accounted for 21% of total trading in 1977: the top one hundred accounted for 66%. Appendix A contains a list of the one hundred listed Canadian companies most actively traded on the TSE. It is commonly believed that, with few exceptions, companies which are not in the

21 It is estimated that in the U.S. there are 30,000 to 40,000 companies whose equity securities are publicly held and traded, and 5,000 of these companies are continuously quoted on NASDAQ. Further, in Canada, very few brokers doing business with the public are not members of the exchanges. Indeed, the OTC departments of exchange member firms probably account for well over 90% of transactions in Canadian over-the-counter equity trading. The IDA has 12 members who are not exchange members. The provincial broker-dealer associations have perhaps the same number again. By contrast, in the U.S., the NASD has over 2,500 member firms which are not exchange members or affiliates.

Table 1
Sole and Multiple Listings of Listed Issues: Canadian Stock Exchanges
1977

	Multi	Sole	Total
Toronto	749 (749)	518	1,267
Montreal	10 (660)	172	182
Vancouver[a]	27 (285)	514	541
Alberta	2 (213)	88	90
Winnipeg	0 (24)	13	13
	788	1,305	2,093

a. Including curb issues.
Sources: The monthly reviews of the Toronto, Montreal, Vancouver, Alberta and Winnipeg stock exchanges.

Table 2
Value of Trading on Canadian Stock Exchanges
1977
In millions of dollars and percentages

	Multi[a]			Sole		Total	
Toronto	$6,475.0	($5,128.1)	99.5%	$ 816.6	65.1%	$7,291.6	93.9%
Montreal	6.0	(1,316.5)	0.1	57.7	4.6	63.7	0.8
Vancouver	28.2	(65.4)	0.4	329.4	26.3	357.6	4.7
Alberta	0.3	(8.5)	0.0	50.0	4.0	50.3	0.6
Winnipeg	0.0	(0.3)	0.0	0.5	0.0	0.5	0.0
Total	6,509.5		100.0	1,254.2	100.0	7,763.7	100.0

a. The bracketed numbers reflect the total dollar value of trading on each exchange in interlisted stocks which are listed on at least one or more of the other exchanges.
Sources: The monthly reviews of the Toronto, Montreal, Vancouver, Alberta and Winnipeg stock exchanges.

currently most active one hundred Canadian companies do not have adequate trading liquidity to make them suitable for institutional investors.

As facilities for transactions, the Canadian stock exchanges can handle a considerable volume of trades. During 1975 volume was extremely low – the TSE handling 3,500–4,000 transactions daily, the MSE 800–1,000, and the VSE 1,500–1,800. In the most recent particularly active trading period (November 1971), the TSE was handling 10,000 trades per day and the MSE and VSE about 2,500 trades each. The capacities of exchange physical plants would not be overtaxed at 50% higher volume than was experienced in 1971.[22]

In providing trading floor, listing facilities, surveillance, clearing, market information and statistical information for the Canadian securities industry, the three major exchanges spent about $9.3 million in 1977. Table 3 summarizes comparative data for these three exchanges and includes the New York Stock Exchange (NYSE) and American Stock Exchange (AMEX) statistics for comparison.[23]

Because the level and variety of services provided by the exchanges may vary somewhat, it is not prudent to draw far-reaching conclusions about relative efficiency from comparisons such as those in table 3.[24] It is evident that exchange expenditure is obviously a small fraction of trading value.

To this point, discussion has focussed on describing various Canadian markets and the securities (source and kind) traded on them. To round out the description, some reference must be made to the securities industry which provides the mechanisms and makes them work, and to the investors whose money is needed and on whose willingness to hold paper assets the whole securities market system depends.

22 In addition to exchange transactions, Canadian brokers and dealers are involved in a significant number of non-exchange trades. Bonds, money market, OTC equities and foreign securities in aggregate are estimated to equal about one-third as many trades as are due to listed business.

23 The information in this table is drawn from TSE ANNUAL REPORT (1978) (year-end March 1978); MSE, ANNUAL REPORT (1978) (year-end December 1977); VSE, ANNUAL REPORT (1978) (year-end March 1978); NYSE, ANNUAL REPORT (1978) (year-end December 1977); AMEX, ANNUAL REPORT (1977) (year-end December 1976).

24 The IDA is reported to have spent about $800,000 in 1977. Added to the $9.3 million expenditure of the exchanges, the securities industry's collective efforts cost just over $10 million in 1977.

Table 3
Comparison of Dollar Value of Stock Exchange Trading per Dollar of Exchange Expenditure

1977

	Number of transactions (1)	Dollar value (in millions of dollars) (2)	Expenditure (in millions of dollars) (3)	Dollar value traded per dollar expenditure (2)/(3)
Vancouver	—	$ 400	$ 2.0 [a]	$ 200
Montreal	214,505	1,370	1.9	721
Toronto	1,402,269	6,040	5.4 [b]	1,120
Totals		7,810	9.3	—
New York	—	157,340	77.7	2,025
American	—	8,620	31.1 [c]	277

a. Includes VSE Service Bureau. *See* note 23 *supra.*
b. Excluding expenditure which is offset by revenues from CANDAT II market information service.
c. 1976 figure.
Sources: Respective stock exchanges.

D. THE CANADIAN SECURITIES INDUSTRY

In 1978, the brokers and dealers of Canada numbered about 120. Table 4 indicates the number of multiple and single memberships on the Toronto, Montreal and Vancouver stock exchanges at that time. In 1978 there were also twelve members of the IDA that were not members of any of the Canadian exchanges. The members of these self-regulatory bodies would account for over 99% of the dollar value of both underwriting and secondary trading business done by all brokers and dealers in Canada.

Evidently there is a great deal of overlapping in membership. The firms that are members of two or more exchanges account for over 90% of the volume of both the TSE and MSE[25] and over 70% of volume on the VSE.[26]

The total capital of Canadian brokers and dealers is $200 million to $250 million, over half of which is accounted for by the national firms. Total revenues for 1977 were estimated at about $350 million, with just under 60% of it being due to trading in listed equities. Employment in the industry currently numbers 12,000, a little over one-third of which is accounted for by producing salesmen.[27]

Direct investment in stocks by individuals is a popular activity. Tax statistics show that nearly 900,000 Canadians paid taxes on dividends in 1975[28] and may be assumed to be shareholders/investors. In 1965, 1968 and 1970 the Toronto Stock Exchange carried out Origin of Business studies on trading in listed securities by their members. These studies had two objectives: first to find out the amount of business coming from different types of investors; second to find out the geographical distribution of investors. Another more detailed and continuous study was launched in 1975. Termed the *Revenue and Market Analysis (RAMA) Study*, it has been conducted continuously since April 1975. Table 5 indicates the changes in sources of agency business from 1965 to mid-1978. It should be noted that this measure is of *agency* trading only. Exchange members in their capacities as

25 Informal study of 1973 trading volume done by the TSE and MSE for the Joint Industry Canada-Wide Committee.

26 The percentage of VSE business accounted for by national firms and joint members is less than on the eastern Canadian exchanges because of the dominant role played by a small number of local houses both in speculative underwriting where they "run the box", and in professional floor trading.

27 The information in this paragraph derives from a report prepared as of December 1977 by the national examiner who is employed by the National Contingency Fund.

28 DEPARTMENT OF NATIONAL REVENUE, TAXATION STATISTICS - 1975 TAXATION YEAR 60-91 (Ottawa 1977) (table 5).

Table 4
Active Stock Exchange Members
By Multiple or Sole Memberships Held[a]

1978

	Active members	Also IDA members
Toronto, Montreal, Vancouver	18	18
Toronto, Montreal	25	18
Toronto, Vancouver	5	5
Montreal, Vancouver	1	1
Toronto	20	13
Vancouver	17[b]	3
Montreal	15[c]	5
Totals	101	63

a. The Investment Dealers Association has twelve members that are not members of any Canadian stock exchange.
b. Nine are inactive.
c. Two are junior industrials, mines and oils only.
Source: Toronto Stock Exchange.

Table 5
Distribution of Agency Business Completed by Members of the Toronto Stock Exchange, Based on Value of Trading

1965 to March 1978

	1965	1968	1970	1975	1978[a]
Individuals	54.6%	54.1%	45.9%	47.3%	45.2%
Institutions	27.3	33.5	41.3	43.9	49.1
Intermediaries	18.1	12.4	12.8	8.8	5.7
	100.0	100.0	100.0	100.0	100.0

a. January to March.
Source: Toronto Stock Exchange, *RAMA Study*, 1978.

market-makers, arbitrageurs and other inventory dealers account for about 20% of the value of exchange transactions.

The other topic investigated in the Origin of Business studies was the geographical location of investment activity which ended up as transactions on a Canadian exchange. It is evident from table 6 that while the bulk of the Canadian securities trading is based in Ontario and Montréal, brokers and dealers must maintain extensive branch office communication networks to serve a widely dispersed investing public. In fact there are over 500 brokerage branch offices in Canada and virtually every Canadian city of over 20,000 people is served by at least one brokerage office.[29] In addition, there are about fifty branches of Canadian brokers in the U.S. and abroad.

RAMA data are not collected on a basis which permits measuring the origin of trades executed solely on the TSE, so no 1978 data are available on this basis for table 6. It is necessary to remember that about one-third of the Toronto-originated business is for the accounts of registered traders[30] whose job it is to ensure a continuous flow of market quotations and enhance liquidity. It is generally agreed that non-Ontario areas have increased the proportion of TSE trading which they account for.

Information drawn from the *RAMA Study* indicates the geographic source of *all* agency business handled in 1977 by members of the Toronto Stock Exchange: Ontario, 48%; Québec, 21%, Atlantic provinces, 3%; Prairie provinces, 11%; British Columbia, 9%; and foreign sources 9%.

E. REGULATORY FRAMEWORK

1. *Government Regulation*

With such a complex and geographically dispersed system of markets and investors, an important feature of Canadian markets is the regulatory framework within which they operate. There is no national regulatory authority with a role parallel to that of the Securities and Exchange Commission in the United States.[31]

29 M. Fruitman, Data Communications within the Brokerage Industry (Ottawa, November 1974) (unpublished study for the Department of Communications).

30 TSE, Notice to Members No. 1039 (July 3, 1973). This notice outlines policies and rules applicable to this category of traders which operate special accounts on the trading floor on behalf of member firms.

31 The Securities and Exchange Commission established by Congress in 1934 to administer federal laws governing the issue and trading of securities is clearly the national securities regulatory body in the U.S. For 1975, it had a budget of $43.1 million, 1,200 employees located in Washington and nine regional offices. By the Securities Reform Act of 1975, the scope of the SEC's authority was extended to

Table 6
Geographic Origin of Business on the Toronto Stock Exchange

1970	
Toronto	50%
Other Ontario	12
Montréal	10
Other Québec	1
Atlantic provinces	2
Prairies	7
British Columbia	6
Foreign	12
	100

Source: Toronto Stock Exchange, *Origin of Business Studies.*

Rather, each province is responsible for the protection of investors and the regulation of the issue and trading of securities within its own boundaries.

To accomplish this mission, there are ten provincial securities commissions or bodies of similar function. These bodies protect the residents of their own provinces by:

(1) registering any broker or dealer firm which is resident in the province and/or dealing with its residents on a regular basis;
(2) registering any salesmen of a broker or dealer who deals with residents of the province;
(3) monitoring the meeting of disclosure requirements for prospectuses of companies which offer securities to its residents;
(4) supporting an investigation and enforcement function.

In the provinces where a stock exchange exists, the securities regulators also have responsibility for oversight of the exchange's operation and rules.[32]

The provincial regulatory authorities have increasingly cooperated in developing "national policies"[33] and British Columbia, Alberta, Saskatchewan, Manitoba and Ontario are known as the "uniform provinces".[33a] Québec has reworked its securities law in the past three years to be largely similar to the "uniform provinces". To date, there is no specialized securities legislation in the Atlantic provinces but work is under way.[34]

In parallel with the provincial securities regulators, there are certain self-regulatory bodies which are recognized to varying degrees by the provincial legislation. In general the securities commissions do not become involved in day-to-day regulation of exchange members, trading or listed companies, but rely on the industry's self-regulatory bodies.

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cover clearing corporations, depositories and transfer agencies, and also increased substantially in its overriding authority over the U.S. self-regulatory bodies.

By contrast, the Ontario Securities Commission had about 85 employees and a budget of $2 million. The entire complement of provincial Canadian securities regulators is under 150 people with a budget of less than $3.5 million.

32 In British Columbia, the securities act has been amended to give the Superintendent of Brokers greater responsibility and powers over the Vancouver Stock Exchange and the securities industry than exists in Ontario and Québec; *see* B.C. Securities Act, s. 137, *as amended by* S.B.C. 1975, c. 70, s. 9.

33 National Policies, 2 CCH CAN. SEC. L. REP. ¶¶ 54-838-54-870.

33a Uniform Act Policies, 2 CCH CAN. SEC. L. REP. ¶¶ 54-871-54-882.

34 Dennett, *Maritimers a Little Wary about Stock Exchange Plan*, The Toronto Star, September 3, 1975.

2. *Self-Regulation*

The principal self-regulatory bodies are the Investment Dealers Association of Canada (IDA) and the Toronto, Montreal and Vancouver stock exchanges.[35]

The Porter Commission stated in 1964:

> "A substantial measure of self-regulation is vital, both because the industry possesses an intimate knowledge of its own workings and problems that no outside agency can hope to equal and because self-discipline helps to develop a broader sense of public responsibility."[36]

Since then there has been increased attention paid to the effectiveness of self-regulation by the aforementioned bodies. As each body upgraded its regulatory capability, it became necessary for the self-regulatory bodies to divide responsibilities to avoid duplication of expense and undue harassment of firms which were members of more than one self-regulatory body. For example, sixty-three of the IDA's seventy-five members as of mid-1978 were also members of one or more stock exchange and eighteen of these were members of the three major exchanges as is shown in table 4.

The IDA is a national body, with headquarters in Toronto and staff representatives in Vancouver and Montréal. In addition it has a district council in each of seven regions. The IDA functions substantially as a trade association to promote the welfare of its members with government and the public. It also carries out certain regulatory functions with respect to the bond market through the Montreal, Toronto and British Columbia bond traders associations. In addition, for its sole members and certain stock exchange members it has responsibilities for supervision of member firms' compliance with the industry's requirements regarding capital and internal procedure as well as salesmen's conduct in servicing customers.

The three stock exchanges all claim absolute jurisdiction over their members and listed companies. They do, in fact, exercise

35 The Alberta Stock Exchange and the Winnipeg Stock Exchange are also self-regulatory bodies but have exercised little administrative power. The Alberta Exchange, however, has employed a full-time president and is making efforts to increase its importance in the securities markets. It is understood that securities firms with branches in Alberta have been encouraged to buy a seat on the Alberta Stock Exchange as an affirmation of their involvement in the province's capital market and to protect their underwriting position in the province's securities issues. In addition, financial institutions (banks and trust companies) with Alberta branches have been similarly encouraged to list their shares on the Alberta Stock Exchange.

36 REPORT OF THE ROYAL COMMISSION ON BANKING AND FINANCE (PORTER REPORT) (1964) at 347.

authority over their members with respect to trading carried out on their own facilities.[37] Most regulatory responsibilities, however, are split. In effect, for a listed company there is a tacit understanding that the major thrust of regulation will come from the largest exchange on which it is listed.

With respect to supervising the operations of members, jurisdiction is also rationalized so that continuous monitoring of capital and procedures has been divided over the three exchanges and the IDA. The IDA has responsibility for several of the larger underwriting and money market houses. With two or three historical exceptions, the division of responsiblity for supervision of brokers is generally along regional lines by location of head office.

In responding to complaints from investors, there is the added problem of unlisted as against listed trading. If an offence is in a listed stock, then the burden of enforcement is assumed by the self-regulatory body on whose facilities the alleged offence took place. If an offence takes place in an unlisted stock or if a complaint involves a salesman's conduct but does not relate to trading, then the enforcement usually falls to the body which receives the report/complaint. The usual result is a regional division of enforcement.

As might be expected, evenhanded administration of rules on matters where jurisdiction falls to four different bodies is a continual challenge. Nevertheless, cooperation between the exchanges and with the IDA is generally good on such matters and has steadily improved.[38]

37 On the other hand, no exchange has succeeded in restricting the activity of its members on other exchanges. For example, when one exchange has issued a stop trading order in a particular stock and another has not, members of the latter exchange regard it as proper for them to trade on that exchange irrespective of their membership on the exchange where it is halted. Similarly, though short selling of listed securities is restricted on the TSE, joint members of the TSE and MSE are able to sell the same stocks short on the MSE without restriction.

38 If a split jurisdiction between the self-regulatory bodies seems to offer potential problems, it may be worthwhile to note the tangle of enforcement agencies which supplement or override the work of the self-regulators. In the few years preceding 1973, particularly in B.C. and Québec, questionable elements appeared to be able to exercise unusual influence with the Vancouver Stock Exchange, the Canadian Stock Exchange (now being wound up) and Quebec Securities Commission. In response to the explosion in securities fraud, which took place during that period, numerous enforcement agencies increased their complement and competence. In addition to stock exchange examiners and compliance officers, brokers and dealers may be visited by representatives from the RCMP Commercial Crime Section (branches in 15 major Canadian cities in all provinces but P.E.I.), the provincial securities commission and (in Toronto and Montréal) the city police fraud squad.

F. COMPARISON WITH U.S. MARKETS

As one would expect from their geographical proximity, the Canadian and United States markets are quite similar in organization. There are, however, some differences which are worth noting to place the Canadian market in context.

1. *Market Size*

The data for stock exchange dollar values of trading in 1977 in table 7 indicate how much larger the U.S. market is than the Canadian.[39] Although the U.S. population is about ten times that of Canada, the volume of trading and other U.S. market statistics indicate (as a rule of thumb) a factor of twenty to thirty times in terms of size of the industry and volume of activity. Merrill Lynch alone, with 1977 revenues of $1.1 billion, capital of $650 million and 20,000 employees, is substantially larger than the whole Canadian industry.[40]

2. *Market Structure*

With respect to detailed organization, U.S. primary issues, bond and money markets are generally similar in structure to those in Canada. There are some differences in the OTC equity markets and in the stock exchanges, however.

An historical difference is that the New York and American stock exchanges list bonds for trading. In 1976, bond volume on the NYSE amounted to $5.3 billion in 2,700 issues. The same issues also trade in the OTC bond market. A second difference is that though the U.S. regional exchanges (Midwest, Pacific Coast and Philadelphia Baltimore Washington) traded a substantial dollar value, most of that trading was in stocks listed on the New York or American stock exchanges. Unlike the Vancouver stock exchange which has several hundred stocks of its own (and to a lesser extent, Montreal), the U.S. regionals have only a small representation of local securities.

Probably the most noticeable structural difference is the large over-the-counter equity market in the U.S. Over-the-counter trading of equities in 1969 through 1972 was equal in volume to more than half the share trading of the New York Stock Exchange. The parallel Canadian comparison would indicate total Canadian OTC equity trading at less than 5% of exchange trading.

39 Toronto Stock Exchange, Statistics Department, 1978.
40 MERRILL LYNCH, PIERCE, FENNER & SMITH INC., ANNUAL REPORT 1977, at 1 (1978).

Table 7
Comparison of Stock Exchange Dollar Value of Trading

1977
In millions of dollars

Stock exchanges	Value of trading
New York	157,339
Midwest	9,883
American	8,624
Pacific Coast	6,615
Toronto	6,045
Philadelphia Baltimore Washington	3,038
Montreal	1,374
Vancouver	395

Source: Toronto Stock Exchange Statistics Department, 1978.

The importance of OTC equity markets in the U.S. is mainly due to the much higher listing standards of the U.S. exchanges.[41] Although a small number of senior securities – principally life insurance companies, but also such well-known names as Anheuser-Busch, First American Bank and Tally Corp. – have long-standing relations with OTC market-makers and have so far chosen to remain aloof from listing, the fact is that a much smaller proportion of publicly-traded stocks are able to obtain listing.

It is worth noting that the size of the United States OTC market has resulted in a nation-wide system being established to make quotation information conveniently available to brokers servicing investors in OTC stocks. The National Association of Securities Dealers (NASD) arranged in the late 1960s with Bunker Ramo to create an automated quotation system (NASDAQ).[42] This system permits market-makers to enter bids and offers through Level 3 terminals for dissemination to trading desk (Level 2) terminals. In addition a median bid/offer for each stock is available on most of the 40,000-odd desk-top sales terminals scattered around North America.

Three recent developments in the legal framework governing the U.S. industry are creating pressures which are gradually causing it to diverge in structure from its Canadian counterpart. These three developments are institutional membership in stock exchanges, public ownership of securities firms and removal of the stock exchanges' power to fix brokerage commissions. A fourth (and perhaps most important) issue has been the subject of hearings before the SEC in that the New York Stock Exchange's cornerstone rule (No. 390) – that is, that all trading by members in listed securities must be done on the exchange and subject to its rules – is being attacked as anticompetitive and inimical to the public interest.[43]

The related questions of institutional membership and public ownership go back to the 1969–71 period when the U.S. industry was suffering from the collapse of back office systems[44] and a general exodus of old family money from Wall Street. Whereas before that time some institutions had gained access to the regional exchanges in order to pocket part of the commissions generated by their portfolios, the NYSE had stood firm against financial

41 *See* ch. III.C *supra*.

42 *See*, *Jenkins*, ch. III.B.

43 *Notes on Rule-making Proceeding to Consider Rules Which Limit or Condition the Ability of Members to Effect Transactions Otherwise Than on Exchanges*, SEC, Securities Exchange Act of 1934 Release No. 11628, September 2, 1975, 7 SEC Docket 762 (1975).

44 LYBRAND, ROSS BROS. & MONTGOMERY, PAPER CRISIS IN THE SECURITIES INDUSTRY: CAUSES AND CURES (1970).

institutions either becoming, or investing in, member firms. With the crisis of 1970,[45] any source of capital became welcome as firms struggled to meet daily capital requirements. Various insurance companies and other corporations were permitted to buy substantial minority positions in NYSE member firms.

Similarly, public ownership was another source of permanent capital for a troubled industry. The first public issue was made in April 1970, when Donaldson Lufkin & Jenrette went public (underwritten by Merrill Lynch and First Boston) and raised $11 million by sale of shares to the public. Merrill Lynch, Bache, E.F. Hutton, Paine Webber, A.E. Edward, Dean Witter Reynolds, among others, followed by the end of 1974, resulting in a large amount of *new* capital being raised by public share issue, and committing to a "permanent capital status" more than $1 billion of brokerage firm capital.

By contrast, the Canadian industry considered and rejected both institutional memberships and public ownership in the so-called *Moore Committee Report*[46] and its follow-up *Joint Industry Committee Study*.[47] Rules governing Canadian brokerage firms' sources of capital were liberalized as a result of these studies but it has been made clear that public ownership of securities firms' shares would not be permitted and that capital invested in such firms by banks and other potential investors is to be closely restricted so that the persons providing not less than 60% of a firm's capital have to be actively involved in the firm.

From 1968 to late 1974 in the U.S., various SEC and congressional hearings took place to examine the need for fixed commission charges on stock exchange transactions. The result of these enquiries was that U.S. commission rates became negotiated as of May 1, 1975.[48] In the succeeding thirty months the U.S. industry adapted to the new competitive environment by significantly cutting commissions to large institutional investors and by consolidating into more capital-intensive units. In that it has so far

45 C. ELLIS, THE SECOND CRASH (1971).

46 REPORT OF THE COMMITTEE TO STUDY THE REQUIREMENTS AND SOURCES OF CAPITAL AND THE IMPLICATIONS OF NON-RESIDENTS, CAPITAL FOR THE CANADIAN SECURITIES INDUSTRY (1970) [hereinafter the MOORE COMMITTEE REPORT].

47 Toronto Stock Exchange, Submission to the Ontario Securities Commission, Securities Industry Ownership Study Committee (October 1971).

48 *Adoption of Securities Exchange Act Rule 19B-3*, SEC, Securities Exchange Act of 1934 Release No. 11203, January 23, 1975, 6 SEC Docket 146 (1975). This release contains an outstanding historical review of the fixed commission question as well as highlights of the crucial arguments and a complete set of footnotes referencing the key documents relating to the question and the SEC's paper record in dealing with it.

retained a fixed-rate structure, the Canadian securities industry is, of course, greatly concerned by the U.S. change.[49]

Before May 1975 the Canadian fixed-rate schedule was slightly higher than, but rather similar in structure to, the American one. Rates for small transactions (usually applicable to individual investors) were higher than for large trades (generally those of institutions). When it became clear that the U.S. rates would become unfixed, there was concern that the 30% of Canadian exchange business which is in securities interlisted with the New York and American stock exchanges might tend to move to the U.S. markets where American brokers would presumably charge less for institutional executions.

Four proposals for the Canadian exchanges were put before the memberships:

(1) Move immediately to unfixed commissions on all listed stocks.
(2) Move to unfixed commissions for executions on Canadian exchanges on a subset of stocks which were particularly subject to competitive activity by American brokers servicing Canadian institutions, and leave rates fixed on all other stocks.
(3) Require Canadian exchange members to charge Canadian rates on all transactions in Canadian securities for Canadian accounts regardless of whether the execution would be in the U.S. or Canada.
(4) Make no changes but monitor developments closely.

After much discussion,[50] the Canadian industry decided by majority votes of the members at the Montreal and Toronto exchanges that the appropriate course was to change no rules but to monitor developments. This meant that Canadian brokers could meet U.S. competition on interlisted stocks by taking executions to a U.S. exchange but that such business as came to the Canadian exchanges would be at traditional Canadian commission rates.

Extensive monitoring is being done by the Toronto and Montreal stock exchanges. Data obtained indicate that in the fifteen international stocks which account for 41% of total trading in interlisted stocks, the portion of total trading which was executed in the U.S. was 45% in the period January–April 1975, 54% in the period May–September 1975, and 58% in the period January–May 1977.

49 P. Lortie, The Case for Fixed Commission Rates (study prepared for MSE, April 1975).

50 Toronto Stock Exchange, Memorandum to Members (attached to TSE Notice of Meeting, April 14, 1975 and TSE Notice to Members No. 1216, April 23, 1975); Montreal Stock Exchange, Circular No. 116-75, April 30, 1975.

Chapter IV
Mechanics and Daily Operations of the Securities Market System[51]

The functions and mechanical operations which constitute the daily business of the securities market system in Canada are shown in figure 2. The diagram also indicates, with cross-references to the text, those sectors of the system in which computer automation is used. The primary issuers of securities instruments, corporations and governments, are shown on the upper left. Typically, an issue is underwritten by securites firms and distributed through salesmen to investors. In the event that the new buyers wish to sell, the contact is back through a salesman to a securities firm's trading department. That department may be inventorying the security or it may be turning it around immediately for OTC resale. Bonds generally trade on this basis. Equity securities also trade on this basis unless or until they become listed on a stock exchange.

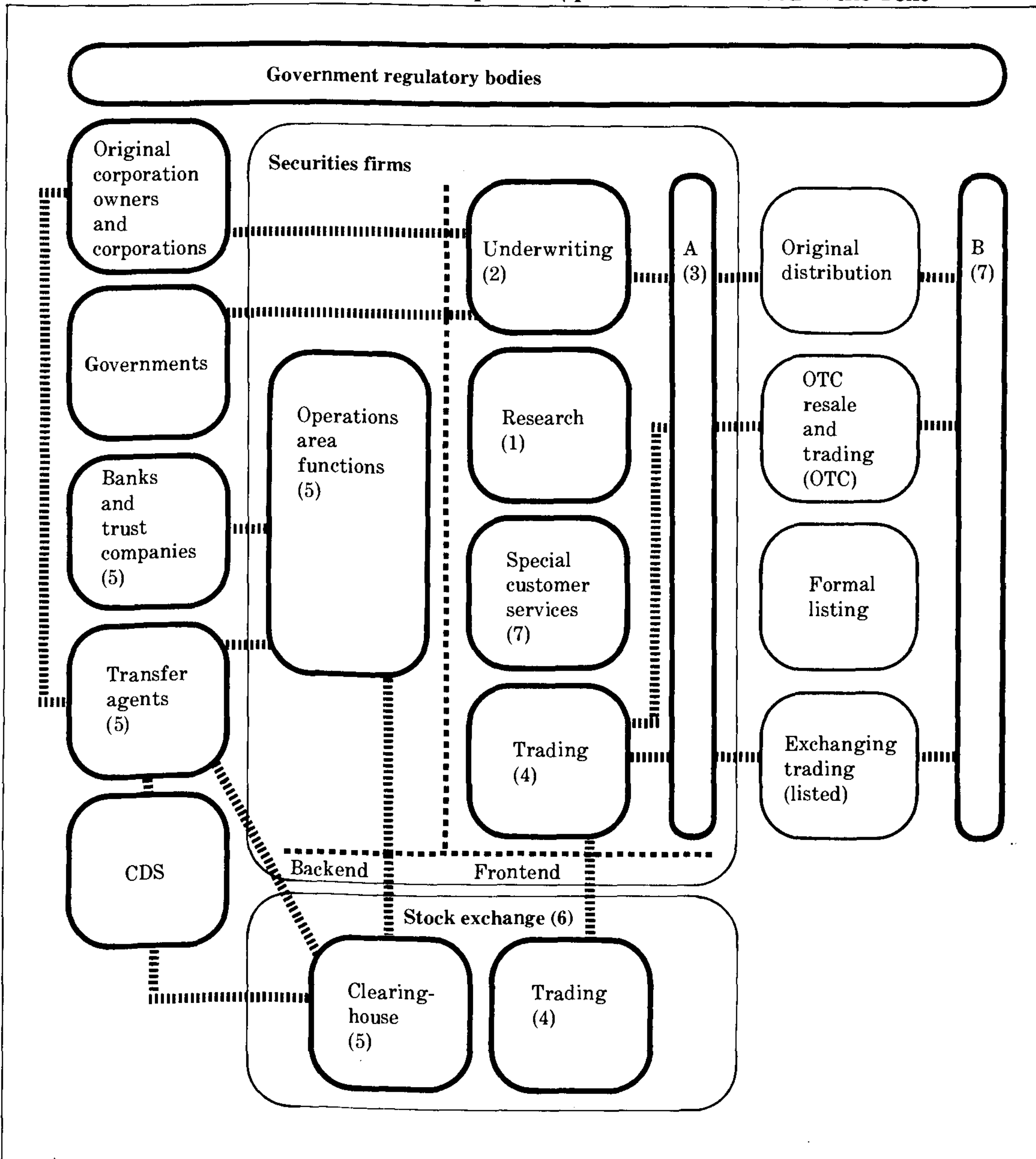
After listing, the trade is more complex when orders to sell or buy are not dealt with completely in the securities trading area but are sent on to the stock exchange floor to seek a match as indicated in figure 2, lower right. When trades are taking place, immediate notice of them is handled in the securities firm's contracts, accounting, cashier and securities certificate storage ("cage") operations areas. If a trade is in a listed security, the exchange's clearing house procedures would also be activated.

In support of transaction settlement activities in the securities cage area, there is frequently an involvement of corporate transfer agents, as indicated in the lower left to put securities in the form requested by the securities cage. This contact is often through the "mailbox" envelope transfer facilities of the clearing house whereby the exchanges/depository provide a centralized envelope/mailbox service. It is not uncommon, however, for direct contact to be made between securities firms and transfer agents.

The banking and trust company areas are also involved in providing storage for certificates under the control of brokers' securities cages as well as those owned by the bank or trust companies or by clients of these institutions acting as investment managers. Similarly banks have a relationship with securities firms in financing, through collateralized call loans, the securities

51 This chapter was prepared in late 1975. In the intervening two years, there have been some changes, but basically the same services are currently offered and the conceptual material remains valid. Therefore, the details have not been updated and the reader should bear in mind that the facts constitute a status report as of year-end 1975, not 1978.

Figure 2
Securities Market System
With Numerical Cross References to Computer Applications Described in the Text



A: Salesmen (registered representatives)
B: Capital suppliers - public (individuals and institutions)

Numerical cross references to computer applications: see text, ch. IV
1. Research
2. Underwriting
3. Sales support
4. Trading and trading support
5. Clearing and settlement
6. Regulation and enforcement
7. Special sales-attracting services

positions in customer margin accounts and also in house accounts, as well as the financing of underwritings.

In effect the model can be neatly divided into two sections: the "frontend" dealing with sales and trading; the "backend" or "operations area" dealing with credit, settlement, custody and ownership. The functions of both the frontend and operations area are increasingly being facilitated and streamlined by various applications of computer and communications technology.

A. FRONTEND SUBSYSTEM

In the securities industry, the frontend is where the money is made and where the saleable products and services are created.

There are four principal components in the frontend: sales, trading, underwriting and research. As the greatest part of securities industry revenue is in transaction charges (commissions) or underwriting spreads, sales is the pivotal function. The sales "system" in the Canadian securities industry involves 4,500 registered representatives in 550 branch offices in Canada and abroad.[52] The principal job of the other frontend subsystems is to support these salesmen with desirable products.

In effect, securities firms may be regarded as marketers of securities and securities-related products. It is not misleading to envision a securities firm as a team of salesmen (with customers having investment needs) whose job it is to keep the customers happy, and a backup group of product-makers, whose job it is to provide the salesmen with the necessary merchandise, ideas and services. Though firms vary greatly in the emphasis they place on different products, their goal is to offer sought-after products and services in a way that will win them business. There are four main products.

(1) *New issues and secondary distributions.* Although the conventional description identifies underwriting as a capital-raising function wherein the capital needs of corporations and governments are met by issue of securities to the public, it is equally a customer-servicing function. The sales manager is an increasingly important factor in deciding whether a firm will make an underwriting, what will be the terms of the issue and how it will be priced. His concern is not only that the securities can be "placed" (sold) on issue date but also that the customers who buy the securities will continue to want to deal with the firm in the future. Thus underwriting is in fact a complex trading off of issuer and investor needs. It analyzes

52 *See* text accompanying notes 25-30 *supra.*

divergent requirements and results in an accommodation of competing interests that will bring funds to the issuer in an acceptable form while meeting investors' needs for capital preservation or income, and assuring that both corporation and investor will want to stay with the firm for repeat performances in the future.

(2) *Liquidity for secondary trading.* This important product is an outgrowth of the organized marketplace for securities where a large number of investors' wishes are coordinated. Liquidity is the ability to convert (with convenience and at low cost) securities to cash, thus making direct investment in securities (instead of, for example, in mutual funds or a bank account or savings bonds) a credible proposal. The more liquid is the market for any security the more attractive will be investment in that security. The amount of liquidity in a market at any given time is the result of many factors. It is, in the first place, a function of the public's confidence in the fairness of that market and their interest in securities investment. Other factors determining liquidity are the degree to which professional investors and dealers are willing to trade in that market and the extent to which all trading interests are expressed in a single marketplace. In addition, liquidity is inversely related to any inconvenience and undue expense to investors in participating. The complex interplay of these various factors will further be affected by the regulatory environment and by the facilities and supporting systems which constitute the marketplace.

(3) *Research.* This is a "better idea" product. Through the provision of timely and insightful research, the salesman endeavours to persuade the investor to regard the firm's investment recommendations and analytic information as superior to that of other firms – therefore, warranting sale and/or purchase of securities through that firm. Investment research has become an extremely sophisticated field. To research a company at the level required today, analysis is required of national and international economic circumstances, the industry as a whole, and of the subject company in particular. The requirements for raw data and the ability to manipulate it are enormous.

(4) *Service.* This is a catchall of work. It includes everything from relatively concrete matters like favourably priced executions and quick reports, timely answers to customers' queries and provision of *unsolicited* information on their holdings, to such ephemeral services as sympathetic commiseration and remembering the customers' wives' birthdays. Although part of

a customer's view of a firm or salesman's "service" rating is based on personality or on facts such as execution price, a large part of service quality is dependent on the information and communication systems available to support the salesman.

Until six years ago most management and development efforts by Canadian securities firms were spent on the frontend functions outlined above. The data processing and paper handling systems which accomplished internal accounting and record keeping, and settlement and ownership recording functions were relatively neglected.

B. BACKEND SUBSYSTEM

There are several crucial functions of the back office or "operations area" in the broker and dealer offices. Preparing contracts and statements to obtain payment and inform customers of their securities positions, controlling credit, handling and keeping track of certificates and carrying out execution of customers' instruction for certificate registration and delivery are among the major functions. Volumes are large.

In all, active Canadian corporations and governments have outstanding over 30 million securities certificates, 16 million to 18 million of which are equities. Nearly half of the equity certificates were reckoned by the Canadian Depository for Securities Ltd. (CDS) to be in the hands of the financial community (brokers, 3 million; banks, 3 million; and trust companies, 2 million), primarily in safe-keeping custody or hypothecation for customers.[53] No estimates were made for bond certificates but an equal or greater number are likely to be similarly held, particularly by banks and trust companies.

In order to keep corporate ownership records up-to-date, brokers and dealers in 1971 were shuttling equity certificates back and forth at the rate of 10,000 units per day with the seven major transfer agents which do 90% of the corporate transfer for the 3,000 active Canadian corporations.[54] Transfer agents issued and cancelled an average of 22,000 certificates daily. In support of their call loan needs, brokers and dealers were moving 1,500–2,000 units daily with banks. Another 1,500–2,000 units were moved to

53 *See* REPORT OF THE OPERATIONS COMMITTEE, *supra* note 8, app. 6.

54 One unit of movement is one security delivered or received with a transfer agent by one brokerage office. There are often two or more certificates in one movement.

make delivery on purchases and sales involving other institutions.[55]

For every active customer a broker maintains at least one securities account. Given that institutional customers deal with a large number of brokers and that many individuals also have more than one broker, indications are that Canadian brokers and dealers maintain over 1 million accounts. Transfer agents maintained about 4.5 million corporate shareholders' accounts in 1971.

Evidently there are a lot of records to keep track of and a high level of daily activity. The cost for this work in 1971 was reckoned by CDS at about $40 million for brokers and dealers and about $10 million to $15 million for trust companies, banks and transfer agents solely in connection with settlement and transfer contacts with brokers and dealers.[56]

A securities firm operations area has two principal interfaces – streetside and clientside. The former deals with settlement of trades between members; the latter with settlement of transactions with customers. For some years streetside settlement has been highly organized through the stock exchange clearinghouses. Movements of certificates between exchange members and stock transfer agents is also coordinated through the clearinghouses. At the present time (1975), the thrust of new development is to bring the banks and trust companies within a formally organized clearing arrangement. This will mean that settlement of clientside transactions for institutions (which use banks and trust companies as agents for delivery and safekeeping) will have been converted to the same economical basis as streetside settlement. More explanation of this matter is included in chapter V.

C. COMPUTER SUPPORT FOR SECURITIES INDUSTRY FUNCTIONS

To this point, we have outlined the economic function of the securities markets, described the various types of markets, the principal participants and the regulatory framework in which they exist. We have also outlined, as an integrated system, the various functions and mechanics of the daily operation of the securities firms and certain bank and trust company operations in the market.

This section enumerates and describes the areas of this integrated system which use computers and communication technology. It constitutes, in effect, a status report as of year end 1975 on

55 REPORT OF THE OPERATIONS COMMITTEE, *supra* note 8, at 32.
56 *Id.* app. L.

the various applications of automation in North American securities firms and in the markets in which such firms participate.

There is nothing magic about computers. They are simply a highly organized collection of electronic circuitry, capable of moving, manipulating and storing vast quantities of information quickly and accurately. Even the most complex systems can be seen as an ordered arrangement of devices for data input, movement, storage, manipulation/calculation, and output. The large number of routine transactions to be processed and great amounts of corporate and market data to be collected and dispersed in securities research and trading functions make the securities industry a natural area for exploitation of the computer. What has perhaps opened up the securities industry for particularly significant progress is the ability of computers to be connected to remotely located users through communications systems such as the telephone (Bell Canada) or telegraph (CNCP Telecommunications) networks. By these connections, the former barriers of space and time and the difficulties of mailing and storing expensive paper records for awkward future access are being overcome.

In figure 2, note has been made in each area where a computer application is now being used by some participants in the market system.

The review of the several roles of computer and communications technology in the securities markets could be approached in several ways. For example, the review could be organized in terms of the users (brokers, exchanges, banks and trust companies), or it could be organized in terms of automation function (data base management, terminal communication networks, modelling, inventory control/transaction processing). Instead, the simple approach of going step-by-step around the areas of the securities market system schematic has been chosen and probable cross-references, rationalizations, or common trends noted. The areas on the schematic are cross-referenced by numbers to the headings in the text below.

1. *Research*

a. *Historical and Current Market, Corporate and Economic Information Data Bases*

Information is the raw material of securities industry research departments. Before computers came into general use, many thousands of hours were spent collecting and filing data from corporate financial statements as well as historical data on market prices and volumes and general economic statistics. Because each firm had to have its own file of information, the same

work was duplicated dozens of times to build these three data bases in usable form.

The ability of electronic memory devices to hold vast amounts of such data in a form easily accessible from terminals has greatly changed the organization of securities research. Instead of maintaining dozens of duplicated file folders, brokers and financial institutions subscribe to one or more of several data base services. In additon to raw data access, data base services also allow their users to program statistical comparisons and various analytic routines. Such time-share accessibility not only is a great time-saver compared to manual tabulations but it makes feasible a much more ambitious and comprehensive program of securities research.

At the simplest level (Ian Sharpe Associates Ltd., Dataline, Comshare, IBM's "Market"), a time-sharing computer facility simply loads memory devices with the basic data files. Trade data is obtained from stock exchanges (or indirectly via the *Financial Post)*, corporate data is obtained from the *Financial Post* (which gathers it for its own publishing purposes) and economic statistics are taken from Statistics Canada sources (CanSim tapes). Although certain standard programs and programming assistance are usually available from the service bureaus, users of the services generally develop their own programs or buy commercial program packages. Suppliers of these simple data base services are basically selling computer time. They do not tend to specialize in financial data or securities market servicing.

At a more specialized level, FRI Information Services Limited[57] offers a customized research/data service via Bell Canada's "Dataroute" service to seventy-five customers. Because of its specialization and sponsorship, FRI has made special efforts to upgrade and standardize the quality of its market price data and especially of its corporate financial data.[58]

In addition to maintaining a comprehensive data base of market and corporate data and CanSim series, FRI also has a large library of standard analytic programs which subscribers can activate in order to have specified runs produced on their terminals. Subscribers may also create custom programs of their own which

57 FRI (Financial Research Institute) started out in 1967 as a cooperative venture of the Financial Post and McGill University but has evolved to a more commercial operation. For a more complete write-up of its background, purpose, services and plans write to FRI Information Services Limited, 1801 McGill College Ave., Suite 600, Montréal, Québec, H3A 2N4.

58 FRI has its own programs to put stock price volume and dividend data in memory and has designed some special standardization methods which The Financial Post carries out exclusively for the corporate financial data it provides for FRI.

they can then run against the data to make their own unique analyses.[58a]

Many brokers have arranged connections to extant data base services. Two, however, are themselves involved to varying degrees in the business of providing securities research data bases. Jones Heward & Company Ltd. of Montréal, a broker of long-standing reputation in research and portfolio management, has developed its own data bases tailored to its own needs. To a limited degree it sells access to its data bases and also, through its own programming group, provides customized analytic and portfolio programs for clients. Wood Gundy Limited of Toronto which has made a large investment in computer capability has also organized a specialized data base of historical information on the trading, capital and similar matters of 200 companies. Access is limited to the firm's own purposes.

b. *Modelling/Simulation*

Securities firms are using econometric techniques to test various commercial and economic assumptions in computer-based models of the economy. By such simulation they hope to improve their judgments on how particular companies will be affected by certain economic shifts (component or product price changes, interest rate changes, foreign exchange rate shifts) or corporate changes (levels of production, etc.).

c. *Technical Analysis*

Stock price and volume charts which were formerly the product of trading and laborious posting are now produced by computers based on collection of machine-readable data direct from the exchange trade ticker. Draper Dobie & Co. Ltd. of Toronto, which has its own installation of Digital Equipment minicomputers and a network of video terminals, has a notable example of this application in "Dobie's Online Graphics System" (DOGS). DOGS has charts available for print-out or CRT (Cathode Ray Tube) display on request by any of the twelve terminals now operative in Toronto. Various other technical measurements and indicators are calculated through the aid of the system (*e.g.*, on balance volume, new highs and lows, etc.).

58a FRI began in 1967 with five employees and subscriptions from 10 interested institutions and broker-dealers. It and Data Directions (a commercial affiliate) now have 26 system consultants, programmers and clerical support staff and provide service to 75 customers, 23 brokers, 35 institutions, 17 universities and government departments. Including multiple location users, there are 125 terminals able to access FRI data bases.

d. *Liquidity Measurements*

Built on a data base of trading volume information, liquidity indices can be calculated to compare the relative liquidity of listed Canadian securities. Crang & Ostiguy Inc. are prominent in this area and will provide variations on request to screen for available issued shares, dividend reliability and growth of earnings records.

2. *Underwriting: Modelling/Simulation*

In order to test the financial impact on a corporation for which a financing is planned, some underwriters have developed modelling programs which permit various proposals to be tested against both selected economic and commercial assumptions and the detailed financial situation of the company in question. The result of such activities is believed to be more appropriately conceived and better-priced issues. Thus, both issuer and investor are afforded an improved product.

3. *Sales Support*

a. *Market Information for Salesmen*

i. Ticker tape

As noted earlier, the NYSE established its ticker tape in 1867. In 1909, the Toronto Stock Exchange established facilities to transmit quotes every ten minutes. It was not until the mid-1920s that a continuous trade ticker such as is known today was offered in Toronto (by the Standard Stock and Mining Exchange).

The stock ticker is an inherently simple system composed of a device to organize stock trade and quote data for transmission, a communications net to carry the transmission, and a device to read the transmissions, convert them to man-readable form on a paper tape or play them sequentially across a display panel. At present there are 540 stock tickers in Canada: TSE 450, MSE 30, VSE 60, plus a few NYSE and AMEX.

ii. Market information inquiry terminals quotation devices

One of the earliest online applications of computer by any industry was the introduction by Scantlin Electronics Inc. of "Quotron" desk-top market quotation terminals to the U.S. industry about 1959–60. Ultronics Systems Corp. introduced Stockmaster terminals to Canada in 1962. Such inquiry networks involve a computer-driven data base, communications net and addressable terminals. Up-to-date transaction and quotation information is collected by a computer which carries online files of the informa-

tion read from trade and quotation ticker tapes produced by the exchanges. A computer also manages the communications net and terminal system to give immediate responses to information requests.

In 1975, Scantlin, Bunker Ramo and Ultronics, the main commercial suppliers, had between 40,000 and 50,000 terminals operative in North America. In Canada, Scantlin does not operate, but Bunker Ramo had 200–300 installed terminals and Ultronics, 1,400–1,500. An additional factor in the Canadian market is the Toronto Stock Exchange which has 550 installed inquiry terminals,[59] while the VSE has a network of 40 dialup Telex terminals and 20 Vucom terminals in its recently announced MARS system.[60]

The marketing thrust of Ultronics and of Bunker Ramo in Canada has been to service the heavy population centres. On the other hand, the TSE's CANDAT system (first operative in 1965) was developed by the exchange principally to service smaller and more remote communities. Because of its basic teletype keyboard design and CNCP sales and service contract, it could be offered at low prices in areas where the population size did not justify a more elaborate terminal. CANDAT has devices as remotely located as Dawson City, Yukon, and St. John's, Newfoundland. Its existence in the larger centres has also ensured that a monopoly does not exist for the other suppliers.

iii. Block offering devices

An important innovation in the specialized market for big blocks of stock was engineered by Automatic Exchange Ltd. (AutEx). The founders of AutEx recognized in the mid-1960s that traders at both institutions and brokers spent many hours shopping around for offsetting trading interests. Recognizing this as an opportunity to save time and effort for highly paid people, AutEx devised and set up a data base and interactive terminal network which would permit brokers and institutions to file trading interests and broadcast messages to any or all subscribers. The messages indicate in which stocks they have buying or selling interest and give an indication of the size of the interest (small, medium and large). In 1973 AutEx had 474 subscribers and 550 terminals in the field.[61]

AutEx charges are high ($5,500 to $9,500 per terminal per month) and at the present time (1975) a competitor, Comstock, is

59 Including some 70 CANDAT II terminals which are part of a system described in ch. VI.B *infra*.

60 The Financial Post (Toronto), September 20, 1975, at 22; *see also* app. B *infra*.

61 *See*, *Jenkins*, at text accompanying n. 23.

attempting to set up a competitive network[62] to give much the same service but at lower cost. An earlier competitor of AutEx, the New York Stock Exchange Block Automation Service (BAS) which also did essentially the same thing as AutEx was discontinued in 1974.

b. *Customer Account Information*

A recently planned innovation is the use of desk-top terminals to provide salesmen and operations area personnel with up-to-date information on customer accounts – for example, what securities are held, excess cash or buying power and status of settlement on open transactions. At this date, a number of brokers in the U.S. are setting up their own in-house systems. In Canada, IBM has planned such a system, Online Account Status Information System (OASIS) and is trying to market it through the data centre but with little success. Both Draper Dobie and Wood Gundy have such systems in the design and development stage, but neither is looking for near-term implementation.

Because of its departure from traditional operations area practice Nesbitt Thomson has an online customer information system operating (1975) on terminals in Toronto, Vancouver and Montréal offices. So far the main application has been in the operations area to monitor open items but the firm expects salesmen to be using it for account servicing and sales by mid-1976.[63]

The potential for such systems appears very great in that a salesman will be able to have current information about a customer's portfolios on a screen in front of him before he talks to the customer. This will be a significant improvement from the present inter-office memo system giving periodic reports (perhaps as infrequently as monthly) on customer security positions. In addition, the potential will be available for firms with such facilities to distribute research opinions, information bulletins and margin calls instantaneously to all salesmen with terminals.

4. *Trading and Trading Support*

a. *Trading Systems*

There are at present (1975) no computer-based trading systems in Canada.[64] However, chapter VI describes at length the

62 Securities Week (New York), July 21, 1975, at 9; *id.* August 25, 1975, at 2a.

63 Conversation with G.D. Bronson, Manager of Systems, Nesbitt Thomson & Co. Ltd.

64 The OSC in July 1971 directed Guardian Management of Toronto to remove the Instinet terminal which it had obtained on an experimental basis because one of its subsidiaries was an investor in Institutional Networks Corp. Ltd. *See also* TSE, Notice to Members No. 744, December 1, 1970, reporting a TSE submission to the

current experiment at the TSE involving computer-assisted trading.

In the U.S., Institutional Networks Corp. Ltd. (Instinet) has been offering a computer-based trading system since 1969. Its purpose is to attract business away from regular brokers by offering low-cost executions to institutions.[65] The Instinet system has been installed in England under the name of ARIEL to service the accepting banks. At present Instinet is implementing an upgraded system and will be integrated into the SEC's Central Market System which is described in more detail in chapter V.

The Pacific Coast Exchange in San Francisco/Los Angeles has had an automated transaction system for up to 199 shares for some time in its COMEX system. In the COMEX system a member broker with a terminal sends orders to the Pacific Coast exchange specialist for automatic execution against the New York Stock Exchange market.

b. *Money Market Inventory Control*

The larger Canadian money market dealers have found that manual or even standard data centre bookkeeping of money market inventories and open transactions is not adequate. To maximize their effectiveness traders need to have their positions in money market instruments maintained on an up-to-date basis. The same is true of the cage area where status of delivery and banking arrangements must be closely monitored.

Nesbitt Thomson and Fry Mills Spence have been particularly innovative in this area and have developed programs run on their own in-house computers to carry out yield comparisons, inventory reports, and trade recaps, produce reports required for the IDA and the Bank of Canada, keep track of maturity dates of notes held by clients, etc. Other dealers have chosen time-sharing systems (I.P. Sharpe, G.E.) to accomplish much the same thing. The view among the aggressive computer-using dealers is that by having a customized system they are able to make quicker and more appropriate responses to market changes – thus improving their competition with profit position.

c. *Order Movement and Control*

At the present time Canadian brokerage firms with branch networks primarily use teletype facilities to carry orders and fill reports between branches and their trading centres. Two (Merrill

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Quebec Securities Commission regarding the undesirability of nonexchange markets.

65 *Jenkins*, at text accompanying n. 35.

Lynch and Richardson Securities) have teletype terminals installed on the trading floors to shorten communication time. However, even these systems do not retain information about the orders entered nor about reports of executions. At this date (1975), capture of information for customer contract and accounting purposes is a separate order room operation.

5. *Clearing and Settlement*

a. *Brokerage Operations Area*

After a trade takes place a record of the completed trade is sent to the "contracts" department for checking and posting. In 104 out of the 124 exchange/IDA brokerage houses in Canada (probably covering 98% of the business) the data are entered into a computer for processing. In 1975, Wood Gundy, A.E. Ames, Richardson Securities, and Nesbitt Thomson[66] had their own operations area computers. The IBM Datacentres in Toronto, Montréal and Vancouver serve all but three of the rest of the computer-using brokers (Bongard Leslie and Midland Doherty run their own systems on the time-sharing facilities of Datacrown; Bache Halsey Stuart processes on its U.S. parent's computer).

Typically the computer serving the operations area will prepare and send a confirmation to the customer, update the customer's account, and enter the transaction in the firm's clearing position. It will also change the firm's stock record position and issue internal advices so that the relevant departments can start the necessary physical processing. Periodically the operations area system will calculate margin positions and other assorted management information, and print reports so that exceptions or errors can be identified by the appropriate manager. As a result of operations area processing an important data base consisting of customer information (name, address), securities owned, credit or debit balance is created. If this data base is maintained in online mode – that is, readily accessible to terminal inquiry – then a couple of important benefits result. First, convenient provision of customer account information to salesmen becomes practicable. Second, the amount of report printing required is vastly reduced as, instead of having to print the whole file, operations managers

66 The recent emergence of Nesbitt Thomson from being a user of the IBM Datacentre to having its own customized system on an "online" basis (rather than the batch basis on which the rest of the street runs) may be a preview of things to come. In addition to giving Nesbitt Thomson the ability to provide customer account information to salesmen, and giving them control over their service development program, the system is expected to provide cost savings of 50% on operations area expenses.

can simply ask the computer system to identify exceptions for their attention.

b. *Exchange Clearing and Settlement*

In the present system, data on all transactions between exchange members[67] in Canadian equity securities are reported to the exchange clearinghouses. On transactions in listed securities the data are captured on the contract made out on the floor at the time of a trade between two brokers; on unlisted trades the data are submitted as a trade report by the involved brokers. On the day of trade, the data are entered into the exchange computer and next day each broker is given a confirming list of trades for correction. The next day, the confirmed trading lists are netted by the exchange computer so that each broker has a minimum of actual deliveries to make in order to settle his transactions with other exchange members.[68]

At the Toronto and Montreal stock exchanges the netting results in reduction of actual delivery of items to about 60% of the number of transactions.

The Vancouver Stock Exchange has mounted a Continuous Net Settlement (CNS) system in which the exchange clearing entity is interposed in each trade and only net amounts are ordered for delivery.[69] In addition, each day's trading is netted against the previous day's closing balances, thus reducing to an absolute minimum the amount of stock or money which a broker is required to give or take in the interest of streetside settlement. The number of items for delivery is reduced to about one-third of the number of trades.

c. *Banks and Trust Companies*

Banks and trust companies are of course very large users of computers and communications technology in many of their functions. We shall consider here the application of automation only to the securities-related functions of these institutions.

As custodian and lenders against securities collateral, most banks and trust companies are now using a computer file to keep

67 Due to work of Canadian Depository for Securities Ltd., transactions by exchange members in Toronto and Montréal for or with banks and trust companies are now being handled by the exchange clearing houses in CDS's "Securities Settlement System". This has the effect of making broker-to-institution trades as easy and inexpensive to clear as broker-to-broker trades. *See* text accompanying note 85 *infra*.

68 REPORT OF THE OPERATIONS COMMITTEE, *supra* note 8, app. F, provides a concise but full description of the present clearing procedures, as well as describing procedures for safekeeping and transfer.

69 *See* app. B *infra* (Automation Program of the Vancouver Stock Exchange).

track of their total securities positions and of customers' accounts and also to produce monthly statements and confirmation of transactions for customers.

Trust companies in their role as transfer agents have also embarked on computerization programs. The most advanced now maintain their corporate clients' shareholder lists on computer files which are available for online inquiry and capable of producing various analyses of shareholder records which are of interest to the corporate clients.[70] Their aggregate data base in this function is practically all the Canadian shareholdings of Canadian brokers, institutions and individuals (4.5 million separate accounts).[71] It was estimated in 1971 that the seven largest trust company transfer agents maintained on the order of 100,000 accounts to cover the registered shareholdings of the 130-odd exchange members in the Canadian securities industry at that time. In addition, each day 3,000 transfers were made which generated a debit, a credit (or both) in the broker accounts. It is believed that this is a growth area for automation.

6. *Regulation and Enforcement*

To support their stated objective of operating a free and open market, the exchanges have assumed heavy trading surveillance responsibilities. While effective surveillance is largely a manual and judgmental task, the timely production by computer of listings of transactions in time sequence enhances the effectiveness of this function. Such print-outs are used to monitor the performance of professional traders as well as to support investigation of possible market manipulations or insider trading.

7. *Special Sales-attracting Services*

In a fixed commission environment, the revenue on large orders – usually from institutions – tends to exceed the execution, sales and administrative costs directly related to the trades. In other words, the incremental net revenue from handling trades for large accounts is great. Because a fixed commission structure prevents institutions from bargaining to squeeze the margins on large trades, the tendency is for them to bargain for more services to be paid for by the brokers in return for commissions or "soft

70 The Globe and Mail (Toronto), April 24, 1975 (full-page advertisement by National Trust).

71 Bell Canada, Imperial Oil, Gulf Oil, CPR, Alcan and the chartered banks keep their own shareholder records rather than contracting the job to a professional transfer agent.

dollars". In order to attract such institutional business, brokers have devised various useful services to provide to accounts willing to make "soft dollar deals".[72] Some of the services made available for soft dollars have involved computer applications as described below.

a. *Portfolio Valuation*

For mutual funds which value their portfolio daily in order to set selling and redemption price, quick and accurate valuation is particularly important. Crang & Ostiguy and Canavest House, among others, have responded by providing valuation services to meet these needs. Daily stock prices and subscribers' portfolio positions in securities and cash are the essential data base for these calculations.

b. *Investment Performance Measurement*

A number of brokers provide a measurement service which rates the participating institutions' portfolio investment results against each other and against some recognized stock average (Dow Jones Industrial Average or TSE Index, Standard & Poor 500). Prominent in this field with Canadian institutions are: A.G. Becker, Alfred Bunting, and Wood Gundy. The levels of various indexes and the net asset value of the subscribing funds are the data base for these measurements.

c. *Portfolio Selection and Modelling*

Given the ability of computers to store great quantities of data and perform myriads of calculations in a short period of time, theorists have conceived of various portfolio modelling techniques for the purpose of selecting a portfolio. Most modelling systems are based on various applications of volatility measurements or "beta" which purport to measure the relative riskiness of stocks. A stock's beta gauges the degree to which the historical price fluctuations of a stock are wider than the price fluctuations of a risk-free investment, for example, Treasury Bills. On the basis of trading off relative projected rates of investment return and the volatility (beta) of a stock based on past trading prices, portfolios are recom-

72 "Hard dollars", by contrast, are direct cash payments for a service. A slightly different meaning is put on "soft dollars" when it is used in the more restrictive sense of referring to the commission payments generated out of the capital of a managed portfolio and distributed to brokers by the investment manager (fiduciary) in order to obtain useful services (*i.e.*, cost-reducing) for the investment manager's benefit. "Hard dollars" in this sense are cash payments of the investment manager's money, rather than commissions from the customer's principal. For a description of allowable and improper soft-dollar deals in Canada, *see* Montreal Stock Exchange, Circular No. 27-75, January 23, 1975.

mended to meet the investment manager's specific objectives. Several brokers and nonbroker service companies are involved in variations of beta measurement and portfolio services which they sell for hard or soft dollars to institutional and private investors. PMS (Portfolio Management Services), associated with Canavest House, is perhaps most aggressive in this area in providing systems consulting and customized programming for customers in Canada and the U.S. for use on the FRI or Ian Sharpe data base/time-share computer installations. Jones Heward and Wood Gundy also are active in this area.

d. *Capital Gains Accounting*

Since the introduction of capital gains in Canada in 1972, accounting for the profits and losses for tax purposes has been a significant chore for investors. Responding to this need, some brokers have developed capital gains accounting systems to offer to their customers. The necessary data base ties in neatly with a customer accounting package and therefore has only been offered by brokers who do their own bookkeeping or by those on the IBM Datacenter. Apparently recent quiet markets and the expense of capturing the data have led to a less than successful marketing of this product.

D. DATA BASES AND NETWORKS – SHORTCOMINGS

Taken piece by piece, the applications of computer and communications technology reviewed in the preceding pages seem lacking in any unifying theme. To date in 1975, this is indeed the case. Each data base and network has been created in response to a specific need. There has been no overview or long-term systems framework within which suppliers of automation and the industry could work.[73]

In retrospect, it is apparent that there are a number of existing and potential terminal networks, each dedicated to a particular and relatively narrow function: market inquiry, order move-

73 Until very recently, the same was true in the U.S. However, the SEC has recognized a need for an overall plan; *see* SEC, White Paper: Statement of the Securities and Exchange Commission on the Future Structure of the Securities Markets (February 1972); SEC, Policy Statement on the Structure of a Central Market System (March 1973). An Advisory Committee on the Implementation of a Central Market System was appointed in May 1974; *see* SEC, Securities Exchange Act of 1934 Release No. 10790, May 10, 1974, 4 SEC Docket 273 (1974). These initiatives by the SEC have had a significant effect on automation suppliers, the exchanges and broker-dealers in their planning, and an integrated system can be seen emerging in the U.S. It is worth noting that the problem of bringing about integration in the

ment, customer account status inquiry, research data access and manipulation. It is also apparent that there are in theory three classes of data: (1) historical and current information about market prices, (2) capital and financial information about issues and issuers and (3) information about securities owner/customer accounts. The three classes of information are not at this time neatly organized into accessible and fully maintained data bases. For example, the Financial Post and FRI collection of market price information is not real-time with the markets. It is not adequate for quote and trade information pursuant to trading. On the other hand, the market inquiry system data bases which are online and more or less real-time retain little historical data and are not useful for technical analysis and other research activities. On the corporate side, financial information tends to be late in being filed in accessible form and is often based on non-standard definitions. Data on customer account status is reasonably good to the extent that customers leave securities with their brokers. However, the files are not updated on a real-time basis and most investors do not hold their shares with brokers. Broader securities ownership information is widely scattered over trust companies, banks and brokers. It may be off real-time by several days and in any case is not accessible, even if the investor should wish it to be.

The data base defects noted above are not unduly serious considering the uses to which the existing data bases are being put by the particular terminal network they are accessed to at this time. The point that emerges, however, is that to use these disparate data bases a user requires several different terminals.

A development which would rationalize these duplications and provide considerable incentive to upgrade the quality of the data bases would be a multipurpose terminal network which, subject to security checks and authorizations, would access any of several data bases. The seeds of just such a network may well be the result of the computer-assisted trading project of the Toronto Stock Exchange – a major topic of chapter VI.

As noted above, shareholder ownership data bases are widely scattered and therefore not available for certain useful purposes. For example, investors' securities holdings information – including investor name and address, names of companies, number of shares, price of purchase and certificate location – is important information for a securities firm's salesman and operations area in trying to service an account. Part of the information underlying broker, bank and trust company nominee names (investor name

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U.S. is substantial in face of the numerous regional financial centres and array of private suppliers of computer services.

and address, company and number of shares held) would also be useful information for transfer agents maintaining a company's shareholder records so that more direct shareholder contact could be obtained. The possibility that this area can also be rationalized in the future is part of the hope of the project of the Canadian Depository for Securities Ltd. which is the other major topic in chapter V.

Chapter V
Canadian Depository for Securities Ltd.

In 1975, there were two automation development projects of national importance going on in the Canadian securities industry: the upgrading of the Canadian settlement, transfer and ownership recording system undertaken by the Canadian Depository for Securities Ltd. (CDS), and the Computer-Assisted Trading System (CATS) investigation at the Toronto Stock Exchange.[74] The latter will be discussed in chapter VI.

A. OBJECTIVE OF THE CDS

The original CDS objective paraphrased from the Woods Gordon study in 1968 was:

> "To put the holdings of all market participants into Depository accounts so that transactions among participants would result merely in debit and credit entries."[75]

That 1968 objective evolved through much analysis, introspection and discussion until by 1975, the objective might best be described as:

> "To have accepted and established in Canada a system of securities ownership such that the necessity to move, record and store paper stock and bond certificates will be substantially reduced or eliminated *in order to enable* operation of a more economical and reliable system for clearing and settling securities transactions for Canadian broker/dealers and financial institutions. The *method* of bringing this about will be to prepare the settlement

74 A third initiative in automation has been undertaken by the Vancouver Stock Exchange which has introduced a Continuous Net Settlement system through Vancouver Stock Exchange Service Corporation as well as an online inquiry system called MARS (Marketing and Reference System). App. B *infra* outlines the Vancouver developments.

75 WOODS GORDON LTD., CENTRAL DEPOSITORY FOR SECURITIES IN CANADA, REPORT NO. 1, at 1 (March 1968).

system so that the removal of certificates is simply one of a series of logical steps."[76]

B. BRIEF HISTORY OF THE CDS

The CDS project began in 1968 with the formation of a study group. In 1969–70 staff was hired and a $1 million funding was arranged with the participation of: Canadian Bankers' Association 15%, Canadian Life Insurance Association 5%, Canadian Mutual Funds Association 3.5%, Investment Dealers Association 10%, Montreal Stock Exchange 10%, Toronto Stock Exchange 40%, Trust Companies Association 10%, and Vancouver Stock Exchange 5%.

In the spring of 1971, a proposal was made by CDS to the financial community. While the proposal had many advanced concepts, generalized industry doubts about the project resulted in non-approval and the appointment by the board of an Operations Committee with additional funding of $250,000. As a result of that committee's work through the 1971–72 winter, the scope of the project was modified. In May 1972 the CDS board of directors adopted its recommendations which were, in part:

> "that the Canadian Depository for Securities Limited broaden its objectives to work toward improvement of the settlement, transfer, ownership recording, lending and safeholding system;
>
> "that the participant groups recognize that improvements in the system and the time required to implement them are dependent, firstly, on the ability of participant groups to agree to changes in procedure and operating patterns, and secondly, on their willingness to provide personnel resources and management effort necessary to support community objectives;
>
> "that work be commenced on the following projects:
>
> "(a) design and obtain agreement for an expanded settlement system;
>
> "(b) implement other innovations including: improved intercity delivery procedures, a mechanism for CUSIP numbering, the offering of deferred transfer service;
>
> "(c) prepare a basic design for a settlement/transfer system which is not dependent on certificates;
>
> "(d) further develop a legislative framework."[77]

76 Letter by S.J. Deudney, General Manager, CDS Ltd. (October 14, 1975).

77 Canadian Depository for Securities Ltd., minutes of directors' meeting (April 19, 1972).

Along with approval of the above program, a further $250,000 interim financing grant was approved in June 1972. This program was designed to work out through step-at-a-time practical experience, the difficulties in inter-industry cooperation.

All the policy problems were not solved by this means, however. In the spring of 1974 additional funds were necessary and the banks, trust companies, exchanges and broker-dealers had still not agreed as to what form the "depository" per se should take.[78] In addition, the Trust Companies Association and the Vancouver Stock Exchange[79] had given indications that they would no longer support the project financially.

To move the project forward on the political level a review committee consisting of the executive director of the Canadian Bankers' Association (CBA), the presidents of the Investment Dealers Association and Toronto Stock Exchange and the president of the National Trust (on behalf of a group of supporting trust companies), was established in June 1974. It made recommendations for further funding and board reorganization and also obtained agreement at the highest level that it would no longer be necessary to debate the final form of the securities ownership recording system (depository per se) but that it could, would and should evolve out of cooperatively working together on the Securities Settlement System (SSS). As a result, a reapportionment of financial support was agreed to, and in the fall of 1974 a group of trust companies agreed to assume 15% of the financing. The dealer community (represented by the MSE, TSE, IDA) and the banking community (CBA) agreed to split the remaining 85%. With the addition of another trust company, the formula was subsequently revised to 20:40:40. In the spring of 1975, a new board of management was appointed to reflect the new financial sponsorship.

C. COMPARISON OF THE U.S. SECURITIES DEPOSITORIES WITH CDS

Before reviewing CDS accomplishments and status as of September 1975, a review of the approach to clearing and settlement and securities depositories in the United States is in order.

Living next to the U.S. has frequently been helpful for the Canadian securities industry. In general, the two economies, their industries and cultures have been similar enough that the Canadian securities industry has been able to watch the Americans

78 *See* app. C *infra* for a discussion of the question of whether the proposed depository system in Canada should be based on physically vaulting a mass of paper certificates or whether it should be based on reducing share interests (at least for broker-dealers and financial institutions) to mere bookkeeping entries.

79 *See* app. B *infra* for a review of the VSE's independent automation program.

experiment and develop new approaches and, after they have been proven, borrow the best ideas without incurring the substantial costs associated with new research and development. In the case of CDS development, however, some significant differences in both the historical roots of the depository concept and the cost structure and volumes of the industries in the two countries have resulted in a somewhat different approach being taken in Canada.

1. *Historical Roots*

While the clearinghouses organized by the exchanges in Canada cleared only transactions effected on the exchanges, the New York Stock Exchange clearinghouse allowed members to put settlement of any transactions through its system. It operated the simplest kind of post office for envelopes of unknown contents and the netting of agreed money payments. In order to make the most of this system it was felt appropriate many years ago to include the major commercial banks in New York – the so-called "clearing banks" – as participants in the New York Stock Exchange Clearing House. Therefore, when the question of a depository arose in the U.S., money settlement of securities transactions between exchange members and the major banks had been a routine process of long standing, accepted by the banks and welcomed by the brokers. Not so in Canada, where each trade for banks and trust companies was settled item-by-item at the cashier's window of the purchaser.

A second and very important difference in the two environments was that in 1968–71, when the major American thrust was made, the U.S. securities industry had been brought to its knees by the "paper crisis".[80] Not only had the stock exchanges been forced to reduce trading hours and even close one day of the week due to the inability of their members and the clearinghouses to keep up with the post transaction paper processing, there was considerable fear that the loss of control over certificates and customer account status would result in many firms falling short of capital requirements and actually being bankrupted.[81] The U.S. depository development program had the aura of a national crisis. A parallel situation did not exist in Canada.

80 Lybrand, Ross Bros. & Montgomery, *supra* note 44.
81 C. Ellis, *supra* note 45.

2. *Early Problems Observed in New York*

In the late 1950s the New York Stock Exchange had initiated development of a "centralized certificate service" for its members. With the high volumes of the mid-1960s, the renamed Central Certificate Service (CCS) became a high priority project of the exchange and substantial resources were invested in it. Thus, when it was suggested in Canada that a depository should be investigated, leaders of the Canadian industry turned to New York for guidance. The view was not very encouraging. It was observed that the U.S. depositories, notably CCS, were having great difficulties. By the end of 1971, some $35 million had been spent, but no satisfactory service was operative, members were not satisfied with processing speeds, delays and breakdowns were common. In addition, bankers and transfer agents were generally unfriendly to the new facility.

The unresponsive attitude of the U.S. transfer agents and banks caused several problems for CCS. First, because the U.S. transfer cycle was upwards of five days (as opposed to a routinized fourty-eight-hour cycle in Canada), it was frequently necessary to release stock certificates registered in the depository's nominee name, Cede and Co., from the facility. These were causing problems regarding the tracing and claiming of dividends and in proxy solicitations. Second, because the custodian and lending banks would not hold securities in CCS or lend money against certificates held by CCS, very little stock was able to be immobilized. In the period 1968–72, it could be fairly concluded that the traffic tie-up in stock certificates had been exacerbated by the interpositioning of CCS.

As a result, the view in Canada was that the principal cause of the U.S. problems was that the transfer agents and commercial and trust banks had not been included in the U.S. planning for a depository. The decision was therefore made to correct this shortcoming and put the Canadian project on an inter-industry basis. The composition of both the original sponsors and the present board indicates this decision.

3. *Difference in Volumes*

When the Canadian project was originally launched, another part of the thinking which led to adoption of the inter-industry approach was the knowledge that the Canadian securities indus-

try was substantially smaller than its U.S. counterpart.[82] In order to finance the project and indeed to find the volumes to justify the investment, the participation of the Canadian banking, trust and transfer industries seemed virtually essential.

4. *Differences in the Unit Costs of Operations Area Activities*

The view that it was necessary to draw in all possible volume was confirmed by the Operations Committee in 1972, but what had not been fully recognized at the inception of the project was that the unit costs for the various processes were substantially lower in Canada. CDS estimates of comparative costs prepared in 1972 indicate that the cost of securities transaction processing in Canada was much lower on a per-transaction basis than it was in the U.S. The figures estimated by CDS were in a ratio of about 2:1 and this was reckoned to be conservative.[83] Principal reasons cited by CDS for relatively lower Canadian costs were:

(1) The great majority of Canadian securities transactions are on stock exchanges where settlement data is efficiently captured and carried through the clearing process. In the U.S. a much greater proportion of trading is over-the-counter. In addition the large U.S. exchanges generally lacked site-of-trade data capture systems.

(2) One or both sides of the majority of U.S. trades ended up in New York City where labour was unreliable and expensive.

(3) Regulatory requirements and the burden of related paper work were significantly greater in the U.S.

The conclusion from the above is that to be economic not only must a Canadian system gather up all available volume and still plan to be effective for what will end up being a much smaller total volume of processing, but it must also be significantly less expensive on a unit cost basis compared to a system which would be attractive in the U.S.[84]

82 Dollar value of trading, commission revenue and securities industry capital were found to be on the order of 20 times as large in the U.S.; *see supra*, text accompanying notes 40-42.

83 Operations Committee Report, *supra* note 8, at C-3.

84 The same point was underscored by members of the Financial Administrators Section of the IDA when the Midwest Stock Exchange tried to sell its clearing and depository services in Toronto in early 1974. Their observation was that while the charges are attractive for U.S. business, they would be unthinkable if they were proposed for Canadian business. More recent comments of Canadian brokers who are in close touch with the U.S. market indicate that U.S. operations area costs are falling significantly as the clearing corporations and depositories provide more and more services.

D. STATUS OF CDS

1. *Status as of 1975*

The Canadian Depository for Securities in 1975 was clearly not at the stage obtaining in the U.S. Evidently the same degree of urgency did not pertain and for various other reasons the approach chosen had to be considerably different. Nevertheless and in spite of the difficulties at the policy level of the banks, trust companies and exchanges, substantial progress on the 1972 recommendations noted in section B above was achieved by the operating people in the participating industries and CDS staff. First, a *standard* securities identification system, CUSIP,[85] (modified to meet Canadian needs) had been implemented and was being maintained by CDS on a continuing basis. Such a system is essential for standard computer-to-computer communications both within Canada and with the U.S. facilities. Second, several major banks and trust companies became involved in the recommended "pilot" securities settlement system to bring banks, trust companies and broker-dealers in both Montréal and Toronto into a coordinated system for clearing and settling securities transactions. Such service has been expanded and has become a routine service offered by CDS to the financial community.

In addition to CUSIP and the operative systems noted above the basic concept of a noncertificated system has been more widely understood and accepted and a master settlement system (phase III) embracing the concept has been designed and agreed to by CDS user-committees. Its implementation will result in creation of a single standard national settlement system capable of having branches in each major financial centre and interconnecting with the U.S. depository/settlement system and designed to work with or without certificates.

2. *Status in 1978*

By year end 1977, CDS had progressed to the point where it had assumed full operating responsibility for clearing all security trades executed on the floor of the Toronto and Montreal stock

85 The CUSIP system was developed in the U.S. under the aegis of the American Bankers Association, Committee on Uniform Securities Identification Procedures (hence CUSIP). Its purpose was to standardize the identification of publicly traded securities issues. CDS adopted the basic CUSIP system but modified it to fit into the Canadian context. This enabled many Canadian issues, which were previously not eligible, to be added to what is now a very comprehensive North American system.

exchanges in addition to the institutional trade settlement originally developed as part of its expanded clearing operation. The volume of settlements being executed through CDS facilities in the cities of Montréal and Toronto reached 8,000 per day by the end of 1977 representing some $16 million. In addition to its regular stock clearing activities CDS was also offering its participants the following services:

(a) an automated dividend claiming service;
(b) an intercity delivery service for the movement of securities;
(c) a drop-off service for delivery of securities being sent to transfer not only within the participant's city but also to any other city where CDS has an office;
(d) a transfer service through the National Securities Clearing Corporation (NSCC) for U.S. domiciled securities;
(e) an intercity reporting and payment option allowing its participants to receive their daily activity reports in any city of their choice where CDS has an operating centre;
(f) two settlement cycles per day;
(g) bond clearing facilities;
(h) a facility for any two participants to effect the settlement of either cash or security loans.

E. CDS ORGANIZATION, PLANS AND TIMETABLE

1. *CDS Organization as of 1975*

Figure 3 sets out the organization structure in 1975 at CDS as it prepared to move to implementing the final steps on phase III.

The Procedures Advisory Committee is a key organ in the CDS structure. It is made up of senior operations personnel selected from the various sponsors and is the principal sounding board for deciding on the desirability of proposed services and for hammering out procedural details. To some degree it also serves as a communication conduit for dealing with the various sponsors or for deciding operational policy matters.

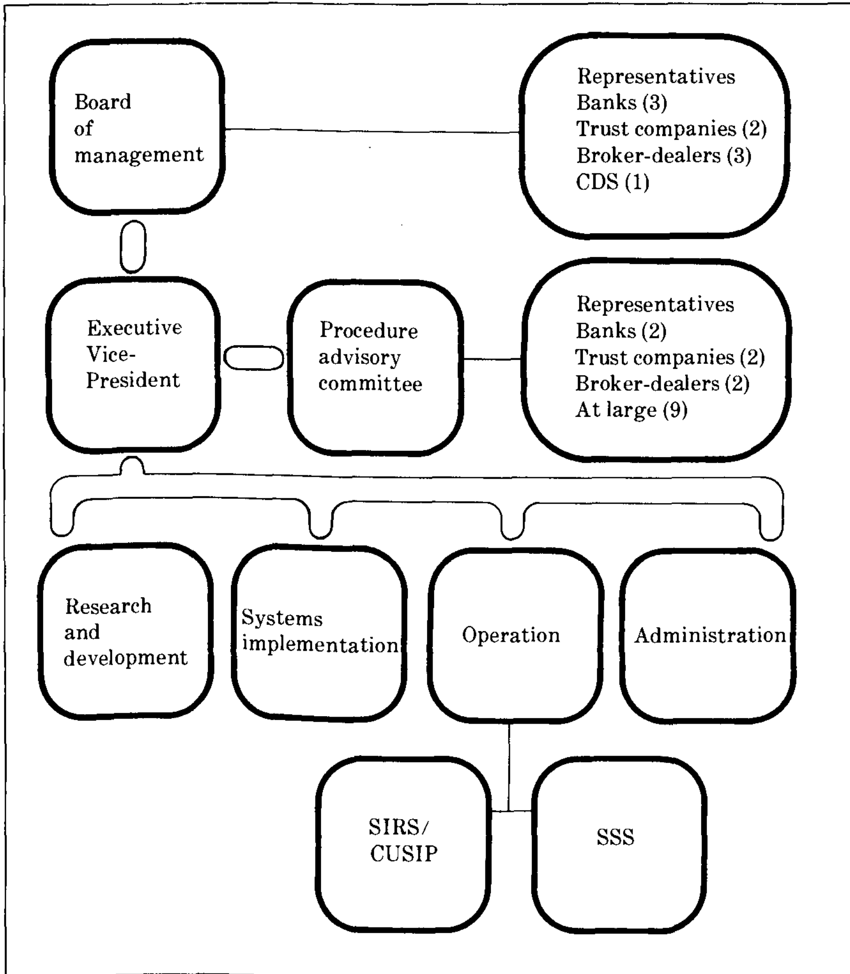
2. *Developments in 1978*

As of 1978, CDS's major efforts were being devoted to:

(a) Implementation of its "new issue" takedown service.[86] This

86 Such a new issue service has been offered by DTC since late 1975. On recent issues carried out in this fashion, as little as 15% of the issue actually is delivered out in registered or bearer form. The balance remains held by DTC and available for book entry transfer. In 1976, there were 134 such issues and debt and equity worth $6.7 billion and totalling 163 million shares.

Figure 3
Canadian Depository for Securities Ltd.



service will function as a pilot for CDS's participants in noncertificated settlements. It will also contribute substantially in reducing the number of certificates issued on the closing of a new issue by presettling all trades made on the "if, as and when" basis prior to settlement date. This service was scheduled to begin pilot operation in September 1978.

(b) Finalizing the systems specifications for its ledger security structure to allow for noncertificated settlements through its clearing facilities. Completion of this step anticipated to be operational by mid-1979 will represent completion by CDS of its major objective – that is, creation of a book-based ownership system – and will open the way for major savings to be effected by its participants as they will then be able to deposit their securities into the system and effect transfer electronically.

In addition to its Canadian operations CDS plans to work actively towards establishing links with its counterparts in the U.S. to allow for cross-border electronic movement of securities.

One of the unique features to be offered by CDS through its systems will be the facility for a participant in one city to effect settlements electronically with any other participant throughout the CDS network, regardless of location. This facility will complement the work being done towards a national system for trading securities.

CDS plans with respect to certificates are to avoid them as far as possible. As settlement system orchestrator it will encourage brokers and investing institutions to put their positions in book entry form by providing services which give strong economic incentive to noncertificated settlement. CDS will not have a vault for deposited certificates. However, handling of certificates, to the extent it is required, will be done by the issuer or by the transfer agent contracted by the issuer, or, alternatively, by a bank or trust company acting as nominee custodian for certificates of issuer/transfer agents which will not handle deposited positions.

With respect to the "deposited" or book entry position, CDS's approach is to provide maximum flexibility. The issuer or its transfer agent will legally be in the same relationship to issuers and their shareholders as pertains today for keeping track of registered ownership. CDS will accommodate transfer agents as the transfer agents choose. For example, if the transfer agent wishes to keep a vault of certificates representing the registered ownerships, that is fine with CDS. If it wants to render all deposited positions certificateless and maintain its own records by high-performance teleprocessing, that is also fine. It can even assign to CDS as subagent the job of keeping track of the deposited posi-

Table 8
Projects Scheduled by Canadian Depository for Securities Ltd.

1975 to June 1978

		Proposed implementation date
Step 1	A national comprehensive clearing system	In operation (Toronto, Montréal, New York)
Step 2	A comprehensive dividend report and claiming service	In operation
Step 3	Loan post services	In operation
Step 4	Takedown of new issues in noncertificated form	September 1978
Step 5	Merging floor trades into Securities Settlement System (SSS)	In operation (Montréal, Toronto)
Step 6	Intercity settlements and redirecting deliveries	In operation
Step 7 (a)	A book-based depository	June 1979
(b)	Automated settlements	June 1980
(c)	A Continuous Net Settlement (CNS)	December 1980

tions. In short, flexibility is the key and whatever suits the transfer agent and meets turnaround and accuracy specifications will be acceptable to CDS.

Although the master package will offer a continuous net settlement system[87] to users, CDS staff feels that it will not be greatly used because:

(a) banks and trust companies have advised that they will not participate in a netting operation;

(b) other phase III services which provide automatic deliveries and automatic loan (if stock is available) will generally reduce outstanding items.

Table 8 sets out a summary of CDS projected timetable.

F. AREAS OF CONCERN – JULY 1978

As of July 1978, there were two areas of concern which bore on the plans of CDS. One relates to the relationship with a group of sponsors (the trust companies), the other is simply the question of whether an inter-industry effort can move forward satisfactorily.

1. *Will the Inter-industry Approach Really Work?*

As the preceding section has indicated, Canadian Depository for Securities Ltd. is well along with design and programming of its plans for improving the securities clearing/settlement system by bringing the principal investing and lending institutions into an organized settlement arrangement with broker-dealers and offering them useful settlement services. The expectation is that the offering of a service to hypothecate and hold securities and transfer ownership interest between members of the system in noncertificated form will soon become simply the next logical step. This approach to depository implementation is designed to minimize the trauma of establishing a system which is not dependant on certificates. Heretofore the radicalness of the change, the attendant rearrangement of revenues and costs and the difficulties of getting inter-industry policy agreement have doomed to failure any frontal attack on the certificated system in Canada. Though it has been painful and relatively slow, the consensus is that the step-by-step approach is the only possible inter-industry route, absent an industry crisis such as was faced by the U.S. industry in 1969.

87 *See* app. B *infra* describing the Vancouver Stock Exchange System.

2. *The Depository and the Transfer Agents*

The problem of the role of transfer agents in a less certificated environment is an ever-present one. Studies at CDS have shown that, contrary to the historically stated position of trust companies that transfer business is unprofitable, corporate transfer agencies have been significant contributors to trust company profits.[88] For the most part, however, the participant trust companies have recognized that a reduction in certificate business is inevitable and that their investment/custodian function will be significantly benefitted by this reduction and by other CDS developments. They therefore have decided that the prudent course from a business point of view is to support CDS efforts. In this way they will be able to participate in the formulation of procedures and find ways to profit from the new and upgraded service.

A continuing difficulty at CDS has been the determination of the Royal Trust Company after June 1972 to withhold its support. The corporate plans and underlying business strategy which may be dictating a negative stance by the Royal Trust are not known. However, given all the discussion of CDS since 1969 and the U.S. developments, it must be apparent to Royal Trust that it too will have to modernize its transfer, safeholding and settlement techniques. It is to be hoped that some time soon the Royal Trust will commit itself to the CDS program.

G. STATUS OF THE U.S. CLEARING AND SETTLEMENT AND DEPOSITORY SYSTEMS

After many false starts and much prodding from Congress, the SEC, consultants and industry groups, U.S. depositories and settlement systems after 1973 went ahead at a rapid pace. Depository Trust Company (DTC) which was created in 1973 to take over the NYSE's Central Certificate Service is particularly impressive. It has a joint industry, user-oriented board of directors chosen from New York banks and a life insurance company as well as from broker-dealers and the exchanges.

During 1974, DTC processed 10 million book entry deliveries with a value of $136 billion. At 1974 year-end it had 258 participants, 59 banks accepting DTC-held stock as collaterial, 32 branch depository facilities, over 6,000 eligible issues and over 2 billion shares on deposit.[89] In 1975, to recognize bank participation, part

88 Operations Committee Report, *supra* note 8, at F-20 - L-32.

89 Depository Trust Company, Annual Report 1974, at 4 (1975).

of its ownership was sold to the banks and other participants. The plan calls for the NYSE to continue to relinquish its share of ownership as banks deposit more securities into the system. Similar but smaller depositories exist in Chicago and San Francisco in association with the Midwest and Pacific Coast exchanges.

The clearing corporations of the New York/AMEX, Midwest and Pacific Coast exchanges are associated with these depositories. In addition, the National Clearing Corporation (NCC) which clears transactions in securities traded over-the-counter has made interface arrangements with DTC. By 1975, negotiations were being concluded for Securities Industry Automation Corporation (SIAC), a wholly-owned subsidiary of the NYSE and AMEX which acts as contract operator for the New York and American Stock Exchange Clearing Corporation, to also run NCC operations. This would mean that there will be only one clearing system in New York as SIAC will carry out all operations on behalf of the historic entities.

Each of the depositories (DTC, MSTC and PSDTC) has opened branches in other major cities and has accomplished two-way interfaces. The interface means, for example, that securities held in a branch of the Midwest or Pacific Coast depository can be dealt with for virtually immediate withdrawal of equivalent securities from DTC in New York. Steps have also been taken to interface the clearing corporations so that delivery to SIAC by a Pacific Coast or Midwest exchange member can be almost immediately credited to meet a Midwest or Pacific Coast Clearing Corporation obligation.

Principal services now offered by the clearinghouse/depository complexes include:

(1) Intercity credit and debit of money and securities for members;
(2) continuous netting of security positions for broker members;
(3) hypothecation/pledging of securities for call loans virtually independent of geography;
(4) speeded up transfer service;
(5) interface with the Federal Reserve Bank of New York for settlement and collateralization of U.S. Treasury securities in book entry form.[90]

Interestingly enough, the next major move at DTC will be to implement positive confirmation of transactions which are for delivery to an agent bank on behalf of an institution. This is much

90 Out of the $441 billion in U.S. Treasury and Agency securities outstanding in August 1975, $260 billion were held in book entry form and could be dealt in without certificates via DTC and the Federal Reserve Wire Network; *see* letter of M.J. Hoey, assistant vice-president, Federal Reserve Bank of New York, to B. Ferguson, CDS (September 30, 1975).

like a system which CDS has already implemented through its agency system in which the bank or trust company acting as delivery agent is notified by CDS of a trade made by a third party for settlement by the agent.[91] The system prevents rejected or "D.K." (don't know) settlements.

The SEC is due some credit for the rapid improvement noted above. For over three years it had been SEC policy that the clearing/settlement systems should be *merged* under the plan for a central market system. However, because the Midwest and Pacific Coast as well as the National Clearing Corporation had made a significant contribution to the advancement of services and because it seemed that interfacing will be achieved, it appeared in 1975 that the SEC would be backing off this stand and would probably accept an integrated and interfaced arrangement such as the industry bodies are now developing.[92]

Through the Securities Reform Act of 1975, the SEC was given large responsibility and concomitant authority over clearing corporations, depositories, transfer agents[93] and processors of quotation information. The result of this significant expansion of responsibility will mean that the SEC can force the securities market systems into the direction chosen by the SEC for future market structure and performance standards.

H. COMPETITION FOR THE U.S. DEPOSITORY/CLEARING COMPLEXES

1. *Competition for Complexes in 1975*

An intriguing feature of the U.S. scene is the progress of the Bradford group of companies. Though it is not clear where this development will lead, the Bradford influence will be significant, and it is worth outlining here.

Bradford Computer and Systems Inc. started business in 1968 as a computer software company. One of its first contracts was to design a shareholder accounting system for mutual funds. It then accepted a system design contract for Marine Midland Bank, a medium-sized transfer agent, to upgrade its corporate transfer system. After designing the system, Bradford was actually awarded operation of the job as a processor and facilities manager. It has since formed Bradford Trust Co. Ltd., a limited powers trust

91 *See supra*, text accompanying note 85 and following.

92 *See* speech by Lee Pickard to SIA (September 1974).

93 In effect, the SEC will not generally be the administrative authority over transfer agents since most transfer agencies are associated with banks which are subject to the Federal Reserve System and in such cases administrative responsibility for enforcing the act will rest with the Federal Reserve.

company, which has taken over on a facilities management basis the transfer business of Bankers' Trust, Mellon Bank, Crocker National Bank and about a dozen smaller agencies. By 1975, Bradford claimed to be the largest transfer agency in the U.S. with six million corporate shareholders accounts, and two million mutual fund accounts.

At the same time as it was expanding into the stock transfer business, Bradford was courting the safekeeping business of broker-dealers with respect to the certificates of companies for which Bradford acts as transfer agent. Also in those companies they have sought to offer brokers a payroll savings or periodic investment plan service on a sufficiently attractive basis that the brokers can compete with similar bank plans. Bradford is able to offer economic service in this area because it is exploiting computer record- keeping rather than relying on certificate issuance and storage. In effect, with respect to their own transfer companies, they are offering transfer agent depository facilities and are marketing a package by the name of TAD.[94]

The third side of an impressive triangle of Bradford services was brought into place, at least temporarily, when Bradford brought the National Clearing Corporation into a facilities management contract through which Bradford will run clearing operations for the NASD.[95] The full synergistic potential of the transfer agent/broker services/clearing corporation base has not yet been fully explored but a significant impact may be anticipated if Bradford is able to market the idea to corporations and brokers that trades in Bradford's agency stocks (which are cleared by NCC) can be done at significantly less cost for all parties concerned. As of 1975 it appeared that Bradford might lose the NCC connection to SIAC and therefore have a less complete package to offer. However, the NCC contract in 1975 had a year to run, and in the meantime Bradford made a bid for the whole SIAC and DTC job as well as NCC, promising the industry an annual saving of $15 million out of $35 million currently spent for these functions.[96]

2. *Competition in 1978*

In 1977, all U.S. clearing agencies joined into the National Securities Clearing Corporation (NSCC).[96a] This created a national system so that brokers and banks could settle items anywhere in

94 BRADFORD COMPUTER & SYSTEMS INC., THIS IS BRADFORD - MID-YEAR REPORT 9 (1975).
95 Securities Week (New York), September 9, 1974, at 4.
96 Securities Week (New York), August 18, 1975, at 6.
96a Securities Week (New York), March 27, 1978, at 11-12; *id.* May 29, 1978, at 10.

the United States without regard to the market in which the transaction was actually made.[96b] This SEC-mandated manoeuvre was highly disadvantageous to Bradford. In 1978 Bradford attacked some anticompetitive aspects of the national system and received a favourable ruling from the Department of Justice. The dispute does not appear to be over, however. The main issue may simply be the amount of monetary settlement which Bradford can obtain as compensation for alleged loss of business.

Chapter VI
Trading Systems

The potential application of computer/communication technology to trading systems has increasingly caught the imagination of theorists.[97] However, in spite of the beguiling (and seemingly logical) theory, practitioners have not yet decided that computer trading is a realistic proposal. No less a forward-thinker than James Needham, president of the New York Stock Exchange has said:

> "We don't think they can duplicate the crowd from a technical point of view. But, in order to overcome that, the SEC says 'We'll build the box and everybody will put their limit orders in there'. Well, the firms tell us that if that's the case, there won't be any limit orders. They'll take inventories 'upstairs' and do business by themselves with other broker/dealers...'[98]

Support for the view that computerized stock trading is impractical can be found in the fact that the very modest Instinet/ARIEL, and WHAM (Weeden Holdings Automated Market) systems are the only extant systems in the world which actually trade within the computer system.

The statement that Instinet/ARIEL and WHAM are unique can be made with a good degree of confidence because of a recent survey done on behalf of the International Federation of Stock Exchanges to summarize the status of automation and the plans

96b *See, Williamson, Capital Markets*, ch. IV.A for a brief review of the various clearing systems now being linked by NSCC into a single functional system for the United States.

97 J. Bossons, The Automated Stock Exchange (University of Toronto, May 1968); Black, *Toward a Fully Automated Stock Exchange*, 27 FIN. ANALYSTS J. 28 (July/August 1971); Black, *A Fully Computerized Stock Exchange II*, 27 FIN. ANALYSTS J. 24 (November/December 1971); M. MENDELSON, FROM AUTOMATED QUOTES TO AUTOMATED TRADING: RESTRUCTURING THE STOCK MARKET IN THE U.S. (1972); Youngblood, *The Argument for a Publicly Owned Stock Exchange*, 25 FIN. ANALYSTS J. 104a (November/December 1969).

98 Securities Week (New York), January 14, 1975.

for it at all the world's stock exchanges.[99] The study disclosed that while some exchanges were designing a shared terminal network to route orders and other messages between the members and the exchange floor, none except the Toronto Stock Exchange was actually experimenting with a complete remote terminal trading system.

A. U.S. SCENE

Since it is unusual for the Americans not to be in the forefront in projects which are considered forward-thinking, a few paragraphs on the situation in the U.S. seem to be in order.

In its *Special Study* published in 1963, the SEC made reference to the need to increase the use of automation in supporting the New York Stock Exchange market.[100] The *Special Study* suggested that the potential for automation appeared great for execution of odd lots and maintenance of the specialists' book. They also felt that surveillance functions should be automated.

About the same time, the New York Stock Exchange, then the clear ruler of the U.S. securities industry and a large spender of money for research, put substantial resources into a very large systems development group with wide terms of reference. Several large projects were initiated and an extensive automation planning paper was prepared in 1968 but never officially released. The paper proposed "a broad development and implementation program leading to an advanced integrated trading system."[101] The early steps involved:

(1) an order delivery system to route orders and reports to and from members' offices and their floor brokers; and
(2) development of an electronic book and inventory management system for specialists.

Subsequently, floor brokers of the exchange would be provided with desks and trading terminals *on the floor* from which to trade with each other. It was felt that by "locking in" the trade in this manner, much of the generation of paper would be avoided and the space problem of the NYSE relieved.[102]

The proposal was less than warmly received by the NYSE board which consisted largely of senior floor traders and special-

99 TORONTO STOCK EXCHANGE, APPLICATIONS OF AUTOMATION TO SECURITIES MARKET FUNCTIONS - PRESENT STATUS AND FUTURE CHALLENGE (prepared for Working Committee of the Fédération internationale des bourses de valeurs, March 1973).

100 SECURITIES AND EXCHANGE COMMISSION, 2 SPECIAL STUDY OF SECURITIES MARKETS, H.R. Doc. No. 95, 88th Cong., 1st Sess. 353 (1963); 4 *id.* at 556.

101 NEW YORK STOCK EXCHANGE, REPORT OF THE NYSE-IBM JOINT STUDY 2 (May 1968).

102 *Id.* at 28.

ists. The board directed that no publicity be given to the paper and that the staff abandon the idea of an automated exchange. As a tradeoff with the pro-automation group, the exchange systems staff was asked to do further work on developing peripheral applications. An electronic book for floor specialists was designed and tested on a small-scale pilot system by a few specialists but it was generally found to be awkward and time-consuming to have to key in the order data and the project was deferred. Similarly a system for automatic execution of 100 share market orders was designed and tested briefly but terminated before implementation.

In mid-1970, the American Stock Exchange which had also developed a systems capability to research a "locked-in-trade" for clearing purposes, announced an eight-stage automation program called AMCODE (AMEX Computerized Order Display and Execution).[103] The program proposed to start with a high performance "floor input system" for switching orders between members' offices and various stations on the floor and move through oddlot execution, limit order booth display, specialist book to broker-to-broker execution on the floor. It was always suspected that the undisclosed ninth stage was remote terminal trading with no floor.

A substantial amount of work was done on AMCODE by the AMEX group in 1971 and 1972. However, in mid-1972 the New York and American stock exchanges announced that they were going to merge their system/automation efforts in a jointly owned service group – the Securities Industry Automation Corp. (SIAC). While the systems groups were merging, the AMEX continued to sponsor AMCODE. One of its more notable accomplishments was the creation of a simulated trading facility. SimFac was set up to model a specialists' station under the AMCODE concept. It was demonstrated in an amphitheatre to various groups of people including the SEC and numerous congressmen. A large number of members viewed it with interest but felt it was "too much automation" and were discouraged by the $20 million to $40 million price tag. At about the same time, the AMEX was facing budgetary restraints and petitioned the NYSE to join in AMCODE as a partner. The NYSE accepted and the project was renamed Centaur (Central Exchange Network and Unified Reporting).

During this whole period the NYSE and AMEX were subjected to SEC and congressional pressure to respond to attacks on the rules providing for fixed commission rates and the closed

103 AMERICAN STOCK EXCHANGE, AMCODE (1970) (an updated proposal of the AMEX Data Systems Division).

nature of exchange membership and to industry pressure to reduce expenses. As a result the automation program became somewhat bogged down. Political infighting and frequent personnel changes had always plagued the NYSE automation efforts but when the leadership of the industry got diverted to more pressing problems (like survival),[104] the automation program became much less dramatic. Centaur, itself, was gradually shelved; however, pieces of it have been carried forward to provide useful services on the floor, but not to interfere with the traditional face-to-face meeting of traders to make trades in the "crowd".

Nevertheless, the New York and American Stock Exchange floors have gradually installed a part of the AMCODE project. First in was the odd-lot switching system. The switch accepts odd-lot orders in a standard format from members and then routes them to the odd-lot dealer (Carlisle & DeCoppet). It handles 85% to 90% of present odd-lot orders and will be expanded in 1976 to send limit orders and "at the opening" market orders directly to the post of execution by the specialist. They have also installed specially designed CRT screens on the specialists' counters (Floor Terminal System – FTS). These are used by the specialists for enquiry into the exchange's market data system (a sort of internal market inquiry system), Dow Jones news, NASDAQ quotations, etc. They will also be used for the specialists to enter their quotes into the composite quote systems, such as "Q-Quote" run by Ultronics. FTS was designed to have considerable capability for expansion of service should the specialists and traders desire it but implementation has not progressed at the rate expected.

In spite of these available automation facilities and a substantial budget for continued development of these facilities, for the foreseeable future the New York and American stock exchanges' floor systems will be based on face-to-face negotiation by traders.

An overriding requirement for face-to-face negotiation means that regardless of how smoothly an order-switching system can capture order data from the salesman or firm order desk, part of that data (stock name, buyer/seller, number of shares, price and strategy instructions) will have to be moved to the traders in a special room (the floor). Depending on how far the system has advanced, the trader will push a button either to direct that the order be further switched in electronic form to the specialist for

104 Note the strong recommendation of the Securities Industry Association that a feasibility study be made of the NYSE and AMEX merger and elimination of executive staff duplication. This arose at the 1973 annual meeting of the SIAC and has since been reflected in pressure for merger of clearing operations; *see* Securities Week (New York), February 24, 1975; *id.* July 21 1975.

booking, or to convert it to memo form for the trader himself to carry to the trading post to negotiate a deal. Once a trader has made a trade, someone will have to reenter the trade information to the system for automatic matching to the original order (or telephone the trade report to the order desk where it will be reentered for matching) and subsequent transmission to the operations area and reporting to the originating salesman.

B. COMPUTER-ASSISTED TRADING SYSTEM RESEARCH PROJECT AT THE TSE

In Canada, no firm commitment has been made to face-to-face negotiation and the Toronto Stock Exchange is experimenting in this area. This is a matter of some controversy in Canadian financial circles as trading-oriented and conservative elements point to the U.S. example. Though it is generally agreed that automation can and should be used to improve and supplement the present system, it is not agreed as to how far to go. Indeed, proponents of face-to-face negotiation have argued that the interfacing of the automated system to the trader on the floor is only a slight variation from a fully locked-in system and it much more closely approximates the tried and true present system. The costs of such a variation are *not* slight, however. Among the major costs are:

(1) the physical floor and its switching system and information displays;
(2) the people on the floor;
(3) the terminals on the floor for the trader to receive orders and reenter fill reports;
(4) the order match system to connect the reports to the original order.

At this juncture, it is not clear to the Canadian exchanges whether the face-to-face negotiation is essential. A preliminary goal of the TSE's Computer-Assisted Trading System Research (CATS) project is to prove or disprove this hypothesis.

1. *Background*

The Toronto Stock Exchange building and trading floor was opened in 1937 – the most modern facility of its kind. Thirty-two years later, in 1969, in the midst of high trading volumes of 15,000 to 20,000 trades per day which strained the trading floor facility to the breaking point, the exchange recognized that the floor and supporting equipment were in need of replacement or at least major refurbishing. The exchange board of governors directed its systems planning department to investigate the problem and

make recommendations. The planning group prepared preliminary analyses of various alternatives including a new building, additions to the old building and minimal renovation of the present facility. Even the latter involved several millions of dollars. At the time it was recognized that the new technology of computers and communications would play a substantial role in any alternative system.

Coincidentally with these planning efforts, announcements were being made in the U.S. of the NASDAQ, AutEx, and Instinet systems.[105] The planning group therefore recommended that prior to any major investment decision, an investigation should be made to determine how far the exchange could go with computer/communications technology to support the trading requirements of brokers in Canada.

Preliminary analysis indicated that the potential economic benefits from using computer communications technology would be maximized if:

(1) all the information relating to buy and sell orders could be captured in data processing form at an early point in the process and held for subsequent use in settlement processing;
(2) trading decisions, *i.e.*, amount, price, timing of tenders could be entered through terminals in members' offices to a sufficient level to make face-to-face contact by traders in a room unnecessary;
(3) the same system which handled order traffic could handle market information, research and administrative traffic for firms and their salesmen.

In effect, if data could be captured at the source and the number of communications links in the system minimized, substantial economic benefits would accrue from fewer people, less need for real estate (*i.e.*, no trading room) and reduction of errors.

In addition to the potential economic advantages, the potential service benefits, both to brokerage firms and also to their customers, appeared to be substantial. The idea that any terminal would be the equal of any other terminal, thus putting the customer in Halifax and Victoria on the same basis as one in Toronto, was very attractive from a marketing standpoint.

It was decided by the exchange that the potential of computer-assisted trading was so significant that it ought to be thoroughly explored before a decision was taken on replacing or refurbishing the present trading system. Loosely put, the key questions were: "Will it *work* for trading?" "What would it cost and will it pay to implement it?" The second question is a standard feasibility

105 TORONTO STOCK EXCHANGE, *supra* note 99, at A-7.

study question. The question of workability, however, is not. And, obviously, the feasibility question cannot be properly addressed unless or until a "workable" system is defined. Such definition is the first purpose of the CATS project.

It is necessary to continually bear in mind that it is quite possible that trading via remote terminals in *not* "workable" in comparison with face-to-face trading. For example, if in making trading decisions at terminals traders find that putting limit orders in the system usually results in either poorly priced trades or no fill at all for the investor/trader, then such orders would not be entered. As a result of orders not being entered, market spreads would widen and liquidity would decrease, thus making for a net detraction from the effectiveness of the market. Or, from a human factors point of view, if it is found that people trading from terminals generate unbearable psychic pressure and traders can only stand the strain for one or two hours per day, then terminal trading is unlikely to be considered workable. The question of workability is one of genuine research into computer applications. There is much work to be done between theory and application.

The question "will it work?" might better be recast: "to what extent can computer/communication technology be used to improve service and decrease costs in support of trading and other related securities market functions?" The view of the TSE board of governors is that if the problems involved in making trading perfectly feasible from remote terminals can be solved, then the exchange can implement a system with very significant cost and service benefits. The CATS project then has the goal of devising and proving such a system. If it cannot do so, then at least the knowledge which has been gained from the project will permit the TSE to define and cost the optimum use of technology in a replacement trading system involving an optimum degree of face-to-face interraction.

2. *Approach to the Project*

The original work on the CATS project was done by two senior managers from Bell Canada and the exchange's Director of Planning and Computer Systems. This preliminary one-week analysis in 1969 resulted in the TSE board authorizing a six-month feasibility study. The study was carried out by a Bell Canada "business information systems" consulting team supplemented by TSE staff. Their conclusion was that computer-assisted trading was

feasible at a design and implementation cost of $28.5 million, exclusive of the terminal network.[106]

TSE systems personnel who had worked with the Bell group felt that their cost estimates were unduly high and they in turn prepared a request for information[107] which was sent to several potential hardware suppliers and commercial systems specialists for reestimation. The resulting estimates had a wide spread but seemed to cluster between $7 million and $10 million. Encouraged by this lower cost estimate and by further planning work done by its own staff at the end of 1971, the exchange board approved work to simulate computerized trading on Air Canada's ReserVec II system. This attracted significant interest across Canada, in the form that it was demonstrated in Air Canada offices in Vancouver, Winnipeg, Toronto and Montréal at the end of 1972. In early 1973 it was decided to develop a "pilot" operation on the TSE's own computer and suitable computer hardware was ordered.

To carry the pilot project and certain other systems developments which the TSE board felt would be desirable in the 1970s, the exchange purchased an IBM 370-145. Although this machine was considerably more powerful than required by 1973 needs, the projection was that the excess power would soon be justified. In addition, if CATS should prove to be workable, then it was estimated that probably at least an additional 370-145 would be necessary to handle the load.

To support the CATS project a subcommittee of the board was appointed to give expert guidance on the desired rules and order types. Trading specialists as well as systems consultants and human factors specialists have been used to advise on various aspects of the project. The pilot terminal design is being done in close consultation with the systems group of Draper Dobie, an exchange member, which is mounting an online computer-based system to supply research, market and customer account information to its salesmen. The pilot project group also works in close liaison with the group in the computer department which is responsible for the exchange's online market information (CANDAT) system. This close coordination has ensured system-compatible programs and system control procedures in the event that the CATS project becomes more than a pilot experiment.

In order to obtain the input of industry practitioners at an early stage, a group of twenty "pilot" traders were recruited in

106 BELL CANADA, BUSINESS INFORMATION SYSTEMS, COMPUTER-ASSISTED TRADING: A FEASIBILITY STUDY FOR THE TORONTO STOCK EXCHANGE 115 (June 1970).

107 TORONTO STOCK EXCHANGE, REQUEST FOR INFORMATION AND SUGGESTIONS AS TO TECHNICAL FEASIBILITY AND COST OF COMPUTER-ASSISTED TRADING SYSTEM (September 1970).

late 1973. They were drawn from all backgrounds (floor trading, institutional trading, trading management and sales) in order to obtain balanced advice. The pilot group was put through an extensive training program to make them familiar with the terminal and the system as it was being designed. As a result of their participation, the terminal has gone through two major phases of redesign and a number of changes have been made to the orders and trading logic. The active involvement of the twenty traders training group and the board's steering committee underlines the exchange's view that trading via remotely located terminals tied to a central computer is not so much a technical problem as a problem of thoroughly understanding and defining the application.

3. *Status of the CATS Project - Fall 1975*

As of October 1975 a wide variety of information displays (CANDAT II), all common orders (limit, on-stop, short, etc.), a number of complex orders (scale, flexible) as well as the opening, an odd-lot system and certain surveillance and control routines had been programmed in experimental mode. An in-house control program had replaced the original IBM CICS/VS software to increase efficiency.

The twenty-man pilot group which was involved in training sessions in late 1974 was to be reactivated to work with the system in its present phase. In addition, the other member firms which had ordered CANDAT II were to have a person trained to participate in the various tests. It was expected that such tests would begin in the early part of 1976 when the training group would be taken through sequences of dummy orders. It was also thought feasible to collect members' orders and retrade an actual day's trading in some stocks to compare results with what happened on the floor.

4. *TSE Plans for the CATS Project*

It bears reiterating that the CATS project involves fundamental research and design with the objective of obtaining a "yes" or "no" answer to the question of whether remote terminal trading is workable per se. It was the opinion of the TSE in 1975 that the question could not be properly answered until a complete working pilot were available and a substantial effort had been made to remedy the problem which would be defined by "hands-on" experience.

As of 1975 many system and terminal improvements had been made in the project, and modifications planned. There remained

some significant problem areas which could not be definitively explored until the complete pilot was operative. These problems included:

(a) the man/machine logistics of handling the preopening retail order backlog and also substantial institutional orders in a fair manner at the opening of trading;

(b) removing from traders acting for either public investors or their own firm accounts the ability which exists in a face-to-face system to change their minds at the instant that a bargain is consummated on the floor;

(c) how many stocks can be watched effectively by a trader? how many orders can he manage at one time?

It was the expectation of the TSE that a fully working pilot would be available in the spring of 1976 and that alterations, depending on their size, could be accomplished in the second or third quarter of 1976. At that time more testing would be done and, at any time after those tests, a decision to end the project could be made. However, there was then a growing body of opinion (even among doubters of the viability of a complete remote terminal system for all stocks) that a remote terminal system would "work" for inactive stocks.

"Inactive" stocks are the subset of 600 TSE-listed stocks which are traded in an open order filing system at one end of the floor. In such stocks members file their bids and offers openly. When a filed bid or offer is accepted by another trader, the trader who entered the order is sought out and a deal consummated. It is felt by many that the last step is simply administrative and that the whole inactive system is amenable to computerization. In any case, it was felt that, lacking an abort decision for reasons not now anticipated, it was likely that during 1976 the TSE would attempt to trade a selection of real stocks on the system.

Trading listed stocks, where the buy and sell orders represent real money and obligations, further defines problems, indicates solutions (or insolubility) and contributes to the decision on how far the exchange can go with remote terminal trading.

The plan for accomplishing a test of inactive stock trading involved using the CANDAT II terminal network which was to be installed in Toronto and Montréal by year-end 1975. Most of the major order-generating houses were to have CANDAT II terminals. To service other houses, a sufficient number of terminals were to be located on the floor to handle their terminal needs.

5. *System Integrity, Security and Back-up*

Questions related to maintaining continuous full-service operations in an actual trading environment, keeping unauthorized persons from using or meddling with the system and preventing improper use of the services attract considerable interest from professional doomsayers. An even-tempered discussion of all facets of this problem area is contained in Jenkins, *Computer Communications Systems*, in this volume.[108]

System breakdown is perhaps the least important. Obviously, failure during the trading experiment is easily remedied. Backup procedure would simply be to reinstitute floor trading in the erstwhile CATS-traded issues. However, such simple backup procedures can only exist so long as there is a floor trading system. If it were to be decided to go further and put all listed stocks on CATS, then the exchange would make a considerable investment in system security and backup procedures involving such things as alternate power supply, dual hardware and "hot" restart procedures.

The question of system integrity is a continually nagging one with computer systems. Terrible tales of altered files and stolen information are widely publicized.[109] With respect to unauthorized access to a remote terminal trading system like CATS there are certain safeguards. At the first level, terminals will only be made available to members for placement in their own offices and only by direct lines. Ability to enter orders and access private files will be controlled by terminal location and by changeable password or identification card procedures.[110]

Such safeguards can undoubtedly be circumvented by a determined criminal. However, there are severe limitations on what can be accomplished by a criminal who achieves access. First the clearing and settlement system (by which trades are settled and money is paid) actually does not pay until three days after a trade. Thus any improperly created trades are likely to have been identified, investigated and in all likelihood cancelled by the exchange before any money has changed hands. Second, the trading system has automatic surveillance monitoring which continually keeps officials advised of any large price changes and, in fact, automatically halts trading at certain levels of price change unless the Surveillance Department actually overrides the automatic halt.

108 *Jenkins*, ch. IV.
109 Parker & Parker, *The New Criminal*, 20 DATAMATION, January 1974, at 56-58.
110 *See, Jenkins*, ch. IV.C.

Manipulation of the market to mislead the public or improperly raise or lower prices is a matter of considerable interest in any trading system. While automation will not make market manipulation any more difficult to affect, it will significantly facilitate the identification and investigation of it so that, if anything, a net disadvantage should accrue to marketeers seeking to make the market "work" unfairly for their benefit.

6. *Attitudes and Expectations of Exchange Members in 1978*

The attitude of exchange members to the CATS project in 1978 varies widely. Some regard the implementation of computer-assisted trading as an opportunity to obtain significant economic and service benefits, perhaps resulting in Canadians having a competitive advantage over other securities markets and thus attracting trade from Europe and the U.S.[111] Another group regards a computer-based system for trading as inevitable but holds no joy at the prospect. This group feels that it will not only "take the fun out of trading" but will also reduce it to a lowest-common-denominator type of activity. A significant number, particularly those who have a trading function in the present system, believe it will not work well enough to be implemented. They feel that the money spent on the CATS project could be better spent elsewhere. However, in spite of their intuitive negative feeling, they have accepted the idea that the work should be completed now so that the question of the potential role of computers in trading is forever laid to rest.

7. *CANDAT II, a Spinoff Product*

CANDAT II has been adopted as a major market information system by the Canadian industry. In 1975, seventy-three brokerage firms and thirty-nine institutions had one or more units installed. Three major securities firms had adopted CANDAT II as their market information system for their whole network. Other firms were still using competitors as their basic device but had CANDAT II terminals on their institutional trading desks and in their major branches. In all, 550 units were in use in twenty-one cities from Victoria to Halifax.

There is undoubtedly risk to the Toronto Stock Exchange in going so heavily into the computer terminal network business. The

111 This feeling has been seldom expressed recently since investment value of Canadian securities was substantially depreciated in the last two years by various taxation and policy initiatives by the federal and provincial governments.

value of terminal hardware which is long-term leased or owned by the exchange now approaches $3 million. While CANDAT II is at present the best market information system available to support trading, it is possible that one of the U.S.-based networks will devise an equal system and offer it at a lower cost, thus upsetting the marketing plans of the CANDAT II group at the TSE.

For the immediate future, however, CANDAT II's success is assured because it is an essential part of the computer-assisted trading test – the CATS terminal being merely a CANDAT II terminal equipped with a printer and enabled in its cluster controller to handle order entry and CATS trading inquires.

8. *CATS in 1978*

For a number of reasons, progress of the CATS experiment was delayed. In the first instance, members felt it unfair that only twenty of their number would be allowed to participate in the project and thus gain the advantage of the sophisticated market information system which is used to support CATS trading activity.[112] Because this gave CANDAT II a much higher profile, it absorbed resources of the exchange that had formerly been directed toward CATS . The wider terminal network also permitted a major upgrading of the CATS experiment to cover many more firms and this meant that a whole new group of traders would have to be trained. Further, the earlier group of twenty traders had identified additional changes and improvements required in the working system.

In November 1977, the exchange first began trading "live" through the CATS system. A selection of eighty relatively inactive securities were gradually mounted on the system and were trading entirely on a CATS basis by mid-January 1978. Minor problems with the system have been identified and slight changes have been made in response but, as of the time of writing, no major problem which would cause the experiment to be terminated has been identified.

The eighty stocks which were in the system in the first part of 1978 experienced a volume of activity on the order of 100 trades per day. This was not deemed to be sufficient activity to attract the attention of enough members and traders to expect a proper evaluation to be forthcoming. Therefore, in April 1978, the CATS

112 The market information system itself has been spun off and made available by the exchange as a separate market information system (*see* ch. VII *infra*). As a consequence, the commencement of the CATS pilot was delayed in order to allow all members to obtain CANDAT II equipment. For the total information package on CANDAT II, write to the Toronto Stock Exchange.

steering committee decided that it should add to the CATS experiment enough inactive stocks to unload the floor trading system and, in effect, make the CATS system the focal point of activity for enough traders and members so that an effective evaluation could be made. In addition to adding up to 500 additional relatively inactive securities, the plan includes adding some representative relatively active securities and representative volatile securities. If the system is able to handle a large number of inactive securities and a relatively stable (but active) security and a volatile security (such as a speculative western oil stock) then the last major hurdle would appear to be trading a major Canadian issue which is interlisted with the New York market.

When mounting additional securities on the system the timing is important. The exchange expected to take delivery of an IBM model 3031 computer in November 1978. Installation of this computer as the main frame with backup from the present IBM 370-145 machine was expected to give the exchange the capacity to carry all the planned experimental additions to the system. Assuming no problems requiring significant delay for reprogramming or system modification, a full evaluation of the CATS system was expected to be possible in the first half of 1979.

As of the time of writing, no insurmountable stumbling block has been identified, though it is by no means agreed that the computer can replace the trading floor as the facility for carrying out the transaction function. Some of the original sceptics have a more positive outlook on the eventual success of the system. The mere fact that no serious problem has been discovered during the first six months of "live trading" accounts for this modest shift in view.

As of mid-July 1978, the CATS system was trading at a rate of 150 trades per day with the value of trading approaching a million dollars. This was just under 2% of total TSE activity.

C. CANADA-WIDE SECURITIES MARKET SYSTEM

1. *Developments to 1975*

Obviously the implementation of a successful computer-assisted trading system by the TSE would have significant consequences for the other exchanges. In Canada there is a heavy overlap of membership[113] and of listings. For example, 93% of business on the Montreal Stock Exchange and 90% of business on

113 *See* table 4 *supra*.

the TSE is done by joint members.[114] Similarly, over 80% of the business of the Montreal Stock Exchange and over 65% of the TSE business is in stocks which are listed on both exchanges.[115] The inferred consequence is that a successful CATS system at the TSE might draw away a great proportion of MSE business.

The overlap with Vancouver is not as great because of the predominance of speculative listings, but nevertheless joint Vancouver-Toronto members account for some 60% of VSE business.[116]

The potential significance of these factors to the Montreal Stock Exchange was recognized by the representatives of that exchange who attended a TSE board study session in May 1972 at which the CATS project was one of the topics discussed. As a result, the MSE struck a committee and engaged a consultant to prepare a proposal for a Canada-wide securities market system. The MSE report was released in February 1973.[117] It proposed that the VSE, MSE and TSE get together to discuss formation of a Canada-wide system which would use computers to support the trading function. The report suggested approaches to various problems such as:

(a) what stocks should trade on the computer system;
(b) how brokers who were not members of all these exchanges would obtain access;
(c) compensation for the impact on seat values occasioned by easier access by nonmembers;
(d) methods for new listings and new memberships;
(e) making exchange rules and policies uniform where necessary;
(f) location of the computer(s);
(g) sharing of costs for development;
(h) user charges for operations;

and concluded by requesting the views of the IDA, VSE and TSE on further joint study of the proposal.

The IDA, VSE and TSE welcomed the MSE initiative and indicated a willingness to pursue the MSE suggestion for a Canada-wide arrangement in spite of some reservations about the specific proposals. A Canada-wide project committee was formed. It consisted of the presidents, chairmen and vice-chairmen of the three exchanges and representatives of the IDA were invited to

114 Based on informal calculation of relative 1973 clearing values by firm.

115 TSE statistics department based on 1969 study. After 1969 the MSE reduced its component of sole-listed speculative securities so that in 1975 the figures were probably closer to 90% and 70%.

116 Though there are exchanges in Winnipeg and Calgary, activity on them is minimal and does not justify separate analysis here.

117 MONTREAL STOCK EXCHANGE, A PROPOSAL FOR THE FORMATION OF THE CANADA-WIDE SECURITIES MARKET SYSTEM (March 1973).

attend as observers. Meetings were held in April, May and September of 1973 and in January, March, May and June of 1974.

At the June 1974 meeting, the project committee decided to recommend to the sponsoring exchanges that a "permanent" committee for the study of a Canada-wide system be established, that IDA representatives be asked to participate as full members of the study and that arrangements be made to staff the research requirements and support the committee's work. The Committee for the Development of a Canada-Wide Securities Market was formed in October 1974 and J. Ian Collins, a Montréal consultant, was engaged to do research and prepare papers. The committee agreed on a "Conceptual Model of a Canada-Wide Market System" and prepared to air its proposal with the industry and government regulators.

The essence of the proposal was that the three exchanges would form a jointly owned body to operate a Canada-wide market which would essentially adopt TSE standards and trade all TSE stocks plus others which were qualified. All members of the three exchanges would have full access to the Canada-wide mechanism. The Canada-wide body would be subservient generally to the sponsoring bodies but would have delegated to it responsibility for surveillance and trading regulation as well as some administrative functions to ensure that listing and membership standards are maintained.

As of 1975, it was evident that all members of more than one self-regulatory body were less than pleased to be supporting the duplication of overheads which arose in the system. Therefore, it was anticipated that the industry would welcome any proposal that reduced multiple jurisdictional difficulties and costs. The question was, whether the Canada-wide arrangement could really be organized so that duplications would be reduced.

As in any such plan to significantly revise the structure of an industry, there were certain problems. Some arose purely out of the probable desire of the provincial jurisdictions to remain supreme over their "own" exchanges. How much delegation of responsibility can be accomplished and still meet the jurisdictional requirements of the local securities commissions? A second set of problems were anticipated possibly arising out of the attitude which brokers who are only members of the Toronto Stock Exchange might take toward dissipation of the monopoly value of their access to TSE trading, while no additional access to the MSE or VSE was given to them for their trading in MSE or VSE stocks which did *not* go on the Canada-wide arrangement. Lastly, the Canada-wide arrangement *assumes* the workability of computer-assisted trading. If CATS was to prove unacceptable, some indus-

try-based effort would undoubtedly be made to rationalize the present structure. This, however, would require a whole rethinking of the present conceptualization of a Canada-wide arrangement.

2. *Canada-wide in 1978*

In 1977 the Alberta Stock Exchange (ASE) was added to the Canada-wide group and participated in the discussions. The invitation to the ASE to join in Canada-wide was due to the fact that the cities of Calgary and Edmonton were rapidly developing as significant regional financial communities.

Through 1975 and 1976 the Canada-wide project came very close to signature by the four exchanges and the IDA. However, alteration of the CATS experiment away from its original schedule disrupted the plans involved in the formation of a Canada-wide arrangement.

In late 1977 the Montreal and Toronto Stock Exchange executives met to discuss the difficulty involved in matching the Canada-wide arrangement with the CATS experiment. It was decided at that time that maintaining the Canada-wide arrangement until the CATS experiment was completed was expensive and not necessarily going to be productive. However, it was also felt that it was important to progress toward a unified market system in Canada, irrespective of the status of the CATS system. Therefore, while the formal Canada-wide proposal was "put on the back burner", efforts were made among the exchanges to devise other ways and means of further unifying the markets.

Certain rule changes were effected which will bring the markets closer together and make better use of the Montreal Stock Exchange's market-making capacity. In addition, an agreement was proposed between the Montreal and Toronto stock exchanges wherein the exchanges would, for the duration of the CATS experimental period, arrange to have all members place their orders in the CATS experimental stocks into the system rather than execute them through the respective floors. The intention of the Toronto and Montreal stock exchanges is that if the steps being taken between the two exchanges to unify their markets can be agreed upon, similar arrangements will be offered to the Alberta Stock Exchange and to the Vancouver Stock Exchange and its sole members.

In this way, without the CATS system being proven or in place, steps are being taken to ensure cooperative efforts between the exchanges and a move toward a Canada-wide arrangement. If the CATS experiment shows that remote terminal trading can be

accomplished through a centralized computer system, then it is possible that parts, if not all, of the Canada-wide arrangement will be brought forward for implementation.

D. SECURITIES MARKET STRUCTURE EVOLVING IN THE UNITED STATES

1. *Evolution to 1975*

Between 1970 and 1975, the U.S. securities industry was subject to extensive examination by the U.S. Senate, the House of Representatives and the Securities and Exchange Commission.[118] The studies and subsequent policy papers and legislation resulted in the initiation of substantial changes in the structure of the U.S. industry. For example, a category of registrant designated as "Securities Information Processor" was established to include non-self-regulatory organizations which collect, process or distribute quotation or transaction information.[119] As of 1975, transfer agents were subject to SEC-determined standards and the effective operation of securities depositories and clearing corporations were made a clear concern of the SEC. In addition, securities firms were to be publicly owned, institutions could be members of stock exchanges (but could not do business for their managed accounts), commission rates were made negotiable, and, on grounds that such rules are anti-competitive, a major assault was thus made on New York Stock Exchange rules which require transactions by members to be done openly and on the floor.[120]

Obviously, the developments in the U.S. were very broadly based, and took into account the economic theories of the Department of Justice, the political forum needs of the senators and congressmen, as well as considerable public resentment against the New York Stock Exchange and its members for past protection

118 *See* INSTITUTIONAL IVESTOR REPORT; *In re* Structure, Operation and Regulation of the Securities Markets, SEC File No. 4-147 (1971) (24 vols. of reported testimony and 4 vols. of written submissions and exhibits); *Securities Industry Study, Hearings before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 92d Cong., 2d Sess. (4 vols., 1971-1972); SECURITIES INDUSTRY STUDY: REPORT OF THE SUBCOMM. ON SECURITIES OF THE SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, 93d Cong., 1st Sess. (Comm. Print 1973); *Study of the Securities Industry: Hearings before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 92d Cong., 2d Sess. (1971-1972); SECURITIES INDUSTRY STUDY, REPORT OF THE SUBCOMM. ON COMMERCE AND FINANCE OF THE HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, 92d Cong., 2d Sess. (Subcomm. Print 1972).

119 *Notice of Adoption of Rule 11Ab2-1 and Related Form under Exchange Act*, SEC, Securities Exchange Act of 1934 Release No. 11673, September 23, 1975, [1975-1976 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,302.

120 *Off-Board Transaction Study*, SEC, Securities Exchange Act of 1934 Release No. 11628, September 2, 1975, CCH FED. SEC. L. REP., No. 603 (pt. II) (September 5, 1975).

of privileges. There was also considerable interest in the potential contribution of automation in bringing about an improved securities market in the U.S. The SEC's policy thrust toward a Central Market System was the overriding influence there.

Already by 1975 several steps had been taken. First, the SEC mandated creation of a consolidated securities transaction reporting tape.[121] The "consolidated tape" was formerly only at stage "A", which included reports of transactions made on all U.S. exchanges and in the third market and Instinet in securities listed on the New York Stock Exchange. Tape "B" was to include all transactions in stocks listed on *other than* the New York Stock Exchange. It was postponed several times due to delays in establishing the high-speed line to carry trade and quote information between the exchanges and commercial vendors of market information. Tape "B" implementation was scheduled for January 1976.

Because of the substantial inter-institutional problems which arose out of formation of the consolidated tape by mandated cooperation, the SEC took a different approach to bringing about the next step – a composite quotation system.[122] Where previously quotes had been available only to exchange members, the SEC simply directed by rule that the exchanges make their market quotations available for a reasonable fee to anyone who wanted them. The "composite quotation system" was therefore to be developed by the commercial suppliers of market inquiry systems: Quotron, Bunker Ramo, Ultronics.

Formation of the consolidated transaction reporting and composite quotations system were supposed to be only the first two steps in creation of the SEC's concept of a Central Market System.[123] In the opinion of most observers, Tapes A and B were considered of minimal value. Though they do have the benefit of forcing third market trades out into the open by reporting them, the uncertainty of the time delays which take place in reporting were thought to make the information relatively unhelpful. Whether the broader reporting of the regional exchange's trading would attract interest to those exchanges (as the press notices indicated was the hopeful intent) was regarded as questionable.

121 *Consolidated Tape Plan Declared Effective*, SEC, Securities Exchange Act of 1934 Release No. 10787, May 10, 1974, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,782. SEC, Securities Exchange Act of 1934 Release No. 9530, March 8, 1972, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,600, gave notice of the intended rule to create the consolidated shape. *See also*, *Jenkins*, ch. III.A.

122 SEC, Securities Exchange Act of 1934 Release No. 11288, March 11, 1975, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,136 (written request to registered national securities exchanges regarding availability of quotation information).

123 SEC, Policy Statement on the Structure of a Central Market System (March 1973).

As the SEC's own advisory committee (discussed below) saw the question of regional exchanges, it was even doubtful whether such a result would be beneficial.

The composite quotation system was seen as providing some benefit in identifying the prices at which the market-makers and specialists of the various markets were bidding or offering. However, since the size of such bids and offers is unknown, the value of the information is minimal and the quotation system may only serve to generate a lot of useless activity for already busy desk traders in checking nominal quotations. In addition, there was the question of whether the enhancement of regional fragmentation of the market for a security was not, in fact, a net loss rather than a benefit. The question was raised as to whether the SEC's real motive in insisting on the composite competing markets philosophy was to cause such mayhem and expense for trading desks that the industry would itself revolt against multiple exchange markets and insist on moving to a unified black box approach!

Step three of the Central Market System was less well-defined. At the heart of it was a communications net connecting all the market centres and all the participants. In addition, the 1973 policy statement spoke of:

(a) a public preference rule (much as exists in Canada today) to give public orders preference over industry-originated orders;
(b) uniformity of rules between exchanges and also the third market – including a uniform short sale rule;
(c) standard membership/access criteria and stock eligibility (listing) requirements; and
(d) removal of NYSE Rule 390 requiring members to do all their trade in listed stocks on the exchange (or an exchange of which they are a member).

The "Advisory Committee on the Implementation of a Central Market Committee" (the Yearley Committee) was struck in May 1974 and reported the following year.[124] The major theme of this industry group was that the various existing exchanges should be brought into a single self-regulatory national securities exchange with as many floors as are desired. But all broker-dealers would be required to trade within the system – sort of a system-wide Rule 394. Except for this departure from the competing exchanges theme, they endorsed and extended the concepts of the SEC's policy statement.

It was clear in 1975 that the U.S. debate on how to structure

124 *Summary Report of SEC Advisory Committee on the Implementation of a Central Market System*, May 15, 1975, 308 BNA SEC. REG. & L. REP., June 25, 1975.

the central market was unlikely to be readily resolved. (The inherent problems in multisited trading of the same security under purported enforcement of some sort of "best execution" rule promised to confound the rulemakers and systems technologists alike.) The insoluable problem arises because, while the dissemination of quote information would be inexpensive and instantaneous, reacting to it by sending an order to a specific exchange and having the trader go out on the floor to make a trade (and perhaps bring back a report that the bid/offer has been preempted) would take a very long time and is costly.

On the face of it in 1975, there was only one solution – a single market for each security. This can theoretically be accomplished technologically by having the filing and matching of orders in any particular security done within a single computer-assisted system. The TSE's CATS project might be helpful in testing the potentiality of this "black box" solution – or, it might equally well be accomplished manually by having each listed security trade on only one physical floor on which all specialists', competing market-makers' and customers' tenders are represented and to which the communication net will direct all orders in the particular security. Whatever the solution, it was evident that until the Americans recognized the verity of the need for a *single* market for each stock there was unlikely to be much real progress toward a U.S. Central Market System, be it manual or computer-based.

2. *Status in 1978*

The preceding comments were also applicable in mid-1978, although it was evident by then that there were two competing points of view in the United States. One set of protagonists believes that a CATS-type system will work and is indeed the only way to implement the SEC's mandated National Market System. The most prominent advocates of a CATS-type system are J. Peake and Morris Mendelson. They are frequently referred to in *Securities Week* and have given papers at numerous conferences.

Weeden & Company, the well-known bond dealer and third market firm, has developed a working automated trading system – designated WHAM (Weeden Holdings Automated Market). Although Weeden has dropped out of the third market, it has put considerable effort into its dominant membership in the Cincinnati Stock Exchange and with a small contribution from the Cincinnati exchange has turned WHAM over to that exchange as an automated trading system – "the Exchange without walls".[125]

125 Securities Week (New York), May 22, 1978, at 5.

The Cincinnati Stock Exchange began trading on June 13, 1978, with two stocks. Merrill Lynch agreed to direct orders for these two stocks to the Cincinnati Stock Exchange and by the end of the first week of activity 143,200 shares were traded in those securities on the Cincinnati exchange.[126] In June 1978, Paine Webber, Prescott Ball & Turben and some other firms agreed to direct certain orders to the Cincinnati exchange. At this time the possible success of the Cincinnati exchange is of major concern to the New York exchange and its regional associates in the Intermarket Trading System (ITS).[127]

The New York Stock Exchange specialists and floor traders are extremely concerned about automation. Recognizing that it removes the ability to deal face-to-face and that it would carry out the specialist's agency function without any human intervention, the New York Stock Exchange has put its large resources into developing ITS with the regionals – the Pacific Coast, Philadelphia, and Boston stock exchanges. The Intermarket Trading System works on the basis that the specialist market (bid/ask) from each floor is available to the other floors. The system not only makes the information available, it also can route an order from one exchange to another for execution – if the market is superior on the second.

Opinions are divided on ITS. The NYSE regards it as a key building block in an evolving National Market System.

3. *Rule 390*

Rule 390 of the New York Stock Exchange was submitted to a major attack by the SEC and the Department of Justice as well as certain leaders of the U.S. Congress during 1975 to 1977. By year end 1977, the SEC had granted a reprieve on the removal of Rule 390. Thus the New York Stock Exchange may continue to have a rule which requires all members to direct orders to the floor of the exchange if:

(a) it is an order for an inventory account; or
(b) it is an order for a client in which the member is itself intending to fill the customer's order from firm inventory.

Spokesmen for both the securities industry and listed companies testified strongly before the SEC on their support for centralizing order flow, rather than letting broker-dealers execute transactions "upstairs" on their trading desks without the benefit

126 Securities Week (New York), June 19, 1978.
127 Securities Week (New York), June 26, 1978. NEW YORK STOCK EXCHANGE, A CORNERSTONE OF THE NATIONAL MARKET SYSTEM (June 1, 1978).

of exposure to potentially better bid or ask prices which might exist on the floor in the specialist's book or in the trading "crowd".

Chapter VII
A View of a Probable Securities Market System - 1980-85

In an industry such as the securities industry in which so much is currently in a state of flux, it is probably foolish to make forecasts about future structure and organization. On the other hand, there may be some very large forces at work which can be depended upon to move toward an inevitable result. On the basis of the kinds of projects and momentum of the Canadian industry reported in this paper, it would seem that computer/communications technology may be such a force.

The needs of the securities markets and the participants in them are for (1) storage of large amounts of accessible data; (2) an ability to manipulate the data; (3) an ability to communicate data and instructions relating to it; and (4) production of documents for archival storage. These needs seem well met by various applications of computer/communications technology, some of which are even now under way and have been described in chapter VI.

At the present time there exist reasonably comprehensive data bases for market quotation and trade data and for corporate financial information and securities issue data. Customer account information is in the process of being brought onto online data bases. What is most lacking at this time is a network of high performance flexible and interactive terminals which are able to access these data bases for the people who need the information. A second gap in the present systems is the ability to drive transaction data (including customer identification) directly into brokerage accounting and the settlement systems. Both these gaps appear to be answered by the sort of network which will emerge from the computer-assisted trading research at the TSE.

In the backend of the securities market system there is the curse of the paper certificate, and also a missing link in that the customer account and shareholder ownership records are not in an online mode, hence not connectable to a communications net. The solution to the former problem appears to be in sight via the Canadian Depository, and a start has been made on solving the latter problem in the CATS and MARS networks at the TSE and VSE, respectively, and in the recent moves toward online brokerage accounting records.

When these systems are in place and settled down (which would appear to be likely within five years) a rather streamlined securities market system will emerge (see figure 4).

In such a system, the salesmen, research analysts, traders, credit controllers, cashiers, lenders and registrars are able to access some or all of the various data bases and functioning systems. The system structure inferred above implies a single coordinated network but it does not imply anything about multiple or merged hardware installations for each of the six areas. Whether the various subsystems are run on independent computers or merged onto large installations will depend on the degree to which competition is found desirable and economic in the provision of services. For example, one could well imagine a large operations area service bureau being integrated and associated with the clearing/settlement and depository systems. But one could equally see a large number of separate operations area installations competing to give service, all coordinated to a standard terminal network and a single settlement/depository system.

Like settlement and depository systems, it is hard to imagine competing trading systems over any long term – certainly not in the same securities. The directions of the CATS and Canada-wide projects are consistent with this projection and it is plausible to regard the present Vancouver Stock Exchange program as ultimately complementary rather than competitive.

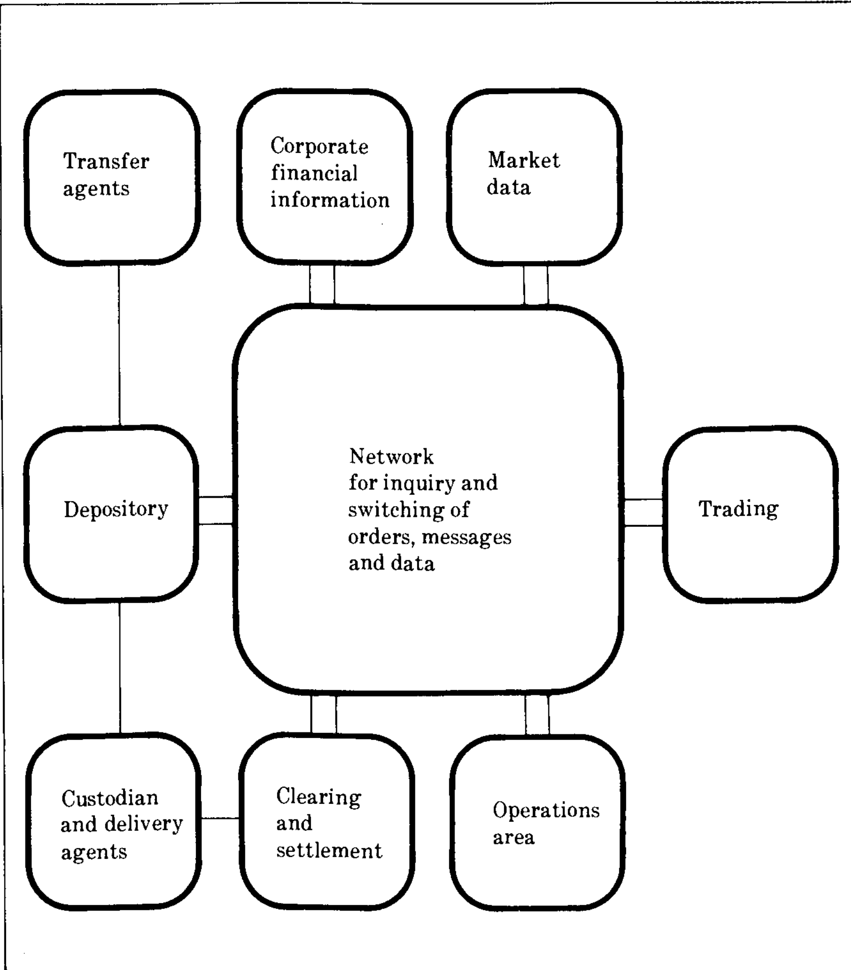
In the future, when the legendary retired farmer in Victoria decides to buy some ABC stock and the institution in Halifax has decided to sell ABC, the transaction might be described as follows:

Salesman Jones in Victoria, having been alerted on his desktop terminal that his firm's research department likes ABC, calls up the portfolio program which shows him all accounts of his which have a position in ABC and/or excess "buying power". Noting retired farmer Abernathy as a potential buyer, he telephones Abernathy. In response to questions, Jones uses his terminal to call forth recent research information, past prices, earnings projections and recent news releases from the corporate information data base supplier with which his firm has a contract. Satisfied that ABC is a good purchase, Abernathy expresses an interest in up to 500 shares. While still talking to Abernathy, Jones calls up the recent market information and the CATS market. He informs Abernathy that the market is 7-7/8 to 8, last sale is at 8, 1,000 shares have been traded today in three small trades at 8 and 8-1/8. Jones suggests that they try to buy 500 at 8. Abernathy agrees and Jones keys in the order and Abernathy's account number.[128]

Since the dollar value order limit assigned to Jones by his firm

128 His account number is something like his present social insurance number but is unique to him and therefore identifies Abernathy discretely at brokers, banks, transfer agents and other financial intermediaries.

Figure 4
Network Based on Securities Market System



is $3,000 and this order has a total value of $4,000, it is routed by the network to the central trading desk of his firm for control purposes. The master trader on the desk observes the stock is on their "buy" list and routinely OK's the order. The order then goes to the trading module for attempted match/execution. At $8 it finds 200 shares which it purchases and bids $8 for 300 shares more. The terminal reports that 200 have been purchased and that the order is actively bidding for 300 at $8. In the approximate 10 to 30 seconds (less than 5 seconds if the master trader authorization had not been activated), Abernathy waited on the telephone for the report. Upon hearing that he had 200 and that the market was 8 to 8-1/8, Abernathy decided to raise his bid to 8-1/8. Jones accomplished this with a single key stroke and sent the order again, whereupon 300 were bought at 8-1/8 and the order completed.

Reports of the trades were automatically produced by the network at the firm's operations area. Since Abernathy has given standing instructions for delivery of his purchases at a chartered bank, the operations area sets in motion the client accounting requirements and clientside settlement process. This is done by calling up Abernathy's account on the operations area terminal and by keying-in instructions to direct the depository and settlement system to go ahead with the book entry transfer of 500 shares of the firm's "free" stock to the bank against payment of cash from the bank.

On the streetside, the clearing house will advise the firm as of the close of business what its net cash pay or receive is as a result of that day's trading in all issues and also as to the positions to be settled by receipt or delivery of stock. (Abernathy's transaction may well be netted out.) The settlement system will be instructed (also via the terminal) as to what to do with the incoming positions and from which subaccounts to take the outgoing stock.

In Halifax the insurance company investment fund (for which the 200 shares purchased by Abernathy at $8 were being offered) is run by an ultraconservative manager. He likes to have his holdings held in the traditional manner. Thus certificates representing the shares he is selling are held in a vault at the Bluenose Trust Company. On receiving written confirmation of the sale two days later, he instructs Bluenose to make delivery to Broker X. Having only certificate denominations of 1,000 shares, Bluenose sends a 1,000-share certificate to the transfer agent for ABC (another trust company), requesting 1 x 200 and 1 x 800. Since ABC's transfer agent does not have a branch located in Halifax, Bluenose Trust must send the certificate to Montréal by insured mail or courier. The requested certificates are not received back

until seven days later. ABC is debited $5 by Bluenose for the transfer. (ABC is one of the few companies that continues to pay the agents for share transfer – most companies require the $5 certificate issuance charge to be made to the person asking for the certificate.)

On receiving the certificates back, Bluenose delivers 200 shares to the Halifax office of Broker X and receives a cheque for $1,600 *less* commission, *less* a handling charge of $10 in respect of the certificated delivery. (In spite of the $10 charge, the insurance company's broker will be out of pocket due to interest loss, insurance, mailing and accounting expense in handling the paper certificate.) The Halifax branch of Broker X then sends the 200-share certificate by armoured courier or insured mail to Broker X's head office in Montréal where it is sent to ABC's transfer agent for deposit in the CDS noncertificated account to the credit of Broker X (and cancellation of the certificate).

The 300 shares bought by Abernathy at 8-1/8 came from an offering by Broker Z on behalf of a sophisticated client in Alberta. Since the Alberta client has used the full service facilities offered by Broker Z and the stock position is held in noncertificated form, the settlement of the transaction is extremely simple. The client's account is reduced by 300 shares and his bank account credited with the proceeds (less commission). In streetside settlement, Broker Z's account with ABC's transfer agent is reduced by 300 shares (which are credited to the account of Abernathy's broker) and the money proceeds are directed into Broker Z's clearing account for daily netting.

Appendix A
The Toronto Stock Exchange Top 100 Companies by Dollar Value Traded

As of December 31, 1977
In dollars

1	Bell Canada	272,774,730
2	Norcen Energy	148,907,867
3	Amalgamated Bonanza	142,475,191
4	INCO Ltd. Cl 'A'	121,765,796
5	Dome Petroleum	118,521,795
6	Alcan Aluminium	113,640,574
7	Imperial Oil Cl 'A'	100,368,062
8	Canadian Pacific	91,492,717
9	Moore Corporation	84,845,327
10	Husky Oil	68,365,400
11	TransCanada PipeLine	67,277,529
12	Alberta Gas Trunk Cl 'A'	65,133,917
13	Noranda Mines Cl 'A'	61,924,622
14	Bank of Montreal	59,030,583
15	Royal Bank of Canada	57,071,147
16	Canadian Imperial Bank of Commerce	54,082,505
17	Home Oil Cl 'A'	53,377,583
18	Pacific Petroleums	53,173,291
19	Massey-Ferguson	51,387,721
20	Steel Co. of Canada Cl 'A'	50,462,088
21	Calgary Power Cl 'A'	49,151,050
22	MacMillan Bloedel	48,746,121
23	Bank of Nova Scotia	47,364,673
24	Toronto-Dominion Bank	45,741,033
25	Canadian Superior Oil	45,701,629
26	Westcoast Transmission	44,160,627
27	Consumers' Gas	42,132,991
28	Coseka Resources	40,681,173
29	Bow Valley Industries	40,645,550
30	Seagrams	40,643,903
31	Walker-Gooderham Cl 'A'	38,100,955
32	Interprovincial Pipe Line Cl 'A'	38,061,343
33	Alminex Ltd.	37,995,522
34	Canadian Tire Cl 'A'	37,735,214
35	Ranger Oil (Canada)	37,202,716
36	Denison Mines	37,042,415
37	Cominco Ltd.	35,703,189
38	Shell Canada	34,819,269
39	Bell Canada $2.28 Pr	34,125,719
40	Brascan Cl 'A'	33,537,270

41	Kaiser Resources	32,751,124
42	Trans-Canada Resources	32,534,651
43	Canada Southern Pete	32,282,845
44	Hudson's Bay Oil & Gas	32,092,967
45	Bridger Petroleum	32,064,856
46	Ocelot Industries Cl 'B'	30,892,786
47	Northern Telecom	29,294,770
48	Asamera Oil	28,847,028
49	Canada Northwest Land	28,330,919
50	Gulf Oil Canada	28,149,966
51	United Canso Oil & Gas	27,777,991
52	BP Canada	27,043,312
53	Merland Explorations	26,980,101
54	Oakwood Petroleum	26,196,163
55	Alberta Energy Co.	25,940,227
56	BM-RT Realty Investments Trust Units	25,828,361
57	Canada Development 8% 'B' Pr	25,471,649
58	IU International	25,407,385
59	Westcoast Petroleum	24,760,728
60	Numac Oil & Gas	24,757,185
61	Siebens Oil & Gas	24,596,554
62	Dominion Foundries & Steel Cl 'A'	24,591,922
63	Union Gas Cl 'A'	24,141,134
64	Genstar	23,445,348
65	Dome Mines	22,347,608
66	PanCanadian Petroleum	22,118,776
67	Total Petroleum (N.A.)	21,943,822
68	Skye Resources	21,942,265
69	Trans Mountain Pipe Line Cl 'A'	21,849,941
70	Abitibi Paper	21,761,844
71	Chieftain Development	21,567,430
72	British Columbia Telephone	21,531,237
73	Texaco (Canada)	21,088,569
74	IAC Limited	21,058,459
75	Canadian International Power	21,033,824
76	Canadian Homestead Oil	20,870,555
77	Simpson's Ltd.	20,741,254
78	Westburne International	19,912,426
79	Atco Industries Cl 'A'	19,848,236
80	Texasgulf	19,792,938
81	Traders Group Cl 'A'	19,314,308
82	Voyager Petroleums	19,191,784
83	American Eagle Pete	19,133,727
84	Peyto Oils	19,096,217
85	Camflo Mines	19,087,889
86	Canadian Pacific Investments	18,646,434

87	Domtar Ltd.	18,471,565
88	Asbestos Corp.	18,450,910
89	Dominion Bridge	17,289,298
90	Cadillac Fairview	16,915,437
91	Canadian Utilities	16,827,477
92	Ram Petroleums	16,803,393
93	Thomson Newspapers Cl 'A'	16,778,017
94	Zellers Ltd.	16,669,451
95	Royal Trust Cl 'A'	16,623,326
96	Westcoast Transmission Wt	16,218,766
97	Sceptre Resources	16,192,438
98	Hudson's Bay Co.	15,840,080
99	Bell Canada $4.23 Pr	15,668,545
100	Kerr Addison Cl 'A'	15,647,055
	Total	3,997,826,080

Note: Dollar value traded by the top 100 issues as a percent of all listed issues: 66.1%.

Appendix B
Automation Program of the Vancouver Stock Exchange

For many years, the Vancouver Stock Exchange has had its own computer department which operated both a simple clearing system, a ticker tape and a modest market inquiry system. In 1973, however, the VSE undertook to upgrade its automation program. The old Univac system was replaced with an IBM 370-125 and projects were initiated to redesign the clearing system and also improve the online market inquiry offering.

1. *Clearing System*

The new VSE clearing system was decided on after a broad study of what other exchanges in North America were doing and considerable debate as to the VSE role as a sponsor of the Canadian Depository for Securities Limited. In early 1974, the decision was taken by the VSE Board that it would discontinue its support for CDS and put its full resources behind development of a Continuous Net Settlement (CNS) system modelled along the lines of the system run by the Midwest Stock Exchange Clearing Corp. The Vancouver Stock Exchange Service Corporation was formed and the new clearing system was brought on stream at year-end 1974.

In the Continuous Net Settlement system the Exchange Service Corp. takes the opposite side of every trade. That is, the contract resulting from a floor trade between brokers results in an obligation on the buying member to pay the Service Corp. and on the selling member to deliver to the Service Corp. Because the Service Corp. becomes the opposite side of every transaction, opportunities for netting are maximized, not only on a daily basis but in effect on a continuous basis as each member simply runs a position with the Service Corp. In each security, each member is "owing shares to", "owed shares from" or "flat" vis-à-vis the Service Corp.

In addition to maintaining continuously netted "owing to" and "owing from" positions, the VSE Service Corp. has set up a depository which allows members to deposit any Canadian listed security for holding as "free", "loan free" or "seg free" positions in the Service Corp.'s vault. Loan-free positions are available for use by the automatic loan system. This means that the Service Corp. can satisfy another member's "owing from clearing" position or request for withdrawal via delivery of certificates by borrowing stock from members with loan-free positions. The member supplying the loanable free position will gain by receiving a cash credit from the Service Corp. for the full value of the loaned positions. Credit control is tight in the VSE system as the value of all "owing to", "owed from" and "loaned" positions are adjusted to market value every day. The accompanying figure is a diagramatic outline of the system.

The fully implemented CNS system at the VSE has meant opera-

tions area manpower savings for members and savings on the financing of undelivered positions owing to the Service Corp. as well as improved delivery and payment relations with customers.

Some statistics will help put the VSE Service Corp. in perspective. Its vault now holds over 60,000 certificates representing over 210 million shares worth $115 million. On a daily basis, its ten employees clear and settle all VSE and VSE curb trading for the 23 clearing members, as well as continuing to accept net deposits running at an average of over one million shares per day. In 1977, the Service Corp. dividend processing system included over 330 stocks with over $500,000 paid to members for owing positions and certificate claims. The Service Corp. is audited on a continual basis and has had three "perfect" annual audits since 1974.

Another feature included in the Net Settlement package is the ability for members to move security positions from one to another via "book movement" either "free" or "against payment". This means that rather than withdrawing securities from the depository for delivery to another member, both members agree to the amount of securities and monies to be moved and the members' accounts are adjusted automatically.

This facility for book-based movements is available to trading members, non-trading local members and out-of-town members. In effect this means that out-of-town brokers using local trading members of the Vancouver Stock Exchange may maintain positions with the VSE Service Corp, thus avoiding the time-consuming and expensive movement of certificates across the country.

Further evidence of the success of the Vancouver Stock Exchange system was evident with the announcement in March 1978 that the Alberta Stock Exchange was to use the facilities of the VSE Service Corp. The Alberta Stock Exchange is to be linked to the Vancouver Stock Exchange computer network and members of the VSE Service Corp will be able to deposit or withdraw securities in either Vancouver or Calgary.

The attitude of the members toward Service Corp. is highly favourable. There is admiration for the innovativeness and the effectiveness with which the system has been implemented. Originally, there were some who doubted the economics of the new system in that the daily value of trading on the VSE was only $1 million (member gross revenue from such trading would have been something under $50,000 per day and total operations apportionment of this would be only $10,000-15,000). However, the system has proved to be a complete success. The VSE has had to increase its staff to manage the system but there has had to be no increase of the member firms' part of their operations area affected by the new clearing system.

As of December 31, 1977, there was definite evidence being seen in members' offices of reduced cage staffs, lower bank safekeeping charges, transfer costs, audit costs and insurance premiums. Increased costs of the Service Corp. compared to the old clearing house have been

offset by those gains and the general view in Vancouver is that a net positive result has been obtained.

2. *Market Data Inquiry Service*

The VSE announced a Marketminding And Reference Service (MARS) in mid-1975. MARS is an online terminal system which provides to subscribers the ability to inquire into the VSE data base of VSE and TSE trading and quotation information. One planned service of MARS which will be very useful to VSE members is that it will be able to access the VSE Service Corp. data base concerning open clearing items, dividends and issuer data. Section 3 below provides a summary of the services available on MARS.

The VSE database is available to subscribers through three different means.

Firstly, access is available through the dial up telex network.

Secondly, subscribers may use VUCOM I (or other compatible terminals) to access the system.

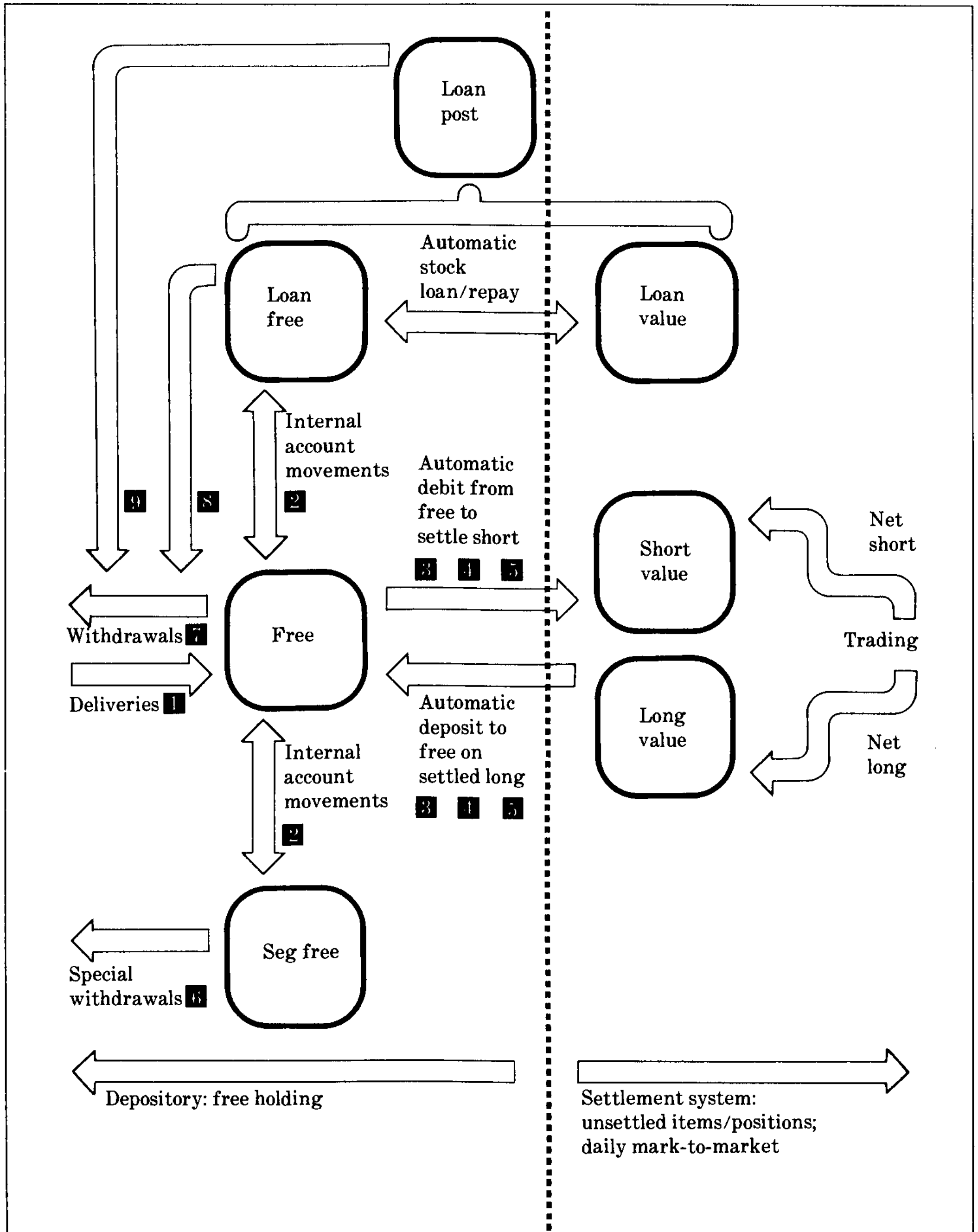
Thirdly, users of the CMQ (Combined Market Quotations) system may use Videomaster terminals to access both the CMQ database and the VSE database through one terminal simultaneously.

3. *Data-processing Department, Vancouver Stock Exchange*

MARS features

1.	Market Quotations	Bid and Ask prices; today's trading statistics; up to the minute sales, value, trend
2.	Most active stocks	By volume; by value; by number of trades; by percent change; by section (mines, oils, industrials, curb)
3.	Historical quotations	High, low, close for any day; high, low, close for any period
4.	Extended stock information	150 items of information per stock; dividend details; capitalization details; declared short position; day, week, month, year statistics
5.	Stockwatching	You choose the stock; you are informed of all trades and market changes as soon as they happen
6.	Toronto quotations	Today's market information; stockwatching
7.	Trade recall	Recall of today's or yesterday's individual trades

VSE Service Corporation CNS Depository/Settlement System



Source: Vancouver Stock Exchange.

Daily trading on the floor results in net changes to long and short value positions in the settlement system. For every eligible security a participant is either long, short or flat "value" in the settlement system.

Settlement Processing

Deliveries (1) of stock certificates received are first processed as directed by depositor (2). "Seg Free" is safekeeping stock which cannot be touched except on explicit directions by participant. "Loan Free" is stock available for loan or loan repay on request by the system. After internal accounts directions are recognized, each member's Free position is checked to see whether it can be used to reduce Short Value; if it does, money balance is credited (3). The Long Value is checked. If the service corporation has stock available to reduce Long Value, to the extent that it does, the position is moved to Free and money balance is debited (4) and (5). Special withdrawals (6) are recognized from Seg Free. An ordinary withdrawal request (7) is met from Free, but if the request cannot be met from Free, then that member's Loan Free position is searched (8). If the request is not met from the member's Loan Free, then the Loan Post (which is the amalgam of all members' Loan Free) is requested to supply it (9). If it can, the lender's Loan Value is raised and money credited. The borrower shows an offsetting Short Value. In any stock, Loan Value + Long Value = Short Value.

4. *Brokerage Accounting Services*

In December 1976, the VSE ventured into the role of providing brokerage accounting services to members. These services were achieved by acting as the input/output focal point for users and by buying raw computer power from the local IBM Datacentre, the traditional supplier of the service. Users of the service now look to the VSE rather than IBM for service and support.

By the summer of 1977 all Vancouver-based brokers, who had previously used the IBM system, were availing themselves of the service provided by the VSE, which by the end of 1977 was being offered at a cost which was significantly lower than its IBM equivalent.

This initiative shown by the VSE was based on the additional computer capacity which VSE's own computer system had during the overnight time period. The VSE was therefore able to provide the service at a low marginal equipment cost.

Savings accrue to the users of the VSE system in two ways. Firstly, there is a direct cost savings. Secondly, by deriving revenue from the provision of the service the VSE is able to avoid raising members' fees in other areas.

The VSE is also now in the process of developing programs to run on its own computer system. This will reduce the costs to the VSE of providing this service. A phased approach is being used and it will likely be a number of years before all the programs could run on the VSE computer. The first programs are scheduled to be run on the VSE's computer in the second quarter of 1978.

Appendix C
Nominee vs Shareholder Record - Two Kinds of "Book-based" Systems[a]

At this date [1972] there is considerable controversy among the banks and trust companies as to what form of depository should be instituted in Canada. Much of the debate seems to be based on a misunderstanding of the meaning of "book-based". This memorandum is to clarify that issue in the context of transfer agents.

The overall purpose of the CDS [Canadian Depository for Securities Ltd.] project is to make the Canadian securities system work more efficiently. The operational objective is to reduce the dependence of the system on the movement, storage and control of paper certificates. In effect the goal is to change the basis of the system from paper certificates representing negotiable ownership interests to computerized book entries. Two basic forms of book-based systems have been described by CDS. One is dubbed a "nominee" system because in it CDS would become an actual depository of certificates which it would have registered in its nominee name, and hold them on behalf of CDS participants. The issuing companies' shareholder records would simply show CDS as nominee holder of a large position. CDS would maintain records of the breakdown on this holding over its participants. The other system is denoted a *shareholder record* book-based system because it contemplates that the share certificates would be cancelled and the actual records of the company relied upon to keep track of shareholders and reflect their transactions.

In either system it is apparent that a lot fewer certificates will be issued as all changes in ownership between CDS members would be effected by book entry. Only deliveries out to nonmembers would require issuance of a certificate. If the large financial institutions are members, then compared to today's system, certificate issuance would be reduced to less than half its present level.

In a nominee system transfer agents and the shareholder records which they maintain would be merely peripheral to the system, reflecting only the net change each day in CDS's position on behalf of *all* members and issuing certificates only for nonparticipants.

In a system based on shareholder records rather than a nominee, the issuing company's records would themselves be the data base which is updated by transactions and certificated deliveries to and from nonparticipants. If trust companies are to maintain their traditional role as maintainers of corporate shareholder records, then a shareholder record system would imply a much more direct involvement of trust companies. In effect, the trust companies would either gear up to maintain their geographically dispersed records on a basis responsive

a Memorandum to file from H.J. Cleland, June 10, 1972.

to changes in ownership as reflected by settlements or they would use some centralized service bureau technique. For reasons of economy and standarization of service, the latter is believed to be preferable. In the end, the shareholder record service bureau would not look substantially different in terms of file sizes and response requirements than a nominee depository.

The trust companies are not keen on the nominee system because it reduces their revenues but at the same time they are nervous about a shareholder record system because they doubt their abilities to carry out a sufficieint standard of record-keeping.[b] Critics of the trust companies take some delight in pointing out the duality of the trust companies' position. With respect to cash deposit-taking the trust companies are competitors of the banks, yet their position on securities transfers is the opposite of what they are really doing with money. To make the two positions parallel, one would imagine the deposit-taking area saying that they would not take in money for holding nor rely on savings account bookkeeping, but would insist that customers store their currency bundles themselves. However, they would be willing to make change on presentation and they would keep a little score sheet on how much currency each person had. The score sheet would be updated for the owner of the currency if he would appear at the window (or mail his bundle) in for verification and score updating, after which the bundle would be returned.

b In the present system, shareholder records are only memo records of the real ownership interest evidenced by issued certificates. Consequently, maintenance of the shareholder records can be casual with respect to timeliness and even accuracy. Whether a noncertificated system is of the nominee or shareholder record type, the standard of record maintenance has to be an order of magnitude better than the present dual system. However, the system is well-precedented in the deposit-taking area of trust companies where the records of money ownership are maintained on a book-based system.

Computer Communications Systems in Securities Markets

Michael A. Jenkins

January 1978

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Chapter I
Introduction

This paper provides a technical background for automation in the securities industry. It is intended to complement a companion paper in this volume which concentrates on the functional aspects of automation in the industry.[1] No attempt has been made to give an exhaustive study of all automation projects in the industry; instead, a few were chosen for detailed study to present the breadth of activity which is currently under way. The particular projects studied in detail in chapter III were chosen because of intrinsic interest or, in some instances, because of availability of information.

As well as reviewing particular systems, the paper presents in chapter IV a technical survey of security in automated systems with a focus on issues that might arise in automated trading and

I would like to acknowledge, with thanks, the people who assisted me in preparing this paper. Staff members at the Institutional Network Corporation, Automated Real-Time Investments Exchange Ltd., Securities Industry Automation Corporation, National Association of Securities Dealers Automatic Quotations system, Philadelphia Stock Exchange, Toronto Stock Exchange, Montreal Stock Exchange, and the Canadian Depository for Securities Ltd. - all cooperated by providing much of the information on which the paper is based. I would especially like to thank Philip Anisman, Mat Ardron, Hugh Cleland, and Stan Deudney for giving their valuable time to introduce me to the securities industry and to automation's role in it.

1 *See, Cleland, Applications of Automation.*

settlement systems. This is a large topic and an attempt has been made to present the basic points with a few examples. References to a number of sources for further information are provided.

Chapter V discusses three unrelated but short topics, none of which seemed to deserve a chapter to itself. These are: the rapidly evolving technology of the computer industry over the next ten years and the effect it will have on applications in the securities industry; the possibility of international hookup of automated trading and settlement systems, and the automated surveillance work which is an integral part of some of the automated systems in the industry.

The paper makes no specific recommendations since it is primarily intended for background reading. For those with little or no experience in computer systems, a brief definitional description is included in chapter II.

Chapter II
Computer Systems

This chapter is intended to introduce the reader to the design concepts and terminology of computer-based information systems.[2] It may be skipped by the reader familiar with such systems, although he may find it helpful for reference to ensure that his understanding of the terminology in the remainder of the report agrees with the definitions below.

A. WHAT IS A COMPUTER?

A *computer* is an electronic information processing device which carries out specific data processing tasks under control of instructions stored in its memory. A set of instructions to carry out a specific task is called a *program* and it is designed and written by a *programmer* who must understand the task to be done, must know or develop a procedure or *algorithm* to accomplish the task, and must know the *language* in which the computer accepts instructions.

2 The description given here is necessarily brief and it is suggested that the reader who wishes to gain a more thorough background read an introductory text on data processing. Suggested texts are A. VAZSONYI, INTRODUCTION TO ELECTRONIC DATA PROCESSING (1973). D. SANDERS, COMPUTERS IN BUSINESS: AN INTRODUCTION (1975). J. MARTIN, INTRODUCTION TO TELEPROCESSING (1972).

1. *Hardware*

Computer *hardware* refers to the electronic, magnetic and electromechanical devices which make up a computer system. The primary components are:

(1) the central processing unit (CPU) which is the control centre of the computer, actually executing instructions and controlling the sequence in which instructions are obeyed;

(2) the main memory which stores the instructions that make up the program and also stores the most actively used data in the system;

(3) the auxiliary memory which stores the bulk of the data used in the information system; and

(4) the peripheral devices which accept information into the system and display or print information as output from the system.

There are several ways the major hardware components of a computer system can be joined together; figure 1 indicates one simple approach in which all information flows through the CPU.

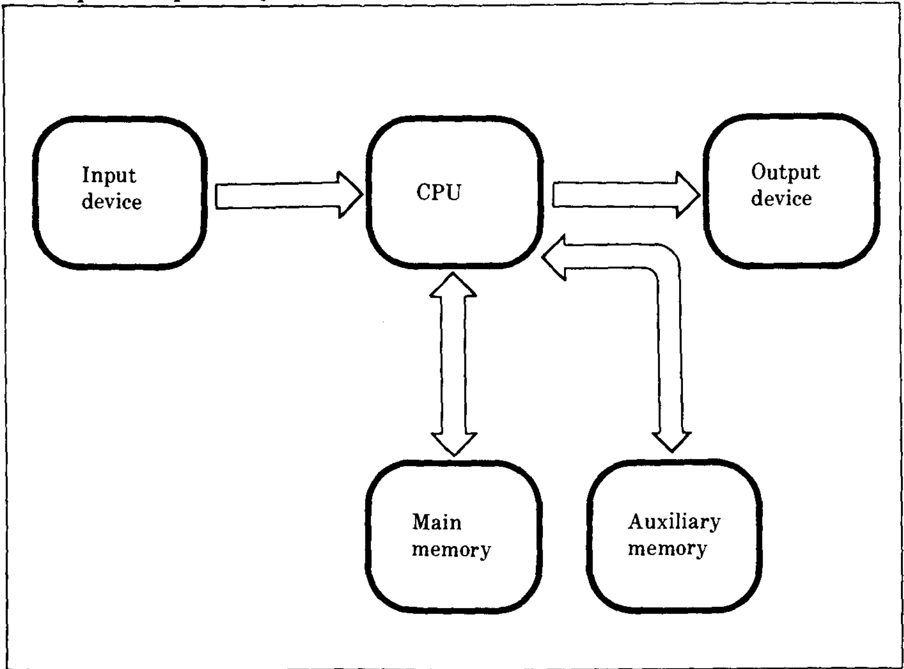
The input device may be a card reader which accepts the all-too-familiar IBM punched cards or it may be a typewriter terminal which accepts information from the keyboard. The output device may be a line printer, a card punch, or a typewriter terminal which types information under program control. Devices such as interactive typewriter terminals, or TV-like terminals, can act as both input and output devices. A computer system usually has a number of input/output devices of various types. Systems which connect large numbers of terminal devices to a computer system using telecommunications technology are discussed below.

The auxiliary memory of a computer system is usually viewed by the central processor as an input/output device, with the special property that information written out can later be read back in. Auxiliary memory is of two types:

(1) Sequential storage media – the prime example is magnetic tape which is used to store large volumes of information that can be processed efficiently by sequential access to the data stored on the tape. This is an inexpensive storage medium but the access time to retrieve a particular unit of data is quite long since all the information on the tape between the beginning of the tape and the unit of data required must be examined to see if it is the desired unit. This process may take three or four minutes on a typical magnetic tape unit.

(2) Random-access storage media – the primary examples are rotating drums or disks which can store information on mag-

Figure 1
A Simple Computer System



netized surfaces. Because each region of the disk or drum can be separately accessed, any unit of information can be quickly retrieved in a few thousandth's of a second (5–40 milliseconds).

The main memory of the computer system consists of a large number of cells each of which can contain one unit of information. The cells are assigned sequential numeric addresses and in modern systems the CPU can retrieve or change the contents of any cell in less than a millionth of a second. The main memory is used to contain both instructions and data to be processed immediately. The distinction between instructions and data is primarily one of their uses; the computer assists in preparing its instructions and while doing so is treating them as data. Of course the instructions being obeyed to carry out this preparation are separate from those being manipulated.

The technology of main memories is changing rapidly. Until very recently almost all main memories were made up of magnetic cores, which are small doughnut-shaped pieces of magnetic material arranged in a large wired array, but now semiconductor memories built on a few silicon chips have become economically viable and are being mass-produced.

The central processing unit is the "brain" of the computer system, and under direction of the program being executed it controls the flow of information in the computer system and carries out the processing actions required. It usually contains an arithmetic-logic unit and a number of special high-speed cells (called *registers*) which store information being processed by the CPU. These registers can typically be accessed in 40–60 billionth's of a second and are used to avoid access to the much "slower" main memory. The arithmetic-logic unit performs arithmetic operations on numeric data and comparisons or relational operations between numeric or non-numeric data items. It is its ability to perform arithmetic and comparisons operations at a rate of millions per second which gives the computer its information processing power. Each step is so simple that the detailed description of all the steps to accomplish any moderate-sized task is tedious to write, but once written, the specified steps are performed by the computer, at a rate almost beyond our comprehension. It is this power that allows the automation of information processing on a scale unimaginable even thirty years ago.

2. *Software*

Computer *software* refers to the programs used to control the processing carried out by a computer system. These programs can

be divided into two somewhat arbitrary classes: systems software and applications software. In general, systems software refers to programs which directly support the hardware functions of the computer and are not intended to accomplish any specific computer application. Systems software makes the interface between application programs and the computer system much simpler because many of the detailed hardware characteristics are masked from the application programmer's view. It also allows more efficient use of the hardware resources by permitting several application programs to be proceeding simultaneously, sharing the hardware resources among them. Management of the computer system resources is the task of a set of programs collectively referred to as the *operating system*. The operating system includes programs to manage the utilization of main and auxiliary memory, control all input and output functions, schedule the execution of application programs and record, for account purposes, the hardware resources used by each program. Operating systems are designed and written by the hardware vendors to utilize their particular hardware design efficiently. For most purposes the computer system is best viewed at the level of detail required to make use of it with the operating system in place.

The other major components of systems software are language processors. Programs are written in symbolic notations called programming languages. A low-level programming language is one that specifies actions to be executed which can be mapped directly to the machine's instructions. Translators for such languages are generally called *assemblers* and programs written in such assembly languages are potentially very efficient since the instruction set of the computer can be optimally utilized. However, the development of such programs is both time-consuming and error-prone and hence there has been a trend to avoid low-level programming except where efficiency is of prime importance. A high-level programming language is one that has been designed to allow algorithms to be expressed in a notation more natural to the programmer. Examples are FORTRAN and ALGOL which are intended for scientific computations, COBOL for data-processing applications, and PL/I which is a general purpose language. High-level languages are translated by *compilers* and result in many machine instructions being produced for each statement in the language.

The normal pattern of execution of a program is a two step process. The first step is the translation from the high-level language to machine instructions; the second step is the execution of the machine instructions. For a frequently used program, the result of the translation is retained and subsequent executions

may omit the first step. An alternative approach to the two step execution process is taken with some languages. The high-level language program is not translated but is executed directly by the actions of a program which "interprets" the meaning of the language statements. APL is an example of a language that is processed by an *interpreter*.

B. COMPUTER SYSTEM CHARACTERISTICS

Computer systems can be characterized as operating in three ways:

(1) Batch processing mode. A stream of programs or *jobs* continually enters the computer system: the jobs are executed and the results produced. There is no interaction between a job as it executes and the user who has requested its execution. The stream of jobs may be entered from a number of remote sites without output being transmitted to the submitting site. The operating system may share resources between jobs in order to make best use of the resources.

(2) Time-sharing mode. The operating system shares the resources of the computer system among users at interactive terminals. Each user appears to have a portion of all the resources of the system available to him and can communicate with his program as it executes. The terminals are usually located at sites remote from the computer and connect to the computer over leased or dialed telephone lines.

(3) Online processing mode. A computer system is used to support an application which requires gathering inputs and providing outputs to a large number of widely separated locations. The computer system acts as a databank and provides information on request. An example is an airline reservation system. The system must be capable of responding to requests fast enough to make the system useful in the normal working environment to which it is being applied. The functions of the application are accomplished by a set of programs which store, manipulate, and retrieve information as required. Information is transmitted to the remote locations over telephone lines and is displayed on teletype, typewriter or TV-like terminals. The users of an online system are not programmers. Hence much of the effort in its design is spent in ensuring that it provides functions that are convenient and efficient for users.

While it is conceptually convenient to classify a computer system as being one of the three types above, frequently a particular system operates in two or three of these modes simultaneously. For example, a time-sharing system may, for some group of users,

appear to be an online processing system because they are using it via an applications program. In addition there may be a batch stream of jobs executing in the background whenever the time-sharing process has spare resources. The latter may also be the case for a system whose primary task is an online application. Although some modern operating systems are capable of supporting any of these modes of processing, there still is a tendency to tailor the operating system to meet the primary function of the system.

All three modes of processing potentially involve the transmission of data between remote locations and a central computer site over telecommunication lines. The technology required to support such telecommunication systems lies on the boundary between computer technology and communications technology.

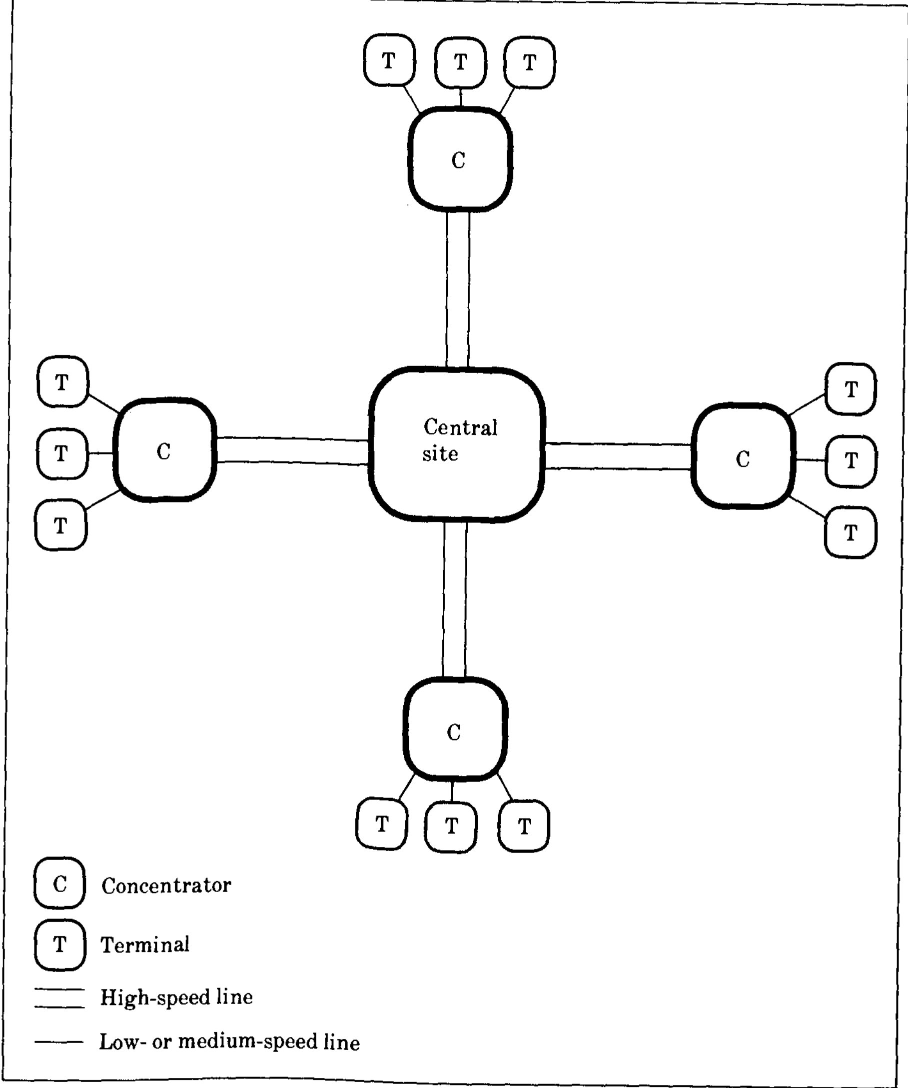
C. COMPUTER COMMUNICATIONS NETWORKS

In the most common design, a network functions as an information system in which the primary node is the central site. The central site has the major computer system in the network. High-speed trunk communication links connect the central site to small computers (usually called concentrators) at remote locations near centres of high usage of the system. Attached to each concentrator by low- or medium-speed communication links are the terminals through which the system is used. Schematically the network often is like a star as indicated by figure 2. The terminals may be connected by leased lines or by a dialup facility using normal voice-grade telephone lines. Information is received from and sent to the terminals one character at a time.

The task of the concentrator may be simple or sophisticated depending on the system design. It may simply act as a multiplexor, combining the stream of characters coming from a number of slow terminals into a single character stream to be sent at high speed over the trunk line. The central processor decodes the input from each terminal and determines the nature of the request. In a more "intelligent" concentrator much of the housekeeping work is done before messages are sent to the central computer. The concentrator handles message collection, answering simple requests, user authentication, password checking, display support, etc. By increasing the power and sophistication of the concentrator the message load being sent over the trunk lines can be reduced and hence reduce the communications cost and amount of work to be done at the central site. With the rapidly decreasing cost of processing units a trend to "intelligent" concentrators is developing.

The terminals at the edge of the communication network may

Figure 2
A Star-Like Computer Network



be simple teletype devices, typewriter terminals, or sophisticated display terminals. They may operate in full-duplex mode in which characters may be transmitted both ways over the line simultaneously or in half-duplex mode in which the line is used to send a number of characters and then is "turned-around" and used to receive a number of characters.

The terminals used in most of the securities industry systems are display-type terminals in which a cathode-ray tube (CRT) similar to a television picture tube is used to display the output information. The screen is often split into two or more sections with information for different purposes displayed in different sections. For some applications a printer is attached as well so that hard-copy documentation of what has appeared on the screen can be retained. Some of the terminals also contain a bell or buzzer which sounds when important new information is being displayed.

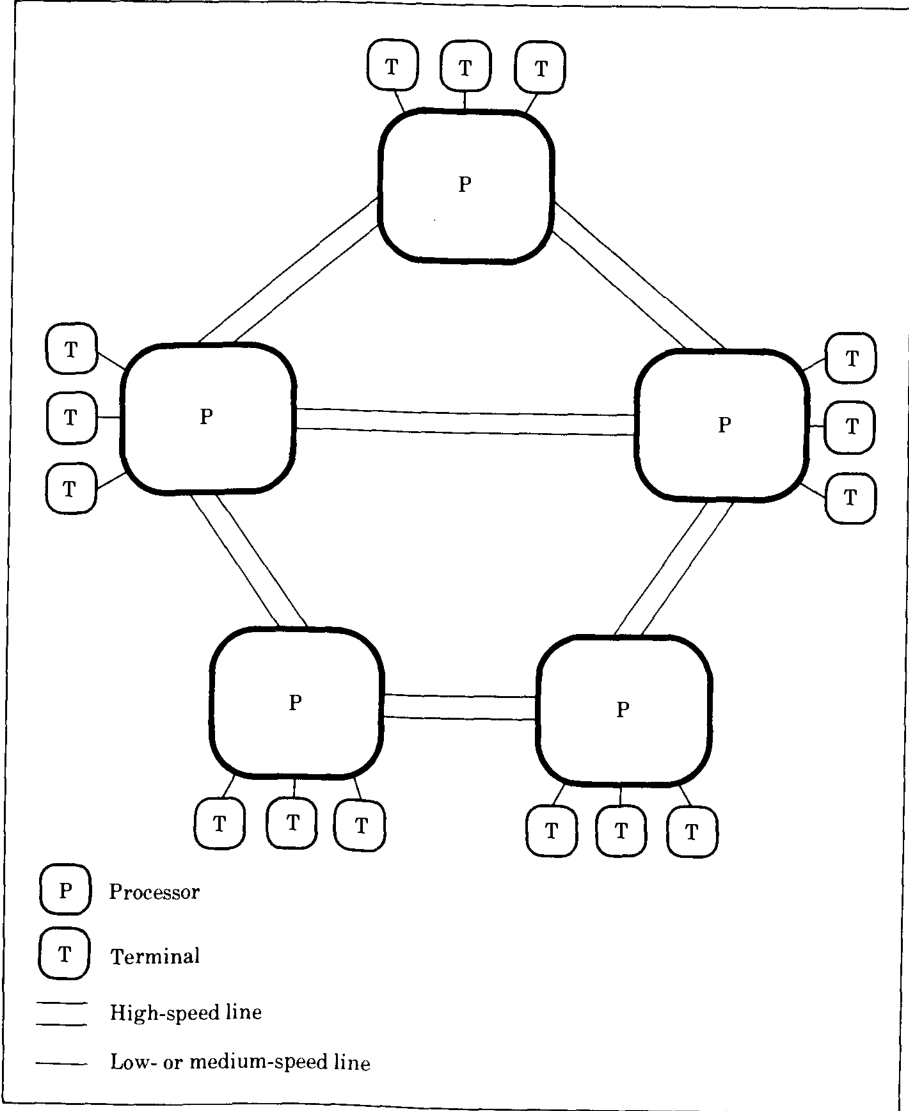
The input for the terminal is through a keyboard which has, as well as keys for all the letters, digits, and special characters normally found on a typewriter, a number of keys designed to expedite the normal activity for which the terminal is used. For example, on a terminal which displays a stock quotation, there may be a key marked ↑ and another marked 1/8 so that a market-maker wishing to change his quotation on the stock may simply press these two keys in succession to raise his quotation by an eighth. A great deal of human engineering is involved in tailoring a terminal so that it can be used efficiently for a specific application and the success of an automation project can be adversely affected if sufficient care is not taken in this task.

The connections of the leased or dialup telephone lines to the terminals at one end and the computer at the other is accomplished through electronic devices called *modems* which convert data between digital pulses used in the computer system and analog signals transmitted over conventional telephone lines. Modems are available to support half- or full-duplex transmission at a wide variety of transmission speeds. Transmission rates are generally quoted in terms of bits per second transmitted. The term "baud" has come into use as an abbreviation for bits per second. A 2,400 baud line is one capable of transmitting at a rate of 2,400 bits per second.

In some applications of telecommunication systems there is no requirement for a large databank of information and hence no need for a central large-scale computing system. In such cases the network no longer is star-like and involves direct connection between the smaller concentrator computing systems.

Generally each node in the network is directly connected to only a few of the other nodes and messages are routed from one

Figure 3
A Distributed Network



node to another in a number of steps. In a communications system of this design, the processors at the nodes provide the computational power required to support the function of the system. Such a system is referred to as a *distributed* network, referring to the fact that the computational power of the system is not concentrated at one location. Figure 3 illustrates a distributed network. This model of a computational system is acquiring more importance as the cost of processors decreases due to technological advances. Chapter V.A elaborates on these advances and describes in more detail the nature of computer networks as they appear to be evolving.

Chapter III
Automation in Securities Markets

This chapter provides a snapshot of the state of automation efforts in the securities markets in Canada, the United States and to a lesser extent in Britain in the spring of 1976.[3] The securities industry in the United States is in a state of rapid change and much of the technical data presented within this chapter will rapidly become outdated. The projects described are divided into four classes: trade reporting systems, quotation and pre-trade information systems, automated trading systems and clearance and settlement systems. There is considerable overlap of function among the first three classes since all of the systems make market information available and the automated trading systems do provide quotation information. The description of each project includes both functional and systems information in an attempt to present a complete picture of what the system does and how it accomplishes it. The descriptions assume familiarity with the terminology of computer systems to at least the level presented in chapter II. Not all of the systems mentioned are described in complete detail, and no attempt has been made to cover all similar projects that are going on at some of the smaller exchanges.

A major purpose of the chapter is to examine the possibility of nation-wide centralized securities markets which are substantially computerized. Both in the United States and Canada there are developments which are moving the industry in this direction. In the United States the impetus is coming from the Securities and Exchange Commission and Congress, which has enacted legisla-

3 The chapter does not treat automation efforts involved in the brokerage business for research or operations nor does it discuss the commercial market information services provided by information processors such as Bunker Ramo, GTE and Ultronics.

tion that gives the commission authority to direct development towards a Central Market System.[4]

In Canada, the necessity of updating the physical facilities of the Toronto Stock Exchange seems to be the prime motivation and a pilot project to develop the techniques for a computerized trading system is well under way.[5] A computerized central market for securities may be a single entity or it may consist of a number of linked facilities. Each of the classes of automation projects is discussed separately in this chapter, and the prospects for a computerized national market system are examined in section E.

A. TRADE REPORTING SYSTEMS

An early automation project at many stock exchanges has been to support the basic trade reporting technique, the ticker tape, by a computer system which receives information about all executions as they occur on the floor. The move to automated collection of data for the tape was motivated by the rapidly increasing trading volumes of the early 1960s and the desire to provide aggregate trading information on an up-to-the-minute basis. Most exchanges currently have some automated system to report trades; they differ primarily in the range of additional services provided by the exchange's system. Following is a detailed description of two trade reporting systems.

1. *Trade Reporting at the New York and American Stock Exchanges*

The Securities Industry Automation Corporation (SIAC) operates the Market Data System (MDS-II) for the New York exchanges. SIAC was formed as a joint venture of the exchanges to avoid duplication of efforts in the automation area. It took over the separate computer systems each exchange had developed for its own use and is responsible for implementation of all new automation efforts at the exchanges.

Whenever a trade is consummated on the NYSE, a floor clerk records the details of the trade on a mark sense card and this is fed into a small card reader located at the trading post. The information is transmitted directly to the MDS computer system for the

4 *See* Securities Reform Act of 1975, CCH FED. SEC. L. REP. ¶¶ 101-26, 1095-99, 2001-08 (extra edition June 4, 1975) (No. 589); Werner, *Adventure in Social Control of Finance: The National Market System for Securities*, 75 COLUM. L. REV. 1233-98 (1975); Rowen, *The Securities Acts Amendments of 1975; A Legislative History*, 3 SEC. REG. L.J. 329-46 (1976).

5 *See, Cleland*, ch. VI.

NYSE, is stored in the memory of the computer and is used to update the last sale data file for the particular stock. In addition, the trade information is processed for the tape and made available to the computer systems of the market information vendors, Bunker Ramo, Ultronics, and GTE Information Systems. The information from all trades is used to compute the market index which is continuously displayed and, in addition, the trading activity in each stock is monitored for surveillance purposes by observing price fluctuations and the volume of trades. The system also provides hard-copy documentation of trading activity, and at the end of the trading day, summary reports are produced.

The MDS-II system is implemented on a cluster of IBM 360/50s which provide reliability by duplication of system components. The workload is normally shared, but when one CPU fails, the system can remain operational using a single CPU.[6] A single IBM 360/50 can handle the data processing associated with the normal trading activity of the NYSE quite easily; only if one of the central processors breaks down during a period of peak trading activity is there any slowdown in handling the market data. One of the design difficulties in any automation effort in the securities industry is the wide fluctuation in trading activity. The activity during the peak hour of the peak day may well be four to ten times as large as the average activity on a normal trading day. Thus a system needed to handle the peak periods is under-utilized most of the time.

2. *Trade Reporting at the Toronto Stock Exchange*[7]

The Toronto Stock Exchange has a similar system based on an IBM 370/145. The information on trades is transmitted from the floor via a canister delivery system to a key-in room where the data is entered into the system.

Unlike the New York systems which essentially process raw trading data, the TSE system also maintains a data base of information about each stock (high, low, last sale, volume) and computes aggregate market data on selected groups of stocks at regular intervals. The TSE also has its own terminal network, in competition with the commercial vendors, which allows brokers access to the data base information. The network, called CANDAT I, involves 450 modified teletype terminals located in brokerage offices, connected to the system over leased or dialup lines. A new information network, CANDAT II, allowing access to the market information

6 The NYSE computer system has been modified to support the consolidated tape.
7 Information provided by the staff at TSE.

using CRT terminals[8], has gained wide acceptance. It provides a wider range of information, including the identification of brokers involved in large trades.

3. *The Consolidated Tape*

The first step in the evolution towards a Central Market System in the United States is the consolidated (or composite) tape which combines trade reporting from all the markets, including all the major exchanges, third market trades reported to NASDAQ, and fourth market trades processed by Instinet. The political and economic pressures which lead to the development of the consolidated tape are documented elsewhere;[9] here we are concerned with a functional description of the system and how it is implemented.

The tape is in fact two tapes: tape A, which displays all trades in NYSE listed stocks wherever the trade occurs; tape B, which displays all trades in AMEX listed stocks in other major issues listed on a regional exchange or traded in the over-the-counter (OTC) market. A data communications network linking the exchanges, NASDAQ and Instinet, has been established which feeds the trade reports to the consolidated tape processor, SIAC. A high-speed data link has been established to ensure that reports on all trades are available to the vendors of market information without delay. Because of variations in reporting methods, it is not guaranteed that the tape will always reflect the exact order in which trades occur but it should be reasonably close. The SIAC computing system, in fact the same one which handles the trade reports on the NYSE exchange floor, processes the trade reports and feeds the combined data to the ticker tape output. Trades from markets other than the NYSE are designated by a letter indicating the market.

After a pilot project and many delays, the full consolidated system including both networks was operational by March 1, 1976, and the market information vendors were reporting trades on a consolidated basis by April 30, 1976.[10] It is instructive to examine the difficulties encountered in getting the consolidated reporting system fully operational. An early difficulty was the political foot-dragging by various participants as the plan for the system

8 CANDAT II is a spinoff of the development of CATS; *see* The Globe and Mail (Toronto), January 28, 1976, at 83.

9 Panel, *Regional Stock Exchanges in a Central Market System*, 2 EXPLORATIONS IN ECON. RESEARCH 303 (1975).

10 342 BNA SEC. REG. & L. REP., March 3, 1976, at A11-12.

was developed on the SEC's insistence.[11] However, a more fundamental reason for the delay was that the system involved the interconnection of a large number of different computer systems, each owned by an independent body and each with its own conventions for representing trade reports. An agreement on how data was to be formatted had to be negotiated and then each system had to be modified to transmit data in the appropriate form. Since each of the systems was being actively used for production work the modification had to be carried out very carefully and testing could be done only during non-production hours. In addition there were delays due to lead time on hardware acquisitions and integration of the tape processing with MDS-II. Thus a project described in the *Martin Report*[12] as requiring only a few months to complete took two years to reach a final plan[13] and a further two years to implement at a cost of $4.5 million. This underscores the difficulty in getting institutions to cooperatively carry out a project under government regulation. Compare this with the experience of NASD in developing the OTC quotation system reported in chapter III.B, and the advantages of designing a system from scratch are quite apparent.

B. INTERACTIVE INFORMATION SYSTEMS FOR QUOTATIONS

Two major segments of the securities market in the United States are now served by computer-based information systems which have gone beyond the simple market information inquiry systems. These are the over-the-counter market (OTC) and the large block institutional traders. The two computer systems, NASDAQ (an acronym for National Association of Securities Dealers Automatic Quotations) and AutEx (Automatic Exchange) were developed to meet the information needs of these respective parts of the securities industry. Each of the systems provides information to potential buyers and sellers of stocks but the actual execution of the trade occurs in the traditional manner. In the case of NASDAQ the trade is negotiated by telephone with a market-maker who has been located by the use of the system. Whereas in AutEx, which is used to express block interests in listed stocks, the trade may be executed on the floor of an exchange or over-the-counter.

11 *See* Panel, *supra* note 9, at 304-09.

12 W. MARTIN, JR., THE SECURITIES MARKETS: A REPORT WITH RECOMMENDATIONS 23-24 (Board of Governors of the New York Stock Exchange, 1971).

13 SEC, Securities Exchange Act of 1934 Release No. 10787, May 10, 1974, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,782 (Consolidated Tape Plan under Rule 17a-15).

1. *NASDAQ*

The NASDAQ system was designed to provide information on the over-the-counter market comparable with that available for listed stocks on the major exchanges. It was felt that with this information available the OTC would be a much more visible market and hence more attractive to investors. The system would also make brokerage operations in the market more efficient by reducing the number of phone calls that a broker would make per completed transaction. The NASDAQ system was designed and implemented by Bunker Ramo from system specifications prepared by Arthur D. Little Inc. in little more than two years from the time the competitive contract was awarded. The system became operational on February 8, 1971, with the quotation system in place, and by the end of 1971, trading volume information and market indices were added to the system.[14]

The NASDAQ system is the only automation project in the securities industry in the United States which is on a scale with the type of system that would be required to support a computerized securities market. Therefore a more complete description of this project than of the majority of the others is included here.

2. *A Functional Description of NASDAQ*

The main purpose of the NASDAQ system is to provide timely and accurate price quotations for stocks actively traded in the OTC market. For a stock to be included in the system it must meet minimum NASD requirements – $1 million in assets, 500 or more shareholders and 100,000 or more shares outstanding.[15] In order for quotes to be disseminated to Level 1 terminals there must be at least two broker-dealers registered as market-makers and continually quoting the stock in the system.

There are three levels of service provided by the NASDAQ system. Level 1 is intended expressly for registered representatives working across the country. They can get a representative quotation for any stock in the system through one of the standard inquiry terminals provided by the market information vendors, Bunker Ramo, Quotron, Ultronics, and Telehuss and Reuters overseas. There are over 40,000 terminals in brokerage houses in the United States, Canada, Europe and Japan that are capable of

14 *Potential Use of NASDAQ Facilities in a Central Market System, Pt. II* in NASD, NASDAQ SEMINAR: NASDAQ ONE YEAR LATER 20 (Investment Dealers Digest, New York, April 27, 1972).

15 *Id.* at 18.

providing NASDAQ quotations. The bid quotation is actually a median quote representing the middle point of the bid quotes of all dealers. The ask is computed by finding the median spread and adding that to the representative bid. (The median rather than statistical average of the quotes was chosen deliberately to avoid any temporary distortion of the representative quote that might occur if an erroneous quotation was entered by a market-maker, and also to avoid quotes expressed in decimal fractions.) The representative quotes are always current, being updated within five seconds of a change in quotation by a market-maker.

Level 2 service is intended for traders effecting orders over-the-counter. The trader is equipped with a specially designed CRT display terminal which allows him to display the current quotations of all the market-makers in any security. After indicating the stock of interest and either the bid or ask side, the trader receives the first display of up to five quotes from the market-makers through his terminal. If there are more than five market-makers he can request more quotes to be displayed. The trader then uses his judgment on which market-maker can best effect a trade of the size he has in hand and proceeds to negotiate with that market-maker directly by phone. There are currently 1,112 Level 2 terminals in the field.[16]

Market-makers have Level 3 service from the NASDAQ system. They are equipped with terminals similar to Level 2 terminals with the additional capability of entering and changing their quotations to keep them current with market activity and the quotes of competitors. A market-maker can monitor the quotes of competing market-makers using the Level 2 functions; however, he is restricted to entering quotes only for issues in which he is registered. Market-makers currently have 923 Level 3 terminals.

The NASDAQ system also provides at all levels of inquiry a composite index and six group averages for various market sectors which are computed throughout the trading day and updated at five-minute intervals.

Although all trades are executed outside the system, each market-maker is required to report trades at the end of the day or within ninety seconds of their consummation if they involve NYSE listed stocks traded OTC. The latter reports are fed to the consolidated tape system and the former are used to produce aggregate daily volume figures which are made available to the press. The final closing representative bid and ask quotes, the change in bid from the previous day's close and the volume of

16 The number of Level 2 and 3 terminals on April 30, 1976, as reported in NASDAQ, THE NASDAQ/OTC MARKET FACT BOOK 1976, at 5 (1976).

trading are made available for each stock. Thus, much the same information available about trading activity of listed stocks is also available for the OTC market. The size and importance of the OTC market in the United States securities industry is reflected in the fact that total volume of shares traded daily through NASDAQ represented 27.8% of all trading activity in 1972, although this declined in a bear market to 20.6% in 1974.[17] This information only became available to the general public through the implementation of NASDAQ.

NASD has considered many additional functions which it could provide through NASDAQ in order to increase the use of this large computer system. Ideas which have been explored include an OTC options trading system, a missing securities certificate serial number databank, a supplier of the composite quotation information to various market information vendors, and a block interest system similar to that offered by AutEx.[18]

The NASDAQ system also carries out a market surveillance function similar to that described in chapter V.C.

3. *A System Description of NASDAQ*[19]

The NASDAQ system is primarily a communications network driven by computers to provide rapid dissemination of information on request to a large number of dispersed locations. The system has much in common with other large online computer applications such as airline reservation systems and large time-sharing services. The heart of the NASDAQ system is the data centre at Trumbull, Connecticut, where a pair of Univac 1108 computers provide the central computational power of the system. The NASDAQ communication network consisting of 20,000 miles of leased lines has a star-like structure with the 1108s at the centre and four concentrator sites. The concentrators are Honeywell 516 processors, with four located in New York and two each in Chicago, Atlanta and San Francisco. They are attached to the 1108s via leased high-speed trunk lines. There are two 50,000 baud lines to New York while the remaining cities are connected by dual trunk lines of 7,200 baud each. Each line is capable of carrying all the NASDAQ traffic; the second line to each city which goes out of

17 Macklin, *Letter to the Editor*, The Commercial and Financial Chronicle, June 23, 1975.

18 NASD recently purchased NASDAQ from Bunker Ramo for $9.6 million. Bunker Ramo will continue to operate the system on a four-year contract. It also announced plans to proceed with the composite quotation service and the OTC options market; 339 BNA SEC. REG. & L. REP., February 11, 1976, at A-7.

19 The information in this section was obtained, in part, by a personal visit to the Bunker Ramo data centre in August 1974.

Trumbull through an alternate route is included for reliability. Thus a natural disaster such as a flood or fire or an accident would not halt service to a section of the country served by one concentrator. The concentrators are multiplexors combining input from many slow-speed lines connected to terminals into one high-speed data stream. NASDAQ has an elaborate communications monitoring system which includes hardware detection of component failure and software error reporting. The latter allows indications of outage to be displayed at the central and concentrator sites.

The main computer system is a pair of Univac 1108 processors used in a multiprocessing mode. They share four memory modules and two drum memory subsystems. In normal operation both processors share the workload. If one component of the system breaks down, it can be switched out and the remainder of the system continues in operation. In some cases a breakdown may cause a thirty-second halt in order to remove the damaged component for repair. The system operates on a modified Univac operating system (Exec 8) which was altered with Univac's help to improve the performance of the system for this application. All of the telecommunications support software was developed especially for NASDAQ to achieve the efficiency required for the system specifications. NASDAQ is designed to handle 120 requests per second with the present configuration of hardware and once reached a peak activity of 130 requests per second on a busy day around opening time.

The software is designed to be as reliable as possible. Every piece of information in the security file system stored in drum memory is duplicated in the other drum subsystem. The secondary copy is used immediately to create a new copy if the system detects that the first one is lost due to hardware (or software) malfunction.

Each drum storage subsystem consists of two high-speed small drums and two lower speed large drums. The main copy of the files associated with the most frequently referenced stocks are kept on the high-speed drum to increase the efficiency of access. Another programming trick used to improve the efficiency of the system is that the information for the first display frame (up to five quotes) for each stock is kept in the security file in a format ready to be transmitted directly to a Level 2 or Level 3 terminal without any calculation. The ranking of quotations format must be recomputed each time a quotation is updated and this may require regeneration of the display frame. Since 90% of all requests for displays on Level 2 and Level 3 terminals are for the first frame of output this design greatly reduces the processing overhead. If subsequent frames are requested, the format must be generated for display.

NASDAQ software is organized as a number of separate program modules supporting the different functions of the system. These include modules for:
(1) communications network support and monitoring,
(2) online file maintenance,
(3) display processing,
(4) market index calculation,
(5) trading volume information,
(6) market surveillance,
(7) historical audit trail,
(8) consolidated tape support,
(9) end of day report generation,
(10) end of day file maintenance.
The programs used for online processing are all written in assembly language to achieve the high level of efficiency required for the system.

The Bunker Ramo data centre is a model of physical security for a computer installation. Virtually all the precautions mentioned in chapter IV.C have been taken. Electronic door locks operate only with magnetic coded keys. An intricate fire prevention system employs highly sensitive ionization detectors in the floors and ceilings which, if activated, indicate exactly where the incipient blaze is located. Complete historical records of each day's activity are stored on tape in a fireproof vault.

There appears to be very little possibility that the NASDAQ system will be misused. NASDAQ is essentially a communications network supplying quotation information which is made widely available, and because of such easy availability there is very little motivation for unauthorized access to the communications network. There is also little possibility of tampering with the system for private gain, both because of good operational practices and the difficulty in translating such manoeuvers into a personal gain without detection. Even if quotes were misrepresented the fact that trades are still negotiated over the phone would quickly reveal incorrect quotes in the system.

4. *NASDAQ as Part of the Central Market*

It has been suggested that NASDAQ could be converted into the electronic marketplace of the future, complete with automatic matching of orders and keeper of an electronic book.[20] From a

20 M. Mendelson, From Automated Quotes to Automated Trading: Restructuring the Stock Market in the U.S. (1972); Blumenthal, *The Development of the Central*

conceptual point of view it is true that NASDAQ has the communications network and the quotation information which would be required as part of the Central Market. However, it does not have access to the order flow of the exchange markets and is not designed to handle the much larger task of being an automated marketplace.

NASDAQ is an integrated hardware-software system tailored to do its present application effectively. With careful planning for a limited problem the designers have been able to achieve up to 120 data transactions[21] per second. The load on NASDAQ is well below this level most of the time but even the inclusion of a trading capability for the OTC market would seriously strain its capabilities as the volume of data and variety of tasks it would have to handle would increase sharply. Increasing the computational power of NASDAQ to support a Central Market System is not simply a matter of adding some more hardware to the central computers or increasing the transmission capabilities of the communications network. The characteristics of real-time systems are not enhanced in direct proportion to the increase of raw computing power added to the system. Thus doubling the CPU power of NASDAQ will not automatically increase the maximum transaction rate to 240 calls per second. If the U.S. securities markets are combined into a large electronic marketplace the computing system (or systems if the market is split) will require the careful design and tailoring which characterized the development of NASDAQ.

NASD has prepared a discussion paper on the Central Market in which it discusses the potential use of the NASDAQ facilities in a Central Market System.[22]

5. *AutEx*[23]

The AutEx Equity Trading Information System was designed during the late 1960s to meet the information needs of block trading broker-dealers and financial institutions. The system went into operation in August 1969 with 70 subscribers and grew steadily to the middle of 1973 when it had a total of 474 subscribers (264 institutions and 210 brokers). The cost of the system is borne primarily by the broker-dealers, who may partici-

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Market System: Revolution - One Step at a Time, 3 RUTGERS J. COMPUTERS & L. 232 (1974).

21 A "transaction" here meant one request for data.

22 NASD, Three Issues in the Development of a Central Market Advisory Board, pt. II (April 12, 1976) (submission to the National Market Advisory Board).

23 Much of the information in this section was obtained on a visit to AutEx in New York in August 1974. *See also, Cleland,* ch. IV.C.

pate through a flat-rate, usage or performance plan. The most popular option is performance, where brokers pay a small monthly service charge, plus charges based on the dollar value of all trades made as a result of information provided by the system. Institutional subscribers are subject to a basic monthly charge which is reduced by credits for AutEx-initiated trades. This pricing arrangement is attractive to brokers because their participation in the system frequently allows them to capture the commission revenue on both sides of a sale.

Since the middle of 1974 AutEx has faced a number of challenges. First it was forced to abandon a lumber trading information system which proved unprofitable in the soft lumber market of 1974. With the advent of negotiated commission in May 1975 there was considerable broker resistance to proposed changes in AutEx's pricing. Moreover NASDAQ and a new company, Comstock Information Services, announced plans to enter the block-interest information market with competing systems. AutEx has emerged as the winner in this competitive battle.[24] Recently AutEx has moved to widen its role as an information service vendor in the securities market. It has merged with Itel, a computer manufacturer, and was the successful bidder for the SEC's Lost and Stolen Securities System. It has expressed interest as a facilities manager for the Intermarket Trading System (ITS) discussed in chapter III.E.[25]

6. *A Functional Description of AutEx*

Unlike NASDAQ which provides a wide range of information services to an extremely large number of subscribers, AutEx provides a highly specialized service to a small number of subscribers. All AutEx subscribers use a TV-type terminal equipped with a special keyboard and a small slave printer for hard-copy documentation. They are normally continuously connected over leased lines, though some of the smaller institutions and brokers are connected by dialup facilities over ordinary telephone lines. The basic input unit of the equity system is called an "interest-message". A broker simply enters his buy or sell interest in a stock, the size of the block (small, medium or large) and the security symbol. At his option he may include additional data such as scale, all-or-none, limit price or exact size. The message appears

24 Comstock has withdrawn from the market. NASD and AutEx have reached an agreement to have AutEx information displayed over NASDAQ; Securities Week (New York), August 8, 1977. A similar agreement is in effect with Bunker Ramo; Securities Week (New York), March 7, 1975.

25 Securities Week (New York), December 5, 1977.

on the screen of all participating institutions whose terminals are in normal mode and on the screens of any brokers to whom the initiating broker indicates he wants his messages sent. The terminals use a split screen approach, with the upper part of the screen displaying the latest interest-messages on both the buy and sell side in an abbreviated form. An institution may have its terminal in "flash-top" mode, in which case only interest-messages associated with stocks it wants monitored are displayed in the top part of the screen. All interest-messages are held in files stored on the auxiliary memory of the system and can be retrieved by asking for a recap of a stock. The recap appears in the lower part of the screen and displays the time or date of the message, the side, size, security symbol and the abbreviated broker symbol.

The AutEx system also includes a block trade reporting function which displays broker reported trades executed on any exchange or over-the-counter. Participating brokers, on a voluntary basis, report all trades they effect whether they were initiated by AutEx or not. The information displayed includes the security symbol, the size, price, side (buy, sell or cross), place of execution and broker. The trade reports are available for retrieval by all subscribers as part of the historical record of each stock. Unlike the consolidated tape the AutEx trade reports are voluntary and include the name of the broker.

There are two additional types of input to the system, "information-messages" and "super-messages". An information-message is entered by a broker to indicate that he has research or market information on the security or industry named. The broker may be in touch with a buyer or seller, he may be making a market in the designated security or he may have research information available. A super-message is a long flexible message form used to convey market and related information that requires a more lengthy description (up to eight lines or 280 characters of text). As with other message formats these can be made available selectively to other subscribers and can be retrieved as part of the historical record.

The recap by stock feature displays all entries relating to a particular stock, including active and inactive interest-messages, information-messages, super-messages and completed trade information on the NYSE for that stock. This display is only available to institutions. Recaps appear in the bottom half of the screen replacing the trade information and message displays.

Another feature of the system is the ability to monitor all information on stocks of particular interest to the subscriber. In "market-minding mode" all new entries associated with the selected stocks cause a warning bell to ring and hard copy to be

printed. If the terminal is in "flash-top" mode only interest-messages for these market-minded stocks are displayed in the top two lines of the screen. The remaining portion of the screen can be used to display recap information and/or incoming messages.

The AutEx system also permits the use of the terminal keyboard and display as a simple calculator for numeric computation and has the capability to compute commission rates.

An additional facility that AutEx provides to its subscribers is the ability to construct a private data base consisting of a collection of independent files using the subscriber's own indexing system. The system sorts and stores messages for the files and allows online editing and updating. The data base information is available for instant retrieval at remote branches or affiliates of the subscriber. AutEx prevents unauthorized access to this private information by stringent system controls.

As the system evolves AutEx is continually adding new services to meet its customers needs. With the rapidly changing conditions in the securities market in the United States and the pressure from competitors this evolutionary development will continue.

7. *A System Description of AutEx*[26]

The AutEx system is, in many aspects, similar to the NASDAQ system but on a smaller scale. The main AutEx computational facility is located at Wellesley, Massachusetts, and is built around a pair of Xerox Sigma 9 computers. Unlike the Bunker Ramo system where both computers normally share the computational load, the AutEx system runs on one of the Sigma 9s while the other is used for backup and development purposes. The use of the backup system for development reflects the philosophical difference between the stable single-purpose NASDAQ system and the continually evolving AutEx system. If the Sigma 9 computer supporting the AutEx system breaks down, the second computer is switched immediately from development to production work and service continues with only a short interruption. Both systems have access to the auxiliary memory where current and historical information is stored.

The AutEx communications network has evolved from a single frontend communications processor to a star-like network with 4–6 concentrators connected over trunk lines of either 1,800 or 9,600 baud. The concentrators are Interdata 50 minicomputers

26 Information was provided by the systems staff at AutEx and reflects the configuration in use in June 1976.

supported by software explicitly developed by AutEx for this application. The AutEx system uses a Xerox operating system (CP-V) substantially modified to meet the system requirements. The software is primarily implemented in assembly language, although AutEx does make use of the COBOL, FORTRAN, BASIC, APL and RPG language processors supplied by Xerox to do some of the applications programming. AutEx is designed to handle 1,000 terminals and up to 25,000 data transactions per day. There are currently 550 terminals on it with an average load of 14,000 daily data transfers.

The software has a standard restart procedure which, using the information stored on disk packs and tape, can recoup all the messages up to the point of a failure with the possibility of losing only those messages in process of transmission. The validity of data transaction processing is checked by the use of offline management programs which analyze the system's activities.

The physical security of AutEx is also impressive. A sprinkler system, and smoke and heat detectors protect the computer operations and tape storage area. The system is manned twenty-four hours a day and is protected from natural disaster by having the two central processors in physically different locations.

C. AUTOMATED TRADING SYSTEMS

Automation of the trading process has been proposed in a number of studies[27] as a means of reducing the cost of securities transactions and also as a means of achieving a centralized marketplace for securities. The latter aspect will be taken up in chapter III.E. A number of computer systems for automatic trading are already in use and others are being developed or designed. The trading systems being designed are primarily of two types:

(1) exchange-oriented systems which automate the function or part of the function of the exchange floor, and
(2) computer-based trading networks operating independently of traditional exchange floors.

The exchange-oriented systems are designed to automate those aspects of activity on the exchange floor which do not require the judgment of a broker or specialist. For example, at the NYSE, all odd-lot orders are automatically executed near the

27 J. BOSSONS, THE AUTOMATED STOCK EXCHANGE (1968); Black, *Toward a Fully Automated Stock Exchange - I,* 27 FINANCIAL ANALYSTS J., July-August 1971, No. 4 at 28; Black, *A Fully Computerized Stock Exchange - II,* 27 FINANCIAL ANALYSTS J., November-December 1971, No. 6 at 24; M. MENDELSON, *supra* note 20; Youngblood, *The Argument for a Publicly Owned Stock Exchange,* 25 FINANCIAL ANALYSTS J., November-December 1969, No. 6, at 104A. Blumenthal, *supra* note 20.

market price using the Odd-Lot Automation system, which routes all odd-lot orders to a computer system recently purchased from Carlisle DeCooppet.[28] Odd-lot trades are priced at one-eighth off the last sale after opening automatically.[29] After execution, a confirmation is routed back through the Odd-Lot Automation system to the order broker. Other activities on the NYSE floor have been or are being considered candidates for automation.[30]

It is important to distinguish between automatic execution and automated trading. Automatic execution involves matching an incoming order against a standing order to trade from a market-maker's inventory at a price determined by formula from the last sale or next sale on the principal market (invariably the NYSE). Processing such orders automatically with a computer system is technically quite simple as the NYSE Odd-Lot Automation program has shown. Automatic execution of small orders (up to 300 shares) based on either last sale or next sale information has gained rapid acceptance in the regional exchanges in the U.S. With the growth in volume handled by the Pacific Coast Exchange's COMEX system[31] (3,000 executions per day in January 1976, double the average rate of the fall quarter 1975), the other exchanges indicated a desire to share in this market.[32]

Automated trading involves the matching of two or more incoming orders on opposite sides by using a computer system to store and compare all such orders. Trading systems are characterized by an elaborate network to feed orders to the central processor in real-time and sophisticated handling of the order information once it reaches the central computer.

An order to buy or sell stock is reflected in it as an entry in an "electronic book" or file of outstanding orders. If offsetting orders appear in the book they are automatically matched and the trade executed. Automated trading already occurs in Instinet, a system which handles large trades in the fourth market between institutional customers. A similar system, ARIEL, has been set up in London by a consortium of merchant banks. There are also several other systems in development or being proposed.[33] The Computer-

28 Securities Week (New York), March 8, 1976, at 5.

29 The use of the odd-lot differential on last sale has been challenged by Merrill Lynch, which has implemented its own odd-lot automation program with no odd-lot differential; Securities Week (New York), December 29, 1975, at 3.

30 NYSE, THE CENTRAL MARKET SYSTEM: A PROGRESS REPORT (1976).

31 Securities Week (New York), January 26, 1976, at 13.

32 Both Midwest and the PHLX have "automatic" execution programs, but here automatic refers to the formula pricing scheme, and in fact their systems are not automated; Securities Week (New York), January 19, 1976, at 26 (Midwest); Securities Week (New York), December 15, 1975, at 2 (PHLX).

33 Weeden Holding Corp. announced an automated market system pilot project

Assisted Trading System (CATS) being developed as a pilot project at the Toronto Stock Exchange is similar in philosophy to Instinet in that it is independent of the exchange floor as the trading site.

1. *Automation of Trading Functions at the Philadelphia Stock Exchange (PHLX)*

The automation of trading functions at an exchange are best put in perspective by examining one such project in detail. Each exchange has sought its own solutions to the problem it delineated as requiring automation and no two projects are very similar.

The PHLX Centramart system is primarily a tool to assist the specialist in managing his market-making job effectively. It supports a data base on approximately 3,700 securities traded on the NYSE, AMEX, CBOE and PHLX and provides the specialist with rapid access to the information he needs.[34]

Each specialist has a terminal which allows him to monitor as many as thirty-four securities at one time. For twenty-five of these, he has access to the last sale in the primary market, the market tick of that sale, the last sale on the PHLX and the PHLX specialist's bid and ask. The remaining nine securities depict the same information with the addition of the volume, the time of the last sale and high and low for the primary market.

A specialist or floor broker may obtain a quote on any stock which is in the data base, and in addition to the last sale information already mentioned, he may receive the volume on the PHLX, the time of the last PHLX sale, the primary market open and close, the earning, yield, price earning ratio, and ex-dividend date. All competing PHLX specialists' quotes (as many as four per security) are also visible.

All trades are entered through a CRT terminal by the specialist executing the trade who supplies the symbol, price and size data. Additional information needed for clearing on execution is picked up from the data base and recorded on magnetic tape. In the process, a three-part ticket is printed; one copy goes to the buyer, one to the seller and the third copy is maintained as a backup to the magnetic tape. The clearing data is later processed by the Clearing Corporation of Philadelphia. The result is a "locked-in" trade. This

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scheduled for industry tests by October 1976; Securities Week (New York), January 26, 1976, at 5; *see also, Merrill Lynch Proposal,* Securities Week (New York), October 17, 1975.

34 The information on PHLX automation efforts was provided by PHLX in the spring of 1976.

innovation in the Centramart system makes the PHLX an attractive marketplace for option contracts which must settle "next day".

An automatic bid-ask tracking device in the system allows the specialist to track his quotes based on the last sale on the primary market. By setting a differential above, below or equal to the last sale and indicating tracking mode, the increment or decrement that he establishes will remain as the stock price fluctuates. A message area allows specialists and floor brokers to communicate with each other through the system.

Centramart acts as the PHLX's interface into the consolidated tape. Future plans for the Centramart system include interfacing with an order-processing message-switch operated by an independent company to bring orders to the PHLX floor for automatic execution and an extension of the system to all back offices of member firms.

2. *A Systems Description of the PHLX System*

The Centramart system is implemented using a duplexed Honeywell 716 computer system with four Incoterm minicomputers as concentrators each supporting up to sixteen Incoterm terminals. The communications network has three concentrators to support activity on the Philadelphia floor. The system runs under an operating system developed by Incoterm for the Honeywell 316 and modified for the Honeywell 716. The communications software to support the terminal network has also been developed by Incoterm specifically for the Centramart system. All the software for the project is written in assembly language for the two types of processors. Centramart has been designed to handle two PHLX trade reports per second and four requests per second for retrieval of databank information. Currently there are approximately four trade reports per minute on average and about ten data requests per minute.

The system achieves reliability by being duplexed. When a hard failure occurs it is manually switched to the backup computer after logging the conditions existing when failure occurs. A software support package to simulate trade traffic has been provided to verify correct behaviour of the major system functions. Communications traffic can also be simulated and there is maintenance software to assist in testing terminal functions.

The Centramart computer physically resides in a locked room on a balcony overlooking the trading floor. It is accessible by only one staircase and access is limited to authorized personnel.

3. *Instinet*[35]

Instinet, which began operations in 1969, services the so-called fourth market, *i.e.*, direct trading between institutions without the intervention of a broker-dealer. In effect the Instinet system acts as the broker and Instinet receives a commission for completing the transaction. The Instinet system has not been as successful in penetrating the securities market as one would expect given the relative efficiency with which it can complete large block trades.[36] Although Instinet is primarily aimed at servicing the fourth market it does have some third market firms as subscribers. The first Instinet system which was referred to as Instinet-1 has been replaced by Instinet-2 which greatly enhances the services provided.

4. *The Instinet-2 System*[37]

The Instinet system is primarily a system to store an electronic book of bids and offers made by its subscribers and to automatically execute any matching orders. It has been developed by Instinet as a vehicle for trading in the electronic central marketplace envisaged by the SEC. In addition to an electronic book of orders, it provides current market information, including information from the consolidated tape and composite quotation information.[38]

Orders are entered into the book by a subscriber who is equipped with a CRT terminal and hard-copy printer. With a few keystrokes he indicates the side, size, price, security symbol and expiry time of the order. The order is displayed to the sender with a unique order number attached and with the complete company name and total cost of the transaction. If the order is correct, the user confirms the message and it is placed in the book. If it is not correct or if the user has second thoughts about the order, it can be revised or cancelled at this point. The book entry identifies the order by its unique order number and only the sender is aware of the origin of the entry.

35 The information in this section was largely obtained on a visit to Instinet in August 1974.

36 With the unfixing of commission rates on May 1, 1975, there was a marked upswing in business by all fourth market firms, apparently due to the increased awareness by money managers of their fiduciary responsibility to achieve executions at the best possible price; *see* The Wall Street Journal, May 5, 1975, at 5, col. 1.

37 The description of Instinet-2 is based on a demonstration of a prototype implementation given in August 1974; however, the current system is believed to be very similar.

38 Securities Week (New York), July 19, 1976.

The order is transmitted to each subscriber and displayed on his screen. If he is "market-minding" that stock its appearance will be accompanied by an audible tone. Any terminal displaying the book for that stock is updated with the new entry.

The book for a stock consists of a list of orders on both sides indicating price, size, expiry time or date, order number and an indication of whether the order is active, has expired, has been traded or cancelled. A book entry may not include a price, in which case the sender is indicating an interest in the stock and is willing to negotiate a price. Expired or traded orders are kept in the book for thirty days and a buyer or seller can negotiate through the order number to see if there is further interest in the stock.

Trades are accomplished either by accepting a firm active order or by negotiation. The latter occurs by sending a reply message via the order number to the originator of the entry. The message indicates the size and price at which the replying party is willing to take up the order. The originator can accept this reply or send a counter offer. Negotiations on expired or traded book entries are primarily to see if the originator has further interest in trading the security. Many of the trades occur this way as the subscriber may not wish to tip his hand as to how large a block he is trying to move.

Once a trade has been accepted the system prints out two copies of trade confirmation to the parties involved and reports the trade to the consolidated tape. The actual transaction of cash and securities is handled by the Bank of New York which acts as the escrow bank for the system.

Many convenience features have been designed into Instinet-2 to make it a useful tool for the active trader. The format for the screen has two parts. The upper half contains the time, number of active orders and replies the subscriber has outstanding, and message fields labelled ALERT, BROADCAST, REPLY and SYSTEM. The ALERT field is used to display entries associated with stocks that are being market-minded, the BROADCAST field to display all order entries, REPLY to display replies to orders the subscriber has entered in the book, and SYSTEM to display messages sent by the Instinet operations centre to all subscribers. Each of these fields behaves like a push-down stack with the latest message overwriting the previous one. If the subscriber wishes to see the message prior to the current one for any of the fields, he deletes the current one and the previous one reappears. He can continue this search back through the message list for any messages which have not been deleted. The bottom part of the screen is used to display the book associated with a stock or is used to display order messages or replies as they are constructed. When the book for a stock is

requested, last sale data and quotations data are displayed along with the book entries.

The CRT terminals used in Instinet-2 are programmed to be used interactively. There is a flashing mark or cursor which can be moved to any part of the screen. It is used along with displayed information to construct messages from context with only a few keystrokes. For example, suppose the book for IBM is displayed and a bid is entered for 5,000 shares of IBM at $200. A reply for that entry at a price of $202 can be entered by moving the cursor to that entry and touching the PRICE key, followed by the digits 2,0,2, followed by the REPLY key. The appropriate message indicating that this is a reply to sell 5,000 shares of IBM at $202 is transmitted to the originator of the entry. The keyboard has many function keys such as REPLY, ACCEPT, etc., which greatly enhance the efficiency with which a user can effect trades.

The Instinet-2 system is functionally one of the most sophisticated trading systems in existence. It has been designed to provide the subscriber with immediate access to the market information (book, last sale, quotations) he needs to keep abreast of trading activity in a particular stock and will automatically update that data as it changes. The system is a prototype for the type of system which would be required for complete automation of the stock market. It has been designed to have a much larger capacity than its predecessor Instinet-1 but it is still far short of the size required to become the marketplace of the future. Instinet has proposed a system called UNIMART based on the Instinet-2 system as a contender for the Central Market System.[39] The backers of this company have clearly set their sights on winning a share of the central market business and, given an opportunity to compete in it, should fare very well.

5. *A Systems Description of Instinet-2*

The Instinet-2 system has been developed by Data Index Inc. for the Institutional Network Corporation. It is based around a network of Digital Equipment Corporation PDP-11 computers. The main site in Lexington, Mass., has a PDP-11/20 processor with 24K words of 16 bit memory. The system uses single plate removable disk cartridges for file storage using two disk drive units on a single controller. Historical data is retained in a library of disk packs. The main site communicates asynchronously with PDP-11/05 concentrators over 1,200 baud full duplex leased lines which will be increased in capacity as system traffic grows. The concentra-

39 Securities Week (New York), November 22, 1976.

tors each have a capacity for thirty-two terminals which are connected by 1,200 baud full duplex lines. The high-speed link between the terminals and the processors allows rapid update of the terminal displays and improves the response time at each terminal.

The terminals are teletype-compatible Datapoint 3300s made by Computer Terminal Corporation. Much of the "intelligence" of the terminals discussed in the previous section is achieved by programming in the PDP-11/05s. The concentrators, each equipped with 16K words of memory, are almost as powerful as the central site computer and are able to do most of the terminal support function on both input and output. The central system supports the functional aspects of the trading system. It retains a file of limit orders for each stock, processes all order messages and implements the order matching algorithm. It also retains a journal of all user actions which is used for market surveillance.

The Instinet-2 system used its own operating system written specifically for this application in PDP-11 assembler. This route was chosen because no existing PDP-11 software could meet the operational requirements of the system.

The security of Instinet-2 is enhanced by its use of leased lines throughout and by a password feature which allows subscribers to limit who can place orders in the system. Since all transactions involve the accounts of the subscribers at the escrow bank, Instinet is a closed financial system and there is little danger of fraudulent activity for the private gain of individuals who have access either properly or improperly to the system. Since all entries are public in the system and a journal of subscriber inputs is kept, any attempt to manipulate the market through the system should be easily detected.

6. *ARIEL*

ARIEL is the acronym for Automated Real-Time Investments Exchange Ltd., a company which was formed by a consortium of Accepting Houses to establish a computerized trading system to operate outside the London Stock Exchange. ARIEL has obtained the United Kingdom rights to Instinet's patented concepts of a trading system. The system is functionally very similar to the first Instinet system with two major changes. First there is no automatic matching of bids and offers. ARIEL is a negotiating system and although a subscriber may make an entry in the book at a certain price, he may wish to negotiate at a different price if a reply to the offer comes after the market has shifted. The removal of automatic matching has meant that entries in ARIEL have prices

attached, as compared to Instinet where the majority of entries are unpriced. The second difference is that a subscriber can make a "discreet" entry into a book, in which case it is not broadcast to all subscribers but merely added to the list of entries in the book.

ARIEL went into operation in early 1974 and by December 1974 had sixty-five terminals on line and was operating with a profit.[40] By June 1974 it was handling 1% of the equity business of British institutions and was on target for its eventual goal of obtaining between 5% and 10% of this business within five years.[41]

7. *A Systems Description of ARIEL*[42]

The ARIEL system is implemented on a PDP-11/40 system with a 64K bytes of memory. It can handle up to thirty-two multiterminal lines with up to five terminals per 1,200 baud line. It has, in addition, fixed head disks for fast retrieval and a disk pack capability for longer term storage. The operating system is a hybrid one using the standard PDP-11 Disk Operating System (DOS) with a substantial additional software written by ARIEL superimposed on DOS to handle the real-time monitoring, communications support and extended memory support. The system is written partly in PDP-11 assembler language and partly in FORTRAN IV.

The ARIEL system has been designed to handle up to 2,500 transactions or terminal input messages per hour giving rapid response time. The actual peak rate which can enter the system over the current network varies between 800–2,500 transactions per hour depending on the mix. Currently the peak hour rates rarely exceed 400 per hour and daily figures are rarely above 2,000.

Data integrity is a vital aspect of the system and sophisticated recovery procedures are used. Most failures require only a "fast recovery" technique which restores *all* data to the state it had following the most recent successfully completed transaction. The process may take only a few seconds, depending on whether hardware reconfiguration is necessary. To facilitate recovery, "transient" copies of active data are held on fast data storage during transaction processing.

A more conventional "slow recovery" technique is also available which operates completely independently of fast recovery and uses an audit trail to reconstruct the data from copies of start of day files. It may take several minutes if activity has been high, but

40 The Times (London), July 10, 1975, at 21, col. 1.

41 CITY CAPITAL MARKETS COMMITTEE, SUPERVISION OF THE SECURITIES MARKET, app. III (London, June 1974).

42 Information provided by ARIEL staff.

allows recovery even from catastrophes such as the loss of all data on a disk pack.

The ARIEL system has many features which assist in ensuring that the system is used properly. An advanced intelligent terminal (Computek 200) is used to minimize operator errors. It has function keys for the important transactions which display predetermined headings in the fixed input area of the screen, indicating the mandatory and optional input fields. Input may be visually checked and corrected before transmission to the system, or on receipt of a descriptive error message, prior to retransmission.

Subscribers must log in with their personal passwords before they can use the system. They may use training mode to familiarize themselves with facilities without danger of inadvertently using real securities. A transactions room at ARIEL has special terminals which monitor and control all transactions. The room is constantly manned by people experienced in the securities industry who may intervene in any negotiation if needed and can, if necessary, lock individual terminals or securities. The validity and consistency of all data is checked daily (offline) and backup and historical data is held either at the computer centre or at a remote secure location. All subscribers agree to a "code of conduct" which covers both confidentiality of information gained via the system and manipulation of the system. The code is policed by the transaction room.

Physical security at ARIEL is protected by the usual means – magnetic key systems, banditproof glass, etc. All terminals contain their hardware address and are connected via a fixed leased network. When dialup is used (for standby) it is manually initiated from the computer centre.

8. *The Computer-Assisted Trading System (CATS)*

The Computer-Assisted Trading System being developed at the Toronto Stock Exchange as a pilot project is designed to move the actual trading process from the floor of the exchange into an electronic communications network with trading terminals located in brokers' offices across Canada. It is hoped that the project initiated by the TSE will become the cornerstone of a Canada-wide system envisioned by the major exchanges.[43] A working prototype for the system has been developed and advanced testing on a few (inactive) securities has begun.[44]

43 For a fuller discussion of the motivation for and evaluation of the CATS project, *see*, *Cleland*.

44 The Financial Post (Toronto), December 3, 1977, at 25.

The basic philosophy of the CATS system is similar to that of Instinet-2 in that orders are traded according to auction market principles. However CATS is much more ambitious in scope. It is being designed to replace an existing market and hence encompasses a wider range of trading strategies and handles a much larger volume of trades than either ARIEL or Instinet (40,000 daily order entries and 500,000 inquires).

Brokers enter all orders to buy and sell stock through a TV-like terminal and all orders which are not immediately traded are filed for subsequent display and execution. The display indicates the broker's number, and the size and price for each order, with the orders queued according to price and time of entry. The size displayed for an order will be the amount the broker has chosen to show, but there may be additional stock behind the disclosed amount which will not be shown in the marketplace but can be traded. If other orders at the same price are in the system, they will share stock with that order up to their disclosed amounts.

When an order is filled by automatic matching, a message is sent to the terminal screen with a copy to the office's printer which may or may not be at the same location. The printed message or "fill" is the firm's formal confirmation of the trade. Any broker with an order at the bid or offer for that stock will be told of a change in the market's status by a message appearing on his terminal. All orders are automatically retained for the next day unless they were specified as day orders, their expiry date has been reached, or they have been specifically cancelled. Orders removed from the system are listed at the end of the day.

CATS retains a great deal of information about trading activity, including all transactions which have been entered by users and all matching executions. As well, extensive market information including facilities for displays of all stocks or selected groups of stocks (*e.g.*, all banks, oils or senior industrials) is incorporated in CATS as well as a stock-watch monitoring feature. Market information can also be obtained from other Canadian exchanges, from the consolidated tape and from other U.S. markets in the quotation data base. The TSE separated the market information services provided by CATS and offers them to brokers as CANDAT II.[45]

9. *A Systems Description of CATS*

The CATS pilot network shares the IBM 370/145 CPU on which the market information system at the Toronto Stock Exchange is implemented. The network is star-like with PDP-11/05 minicom-

45 *See* ch. III.A *supra*.

puters being used as the concentrators with each one capable of supporting up to fourteen terminals. The concentrators are primarily used to drive the terminal displays. Unlike the Instinet-2 terminals which behave "intelligently" in allowing the user to construct commands in the context of the display and a cursor position, the commands for CATS are keyed independently of the information displayed on the screen. Thus a simpler control program for the concentrator can be used since there is less interaction between the terminal and the concentrator.

The keyboard for CATS has been designed specifically to allow easy command entry. Rather than being a standard typewriter keyboard with additional function keys, it is a much bigger keyboard with colour-coded areas to allow the trader to enter the various parts of a command from different parts of the keyboard. The fields are ordered so that a typical order can be keyed with just a few keystrokes in a left to right sweep across the keyboard.

There is also a capability to define a complete order and have one of the "undefined" keys stand for it. The definition is stored in the concentrator data base and is activated each time the designated key is stroked. The definition feature allows a trader who is actively dealing in just a few stocks to have a "menu" of orders for his stocks prepared ahead of time. He may then concentrate his attention on monitoring the market.

The security of the system is enhanced by having a security code (or optionally a magnetic-strip credit card) required to achieve access to the system either for placing orders or retrieving private information. The code will be specific to the user and the firm to which he belongs, allowing him to access through any terminal designated as belonging to his firm. Only preliminary access security checks are made at the concentrator level in the system; hence once the system is functional the concentrators will not have to be maintained in secure areas.

The software for CATS has been primarily written by the staff of the Computer Systems and Planning Department of the Toronto Stock Exchange. The terminal support software in the PDP-11/105s has been written in PDP-11 assembly language. The 370/145 runs under the DOS/VS operating system provided by IBM and uses software developed in-house to implement the transaction processing associated with CATS.

10. *Summary on Trading Systems*

The design and implementation of a computer system for trading in securities is a difficult task for a number of reasons:

(1) It involves a complex human activity and the choice of which activities are to be automated and which are to be left to the traders is not obvious.
(2) It involves policy decisions such as the rules to apply in order-matching algorithms which have not been addressed before.
(3) There are direct economic tradeoffs between the volume of trading the system can handle and the degree to which it interacts with the trader, and this complicates both the functional specifications and the system design.

Both Instinet-2 and CATS are projects that have evolved using experience gained from earlier versions. Each project has successfully come to terms with the above difficulties in its own way. The ultimate success or failure of the projects in the long run may well be determined by political or economic considerations but their existence shows clearly that the technology and skills exist to create automated trading systems. There is no evidence yet that these automated systems result in better or worse markets than manual systems for the commodity being traded.

D. CLEARING AND SETTLEMENT SYSTEMS AND DEPOSITORIES

The legal document indicating a share of equity ownership in a corporation has traditionally been the stock certificate. The primary function of a stock exchange has been to provide an auction mechanism to allow investors to buy and sell such shares of ownership in a fair, equitable and efficient way. However, the stock certificate has outlived its usefulness[46] and it is just a matter of time until the majority of records of equity ownership exist only as book entries in an electronic information system. This development will be forced primarily by economic pressures to reduce the costs of clearing, settling and recording stock trades.

A discussion of the role of clearance, settlement, transfer of ownership and safeholding functions in the securities industry is given in *Applications of Automation*, in this volume.[47] We comment here primarily on the aspects which can be automated. Basically all the advances in settlement procedures involve netting or accumulating a number of transactions in order to reduce the actual number of physical transfers of money and/or certificates.

Systems based on a trade for trade settlement, daily balance order settlement and continuous net settlement have been insti-

46 S. Robbins, Paper Crisis in the Security Industry: Is the Stock Certificate Necessary? (1969).
47 *See*, *Cleland*, ch. IV.B.

tuted in various markets. In the first, only money is netted, all securities being transferred directly; in the second, both money and securities are netted on a daily basis, and in the final system, money is netted daily but securities are netted on a continuous basis, reducing the number of physical movements of securities.[48] In each case the netting operations are accomplished by extremely simple computer processing of files storing the required information. The applications are generally implemented by batch processing on a service bureau computer or on an exchange computer which is used primarily to support other automation programs.

A clearing and settlement system may or may not be associated with a depository. There are two types of depositories: those which hold stock certificates in nominee name and with the goal of immobilizing stock certificates, and those which maintain records of stock ownership only in book-entry form, without any dependence on paper certificates. Depositories which immobilize certificates can be viewed as the forerunners of ones that depend solely on book-entry records. Once the vast majority of stocks are in the depository the distinction becomes blurred, since all inventory control will be done by book entry. In either case the depository's main information-processing task is to maintain a data base of ownership records of the shares entrusted to it. The data base must be updated on the basis of settlement information and the issuance of new equity shares.

If one thinks of shares as being money, there is an analogy between depository book entries and a current account in a bank. However, a major difference is that the net value of shares stored in a depository are orders of magnitude greater than most banking units handle in their current accounts, which implies that much more stringent auditing and security controls are required than are normally associated with current accounts.

Like most banking applications, book entries in depositories are updated, not at the time a transaction affecting the balance occurs, but at a later time after all aspects of the transaction have been verified. There is a delay in processing from the time a trade is agreed upon until the point at which money and/or securities are credited or debited from accounts. The delay is an important aspect in the integrity of the system by which shares are transferred from one owner to another.

The so-called "locked-in" trade, in which information concerning trades executed in an automated trading system will automatically be confirmed and then transferred to the clearing

48 *See, Cleland,* app. B.

and settlement system, will greatly reduce this time from trade to settlement. It is conceivable to think of online settlement systems in which stock and money are exchanged between accounts within a few seconds of trade being consummated. This development must be viewed with a wary eye, however, as it may, for very little real economic gain, greatly increase the vulnerability of the system to fraudulent activities.[49]

1. *Canadian Depository for Securities (CDS)*

A major automation project in the clearing and settlement area is currently in progress in Canada. The Canadian Depository for Securities Ltd., which is funded by both the securities industry and the financial sector, was created in 1969 and has progressed steadily if slowly toward creation of a book entry depository for all Canadian securities.[50]

Phase III of the CDS Security Settlement Service (SSS) became operational in early 1976 and includes a wide range of services.[51] Briefly these are:

(1) a transaction reporting and confirmation procedure for a wide range of securities;
(2) a system for reporting and confirming client transactions for settlement through third party agents;
(3) a continuous net system;
(4) two settlement cycles per day;
(5) a redirection feature that will enable certificates due to be received through the SSS to be directed to delivery to other participants;
(6) a preclearing report available at 4 p.m. of items to be settled the next morning;
(7) a transfer envelope system;
(8) various dividend claiming services;
(9) settlement of new issues (stocks and bonds) on a book-based system up to and including takedown date;
(10) intercity settlement of confirmed transactions;
(11) a settlement interface with the Depository Trust Company in New York.

49 *See* ch. IV.C *infra* for a discussion of the vulnerability of online systems.

50 *See, Cleland,* ch. V.

51 CANADIAN DEPOSITORY FOR SECURITIES LTD., SPECIFICATIONS FOR PHASE III OF THE SECURITIES SETTLEMENT SERVICE (July 1974).

2. *Implementation of the CDS Security Settlement System*

At first glance the list of services provided under CDS phase III appears to require a large number of separate application programs to handle each of the types of service. Fortunately, however, a careful study of processing requirements for each major service shows that they are remarkably similar. The design of SSS takes advantage of the similarity by using a parameterized main processing cycle that can be tailored to each of the services with appropriate choices of parameters. Thus the continuous net settlement service and the new issues settlement service use the same set of programs but with different parameters to select the course of actions to be taken.

The system consists of eight main programs written in standard COBOL. The programs use decision table techniques to provide a systematic approach to achieving correct internal logic.

The entire system is designed for batch processing. Each run consists of feeding new input data and a recirculating transaction file through sorting, editing, updating and report generating steps. The result is a new recirculating transaction file and updated master and history files. Backup of the files is accomplished by producing a completely new file on update rather than modifying the current file. By saving two or three generations of old files and the input for the corresponding runs, accidental damage or loss of a file due to machine problems or programming errors can be rectified.

3. *Other Clearing and Settlement Automation Projects*

Continuous Net Settlement has in a very short time become the standard method and is used in virtually all North American marketplaces. In the United States, the system was pioneered by the Midwest Stock Exchange[52] and later adopted by the clearing corporations in New York associated with NASD and the New York exchanges. In Canada, the Vancouver Stock Exchange has implemented a Continuous Net Settlement (CNS) system independently of the CDS project described above.[53]

In England, where the settlement business has not changed in one hundred years, a major automation project called TALISMAN

52 BANK ADMINISTRATION INSTITUTE, SECURITIES DEPOSITORIES, A METHOD FOR IMMOBILIZING CERTIFICATES 16 (1962).

53 *See, Cleland,* app. B.

is well under way.[54] The settlement process at the London Stock Exchange is quite different from North American procedures and the system must accommodate these differences. However, the major principle of using book entry transfers to effect transfers of ownership is the heart of TALISMAN just as it is for CNS systems.

E. COMPUTERIZED SECURITIES MARKETS

It appears likely that in the not too distant future the securities markets in the United States and Canada will be centralized around computerized trading and settlement systems. This section examines the technical feasibility of the various approaches being discussed to forge such centralized markets; no attempt is made to give an economic analysis of the systems proposed or to comment on the desirability of the various approaches in terms of public interest.

In Canada centralization appears to be coalescing around the CATS project and the CDS efforts which are described above and in a companion paper in this volume.[55] There appears to be little doubt of the technical feasibility of the CATS project. But it is important to stress that it is a development project, and it should not be assumed that once the design is complete there will be no more work to do. If a CATS-like system is to become the sole marketplace for listed securities in Canada, then the system must have a level of security and reliability that will ensure the orderly functioning of that marketplace. This will require the implementation of many of the reliability and security measures discussed in chapter IV.[56] It appears quite likely that Canada will achieve an effective central marketplace before one is in place in the United States.

1. *The Central Market System in the U.S.*

The Securities and Exchange Commission issued in 1972 and 1973 the Future Structures Statement and the Central Market Statement which present the commission's view on how the securities market in the United States should develop in the near future. The Central Market Statement, in particular, laid down a number

54 *Talisman - A New Settlement System*, The Stock Exchange Journal (London), March 1974.

55 For a detailed discussion of the developments which are occurring in this direction, *see*, *Cleland*, chs. V.B, C, G; VI.A.

56 CATS has been designed with reliability and security as primary goals and hence the major focus will be on establishing operational measures which do not compromise the security and reliability of the design.

of points which are the guiding principles for the central market. The major points are open access to the market, best execution rule, competition between market-makers, competitive commission rates and public preference rule. Congress has actively supported the SEC in these developments and passed a major revision of securities legislation in the summer of 1975.[57]

The Securities and Exchange Commission did not lay down any specific functional form that the Central Market System (CMS) must take, but in order to begin the evolutionary movement toward such a system it mandated the development of the consolidated tape, and required that quotation data be made available to competitive information processors. It appointed the National Market Advisory Board (NMAB) to advise it on how the National Market System should evolve, but the board has completed its mandate without recommending a specific approach.[58]

There have been suggestions both by academics[59] and from industry[60] that the CMS will eventually be a large computer system and that all present exchanges as we know them will disappear. All current restrictions and regulations which impede competitive forces from making the market more efficient could be removed. The system would maintain an electronic book of orders for each listed stock as well as bid and ask quotations for any market-makers trading in that stock. A great deal of market information would be available since all transaction processing would be centralized. The system would function according to the SEC guidelines and in particular, since all executions occur in a single location, the public preference rule could easily be implemented. The exact nature of the trading process and the availability of information in the electronic book would have to be designed after more experience is gained with current computerized trading systems.[61]

It is not essential for a centralized market to be implemented on a single gigantic computer system[62] and it may be much more practical to divide the market into a number of classes of stocks

57 Securities Reform Act of 1975.

58 NMAB Report to SEC on the establishment of a National Market System, 432 BNA SEC. REG. & L. REP., December 14, 1977, at I1-6.

59 M. MENDELSON, *supra* note 20.

60 MERRILL LYNCH, PIERCE, FENNER & SMITH, PROPOSAL FOR NATIONAL MARKET SYSTEM (October 1975). M. MENDELSON, J. PEAKE & R. WILLIAMS, THE NATIONAL BOOK SYSTEM, AN ELECTRONICALLY ASSISTED AUCTION MARKET (April 1976).

61 CATS, Instinet and ARIEL all differ in these areas, which indicates that there is not one obvious best way to do computer trading of securities.

62 Extremely large online systems are difficult to build if a high degree of interaction is required to a large number of terminals. The success of CATS does not imply that a similar system can be easily built for the U.S. market, which is more than ten times the size of Canada's.

and have the market for each class implemented on a separate computer system. The use of several systems reduces the vulnerability of the market to system failures and would also allow for competition in providing the trading facility. Thus the benefits of a central marketplace can be achieved without the penalty of creating a monopolistic utility.[63] It is conceivable that many of today's participants in automation efforts (the exchanges, NASDAQ, Instinet, AutEx, Weeden) could share in a portion of the central market business if it evolves in this manner.

Not all observers of the securities industry believe that a complete shift to an automated trading system should occur.[64] They feel that the role of the specialist, with his obligation to make orderly markets in the stocks for which he is responsible, is a key feature of the U.S. securities markets and should not be eliminated by automation. If a role for the specialist is to be maintained in the CMS, then it is likely that the system will evolve as a communications network between the exchanges and the third and fourth markets. The NYSE has taken the lead in proposing such a system, the Intermarket Trading System (ITS).[65] This system is envisaged as a preliminary step in building the National Market System and has the support of four of the regional exchanges. Some observers[66] feel that ITS is a delaying tactic by the NYSE to put off the development of the Composite Limit Order Book (CLOB) which the SEC feels is needed to provide limit order protection, a cornerstone of the objectives it has stated. On the other hand, others feel that ITS will lead eventually to a CLOB organized around the current marketplaces (a soft CLOB) and that eventually efficiency considerations will result in its replacement by a computerized market with automatic execution of limit orders (a hard CLOB).[67]

The creation of ITS and then a Composite Limit Order Book based around the existing markets is a much larger and technically more difficult task than the first cooperative venture of the exchanges, the consolidated tape system. The book must reflect limit orders entered at many different markets and specialists at each market must be capable of executing against any order in the book. There are difficult policy problems associated with the processing of a sequence of information requests, order entries and execution reports. These problems may not be easy to resolve in a manner which can be technically achieved. If execution au-

63 *See* comments in M. MENDELSON, *supra* note 20, at 254-85.
64 Blumenthal, *supra* note 20.
65 432 BNA FED. SEC. & L. REP., December 14, 1977, at A-6, A-7.
66 Securities Week (New York), August 29, 1977, at 4.
67 *Interview with Sandy Yearly*, Securities Week (New York), December 12, 1977, at 7-8.

thority resides with the specialists then two executions against the same entry in the book is only one of many potential problems to be resolved.

The approach of achieving the CMS by building a composite book of limit orders at existing marketplaces involves inherently more difficult problems than centralization of the electronic book with computerized trading against it. It requires cooperative planning and design work by a number of independent bodies and complex interactions between several computer systems. If experience from the consolidated tape plan is any indication, a decision to proceed in this direction will require far longer and cost far more money than is currently being estimated.

Chapter IV
Reliability, Integrity and Security in Computer Systems

The securities industry is moving toward a greater dependence on computer systems in its day-to-day operations. Such dependence entails some risk, and this chapter outlines the risks involved and indicates the solutions applied in other areas of computer usage. The basic issues revolve around dependability and security. Two aspects of dependability are:
(1) the reliable provision of the basic computing services;
(2) the integrity of the information being processed by the system.

Four aspects of security are:
(1) physical security of the computer system from wilful damage or a disaster;
(2) prevention and detection of outsider intrusion into the system;
(3) prevention and detection of fraudulent use of the system by authorized users;
(4) internal security to avoid fraudulent behaviour by systems staff involved in the design, maintenance or operation of the system.

This subdivision of the topics is somewhat arbitrary as many of the security problems are closely related to the discussion on achieving dependable computing systems.

A. RELIABILITY

Most of the applications of computers in the securities industry involve large computer/communication systems tieing terminals and computers in scattered locations into a single network. A network allows individuals at widely separated locations to access

a common data base and to interact with one another as if they were all present in one location. Thus the benefits of such contacts are available without the congestion and confusion typical of an exchange floor. However, unlike an exchange floor which can still function (perhaps at reduced efficiency) despite major malfunctions in some of its equipment or failure of some employees to do their job correctly, an automated system may not function at all if there is a major malfunction or if key personnel fail in their task. There are plenty of "horror stories" about such happenings in the computer literature and it is important to realize that a key element in the design of any large-scale online automation system is the inclusion of planning on how to handle hardware and software failures.

1. *Hardware Reliability*

A common technique to achieve hardware reliability is to design duplex or twinned systems in which every component in the system has a twin that can be used in its place in the case of failure. There are a number of ways of designing such systems. A simple approach is to have two identical computers with all components duplicated which both can access a common data base. Only one of the systems is attached to the data base at a time. When the main system is working the backup system may be used for development work or low-priority production work. In the event of a failure in the main system, the second system is used in its place until repairs are effected. In some cases, the backup one may be in a physically separate location to assure that a natural disaster such as a fire, flood or earthquake does not destroy both systems simultaneously. For example, the Pacific Coast Service Corporation, a subsidiary of the Pacific Coast Exchange, maintains identical systems in Los Angeles and San Francisco to support the data processing requirements of the exchange and the Pacific Coast Depository.

A second approach to the duplexed system is to have both systems sharing the workload of the system, with the ability to intermix components of the two systems to ensure that at least one is running at all times. The NASDAQ system uses this type of design. Systems using the first approach are vulnerable to having both systems fail simultaneously due to different components being down on the two systems, whereas the probability of identical components failing in the latter systems is considerably smaller. Of course the latter systems are more vulnerable to natural disasters since the strong interconnection of the two systems requires that they be in adjacent locations. There are various combinations

of these approaches where parts of the system may be interchangeable but other parts are not.

Recently the technique of using several identical small computers as the computing power in a network has received considerable attention. The idea is an extension of the shared duplex system to a many-processor situation. Reliability is achieved by having each of the small systems capable of carrying out any of the functions of the others. Since each of the computers is small and hence inexpensive, it is possible to have one or two spares available which can be switched into the system to take over the function of an ailing processor. The attraction of this technique is that a high degree of reliability can be achieved with only an incremental increase in hardware costs rather than the usual doubling of costs associated with the duplexed approach. The frontend processor for the computer system at the Midwest Stock Exchange uses this distributed computing approach.

The discussion of hardware reliability thus far has concentrated on the hardware of computer systems. A parallel discussion of the hardware reliability of the associated communications network should also be made. Communications lines can be twinned (preferably over an alternate route in the telephone system) either with both lines in use sharing the load or with one primary line and a backup line (frequently of lower speed) to be used only in emergencies. The distributed approach is to have a network in which messages may be routed via a number of points before reaching their destination. By having redundant connections in the network it is possible to have two or more paths between each node and hence there are no individual lines which can shut down part of the network if they fail. Again the distributed approach saves money by reducing the number of connections. It should be noted that the distributed approach to both computer systems and communications networks is not without a cost; there is a significant complication in the software required to support distributed systems and networks that must be taken into account in estimating their cost. These costs are declining as distributed systems become more widely used.

2. *Reliable Software*

The design and development of the software required for a large online data processing application is a difficult and complex task. Although in many cases part of the system is taken directly from manufacturer-supplied software, the integration of the application-oriented programs and the tailoring of the supplied software to meet the operational objectives is still a major effort.

Programming alone is a difficult task. It requires the programmer to understand a problem well enough to write a fixed program which will react properly for the different kinds of input data (both correct and incorrect) that may be supplied to it. If the information is supplied by other programs in the system, the programmer must understand exactly what the input is and what he is to do with it. Since large systems are too big to tackle as a single program they are generally subdivided (sometimes with a hierarchical structure) into many smaller program modules. While this subdivision does make the programming of individual subparts much easier, it adds its own set of complications. The more modules used, the more complex the interactions and relationships between parts of the system, and these complex interactions greatly increase the possibility of misunderstanding among the programmers of the system.

Large computer systems are never completely correct – that is, there are always mistakes remaining in the programs (or bugs as they are commonly called) which have not been encountered or have not been isolated as the cause of improper action by the system. This is a fact of life. A major piece of software is considered reliable if the frequency of occurrence of bugs has been reduced to an acceptable level and the design is robust enough to allow rapid operational recovery when they do occur. It is considered stable if correction of a bug in one part of the system does not result in new bugs appearing in other parts of the system. Examples of unstable software are the operating systems of third generation computer systems, many of which became so big and complex that the list of outstanding bugs grew continously no matter how much effort was put into correcting them.

The techniques for development of stable, reliable software systems are evolving into a discipline known as *software engineering,* which encompasses the whole gamut of programming activity from project management to good coding techniques. A considerable amount of literature has already developed on the subject.[68] In a paper of this scope it is impossible to survey this subject in any detail, but following are a few of the central ideas.

A major idea in software engineering is to write better programs, thereby reducing the effort required to detect and correct errors. Programmers produce better programs if their task is simplified and if their activities are managed more successfully. A programmer's task is made simpler by:

68 F. BROOKS, JR., THE MYTHICAL MAN-MONTH: ESSAYS ON SOFTWARE ENGINEERING (1975); NATO SCIENCE COMMITTEE, WORKING CONFERENCE ON SOFTWARE ENGINEERING (P.

(1) reducing interactions between parts of the system;
(2) programming in a higher level language whenever possible;
(3) using structured programming concepts to make programs more understandable.

The management of programming activities is improved by sharing responsibility for the program modules across the whole programming team (which must be kept small).[69] Although different rationales and organizations[70] are given for this approach, the benefits are real; studies show that the quality of programs produced is greatly increased.

A second topic in software engineering is protection of a system from disastrous errors. By isolating the major tasks and preventing errors in one part of the system from destroying the functional behaviour of the other parts, protection can be accomplished. The discussion here cannot be separated from that on internal security in chapter III.D. Precisely the same mechanisms are used to thwart accidental intrusion of one part of a system into another part as are used to prevent deliberate attempts to intrude. With the mechanisms to provide such protection in place, major errors are generally found quite early in the development stage.

A third topic in software engineering is recovery from software (or hardware) errors. Basically there are two types of recovery required, recovery from loss of control and recovery from loss of data. Loss of control occurs when the normal sequence of control in the system is interrupted due to some error or unexpected event. A recovery routine is invoked which inspects the control tables stored in the nucleus of the system. The integrity of these tables is in doubt after an error and they must be checked before resuming normal execution. If a recovery routine modifies these tables it may also have to modify corresponding data tables to ensure that everything is compatible. To accomplish the recovery satisfactorily, enough redundant information must be retained to ensure that the validity of the tables can be checked.

Loss of data occurs either when data is being received or sent from the system or when it is stored on auxiliary storage. The probability of information loss during transmission over a commu-

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Naur & B. Randell eds. 1969); NATO Science Committee, Software Engineering Techniques: Conference Report (J. Buxton & B. Randell eds. 1970).

69 It is a common misunderstanding by management that programming projects can be hastened by increasing the size of the staff. However, once a critical size has been reached, additional staff only hamper a project by reducing the capability of a team to communicate effectively. The result is usually longer delays and poor quality software.

70 G. Weinberg, The Psychology of Computer Programming (1971); H. Mills, Chief Programmer Teams, Principles, and Procedures (IBM Federal Systems Division Report, FSG, 71-5108, 1971).

nications link is high enough that no one would consider designing the telecommunications part of a computer system without the ability to ask for, or supply, a retransmission of the last message. Moreover, messages are transmitted with enough redundancy that the probability of an incorrect message going undetected is quite small. Often data stored on auxiliary storage is accessed through tables (generally referred to as directories) which give the location of all data items on the auxiliary device. It is essential that duplicate copies of the directories be maintained in case the main one is accidentally overwritten due to a software (or hardware) failure. If a high degree of data reliability is required, it may be necessary to duplicate all files in the system, with the copies placed on different physical devices. If files are duplicated an extra complication is introduced. The copies of a file must be kept synchronized and this task is especially difficult if the file can be rapidly updated.

Recovery can be accomplished only by retaining redundant or duplicate information. It is clear that recovery techniques cannot be added as an afterthought but must be designed into the system right from the beginning. With such planning, redundant information for recovery will be kept and recovery will be as swift as possible. Since manufacturer-supplied software normally has little in the way of designed-in recovery features, systems based on such software frequently have less sophisticated recovery schemes.

B. DATA INTEGRITY

A system is said to have data integrity if it only processes data that has been legitimately entered into the system, verified to be correct, checked for reasonableness, and preserved unmodified in the computer system. The frequency of articles in the mass media about credit billing systems, payroll systems, and banking systems where customers have been incorrectly billed, paid, or credited unreasonably large (or unreasonably small) amounts shows the need for a systematic approach to this problem.

Data integrity cannot be absolutely guaranteed. After all, data in a computer system is represented by a string of bits. There is no means of detecting whether any given string of bits, about to be processed by program B as a record of data, was created by program A (as is assumed), or was randomly selected from memory due to a bug or failure, or even worse, was deliberately fed to program B for fraudulent purposes. However, if program A always introduces redundant information into the data record and program B always validates that the redundancy is present, the likelihood of accidental use of bad data is decreased. It is likely that

those attempting fraudulent behaviour in a computer system would be able to provide suitably redundant information and hence other means for detecting fraudulent behaviour must be found.

There are three basic areas that affect data integrity. First, the data input process, which is frequently afflicted by human error, is examined. All input should be verified by testing it as much as possible for "reasonableness". Do the stock codes reflect actual stocks? Is the price mentioned within some percentage of the market value? Second, data transmission between the "intelligent" parts of the computer system should add redundancy and retain the data until it has been correctly received. As mentioned earlier this practice is pretty well standard today in communications systems and in the future it may include an encrypting process to reduce the likelihood of fraudulent interception or insertion of messages. Third, the data records processed within the computing system and stored in its auxiliary storage should be validated as they flow through the system. Data records should be verified for content and time of creation to ensure they are appropriate for the next task.

The temptation to have parts of the system rely on other parts of the system to validate the data should be avoided as much as possible. Without independent validation the system is vulnerable to massive disruption if bugs in the validation process allow bad data to get into the sensitive parts of the system. All data records in the system should be self-describing so that verification can be done independently of the modules that create the data records and also independently of modules that use them. With this design, validation of the data can occur in as many places in the system as appears necessary to avoid disruption. The verification process will be considerably more efficient and consistent than if every small module encodes a subset of the validity checks.

The techniques described above for achieving increased data integrity in computer systems have been presented simply to indicate that the reliability of data can be increased by sound programming practices. The best approach to be taken in a particular application will vary from one application to another, and it is the responsibility of the project programming management to select an approach to data integrity.

C. SECURITY

Security of a computer system involves not only the protection of the system and the information it contains from loss, damage, or destruction but also the adequate protection of information

from unauthorized access, use, or disclosure, and prevention of abuse or misuse of the system for fraudulent ends. The purpose of a security program is to reduce the risk and probability of loss associated with the above dangers to an acceptable low level at reasonable cost. In order to design security measures for a computer system, the potential threats to the computer system have to be identified and management decisions made on how best to minimize the risks. There is considerable literature now available in this area, including several general-purpose manuals for designing a security program.[71] There are also several good bibliographic sources for finding more specific information.[72]

1. *Physical Security*

The physical security of a computer system involves its protection from dangers that would destroy, damage, or render inoperable the physical components or data storage media of the system. The danger may come from natural, accidental or malicious sources and a secure computer system must have defences against all three.

Included in the category of natural threats is the possibility of damage due to fire, flood, earthquake, and disruption of major services. Protection of the computer system and the backup storage area (assuming there is one) from fire can be accomplished by standard fire protection techniques. Since fires in electronic devices generate a lot of smoke without intense heat, the use of smoke-detectors instead of heat-detectors is quite commonplace. These generally trigger an alarm system and after a suitable delay a fire-quenching system is initiated.[73] Water and smoke damage from fires associated with other uses of the physical location are also a threat and defences should be planned as the installation is designed. The only defence against a flood or earthquake is to choose a location that minimizes the risk and to provide a backup site at another location with a recovery plan to get the alternate system functioning as rapidly as possible. Disruption of the power supply and loss of the communications system are constant dangers. Protection against a power loss can be provided at three levels:

(1) against a loss of power for a fraction of a second, preventing an unscheduled shutdown;

71 AFIPS, SYSTEMS REVIEW MANUAL ON SECURITY (1974). IBM, THE CONSIDERATIONS OF PHYSICAL SECURITY IN A COMPUTER ENVIRONMENT (Manual G520-2700 October 1972).

72 Browne, *Computer Security - A Survey*, 4 DATA BASE, Fall 1972, No. 3, at 1. Hoffman, COMPUTERS AND PRIVACY: A SURVEY, 1 COMPUTING SURVEYS 85 (June 1969).

73 *See* IBM, *supra* note 71 for a detailed discussion on the merits of various systems.

(2) against a brief loss of power, allowing orderly shutdown of the system;
(3) against an extended loss of power, by using private generators to maintain continuous operations. The last level of protection is frequently used for online systems if the economic loss caused by a power failure is sufficient to justify the additional costs and most users of the system are on separate power grids. The loss of the communications system is less of a threat as the service it provides is in discrete quantities and it is unusual for the entire system to go out at once. Backup lines should be routed to avoid a natural disaster taking out both the primary and secondary networks.

Protection from accidental damage to system components or data storage is best afforded by good operational practices and adequate personnel training. A classic (and not uncommon) example is the damage caused if a disk pack, after it has been inadvertently dropped, is placed in a disk drive to see if it "survived". The attempt to use it will likely damage the read/write heads sufficiently that any attempt to read an undamaged pack will result in the destruction of its data. Further attempts to read the damaged disk pack on other drives simply propagates the disaster. If the sequence of events occurs during a backup operation or a recovery operation, it is possible to destroy all historical data from which recovery is possible. Operations staff must be trained to suspect the worst and must be made conscious of the vulnerability of the system to this kind of disaster.

Physical protection of the computing system and the data storage area from malicious attempts to sabotage its operations or to steal data or systems information is provided in much the same way that banks secure their premises. Access to sensitive areas is limited to those with a need for access. Thus the computer room is off limits to all but the operational and maintenance staff except in unusual circumstances. Strangers are kept out of the system location entirely by limiting the number of entrances and providing a guard or receptionist to monitor those who can come and go. Keys, magnetically encoded badges or credit cards, and closed-circuit television monitors are all protection techniques that are useful in limiting access. None of these techniques would protect a centre from a large-scale invasion by an organized group intent on forced entry to sabotage the system. They are designed primarily to increase the risk to an individual who would attempt such an act. As mentioned earlier,[74] the central site for NASDAQ at Trumbull, Connecticut, is a model installation for physical security. It

74 *See* ch. III.B *supra.*

was only while writing this report that it struck the author how vulnerable even a secure computer installation really is. A visit to the site was arranged by the author after placing three or four phone calls to NASD officials and explaining the purpose of the study. At no time was he asked for any evidence to authenticate his "story" (although it is possible that they confirmed its authenticity indirectly). He was given a complete guided tour of the installation including a half-hour visit to the computer room and data communications room. It is quite likely that tours are part of a public relations effort by NASDAQ officials to inform the "world" of their advanced system. Yet such tours lower the consciousness of the installations personnel to the danger of "unnecessary" access to a sensitive area and hence leave the system vulnerable to attack by a "madman" with a "plausible" story. The point is not that NASDAQ security is inadequate, far from it, but that no matter how extensive the technology to prevent unwarranted access, there will always be human judgment applied to exceptional circumstances which will bypass the technology. Hence there is a definite limit to the gain in security that can be made by installing such equipment.

2. *Security from Outsider Intrusion*

In the previous section we discussed means for securing a computer system from malicious attempts to damage or destroy it. Such dangers cannot be overlooked in the securities industry but they are not as great a danger as the possibility of outsiders intruding into an online computing system, either to gain confidential information or to subvert the system for their own purposes. The weakest link in an online star-like system is the communications network that passes information to and from the central computing system. It is possible to make the central site physically secure and to use internal audit procedures to provide protection from internal staff. But the security of the total system will depend on that of the communications system and, as we shall see, security in this area is extremely difficult to obtain.

There are two kinds of intrusion: passive and active. The passive intrusion is one in which confidential information valuable to some outside party is extracted from the communications system without detection. The extraction can be accomplished by wiretapping or by electronic "eavesdropping", *i.e.*, "listening" to the magnetic field emanating from a communications link. The technology to achieve passive information extraction is available today and it could be attempted with little fear of detection. The usual solution suggested is that the information should be scram-

bled or encrypted into a form that will be unintelligible to the would-be wiretapper. New encrypting techniques are now being introduced which can be implemented in hardware at low overhead.[75] However, encrypting of messages does not guarantee a defence against passive intrusion; it simply means the wiretappers have to upgrade their hardware and have to "reach" someone who has access to "keys" used in the encrypting scheme. Undoubtedly encrypting does raise the cost of penetration and hence lowers the risk, but it does so by adding to the cost of the network.

Whether encrypting to prevent passive penetration is economically justified depends greatly on the "value" of the information flowing in the communications system. As an example, consider an online securities trading system. There are proponents for both a closed book and an open book approach to designing a trading system. In a closed book system only the best price on each side would be displayed, whereas with an open book the entire set of outstanding orders would be available. Wiretapping to obtain order information in the open book situation is unnecessary as the information becomes "public" almost instantly. Whether it would be attempted in the closed book situation would depend on what economic advantages could be gained and by whom; the information would be primarily of interest to a broker and the risk involved in obtaining it might far outweigh the potential gain. Part of the overall design task for an online system is to assess such situations and determine the level of protection that reduces the risk of passive penetration to an acceptable level.

Active intrusion into an online computing system is a more severe threat than passive penetration since it can destroy the validity of the data being processed. However, there is also a greater probability of detection. Active intrusion can come in several forms. One simple form is when an unauthorized person attempts to access a system from a remote terminal. Protection from unauthorized access is achieved by using leased lines rather than dial-up facilities (thus, only the terminals known to belong to the system can be used), and by some authentication of the terminal user. Typical protection techniques are the use of sign-on passwords known (in theory) only by authorized users, or badge or magnetically encoded credit cards which must be inserted in the terminal before it will work.

All the techniques to limit access have their shortcomings. Users may forget to remove the credit card or to lock the terminal.

75 *See* Feistel, *Cryptography and Computer Privacy*, 228 SCIENTIFIC AMERICAN, May 1973, No. 5, at 15–23, for an excellent discussion of the use of cryptography in data security.

Passwords are usually jotted down somewhere and this information may carelessly be left near the terminal. Physical security in the area where the terminal is located is probably as important as these other protections. The encrypting schemes described earlier also provide protection against intrusion, as messages that are sent with the wrong key are easily detected.

A second form of active intrusion can occur if the online system is part of a general purpose time-sharing system. Typically such services use dialed rather than leased lines and accept input from almost any terminal device. Moreover the intruder as well as being able to present data to, or receive data from, the system, can create programs to be inserted in the system. No time-sharing system commercially available today is completely secure from this kind of penetration. Probably the most sophisticated system in terms of protection is the MULTICS operating system developed jointly by the Massachusetts Institute of Technology and Honeywell.[76] Yet it was successfully penetrated by the ZARF team with less than twenty-four hours worth of effort (ZARF is the code name for a joint computer security research project between the U.S. Air Force and the MITRE Corp.; one of their favourite pastimes is exposing the vulnerability of current systems).[77]

For most time-sharing systems, it does not take the talents of a high-powered defence research team to subvert them. Consider the following story which appeared in 1975.[78] A fifteen-year-old schoolboy with only four months' experience in assembly language cracked the security of a major time-sharing service in London, England. By dumping the object code of the operating system he was able to determine how telephone lines were assigned to terminals and where information being sent to or from the terminal was being stored. Accordingly he was able to eavesdrop on any transactions entering or leaving the time-sharing service and was also able to determine privileged account numbers. The article left the name of the time-sharing system unmentioned to protect the embarrassed, but it is likely that most time-sharing services have been penetrated in a similar manner at some time or other.

The lesson is that general purpose time-sharing systems are not very secure at present and are unlikely to be made secure in the near future. Their vulnerability arises from two sources: first, they are designed to be a public utility and hence it is extremely difficult to screen who uses them; second, they allow user-created

76 Saltzer, *Protection and the Control of Information Sharing in Multics*, 17 COMMUNICATIONS OF THE ACM 388 (1974).

77 Alexander, *Waiting for the Great Computer Rip-off*, FORTUNE, July 1974, at 143.

78 Computerworld (Boston), January 29, 1975, at 5. *See* ch. V.A *infra* for a discussion of packet-switching networks.

programs to execute, and if such a program can force itself into "privileged" mode it can potentially alter or read any piece of data in the system. A possible conclusion is that any online application where security is a primary concern should not be implemented as a package of programs on a general purpose time-sharing system. Even if the entire system is dedicated to one application, the vulnerable software will be in place ready to be exploited.

A third form of active intrusion is "piggybacking". Piggybacking is a wiretapping technique in which data transmissions are intercepted and processed by a computer which monitors or modifies the message before transmitting it forward. Even encrypted transmissions are vulnerable to piggybacking. However, the computer must have access to the encrypting keys and be programmed to decode the encrypting sheme. A piggyback system can even generate its own transmission, producing a completely false picture of the activity being carried out at either end of the data link. If the piggyback is attached between the concentrator processor and the central computer it may bypass the authenticity checking used to ensure that the terminals are being used for "reasonable" purposes by authorized users. Piggybacking is a potential threat in any system in which money transfers to accounts belonging to the general public can be initiated by messages sent over transmission lines. Bank-to-bank transfers are an obvious target.

Whether there is a serious threat of this sort of intrusion in automated systems in the securities industry depends on the nature of the systems that are developed. Currently, there are no real money transfers to public accounts proposed in the systems being implemented in this country and elsewhere. It is not obvious whether or not piggybacking could be used for fraudulent manipulation of an automated marketplace. The answer depends heavily on the specifics of the automated trading process and the details of the system design.

There are no documented cases of piggybacking being used to intrude on a computer system (except in research studies on the data security problem). With the introduction of packet-switching technology the vulnerability of data communications to piggybacking is reduced. However, the danger, even if just because it has been raised in the literature, is present now and will become greater as the cost of computer technology decreases and the number of highly-trained systems people increases. To not include defences against it in planning for any major online system to be used in the next decade seems at least shortsighted.

3. *Fraudulent Use of Computer Systems*

The previous section was concerned with outsider intrusion into a computer system for fraudulent purposes. The risk of outsider intrusion is much less than the risk of fraud or embezzlement perpetrated by those persons who are authorized to use the system. The Equity Fund insurance scandal brought into public view[79] the possibility of such behaviour on a grand scale. In addition, there have been enough other cases involving individual fraud to indicate the size of the problem.[80]

The following example illustrates the ease with which computers have been used to perpetrate embezzlement. It is the story of an $11,000-a-year bank teller at New York's Union Dime Savings Bank who had access to a computer terminal which hooked into the bank's online account management data base. The teller embezzled money by transferring amounts from inactive accounts into the accounts whose money he had pocketed after accepting a deposit at the window. In a little over three years he managed to pocket $1.5 million. The detection of his crime was purely accidental. Records seized from an illegal betting operation, which showed that he had been gambling $30,000 a day for several weeks, led the police to investigate his work activities.[80a]

This simple form of embezzlement, automated only in that the computer transferred amounts from one account to another, shows the extent to which the data processing community has, in the past, failed to provide adequate audit controls. The trail of paper which has traditionally been the auditor's tool for ensuring that all transactions are proper is rapidly disappearing as transactions are directly entered online into computer systems. As a result, auditors now rely on the computer to perform many of the accounting crosschecks. The computer is programmed to detect suspicious transactions and issues a warning message when they occur.

Internal auditing checks are not adequate in themselves to guard against embezzlement. First, the crosschecking algorithm remains fixed and is known in advance. Hence a would-be embezzler can plan means to avoid the check without the fear of a sudden change in auditing practices. Second, man's ability to find new ways to embezzle seems limitless and the auditing programs just cannot compete with a good auditor's ability to smell out a phoney

79 *Equity Fund Fraud Toll More Than $2 Billion*, DATA PROCESSING DIGEST, June 1973, at 19; Romney, *Fraud and EDP*, 46 CPA J., November 1976, at 23-28.

80 D. PARKER, COMPUTER ABUSE PERPETRATORS AND VULNERABILITY OF COMPUTER SYSTEMS (Stanford Research Institute Report, December 1975).

80a *See* Alexander, *supra* note 77, at 144.

situation. Finally, there is always the danger that the auditing aspect of programs will be tampered with.

4. *Protecting Online Systems from Fraudulent Use*

The enormous potential worth of the stocks and bonds being handled by automated systems in the securities industry makes them vulnerable to illegal activities of the type described above. Following is a survey of good system design techniques and internal auditing practices that can help reduce the risk associated with automated systems.

A major thrust in attempting to assure the security of online systems is authentication of the terminal user. (See the discussion in chapter IV. C.) Although none of the techniques are foolproof, the combination of a badge device along with a user-chosen and changeable password seems to give a level of protection, to both unauthorized access and illegal tampering. If a user regularly changes his password without notice, this greatly reduces the likelihood of an unauthorized person accessing the system by pretending he is the user.

Auditing practices associated with an automated system in the securities industry should be included in the design as the system is developed drawing both on experience with manual auditing practices currently used for the application and on the capability of the computer to perform systematic checks. For example, the auditing function in an online system is much simpler if access at a particular terminal is restricted to a few individuals who can be identified by their function. In a trading system it is likely that a trader for a particular brokerage firm would have responsibility for a certain set of stocks. He would be authorized to place orders to buy or sell only those stocks. Assuming he always works from one terminal or one of a set of terminals, his inputs could be checked to see if they come from a correct terminal and involve stocks in the authorized set. The concentrator which controls the terminal could authenticate the input data both for auditing purposes and reasonableness before transmitting the order to the central system using information which is stored in the concentrator.

Techniques for updating access control information would have to be developed to allow for normal changes in work patterns. The security of the concentrator becomes very important if it controls access since tampering with the information might completely bypass the checks. There is still a need for some authentication information to be sent to the main system for logging purposes and prevention of outside intrusion.

One of the inhibiting factors in fraudulent activity by people in manual systems is that repeated inquiries about the system or repeated attempts to gain information outside a person's normal working needs create suspicion which may lead to a close examination of the person's work. A problem with most early online systems, even if they are programmed to authenticate input to the system, is that they fail to react to suspicious behaviour. Generally the user at the terminal is given a mild rebuke in the form of an error message but no other action is taken. Thus a user with criminal intent can probe the system at will trying to find its weaknesses.

It is important in trying to design a secure system to find techniques that will discourage such probing. One approach is to keep a count of the inputs that violate one of the authentication tests, and when the count reaches some threshhold the system can notify the appropriate security office and produce a dump of the transactions log for that terminal. Care would have to be taken to avoid casting suspicion in instances where the user is simply making an abnormal number of careless errors.

The exact nature of the auditing techniques which should be incorporated in the system software are application dependent and are not discussed in general terms here. Several manuals and guidelines now exist to assist an internal audit team and the software design group in planning the audit process.[81]

5. *Internal Security*

No computer system in public use today is completely safe from threats to its integrity from internal staff or those who have direct access to the system. This fact should not be a surprise. All institutions that handle money or other liquid assets are vulnerable to misbehaviour by their staff; they rely on good audit controls and careful selection of personnel to minimize the risk. The surprising thing is how many institutions have completely ignored the risk of internal subversion of their computer systems.

Undoubtedly the cause of this neglect has to do with the aura

81 For discussions of internal auditing practices, *see The Internal Auditor and the Computer*, 13 EDP ANALYZER, March 1975, at 1. Anderson, *A Guide to Computer Control and Audit Guidelines*, 105 CA MAGAZINE, December 1974, No. 6, at 22; *Advanced EDP Systems and the Auditor's Concerns*, 138 J. ACCOUNTANCY, January 1975, at 66; AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, MANAGEMENT, CONTROL AND AUDIT OF ADVANCED EDP SYSTEMS (1977). This section has been concerned with the threat of fraudulent misuse of automated systems and means of protection to prevent or discourage it; *see* ch. V.C *infra* for the related but more specific question of detecting misuse of the trading activity itself through strategies which manipulate the stock market.

of mystery surrounding the sophisticated online systems. Management has been led to believe that the processes are too complex for them to understand and if the entire operation is left in the hands of experts the job will be well done. Being essentially technicians, the experts devote all their energy to solving the technical problems of designing and implementing an operational system. It is rare that the development team has management's perspective on the importance of non-technical issues to the success and security of the system. The situation is changing, especially with the amount of publicity that security issues are receiving today,[82] but there are still relatively few computer systems that have internal security as a major area of management concern. Following is a review of the technical details of the vulnerability of computer systems to internal subversion and a discussion of the defences being proposed in the literature.

6. *Vulnerability of Computer Systems to Internal Subversion*

The major control mechanism in a computer is the operating system.[82a] Primarily the operating system controls the sharing of the resources of the computer among the various tasks being processed by the computer. In controlling the sharing it must, for short periods of time, have complete control of the computer and all the resources. Computers have two control states: supervisor (or privileged) state and user (or non-privileged) state. In theory, only the programs of operating systems ever operate in supervisor state, and then only when they are carrying out some function that cannot be done in user state. An application program operates in user state. In order to use a systems resource, such as reading from or writing to a file, the application program executes a special instruction which requests supervisor intervention to carry out the required action. Each application program and its private data are kept completely separate from that of every other program and, ideally, there can be no interference or spying between the separate applications. The separation is essential for reliability. It prevents bugs or errors in one program from contaminating other parts of the system. Thus, provided the operating systems programs are completely correct and do not contain any subverting code, and provided no applications programs ever operate in privileged mode, the two-state mechanism prevents all attempts to

82 Grønning, *Data Security and the Financial Community*, 154 SLOAN MANAGEMENT REV., Spring 1974, No. 3, at 69.

82a *See* ch. II *supra*, for the tasks carried out by the operating system.

misuse the system which is not deliberately programmed into applications programs.

In practice the situation is not so straightforward. While most of the operating systems in current use were designed with this model in mind, most of them can be subverted by any good undergraduate student in computer science. Some of the techniques require the collusion of a systems programmer; others can be done entirely without help. An example is the restart game. For long running programs most operating systems provide a restart capability whereby the program can request that a "picture" of the state of the processor and memory be placed on an auxiliary file to avoid having to start again from the beginning if a failure occurs. The "picture" contains the privilege flag and the point in the program at which the restart should begin. This is an extremely useful facility and no one would suggest eliminating it. The flaw is that in some systems the restart file is considered a private file to the program that requested it, and hence there is no mechanism to prevent the program from tampering with it. The restart mechanism can be misused as follows. First, request a restart dump. Second, modify the contents of the file, inserting a new restart point and altering the copy of the program so that it appears the machine was in supervisor state when the dump occurred. Finally, deliberately cause an error to force the restart dump to be automatically retrieved. The net result is that the operating system restarts the application program in supervisor state at a point of its own choosing. The program then has access to all the system resources and files and can do virtually anything.

A second example of system subversion involves collusion with the systems programmer who is responsible for the nucleus of the operating system. The nucleus handles all requests for supervisor functions. Although the majority of these requests are generally designed into the operating system as it is delivered, each user may add some of its own to optimize the performance of its installed system. It is not too difficult for a systems programmer surreptitiously to add a supervisor request which can be used as a "trap door" into supervisor state. Any other programmer who knows about its existence can potentially subvert the system with any program he runs. Thus innocent-looking program development activity carried on in parallel with production work can in fact raid the system in some manner. In some operating systems, the "standard" supervisor requests can be made to act as trap doors if they are given arguments outside the expected range.[83]

83 Whiteside, *Dead Souls in the Computer* (pts. I, II), THE NEW YORKER, August 22, 1977, at 35; August 29, 1977, at 34.

A great deal of research and development effort is being spent on designing and building operating systems that cannot be subverted in this simple manner. Experts believe it will be another four to five years before really secure systems will be in wide use commercially. Of course not all fraudulent use of computer systems by the internal staff relies on the ability to take over the machine. In fact, many of the embezzlement cases that have come to light involve the programmer responsible for implementing an application program.

One of the earliest cases on record[84] is that of a bank programmer in Minneapolis who programmed the account's package so that all overdrafts on his account were ignored. This was discovered only by accident when the computer failed one day and the bank had to go back to manual processing. Another example from the folklore[85] of programming is that of a payroll programmer who siphoned all the fractional pennies from the payroll into his pocket. For every payroll amount which did not come out to the exact penny he would round up before adding it to the payout total, round down for the actual cheque and add a penny to an internal sum. At the end of the run he would add the sum to his paycheque amount just prior to the printing of the cheques. This simple ploy is quite difficult to check by any internal auditing scheme since the cross sums all match and there are no extra cheques printed.

The code to alter an application illegally can be added after the program has been installed by "patching" the machine language program. Thus anyone auditing the program by reading the original source language program would be completely unaware that it differed from the actual program being executed. One can be sure that no such tampering has occurrred only by ensuring that the actual production program in machine language corresponds exactly to the source language program. There is no reason to assume that the originator of an application program is the only person capable of subverting it. If the program documentation is readily available, almost any competent programmer can insert a patch.

There is a close analogy between bank account management and book entry recording of stock ownership. It would be safe to assume that all of the potential means of manipulating bank account programs are potential threats in a book entry system, particularly if accounts are held in individuals' names. (The added risk may be strong reason for not having individuals as holders of

84 *Computer Fraud and Embezzlement*, 11 EDP Analyzer, September 1973, at 1.
85 This story has been retold many times but the author could find no evidence that

records.) It is less obvious that there is a threat of similar subversion of a trading system. The motivation would probably be some deception to manipulate the market value of a share. Whether such manipulation could be carried out by subversion of the system is worth studying in any design for an automated trading system.

The emphasis in the discussions on subversion of computer systems so far has been on situations where the internal staff have intentionally been involved. However, there are cases where in attempting to expedite their job the programming staff may leave the system vulnerable to subversion. In almost all major programming developments the implementors include extra code to aid in debugging the system. Thus from an ordinary user's terminal, a systems programmer may have the ability to scan internal tables, modify them, even alter the machine language programs in the system. These tools are extremely useful during the development stage because they make it much easier to isolate and correct programming errors. The temptation is to leave them in the working version of the system (since it is never completely debugged). The existence of special commands is generally not advertised and frequently they are protected by allowing only "privileged" terminals to have access to them. Such features leave a security gap in the system big enough to drive a truck through. Inevitably word gets around about these "super" commands and their potential for criminal activity may be realized. Even "privileged" protection may not be worth much; terminals have been known to end up in privileged mode during a systems crash, and convincing liars have talked more than one computer operator into privileging a terminal "to aid debugging".[85a]

7. *Defending Computer Systems from Internal Subversion*

If a pretty bleak picture of the vulnerability of computer systems has been painted it is perhaps a good thing. For too long it has been assumed that automated systems will solve all the difficulties associated with information processing problems without creating any of their own. In fact, they usually replace one set of problems with another completely different set.

The picture is not really so gloomy, however. There probably will never be completely secure computer systems just as there are

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such a case has come to public light (which may mean there are a lot of rich payroll programmers around).

85a Much of the discussion on internal auditing for EDP involves an evaluation of operational practices and controls to prevent the type of tampering discussed here; *see*, *The Internal Auditor and the Computer*, *supra* note 15.

no completely secure banks. Internal security of a computing system can be achieved by much the same means as it is for other areas of business or institutional operations. The keys are good personnel policy, sound operational controls to minimize the risks, including regular but unscheduled audits of the computing system, and sound planning to identify and minimize the security risks. Personnel who work in secure areas should be carefully selected and as much as possible motivated to have positive attitudes about system security.

Good operational controls can go a long way toward minimizing the exposure to internal criminal behaviour. Programming responsibilities should be shared for just the same reason that responsibility for a complete business transaction is generally divided among a number of people in a manual system. As much as possible a computer system should be devoted entirely to the production work of the application and not used simultaneously for developmental work. All programs should be carefully audited when they are accepted for production work and reaudited whenever they are modified. That is, the source program should be carefully checked to see that it does not contain trap doors and the object code should be checked to see that it actually corresponds in a one-to-one way. No patching of object programs should be allowed. Periodic checks that the programs have not been tampered with are also worthwhile. Debugging aids, if they are not taken out of the production systems completely, should, as a minimum, contain logging codes to indicate when they are being used. They should also not be any more powerful than necessary for the task for which they are designed.

Not all of the above procedures need be applied to all parts of the system. It is management responsibility in the area of internal security to discern the threats, assess the risks, and provide the defence mechanism necessary to reduce the potential loss to an acceptable level at a reasonable cost.

D. SECURITY PROLOGUE

The preceding discussions, though primarily of a general nature, have emphasized particular risks or threats which might apply in automation projects in the securities industry. A major question which should then be asked is whether in view of these risks the securities industry should automate its processes. The author believes the answer is yes; that defences to the majority of the security threats can be constructed. Although these defences will not be perfect, they should leave the industry at least as secure as it is today, if they are carried out conscientiously. It appears that

the risks are much greater in the settlement, transfer and depository functions than in the trading process. Thus the security measures required to protect the systems and facilities of the Canadian Depository for Securities will be more stringent than those required for an automated trading system. It can be argued that the probability of many of the security threats that have been mentioned earlier is quite low and the economic costs of defending against them may outweight the potential loss. This argument may be valid. However, such an evaluation must take into account the economic effect of a loss in public confidence in the securities industry if it becomes apparent that its automated systems can be subverted for private gain. The industry has a public trust to carry out, and it is extremely important that it be seen to be taking adequate security measures to ensure that the public interest is being safeguarded. A visible security program continuously monitored by an appropriate management body of the industry would provide such assurance.

Chapter V
Future of Automated Systems in Securities Markets

A. IMPACT OF TECHNOLOGICAL CHANGE

There is probably no other industry in which technical advances in the laboratory are incorporated into the products commercially available in the market place as swiftly as those in the information processing industry. An industry that is barely twenty-five years old has produced four generations of hardware designs and corresponding software systems, each with significant improvement in processing capability. The rapid pace of development can be expected to continue in the next decade. What follows is a discussion of these changes, in terms of new telecommunications techniques, advances in processor and memory technology, and developments in computing networks. It is difficult to assert what impact any particular advance will have on the securities industry other than that of lowering the cost of automation projects.

1. *Communications Systems Technology*

The major advance in communication is the development of digital communications networks based on packet-switching technology and digital transmission techniques. Conventional communication networks transmit information in exactly the same way as telephone conversations are transmitted. A connec-

tion is established over a telephone line between the communicating elements of the network with a carrier signal being transmitted on the line. Information is sent by modulating the tone of the carrier signal to produce a square analog wave pattern which corresponds to the bit representation of the data. At the receiving end the wave form on the carrier signal is analyzed by the receiving system and turned back into a bit pattern.

This process has two disadvantages. First, the normal telephone network is not designed specifically to transmit data rather than voice-signal and the square signal pattern gradually distorts as it is transmitted through the elements of the network so that it occasionally is not "readable" at the receiving end. Signal distortion along with "noise" frequently encountered in analog telephone circuits accounts for the rather "high" error rate (one in one million bits) encountered in current communications systems. Second, the connection is used exclusively for data transmission between two elements in the network resulting in an inefficient use of the data-carrying potential of the communication lines. As a result the communications costs of the network are much higher than necessary.

These disadvantages have been overcome by the introduction of digital transmission networks designed to transmit binary wave forms with little or no distortion and by the introduction of packet-switching networks. In the former, the square wave forms are reconstructed at frequent intervals in the transmission before distortion can cause loss of information. In the latter, small packets of information are shunted about the network, being picked up from the sender and delivered to the receiver without establishing an exclusive private link between the communicating elements. Much more efficient use of the available communication lines is made with packet-switching. Moreover its use forces a disciplined protocol for transmitting information, which facilitates the sharing of data among various computer systems utilizing such a network.

The DATAPAC service offered by Trans-Canada Telephone is the first commercial Canadian use of this technology with a true packet-switching network operational since June 1977. In addition, CNCP Telecommunications introduced INFOSWITCH, which combines digital circuit switching with packet-switching, during 1977. Canada is in the technological forefront in this area and commercial applications of this new telecommunication technology are already under way. Whether nationwide securities systems developed in Canada will use these systems rather than a leased

digital route will depend on an economical and functional evaluation carried out during the design phase.[86]

Data communications systems will also be affected by other technological advances. Major advances in encrypting methodology along with decreasing hardware costs will allow low-cost data encoding to be applied anywhere in a communication system where data security is important.[87] The encrypting technique, which is virtually unbreakable, can be encoded by a simple algorithm in hardware at the transmitting and receiving sites thus reducing, although not eliminating, the risk of unauthorized access to the data. It is rumoured in the trade press that the new computer systems under development by IBM will include encyrpting hardware as a standard feature.[88]

The third technological advance, which is only at the experimental stage, involves a combination of radio transmission and packet-switching techniques to transmit data between a central computer and a large number of terminals in a concentrated area. By using radio transmission, terminals can be easily added or removed from the network with no concern over the availability of telephone lines.[89] This technology might be suitable for the securities industry in major financial districts where there would be large numbers of terminals in a small geographical area.

2. *Computer Systems Technology*

Advancing technology is improving both major components of a computer system, namely, the processing unit and the memory subsystem. The major technological advance in processors is the commercial application of large-scale integration (LSI) technology to the fabrication of electronic circuits. LSI circuits are embedded on extremely small silicon chips and in their most sophisticated form may include all the functions of a small processor or a substantial memory storage capacity. "Processors-on-a-chip" have introduced computer control to many aspects of our everyday life including hand held calculators, automotive ignition systems, traffic light control systems, digital wrist watches, and recreational games.[90] The development cost for any one LSI circuit is

86 McMahon, *A New Philosophy in Data Networks*, 8 CANADIAN DATASYSTEMS, June 1976, at 41-45; *see also* 6 CANADIAN DATASYSTEMS, November 1974, at 48-49; 9 CANADIAN DATASYSTEMS, December 1977, at 32, 39.

87 Feistel, *supra* note 75.

88 IBM has released without royalties a patented encrypting technique that is very cost-effective.

89 Kuo, *The Aloha Broadcast Packet Communications System*, in COMPUTER ARCHITECTURE AND NETWORKS 275 (E. Gelenbe & R. Mahl eds. 1974).

90 *See* 237 SCIENTIFIC AMERICAN, September 1977, No. 3; the entire issue is devoted to

extremely high and it is only by mass-producing a particular design that the cost-effectiveness of the technology can be achieved. As a result, research and development efforts are being concentrated on designing a small number of general purpose circuits which can be used in various combinations to achieve a large number of individual tasks.

The development of LSI technology is having two effects. First, processing costs are going down. For example, the cost of sophisticated processing in the concentrators of a communications system is decreasing with the lowering of minicomputer prices. Second, processing power is being utilized in parts of the system to provide more function at little or no extra cost. For example, there are new "intelligent" terminals on the market which utilize a microprocessor to process and react to user input in a manner that has only been accomplished in the past by sophisticated front-end processors. The rapid decrease in processing costs does not imply that total processing costs will also drop as substantially. Other major cost factors in computer systems are not declining as rapidly.

LSI fabrication techniques are being used to mass-produce semiconductor memories which are faster than core memories formerly used for the main memory of most computer systems. The use of semiconductor memories will improve performance and will reduce costs as production volume increases.

The technology of random-access online disk memories for auxiliary storage of data files is improving steadily with increased data capacity and data transfer rates. A major development in the memory area is the emergence on the market of mass storage devices. IBM's 3850 mass tape storage system which holds up to 472 billion characters of data is one of several ventures in this field. Proposals for mass memories based on lasers, holography and magnetic bubbles are in the experimental stage and it appears that mass memory technology is likely to advance significantly in the next ten years. The advent of economical online mass storage may facilitate the use of general data base techniques for efficient and controlled management of data in computer systems.

Improvements in processors and memories will affect applications of automation in the securities industry primarily in terms of its cost-effectiveness. Since labour costs are rising rapidly in this inflationary period, the attraction of automation as a solution to

microcomputing with articles on the technology and its application. 14 IEEE SPECTRUM, December 1977, No. 12, at 20-25, describes new consumer games based on microelectronics.

the economic difficulties of the industry can only be enhanced by such developments.

3. *Computer Communications Networks*

The trend in computer systems design in the coming decade will be more and more to networks of computers which distribute the processing load among a number of processors. Current star-like systems with sophisticated concentrator processors are the beginning of a trend which will accelerate as the cost of communications decreases and the cost-effectiveness of "small" computer systems improve. There are many possible designs for such networks and a number are being explored in research projects currently under way. The major approaches are hierarchical, ring-like and parallel networks.[91]

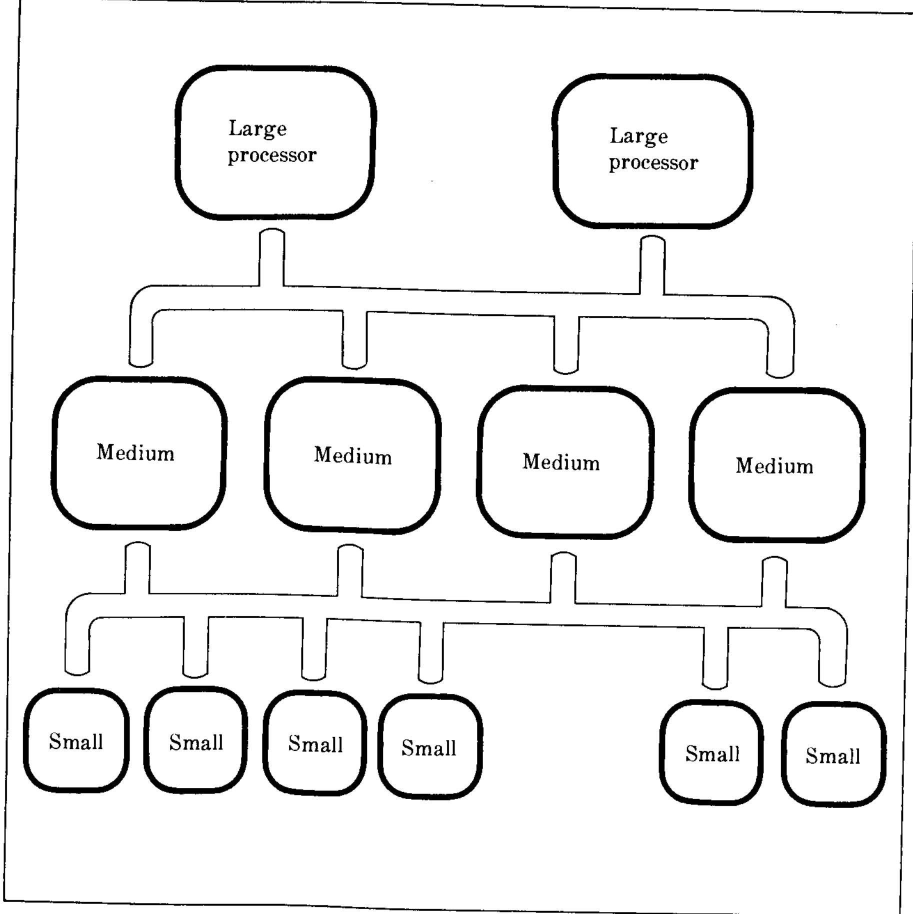
In a hierarchical network, processors of different computational power are combined in levels with the most powerful at the top and the least powerful at the bottom. Figure 4 shows a schematic diagram of a three-level hierarchy in which there are a large number of small processors at the bottom level carrying out simple processing tasks. The bottom level might simply be chip processors embedded in intelligent terminals which would connect to medium-size processors at the middle level. The second level processors would handle more substantial computational tasks, manage the auxiliary data for the small processors and transmit requests to the large processsors. The large processors at the top level would control the total system, manage the data base associated with the system and carry out the major system-wide algorithmic tasks.

The star-like networks described in chapter II.C are basically simple hierarchical networks; however, they have only two levels and very little interconnection between components on the same level. If a hierarchical network is designed so that any of the processors at one level can communicate directly with any of the processors at the next level, an extremely reliable system can be configured. It is expected that the majority of large computer networks will have hierarchial configurations in the next decade.

In a ring-like network there are a large number of small processors connected to a communications ring by ring-elements which transmit messages between the processors in the network. Each processor has its own local memory which contains a nucleus to control its actions relative to messages received and sent. No one processor is in charge of the network and failure of any

91 *See* 21 DATAMATION, February 1975, at 40-56 for series of articles on network designs.

Figure 4
A Hierarchical Network



processor simply removes it from the ring. This architecture has completely distributed control as well as distributed processing power. It can potentially provide extremely reliable computing services at much lower cost than conventional systems which are duplexed for reliability. Figure 5 illustrates a ring-like structure. Ring-like structures are suitable for message switching and other applications where no large data base is associated with the task.

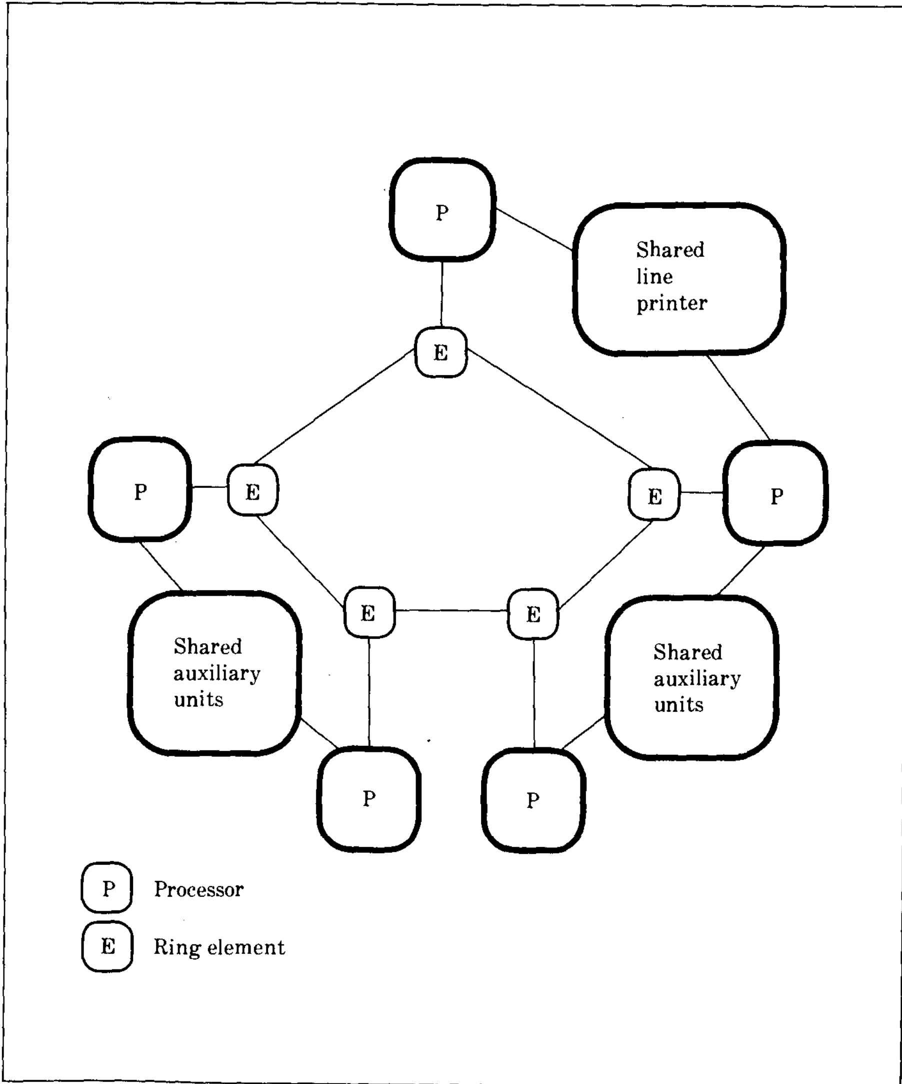
The cross-connected or parallel network approach consists of a set of processors located in close proximity, connected by a special switch to an equal number of memory units. Any processor can be switched to connect to any of the memory units for a particular memory reference. At all times one of the processors must act as the master processor, but the particular processor carrying out that function can change dynamically. Extremely high-speed computations can be achieved with parallel processing. There is little need for such high-speed capabilities in current applications in the securities industry. Moreover, architecture implies that it is suitable only for a local network. Hence it is unlikely that parallel networks will play a role in future developments.

B. INTERNATIONAL HOOKUPS

Futurists foresee a time when all information processing and transfer will be done by computer/communications networks. We will live in a completely wired environment with computerized access to all the information we need for work and pleasure and with automated systems to carry out almost all present-day labour. This technological world will be international in scope. A person sitting at a terminal in his home in Tokyo will be able to buy or sell gold on the bullion market in London. There are, however, many who believe that a totally technologically-oriented society will evolve very slowly – if ever – not only because there are so many important functions involving complex human judgment which will be very difficult to automate, but also because it will make society a less humane environment. For the foreseeable future we will, in my opinion, be faced with limited automation schemes implemented to serve individual segments of an industry or enterprise.

In the securities industry in the United States and Canada, automation projects are developing to provide new functions or cheaper solutions to current problems on a piecemeal basis. There are separate projects under development or already in use in the U.S., each with its own marketing target and tradeoffs in design. For example, Instinet, for fourth market trading; AutEx, for block-interest information, and NASDAQ, for the OTC market. The

Figure 5
A Ring Network



automation of clearing and settlement processes has been implemented at several locations in the United States, independent of the development of computerized trading and with little coordinated planning to achieve a nationwide system.

It is apparent that systems to automate the securities industry in Canada will develop in reaction to the economic forces of the Canadian securities industry and to the stimulus, or lack of it, provided by Canadian regulatory bodies. Moreover, it is apparent that Canadian designs for systems to automate the trading process and the clearance and settlement process, which meet Canadian needs and legal requirements, will likely be different from those adopted in the United States and elsewhere.

Because of the close links between the Canadian and American financial communities there will be some pressure to ensure that these developments do not preclude the orderly processing of international financial transactions, and there may be some desire to forge links in the automated systems to assist in such transactions. There are three potential areas of difficulty in such international hookups: technical, functional and policy.

The technical problem of physically joining the systems so that meaningful interchange of data between the systems can occur is solvable. It is largely a matter of interfacing communication systems and deciding on the conversion that data must undergo as it passes through the interface. If the French and English can connect their telephone systems so that one can direct-distance-dial from London to Paris, it is technically feasible for CATS to interface with Instinet. Connecting the systems, however, does not imply that the differences between the systems will be transparent to the users, only that it is technically feasible to access one of the systems from the other.

Functional differences that arise due to different philosophies in the basic design of the automated system may cause difficulties. For example, if CATS adopts an open book approach to limit orders and a future U.S. trading system works with a closed book approach, then there will be a need to resolve the difference if a hookup is desired. An appropriate solution can likely be negotiated but it will require deliberate policy decisions on what information should be made available in which parts of the combined system. Such policy decisions may be largely shaped by the legal requirements placed on one side or the other in the home jurisdiction.

The major roadblocks to international hookups will likely be legal and economic. It is difficult to envision a complete integration of automation in the securities industry when the systems must operate in different jurisdictions. The difficulty of negotiating a suitable treaty to ensure adequate enforcement of regula-

tions across the jurisdictional boundary is probably far greater than the difficulty of solving all of the technical and functional problems together. Moreover there will be nationalist pressures to ensure that any international arrangements are in the best interests of the Canadian economy and do not jeopardize the capital markets in this country. As a result, it is likely that any international arrangements which do develop will come about as individual solutions to particular problems rather than total interfacing across the border of technically similar systems.

C. AUTOMATED STOCK MARKET MONITORING

The securities industry in Canada and elsewhere is a self-regulating industry, with each industry group or body having regulations which must be obeyed by the membership.[92] Enforcement of a number of the regulations requries detailed information on trading activity in securities markets. With the advent of automation in the industry a great deal more information is and will be centrally organized in a form that can assist in surveillance of the marketplace.

1. *Current Monitoring Projects*

Most of the market information systems described in chapter III.A include a stock watch or market surveillance component. Typically the stock watch monitors the behaviour of trading activity in all the listed stocks, ready to react to a significant price change that might indicate attempts to manipulate the market in a stock. What is meant by a "significant price change" depends on the value of the stock, its normal price pattern, its normal volume of sales, and the market trend. Once a stock has been isolated as having unusual price movements, the audit trail of all transactions can be sifted to produce a display of all trades in it. A surveillance team can then examine the trading record and investigate the possibility of deliberate manipulation. This type of monitoring detects only successful price manipulations and only those which caused a "significant" price change. Therefore it is unwise to publish the parameters of the monitoring process since such knowledge would allow a sharp trader to manipulate the market without fear of prosecution if he keeps the price movements just within the allowable size.

In an exchange market that employs specialists in certain securities there are a number of regulations governing the special-

92 *See*, *Howard*, *Structure and Process.*

ist's affirmative responsibility to maintain an orderly market. The transaction records of a day's trading on an exchange can be analyzed after the close of trading to ensure that the specialist has carried out his responsibilities properly. Specialist performance checking has been done at some exchanges on a spot-check basis and in the United States the SEC has carried out a surveillance program of this nature.

The data to monitor price fluctuations and specialist performance is already captured in the market information systems. Therefore monitoring can be done with little or no addition to the cost of the system. The price fluctuation monitoring mechanism does not need to test the price change on each transmission but instead can periodically check the price movement and volume of trades of each listed stock since the last check. The process can be going on continuously as a lower priority task than the transaction processing. If the market information system has spare capacity to handle wide fluctuations in trading volumes, there is plenty of processor time available to do the checking. Only in times of sustained, extremely high transaction activity is the monitoring function shut out of the processing cycle. Hence, bursts of trading activity during the day are processed as expeditiously as possible without being slowed by the monitoring process.

Automated monitoring is in use in several of the current automation projects. The market information systems at the Toronto Stock Exchange and SIAC's system for the New York exchanges both include a monitoring feature. The NASDAQ system also includes a surveillance function and, in addition, the American exchanges and NASD send transaction data on magnetic tapes to the SEC which has its own surveillance program.

2. *Monitoring in Future Systems*

Current automated monitoring systems for stock markets use data which must be available for the efficient running of the marketplace. There is a limit to the amount of checking that can be done with such data, particularly on attempted manipulation and insider trading,[93] since the principals in a trade are brokers acting as agents for their clients. Without knowledge of the originators of a sequence of transactions in the marketplace, it is difficult to detect manipulative behaviour or insider trading directly. The current practice of having a surveillance group investigate the transaction history of any stocks with "suspicious" price move-

93 *See, Yontef, Insider Trading,* for a discussion of the legislative efforts to prevent insiders from benefiting personally from their knowledge.

ments must be hampered by this lack of information. Moreover the detection of suspicious behaviour is of necessity based on crude measures which may fail to detect many cases of manipulation.

If automated monitoring to detect manipulation behaviour and insider trading is considered essential in a computerized marketplace, more information has to be provided to the system to ensure that it can be done effectively. There is a definite cost involved if the monitoring process becomes more elaborate. The added information will require more time to carry out a transaction both for input and processing, more memory space in the system to store the data, and much more elaborate monitoring algorithms. Will the implementation of a more elaborate monitoring process benefit the public and the industry? If there is, in fact, substantial undetected price manipulation occurring which can be detected by such monitoring, then the public interest will be served. Moreover by increasing public confidence in the fairness of the marketplace by publicizing a strong monitoring program, there may be an increase in public participation which would strengthen the entire industry.

Undoubtedly there will be resistance within the brokerage industry to provide more information for this purpose. Assurance would have to be given that access to the additional information would be limited to those who are involved in surveillance. Arguments against providing the information may well prove futile if automation of trading is extended to include the settlement and transfer of ownership functions in a single system, since all of the information required for the surveillance function would also be required to complete a transaction.

The point to be made is that automated monitoring of stock transactions can be used much more extensively than it is at present, if additional information is provided to the system at the time a trade is consummated. Whether public benefit from doing so outweighs the direct and indirect costs of more elaborate surveillance activity involves a policy judgment beyond the scope of this paper.

One point about the implementation of monitoring should be made. The extent of the monitoring subsystem should be decided during the design phase so that the monitoring information can be organized for efficient access. Attempting to add monitoring to an already existing system may prove difficult if the required information is dispersed across several files.

International Aspects of Securities Legislation

Sholto Hebenton and Byran Gibson

January 1978

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Part I
Extraterritoriality

Chapter I
Introduction

This paper examines two separate topics. The first is the extent to which a federal securities law should attempt to reach beyond the territorial limits of Canada. The second is the problems of investigation and enforcement which arise when a country seeks to apply its laws to persons or transactions outside its boundaries.

The first question is essentially a foreign policy one. We would expect that various government departments will wish to consider this issue carefully before any legislation may be drafted. Our conclusion on this topic is the sort you might expect if you appointed a lawyer to analyze the problem. The traditional lawyer's way of solving a problem is to look at how the problem has been solved by other people in the past, how other people are solving it now, and to follow those precedents. This is exactly what we have done. There are more imaginative and more extreme solutions. We might have advocated unfettered jurisdiction over the discernible universe. We might have urged a retreat into a concept of "Fortress Canada". However, we think our compromise is sound and we shall describe and attempt to justify it below.

The second part of our paper, the discussion of international enforcement, also betrays typical lawyer's thinking. If a lawyer really believes in enforcing something, whether it is a mortgagee's rights or a government's interest in securities transactions, he piles up every possible remedy, existing or imagined, and allows the person having the interest to be enforced to select the remedy or group of remedies which look best when the time comes. This solution lacks grace and neatness but, again, in our opinion, is sound in the circumstances.

There is one important area with which this paper does not deal. That is the question whether a person should be allowed to own or trade in Canadian securities at all if he is not both a Canadian citizen and resident in Canada. Canada already has legislation which in effect denies a non-resident the right to own certain securities by means of constrained share provisions limiting to certain percentages the relative shareholding of a company which a non-resident may own.[1]

Other legislation creates discretionary standards which foreigners must satisfy before they are permitted to acquire certain Canadian securities.[2] Other legislation makes it more expensive to sell securities to a non-resident than to a resident.[3] Rules have also been created restricting the appointment of non-residents and foreigners to the boards of directors of Canadian companies.[4]

We prefer not to involve ourselves in the issue. Like the authors of the proposals for a new business corporations law for Canada,[5] we believe that the issue has no place in a general law such as a securities law. The real difficulty is that notions concerning foreign investment shift markedly from time to time and from region to region.[6] For example, in the Canadian federal election of

1 *For example, see* Bank Act, ss. 53, 54; Investment Companies Act, S.C. 1970-71-72, c. 33, s. 14; Trust Companies Act, R.S.C. 1970, c. T-16, ss. 38, 39. For an excellent summary of Canadian laws affecting foreign investment in Canada, *see* Feltham & Rauenbusch, *Economic Nationalism*, in CANADIAN PERSPECTIVES ON INTERNATIONAL LAW AND ORGANIZATION 885 (R. Macdonald, G. Morris & D. Johnston, eds. 1974). *See also* Ontario Securities Regulations, ss. 6a-6f, limiting the share percentage of registrants which may be owned by non-residents.

2 Investment Companies Act, S.C. 1970-71-72, c. 33, ss. 15; Foreign Investment Review Act, S.C. 1973-74, c. 46. *See* Donaldson & Jackson, *The Foreign Investment Review Act: An Analysis of the Legislation*, 53 CAN. B. REV. 171 (1975).

3 Canada Income Tax Act, s. 190.

4 Bank Act, ss. 18(3), (4); Trust Companies Act, R.S.C. 1970, c. T-16, s. 19, *as amended by* R.S.C. 1970, 1st Supp., c. 47, s. 7; Companies Act, S.B.C. 1973, c. 18, s. 131; Ontario Business Corporations Act, s. 122.

5 Dickerson, Howard & Getz, 1 PROPOSALS FOR A NEW BUSINESS CORPORATIONS LAW FOR CANADA (Ottawa 1971) at 72.

6 Canada is by no means alone in enacting legislation controlling foreign investment. British restrictions are described in Sheldon, *Restrictions on Foreign Investments, United Kingdom*, [1976] INT'L BUS. LAW. 199; and in UNITED STATES

1911, Borden defeated Laurier in a campaign in which he urged: "No truck or trade with the Yankees". This cry is heard again in the 1970s, but in intervening years there were times when the national body politic almost unanimously favoured all obtainable foreign trade and foreign investment. In addition, there are differing regional opinions on the activity of foreigners. Rules which inhibit non-residents from investing in or buying Canadian businesses directly benefit those Canadian investors and businesses which have the financial and managerial resources to be in the investment and acquisition business. Most of those persons and institutions are located in Ontario.[7] It is a public relations coup of a high order that Ontario has succeeded in labelling as "nationalistic" the various measures which promote its investment, manufacturing and publishing industries. Proposals which benefit other regions by, for example, reducing tariffs on manufactured goods or permitting provinces to receive market value for their petroleum products are dismissed as "regional". The Québec government's rejection in 1970 of the Moore Committee proposals for "Canadianization" of the securities industry was one of the few cases when another region has articulated the point that the chief effect of a "nationalist" proposal emanating from Ontario would be to promote existing industry in Ontario by protecting it from foreign competition which might help Canadian customers and industry in other regions.[8]

There is no point in belabouring the issue here. Rules against non-residents will wax and wane.[9] We believe that it is better that the federal rules against foreigners be contained in other legislation, perhaps legislation dealing with the problem industry by industry or region by region. We assume in this paper that the

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TREASURY DEPARTMENT, INTERIM REPORT TO CONGRESS ON FOREIGN PORTFOLIO INVESTMENT IN THE UNITED STATES 70, 73-76, (1975). The restrictions on foreign investment in three European countries are set out in a series of articles; *see* de Marsac, *Restrictions on Foreign Investment - France,* [1976] INT'L BUS. LAW. 51; Haggeney, *Restrictions on Foreign Investment - West Germany, id.* at 59; Briner, *Restrictions on Foreign Investment - Switzerland, id.* at 67.

7 The Ontario Economic Council admits the point that Ontario has benefitted greatly from policies of economic nationalism; ONTARIO ECONOMIC COUNCIL, NATIONAL INDEPENDENCE, ISSUES AND ALTERNATIVES 4, 27 (1976).

8 Restriction of foreign ownership in the securities industry is criticized *id.* at 19; *see also* MOORE COMMITTEE, *Report of the Committee to Study the Requirements and Sources of Capital and the Implications of Non-Resident Capital for the Canadian Securities Industry.* (Trevor Moore, chairman, May 1970).

9 As this paper is being written, some evidence of waning is beginning to appear. *See e.g.* ECONOMIC COUNCIL OF CANADA, LOOKING OUTWARD (1975), a publication consisting in part of a rediscovery of free trade. *See also* ONTARIO ECONOMIC COUNCIL, *supra* note 7, at 18-19. Similarly, Canadian interest in investing in foreign countries will wax and wane. *See* Pritchard, *Small Investors Show Preference for U.S. Stocks,* The Globe and Mail (Toronto), December 11, 1975, at B1.

same securities rules will apply to all persons and it will be our task to investigate ways in which they can be made to apply in cases where some implementation is required outside the country.

A. EXTENT OF FOREIGN INVESTMENT IN CANADIAN SECURITIES

Some passing reference must be made to the extent of non-resident involvement in Canadian securities markets. If there were no non-resident involvement or if that involvement were negligible, it might be sensible to ignore it or specifically to exempt it. Such simple solutions do not commend themselves. Foreign investment in Canada is substantial.[10] This paper is concerned with only a portion of the total amount invested, namely, the amount invested in common and preferred shares and debt obligations of corporations. Even this amount is considerable.[11]

From the point of view of the nation as a whole, the most useful economic function of a securities market is to provide funds for business and government. However, attention is usually focused on a corollary feature: that an initial investor can change his mind and sell his investment to someone else. From the point of view of the individual investor this is probably the most important feature of securities markets. In 1973, companies listed on the Toronto Stock Exchange raised $195,217,927 by issuing shares from their treasuries. The total trading in shares on that exchange that year was $6,737 million. So there was approximately $35 of trading for every $1 of capital raised through the issue of new shares.[12] As of December 31, 1973, the total value of the shares listed on the Canadian securities exchanges, excluding rights and warrants, was probably in the area of $250 billion. The total value of those shares traded in that year was less than 5% of that, namely, $9,402,076,057.[13]

10 Statistics Canada estimated that the book value of foreign capital invested in Canada as at December 31, 1967, was roughly $35 billion; STATISTICS CANADA, FOREIGN INVESTMENT IN CANADA (1971). The amount has increased significantly in the intervening eight years.

11 Government securities will not be specifically considered in this paper though some sections, especially those on crime, will also be relevant to them. Generally speaking the various securities rules dealing with fair and accurate disclosure and representations of the issuer do not apply to governments since governments always reserve the right to keep secrets and (in the case of the Canadian federal government at least) adamantly, and as a matter of constitutional law, assert that they are not bound by their own representations. *See e.g.* Stickel v. M.N.R., 27 D.L.R. (3d) 721 (F.C.T. 1972), *rev'd*, 36 D.L.R. (3d) 153 (F.C.A. 1973), *appeal dismissed*, 47 D.L.R. (3d) 638, [1975] 2 S.C.R. 233 (1974); M.N.R. v. Inland Industries Ltd., 23 D.L.R. (3d) 677, 682 (S.C.C. 1971).

12 TORONTO STOCK EXCHANGE, ANNUAL REVIEW 50, 56 (1973).

13 *Id.* at 56. The $250 billion figure is very rough. The trading volume on the TSE

Total trading with non-residents in 1973 constituted a significant dollar amount and a significant percentage of the amount traded though not of the value of listed shares. Sales of Canadian common and preferred shares to non-residents totalled $1,398,300,000. Purchases of such securities from foreigners amounted to $1,422,000,000. Total foreign activity, therefore, reached $2,820,300,000. (It is misleading to compare this total of $2.8 billion with the trading volume of $6.73 billion unless we double up the latter figure to $13.46 billion so that it includes both sales and purchases.) In the same year, Canadians had substantial dealings in foreign securities with non-residents, buying $1.477 billion from non-residents and selling to non-residents $1.570 billion of foreign securities.[14]

B. INTERNATIONAL FINANCIAL CONTEXT

The foregoing description of the Canadian securities markets must be viewed in the context of a dynamic international situation. Greatly improved transport and communication has created, in recent years, an increasing interaction and interdependence in international financial markets. The trend to increased interdependence has been accelerated by the multinational corporations which operate in more than one country. Large American firms, especially, have found it profitable to operate in several countries at once and to finance their activities by borrowing wherever they can. The desire to borrow abroad began because of American attempts to prevent the outflow of investment dollars and the consequent development of a Euro-dollar market, but it has grown and continued until the treasurers of large corporations have become skilled in evaluating many currencies and money markets.[15] In turn, many European investors and businesses have

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constitutes about two-thirds of the trading volume in Canada ($6,737 million as against $9,402 million; *see id.*). The total value of the securities listed on the TSE in 1973 was $194,764 million; *id.* at 50. If one applies the Toronto-Canada trading ratio of two-thirds, the result is a Canadian listing volume of about $300 billion. Of course the ratio of traded value to listed value may be quite different on other exchanges. And we would expect that there is an enormous duplication in the listing values since so many companies are listed on more than one exchange. Hence we conclude that $250 billion is a better estimate than $300 billion. In either case, the estimate is very rough.

14 Statistics Canada, Security Transactions with Non-Residents (July 1974). Another source of statistics on this matter is Ontario Securities Commission, Report of the Securities Industry Ownership Committee (E. Royce, chairman, 1972).

15 *See* Bodolus, *The Internationalization of the Securities Markets*, 29 Bus. Law. 107 (1974); Cohen, *International Securities Markets: Their Regulation*, 46 St. John's L. Rev. 264 (1971). As an example of the analysis of foreign securities now being

been attracted to the U.S. market because of a sound currency, low interest rates and a volume of trading which ensures liquidity.[16]

Interest in world stock exchanges is growing[17] and bodies such as the Fédération Internationale des Bourses de Valeurs are working on common listing standards, clearing arrangements, exchange memberships and taxes. While few markets rival in size those of New York, and few companies receive large sums from the sale of equities abroad, multinationals have found it beneficial to be better known to local financial communities, especially where they intend to expand into that community or to arrange debt financing there.[18] In a world of rising interest rates, it is the desire for access to new sources of capital which prompts much of this expansion.[19]

C. CANADIAN LEGAL FRAMEWORK

Each Canadian province has a commission, registrar or administrator charged with the administration of the securities laws and with some discretion in the registration of securities and securities traders. The commissions in the provinces with these bodies have wide powers to investigate offences against the securities acts. In addition, there are a number of provisions in the federal Criminal Code which apply to securities transactions.

The rules which have developed in Canada and in other jurisdictions that have attempted to regulate securities fall generally into four classes:

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undertaken by U.S. investors, *see* Shohet, *Investing in Foreign Securities*, 30 FINANCIAL ANALYSTS J. 55 (September-October 1974).

16 Generally on the attempt by U.S. stock exchanges to attract foreign listings *see* Watson, *Global Role for U.S. Stock Exchanges*, [1974] COLUM. J. WORLD BUS. 42 (Spring); on international finance generally *see* H. Areskong, The Liberalization of International Capital Movements: International Financial Consequences (Salomon Brothers Center Working Paper, No. 41, undated).

17 It is not without opposition. *See* the report in Securities Week (New York) May 20, 1974, at 6, on the OECD study; and *see* Loveday, *The Integration of European Securities Markets*, [1974] STOCK EXCHANGE J. (June). *See* also M. Cohen, Report on the Concept of an International Over-the-Counter Market in Securities (December 1975 unpublished paper prepared for OECD) which advocates that a study of such a market be undertaken.

18 *For example, Six Big Board Stocks Go to Tokyo*, THE EXCHANGE (August 1974) (reporting on foreign exchange listings for major American companies); *and see* Garrett, *Is the SEC a Barrier to New York's Role in International Finance?* The Financial Times (London), June 10, 1974. A comprehensive discussion of the Tokyo market is found in Misawa, *Tokyo As an International Capital Market - Its Economic and Legal Aspects*, 8 VAND. J. TRANSNAT'L LAW 1 (1974).

19 It is open to sophisticated investors to profit by the fact that markets in different parts of the world often behave differently. *See e.g.* Bergstrom, *Spreading the Risk*, Barron's (New York), February 24, 1975, at 9; and Shohet, note 15, *supra*, at 183 n. 1.

(1) Registration of the issuing company and the securities being issued, including such specifics as initial and continuing disclosure requirements, rules requiring that an issue of securities be accompanied by a prospectus, or rules requiring approval of the securities for issue.
(2) Registration of persons other than the issuing company, including dealers and investment advisers.
(3) Rules about trading in securities. This is the largest of the categories and contains rules varying from technical rules such as those describing the material which management must send with a proxy to rules which in Canada are found in the Criminal Code and relate to false pretences and manipulation of stock exchange transactions. Included in this list would be rules on insiders, takeover bids, fraud, mail fraud, margin requirements, etc.
(4) The regulation of stock exchanges.

Chapter II
The Effect of International Features on Rules Developed for Canadian Transactions

As this paper is written, we are a long way from having a federal securities law or even a bill describing a federal securities law. However, as we state in chapter I, we assume that the rules set out in any such law should be the same for transactions which are entirely domestic and those which have some international element. Of course the rules might have some exempting or mitigating provisions so that transactions having very little impact on Canada can be exempted, or so that Canadian requirements might be specifically waived where there is an inability to reconcile the rules with a foreign system having a more substantial and significant connection. But if one is going to require that an issuer provide a prospectus with an issue of securities, there is little to recommend a system in which Canadian buyers receive more or less information than foreign buyers of the same securities.

Our paper, then, is concerned with the application of an essentially Canadian system to transactions having foreign elements. It is misleading to use an expression such as "international enforcement" since what we would be doing except in a few cases discussed below is applying Canadian rules. These might be applied in a Canadian jurisdiction or in a foreign one, depending on the sanctions which are incorporated in the Canadian system. At this stage it is important to consider the various situations in which the four basic types of rules described in the previous chapter may apply so that one may see the range of factors which may assume

an international aspect and begin sorting out those which cause problems or justify special Canadian regulation.

Consider the rules about registering the security issuer and the security itself. Their most common application occurs where the issuer is incorporated in Canada, does business in Canada, and sells only to Canadian purchasers. But many variations involving foreign elements are possible. There may be some foreign purchasers as well as Canadian purchasers. There may be no Canadian purchasers but only foreign purchasers of an issue.[20] There may be no Canadian but only foreign purchasers of all the issues of the company. It may be that the latter case is compounded by the further element that the company does not carry on business in Canada though it is incorporated here. The seat of management may also be abroad.[21]

Consider the converse possibility. The company is incorporated abroad, sells all its securities abroad, but carries on business here. Or it carries on no business here but lists its securities on a Canadian stock exchange. Assume that it is not listed here, never specifically sells its securities to the Canadian purchaser, but finds that Canadian purchasers have gone into foreign markets and acquired a few, some, or many of its securities. The problem in each case is to decide when Canada should regulate these situations and to what extent.

The second class of rules deals with the registration of dealers and securities other than those of the issuing company. Should a foreign broker who buys and sells stocks listed on a Canadian securities exchange be subject to Canadian jurisdiction? Should he be subject if he buys and sells outside Canada securities of Canadian companies which are incorporated in Canada but which are listed on a foreign exchange? Would it make a difference if the customers were in Canada? If a foreign investment adviser writes an article about a Canadian company, should he be required to register in Canada? Should it make a difference if he has no Canadian readers? Should it make a difference if none of his readers ever trade in a Canadian security?

Trading rules raise just as many issues. If a person in Canada communicates to a person abroad in violation of a rule relating to fraud, false pretences or manipulation of a stock exchange trans-

20 There have been several recent promotions of Canadian securities in Europe where the company has been inoperative in Canada, of which the Aquablast promotion is the most notable; *see* The Financial Post (Toronto), June 8, 1974, at 1.

21 In this situation the Appeal Division of the New Brunswick Supreme Court decided that the New Brunswick courts had jurisdiction to order the winding up of a federally incorporated company; *see* Re IOS Ltd., 43 D.L.R. (3d) 759 (N.B.C.A. 1973).

action, should that be a case for Canadian concern?[22] What if foreign buyers can succeed in taking over a Canadian company entirely through transactions on a foreign stock exchange? Should they be governed by Canadian takeover bid rules? Should a foreigner who qualifies as an insider comply with the insider trading rules? Should communications between one foreign trader and another, both located abroad, in which Canadian rules on fraud, mail fraud, false pretences, stock exchange manipulation, etc., are infringed, be governed by the rules applying in this country?

The fourth class of rules (relating to stock exchanges) is not considered in this paper. The legal regime governing a stock exchange is the jurisdiction in which it is situated. Consider first a stock exchange located in Canada. There may be rules about how companies incorporated in other jurisdictions deal with the exchange and these rules may differ from those governing how domestic firms deal with the exchange. But the enforcement of those rules against the exchange itself will be a domestic matter. If the transaction involves the infraction of a Canadian rule by a non-resident, that rule will be one of the other three types, perhaps a rule about margin requirements or about disclosing the beneficial owner of a nominee account. Depending on the circumstances, it may be possible to require compliance with the rule by taking action against the Canadian exchange or it may be necessary to chase the non-resident person. But enforcement against the exchange can be achieved without any extraterritorial activity.

What about stock exchanges located in foreign countries? Should a Canadian federal securities law attempt to regulate the London or New York Stock Exchanges? No. Canada may wish to make rules about the way in which Canadian issuers, brokers or investors conduct their affairs on such exchanges but those rules can be within the other three classes of rules. They should not purport to control the business of stock exchanges located in other countries.

Chapter III
Outreach of National Legal Systems Permitted by International Law

The extent of the outreach permitted national legal systems by international law depends to some extent on whether the rules

22 Under Canadian law it is a Canadian concern but under English law a different view is taken; *compare* Re Chapman, 5 C.C.C. (2d) 46 (Ont. C.A. 1970) *with* R. v. Brixton Prison Governor, *ex parte* Rush, [1969] 1 All E.R. 316 (Q.B. 1968).

governing the situation sought to be controlled are criminal or civil. Though the civil and criminal law rules have developed separately, one finds a number of common features. Both systems start from a notion of territoriality and both entertain examples of outreach based on expanded notions of territoriality. For example, a court will assert jurisdiction where not all of the constituent elements take place within the jurisdiction. The court may continue to describe the transaction as wholly domestic when in effect it may be requiring extraterritorial compliance with a domestic rule. When injury or damage is the only feature within the jurisdiction, then the "territorial" justification is more difficult to maintain and both civil and criminal courts assert jurisdiction on an "impact" theory, often coupled with a requirement that the impact be intentional or foreseeable. Notwithstanding these similarities, there are a number of differences between the civil and criminal rules and we shall examine them separately.

A. CRIMINAL LAW

There are five general principles on which penal or criminal jurisdiction is claimed. The first is territorial and determines jurisdiction by reference to the place where an offence is committed. This principle is widely regarded as the basic one and is generally respected by all states. As Marshall, C. J., said in *Schooner Exchange v. McFadden*:[23]

> "The jurisdiction of the nation within its own territory is necessarily exclusive and absolute. It is susceptible of no limitation not imposed by itself."

The territorial principle is neither as certain nor as rigid as it might seem. Where a crime occurs because a person in one state has committed an act which injures a person in another state it is common for the state where the injury occurred to claim that the crime in fact occurred in its territory. Thus, notwithstanding the basic English position that aliens will not be punished for breaches of the criminal laws committed outside England, in *R. v. Godfrey*[24] the court determined that a person who had been in England at all relevant times had committed the crime of obtaining goods in Switzerland by false pretenses through his communications with his partner in Switzerland and ordered his extradition to that country.[25] For the purposes of the territorial principle,

23 11 U.S. (7 Cranch) 116 (1812).

24 [1923] 1 K.B. 24.

25 *See* J. Brierly, The Law of Nations 300-01 (6th ed. 1963). In R. v. Markus, [1974] 3 All E.R. 705 (C.A.) the accused was convicted of inducing a person to take part in an arrangement to defraud even though his acts in England were limited to the processing of an application to take shares that had already been solicited in

courts often assume a constructive presence of the offender at the place where his act caused injury. This assumption of constructive presence is called the objective territoriality principle, although its relationship to territoriality is based upon notional presence.

The second basis of jurisdiction is nationality. Nationality bases jurisdiction on the nationality of the person committing the offence. This principle is also widely recognized although its application may differ substantially from country to country. Examples of an explicit claim based on the nationality principle are the sections of the Criminal Code prohibiting treason and piracy. The treason section states:

> "a Canadian citizen or a person who owes allegiance to Her Majesty in right of Canada,
> "(a) commits treason if, while in or out of Canada, he does anything mentioned in subsection (1); or
> "(b) commits treason if, while in or out of Canada, he does anything mentioned in subsection (2)."[26]

The United States and England have similar provisions.[27]

The third principle, the protective, determines jurisdiction by reference to the nation injured by the offence. This basis of jurisdiction is widely claimed yet is often regarded with a skeptical eye when asserted by someone else. An illustrative American case is *United States v. Pizzarusso.*[28] The defendant, a Canadian citizen charged with knowingly making a false statement under oath on a visa application in the U.S. Consulate in Montréal, was arrested and tried in New York. The court, on the question of jurisdiction, pointed out that a theory of objective territoriality would allow a state to punish acts abroad as if they had occurred in the state if these acts would produce detrimental effects within the state and

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Germany. The court reasoned that no arrangement had been made until the application was approved, and the approval took place in England. In dismissing the appeal the House of Lords took a somewhat broader approach, holding that the activity in London constituted part of the "arrangement" by which the investor was defrauded; Secretary of State for Trade v. Markus, [1975] 1 All E.R. 598 (H.L.). The territorial principle is adopted by the ALI, RESTATEMENT (SECOND) OF FOREIGN RELATIONS LAW OF THE UNITED STATES, s. 17 (1965) [hereinafter cited as RESTATEMENT]. A note discussing extraterritorial application of U.S. securities laws argues that courts should not always assume jurisdiction merely because some conduct takes place within the jurisdiction; *see* note, *American Adjudication of Transnational Securities Fraud*, 89 HARV. L. REV. 553, 568-71 (1976).

26 Criminal Code, s. 46(3) *as amended by* S.C. 1974-75-76, c. 105.

27 18 U.S.C. s. 2381 (1970); and *see* United States v. Chandler 72 F. Supp. 230 (D. Mass. 1947); Kawakita v. United States 343 U.S. 717 (1952). *See also* R. v. Azzopardi, 1 Car. & K. 203, 174 E.R. 776 (Cent. Crim. Ct. 1843) (homicide); Trial of Earl Russell, [1901] A.C. 446 (King in Parl.) (bigamy). Other examples of Canadian assertion of the nationality principle may be found in Zucker, *Extraterritoriality and Canadian Criminal Law*, 17 CRIM. L.Q. 146, 161-65 (1975).

28 388 F.2d 8 (2d Cir. 1968).

U.S. courts would apply such a principle. However, the court went on to say that this principle was distinct from the protective principle because under the latter there need be no claim that the crime occurred within the United States, only that it had a "potentially adverse effect" on government functions.

The principle is sometimes expressed as if it applies only to conduct affecting government operations or national security.[29] Some authors describe it as applying also to the vital economic interests of the state.[30] There is authority for applying the principle to any conduct which is generally recognized as a crime in states which have reasonably developed legal systems.[31] Further, as we shall see in chapters IV and V, there is precedent for applying the protective principle in the securities regulation area.[32]

The fourth principle, universality, determines jurisdiction by reference to the state having custody of the person committing the offence even though custody was acquired long after the offence was committed. Until very recently this principle was regarded as no more than an auxiliary ground for jurisdiction except in the case of pirates, but it has also been used for war criminals.[33] The Geneva Conventions on Protection of War Victims and Prisoners of War require parties to try offenders against them whatever their nationality,[34] and Israel offered universality as one of the bases on which it claimed jurisdiction to try Adolf Eichmann.[35]

The fifth, and final basis of jurisdiction, is passive personality which determines jurisdiction by the nationality of the injured person. This principle is the most widely contested; it is vigorously

29 *See* T. Pickard, Criminal Enactment Jurisdiction: Transnational Problems 115 (unpublished paper for Law Reform Commission of Canada, July 1974).

30 J. Starke, An Introduction to International Law 212 (3d ed. 1954).

31 *See* T. Pickard, *supra* note 28, at 115. *See also* Restatement, *supra* note 25, s. 18; Bassiouni, *Theories of Jurisdiction and Their Application in Extradition Law and Practice*, 5 Cal. W. Int'l L.J. 1, 11-19, 47-50 (1974).

32 A recent example is Bersch v. Drexel Firestone, 519 F.2d 974 (2d Cir. 1975), *cert. denied*, 423 U.S. 1018 (1975). The Court of Appeals, *id.* at 992, in a statement which combines the protective and territorial principles, said: "While merely preparatory activities in the United States are not enough to trigger application of the securities laws for injury to foreigners located abroad, they are sufficient when the injury is to Americans." The protective principle in securities cases is discussed in: note, *supra* note 25, at 556-57, 563-68.

33 Cowles, *Universality of Jurisdiction over War Crimes*, 33 Cal. L. Rev. 177 (1945). *See also* J. Starke, *supra* note 30, at 217 et.seq. The principle is extended to certain offences committed against "internationally protected persons" in legislation recently passed by Parliament; Criminal Law Amendment Act, 1975, S.C. 1974-75-76, c. 93, s. 3.

34 75 U.N.T.S. 135, 236; T.I.A.S. No. 3364 (1950).

35 Attorney-General of Israel v. Eichmann, 36 I.L.R. 5 (Israel, D.C. Jerusalem, 1961).

asserted by some states and just as vigorously denied by others. It has been asserted by Turkey in the *Lotus* case,[36] and by Mexico in the *Cutting* case,[37] but it is unpopular in common law countries.[38] A 1975 article stated that the principle has never been accepted by a Canadian court,[39] but it has now been accepted in Canadian legislation.[40]

The differing bases for asserting criminal jurisdiction over nationals can lead to conflicting claims. If criminal laws were substantially the same, the overlap of jurisdictions could be reduced to a minimum by allowing the state with the most substantial interest in the crime to try the parties. However, as a practical matter, transfer to another state is governed by extradition treaties which are restrictive and cumbersome and which do not necessarily provide for the transfer of persons to the state having the most substantial interest. However, it is clear that very broad claims for extraterritorial jurisdiction are made under the rubric of criminal law and that there is considerable authority in international law to support the exercise of broad jurisdiction.[41]

Treaties are another universally accepted method by which states obtain jurisdiction over criminal acts committed either in another country or in an area having no single territorial sovereign, such as the high seas. Typical examples are the conventions on the suppression of slavery and military agreements, such as those between Canada and the United States, by which the host nation grants criminal law jurisdiction to the visitor with respect to certain criminal acts committed by the latter's armed forces.[42]

36 S.S. Lotus, [1927] P.C.I.J., ser. A, No. 10. The case involved a French officer arrested in Turkey after a collision on the high seas had injured Turkish citizens.

37 For a short summary, *see* W. BISHOP, INTERNATIONAL LAW 459, 465 (2d ed. 1962). The case involved an American citizen arrested in Mexico for the libel of a Mexican committed in an American newspaper.

38 The best summary of the complex international law in this area, viewed from a common law perspective, is the draft convention and comments prepared by Harvard Research in International Law, *Jurisdiction with Respect to Crime*, 29 AM. J. INT'L L. SUPP. 435 (E. Dickinson, Reporter, 1935).

39 Zucker, *supra* note 27, at 168.

40 *See* Criminal Law Amendment Act, 1975, S.C. 1974-75-76, c. 93, s. 3.

41 Criminal judgments may have effects in foreign jurisdictions. *See e.g.* Pye, *The Effect of Foreign Criminal Judgments in the United States*, 32 U. Mo. K.C. L. REV. 114 (1964). A review of the foregoing principles of criminal jurisdiction can be found in Bassiouni, *supra* note 31. The cases cited generally relate to problems of extradition.

42 *See* North Atlantic Treaty Organization Status of Forces Agreement, 4 U.S.T. 1792, T.I.A.S. No. 2846; J. BRIERLY, *supra* note 25, at 270-71. For a discussion of this treaty *see* Mueller, *International Judicial Assistance in Criminal Matters*, in INTERNATIONAL CRIMINAL LAW 410, 427-29 (G. Mueller & E. Wise eds. 1965) [hereinafter cited as G. MUELLER & E. WISE].

B. CIVIL ACTIONS

1. *Defendant Within Jurisdiction*

There are a number of different bases under which jurisdiction is claimed in civil cases. These bases are not as neatly classified as those described above for criminal law. However, some of the same general notions can be identified in the civil law cases. There are, for example, decisions based on the territorial, the impact and the universality principles, but nationality is seldom controlling in civil law situations (at least in the common law jurisdictions).

Under the common law system a court has jurisdiction over a defendant who is personally present and properly served within the jurisdiction. This principle is so firmly entrenched that jurisdiction was sustained in an action brought by one French resident against another when the defendant was served at Ascot, having entered England solely for the purpose of attending the races.[43]

The application of jurisdictional rules in civil cases is more difficult if the defendant is a corporation. For example, the simple question of "presence" creates several problems. Most corporation statutes provide that service may be effected upon a corporation incorporated within the jurisdiction by service on the registered office,[44] and that a corporation which is incorporated elsewhere and carries on business in the jurisdiction must register as an extraprovincial corporation and appoint an attorney to accept service of process in every suit or proceeding by or against it within the province.[45] If a foreign corporation is doing business within the jurisdiction but has not registered as required, it may still be served within the jurisdiction. In determining whether a corporation is doing business within the jurisdiction, the courts have considered, among other factors, the amount of time and attention which has been devoted, and the labour which has been applied within the province.[46]

Though the cases are difficult to reconcile, in many the bene-

43 Maharanee of Baroda v. Wildenstein, [1972] 2 All E.R. 689 (C.A.). *See also* Doyle v. Doyle, 52 D.L.R. (3d) 143 (Nfld. S.C. 1974).

44 *See e.g.* Companies Act, S.B.C. 1973, c. 18, s. 225 (which also permits service of a document on a company by personal service on any director, officer, manager or liquidator of that company).

45 *See e.g. id.* s. 326(1).

46 *See e.g.* Miller v. B.C. Turf Ltd., 8 D.L.R. (3d) 383 (B.C.S.C. 1969). There are also special rules if a company has agents in the jurisdiction; *see* Canada Life Insurance Co. v. C.I.B.C., [1974] 3 O.R. (2d) 70 (Ont. C.A.).

fit of the doubt has been given to the foreigner attempting to deny jurisdiction.[47]

Foreign corporations are also brought before the courts under rules of court which facilitate service on them as an extension of the basic rule which requires "presence". For example, Marginal Rule 55 of the Rules of the Supreme Court of British Columbia permits service of a writ against a foreign corporation by service upon any person who, within the province, transacts or carries on any of the business of or any business for a corporation whose chief place of business is outside British Columbia.

Marginal Rule 64(c) provides for service out of the jurisdiction on any person domiciled or ordinarily resident within the jurisdiction.[48] Both of these rules provide a method of pursuing people who at one time have been within the jurisdiction.

Although the basic requirement in the Rules of Court is personal presence, jurisdiction can also be achieved without it. One example is submission to the jurisdiction of the court. This submission may be manifested in several ways, including appearance in a case or specifically contracting to accept the jurisdiction of a particular court.[49] Submission to a jurisdiction and contracting in favour of a jurisdiction are unknown in criminal law but common in civil law. These principles are useful when a regulatory agency wishes to ensure that it can enforce its orders in courts in its own country.

2. *Defendant Outside Jurisdiction*

There are several types of cases in which civil courts assert jurisdiction even when the defendant is not physically in the jurisdiction, either in fact or notionally.[50] Many of these cases are decided on the same rationale as the claims of territoriality relating to crime. In some, jurisdiction is founded on subject matter in

47 *See e.g.* Re Geigy (Canada) Ltd., 66 W.W.R. 689, 1 D.L.R. (3d) 354 (B.C.S.C. 1968) (foreign manufacturer not carrying on business under Sales Tax Act because contracts made in Montréal); Wat-cha Farms Ltd. v. Charolais Int'l Inc., [1971] 5 W.W.R. 554 (Alta. S.C.) (defendant owned cattle within jurisdiction but they were managed by a local company); Weight Watchers Int'l Inc. v. Weight Watchers of Ontario Ltd., 31 D.L.R. (3d) 645 (Ont. H.C. 1972) (foreign franchiser under licence agreement not doing business in Ontario though some negotiations there).

48 *See also* A. DICEY & J. MORRIS, THE CONFLICT OF LAWS 176 (9th ed. 1973) [hereinafter referred to as A. DICEY].

49 The English cases are discussed *id.* at 167. The leading U.S. case is Bremen v. Zapata Off-Shore Co., 407 U.S. 1 (1972). For Canadian authorities on the validity of contracts to accept jurisdiction, *see* Cowen & Mendes Da Costa, *The Contractual Forum a Comparative Study*, 43 CAN. B. REV. 453 (1965); and *see* E.K. Motors Ltd. v. Volkswagen Canada Ltd., [1973] 1 W.W.R. 466 (Sask. C.A.).

50 *See generally* W. WILLISTON & R. ROLLS, 1 THE LAW OF CIVIL PROCEDURE 323ff. (1970).

the jurisdiction and such cases are really *in rem* claims. For example, under the B.C. Supreme Court Rules it is permissible to serve a person out of the jurisdiction where the whole subject matter of the action is land within the jurisdiction or where the action is to construe, enforce, rectify or set aside any act, contract, deed, will or other obligation affecting land within the jurisdiction.[51] The rules are substantially similar in England and Ontario.[52] In addition, the writ may be served outside the jurisdiction where the action is by a mortgagee or mortgagor in relation to a mortgage of property within the jurisdiction.[53]

Land cases are readily distinguishable from securities cases since companies and securities are not normally thought of as immovable property. A company may be incorporated in state A, have all its officers in state B, all its directors in state C, all of its shareholders in state D and carry on business only in state E. A rule by which, for example, the state of incorporation claims jurisdiction over all transactions in shares between shareholders is plausible; but it is less likely of international recognition than a rule by which the place where land is located claims jurisdiction over trades between owners of that land when the owners are located outside the jurisdiction.

Another territorial type of civil rule, available under the Supreme Court Rules of British Columbia and formerly in Ontario,[54] holds some promise as a guide to expansion of the jurisdiction of the securities laws. Under this rule the court has jurisdiction when a defendant has assets within the province of at least $200 in value. One of the philosophical underpinnings of this rule is the same as that underlying the rules relating to land referred to above, the notion that if an asset is located within a jurisdiction, the courts of that jurisdiction can make orders affecting the ownership and disposition of the asset.

Service upon the foreign defendant under the Ontario rule was upheld in the case of *Gibbons v. Berliner Gramophone Co. Ltd.*[55] The plaintiff sought leave in Ontario to serve his writ in Québec; the contract on which the action was based was founded upon an oral arrangement which was made in Montréal and subsequently confirmed in writing. The defendant company carried on business in Montréal and its assets were substantially all in

51 B.C.S.C.R., Marginal Rules 64(a), 64(b).

52 A. DICEY, *supra* note 48, at 174-75; 1 W. WILLISTON & R. ROLLS, *supra* note 50, at 331-33 (Ont. Rule 25(1)(a)).

53 B.C.S.C.R., Marginal Rule 64(h); A. DICEY, *supra* note 48, at 193; 1 W. WILLISTON & R. ROLLS, *supra* note 50, at 339-40 (Ont. Rule 25(1)(f)).

54 B.C.S.C.R., Marginal Rule 64(j); 1 W. WILLISTON & R. ROLLS, *supra* note 50, at 344-48. The Ontario version of the rule was revoked in 1975; see O.R. 106/75.

55 13 D.L.R. 376 (Ont. C.A. 1913), *rev'g*, 8 D.L.R. 471 (Ont. H.C. 1912).

Québec. It had customers throughout Canada, including Ontario, who were indebted to it. Its contracts with its debtors called for monthly settlement; these revolving debts were the assets in Ontario upon which service was based. In the Appellate Division the court emphasized that the services were performed by the plaintiff in Ontario, that the defendant was also carrying on business in that province and had books and accounts there. Meredith, C.J.O., stated:

> "To read the Rule as (counsel for the defendant) would have us read it, would practically wipe out the provision which was enacted to cover cases where persons living near the border were trading on each side of the line. It was felt a great hardship that, although there were assets in the Province, the creditor had to go to the neighbouring Province and sue there in order to recover his debt."[56]

A case in which jurisdiction was rejected is *Brenner v. American Metal Co.*[57] The facts are not clearly disclosed in the reports, but it appears that the amount sought to be recovered was $91,000, that the contract was made in New York State, that the breach occurred there and that the defendant had assets of approximately $1,000 in Ontario. The main assets of the defendant were in New York. At first instance, Middleton, J., stated that it was "a mere accident that there is some transient property in this country".[58] In the reported judgments there is a clear reluctance to assert jurisdiction based on so small an amount within the jurisdiction. Middleton, J., said:

> "Where our Court assumes to exercise an extraterritorial jurisdiction, and the foreigner has not in any way attorned to our jurisdiction, and the only excuse or justification for the assertion of jurisdiction over him is the existence within the Province of assets which may be reached by execution (Rule 25(h)), manifestly the situation is one of delicacy and one calling for the exercise of the most careful judicial discretion. It is not seemly that a command should issue from our Sovereign to the subject of another State calling upon him to submit himself to the jurisdiction of our Courts, save in the clearest possible cases."[59]

And in the Appeal Court, Meredith, C.J.O., said:

> "The Rule [citation omitted] is an extraordinary one; it is

56 13 D.L.R. at 378.

57 64 D.L.R. 149 (Ont. C.A. 1921), *aff'g*, 57 D.L.R. 743 (Ont. H.C. 1920).

58 57 D.L.R. at 744.

59 *Id.* at 743-44.

> a Rule that does not exist in any other country; and, if my recollection is right, it has been said to be contrary to international practice."[60]

The Divisional Court drew the additional distinction, one which in fact is uncommon in cases of this kind, that the "foreign" jurisdiction involved in the *Gibbons* case was a Canadian jurisdiction whereas in the *Brenner* case the jurisdiction was a foreign one, namely, New York.

The rule on which the *Brenner* and *Gibbons* cases are based suggests that a securities law might adopt the device of requiring persons outside the jurisdiction to leave (forfeitable) deposits within the jurisdiction so that actions can be begun and proceeded with there.[61]

The *Brenner* court's concern that the jurisdictional claim over the foreign corporation was almost accidental would not arise if the jurisdictional claim were based on the foreign person's intentional deposit of funds in this country for the express purpose of providing jurisdiction and an amount from which a judgment or fine might be satisfied, and as a condition precedent to carrying on a securities business. In the half century which has elapsed since *Brenner*, businessmen have become inured to systems by which they must put up security before being allowed to conduct business within a particular jurisdiction.

We have discussed the territorial principle in civil cases. There are in addition a number of specialized rules with respect to particular civil actions. In contract, the British Columbia and Ontario rules are quite narrow and limit jurisdiction to cases where the breach is committed within the province.[62] The English rules are broader, and extend the claim to those cases where the contract by its terms or by implication is governed by English law.[63] The governing law is the law of the legal regime found by the court to be the appropriate or proper one for the transaction being considered. The English courts follow a flexible approach to determining this "proper law" as it is called. In the typical reported case an English court analyzes the facts to determine the proper law and then goes on to apply that law, either English or foreign. Here we are not concerned with that case, but with the

60 64 D.L.R. at 150.

61 Payment of deposits has the disadvantage of being anti-competitive in that it tends to restrict the market to established and large businesses which have less concern to find working capital than many firms just going into business.

62 B.C.S.C.R., Marginal Rule 64(e); O.R.P. 25(1)(e).

63 A. Dicey, *supra* note 48, at 179-83. For a recent example see British Duneston Appliances Ltd. v. Cummins Engine Company Inc., reported in The Globe and Mail (Toronto), November 28, 1975, at 6, col. 7 (Ont. C.A. November 26, 1975).

corollary rule that if the proper law is English, the English court has jurisdiction.

The English approach to the proper law of the contract is especially relevant to securities rules. In criminal cases, courts refuse to apply the criminal law of another state. Consequently the determination of the question of jurisdiction also determines what law is to apply. In civil cases the issues of jurisdiction to try and applicable law may be separated. The English rule reunites the two issues. Such a rule in a Canadian securities law would ensure that Canadian courts can try civil cases involving securities even if the defendants were abroad so long as it is clear that Canadian law is applicable in a substantive though not in a jurisdictional sense.

An illustrative case is *Kleinwort v. Ungarische Baumwolle.*[64] The plaintiff was a London bank which had accepted a bill of exchange drawn by a Hungarian company and guaranteed by a Hungarian bank. Payment was to be made in London. During the period between the acceptance of the bill and the time for payment, Hungarian legislation was passed declaring it illegal for the payment to be made. The English court held that the proper law governing the transaction was English and gave judgment against the two foreign defendants notwithstanding the Hungarian legislation. Though the jurisdiction of the English court was not in issue, the decision that the proper law was English meant that the court asserted its right to give judgment against both foreign defendants.[65] From the point of view of the two Hungar-

64 [1939] 2 K.B. 678, [1939] 3 All E.R. 38 (C.A.).

65 A contrasting case arising from the same type of foreign law is Kahler v. Midland Bank Ltd., [1950] A.C. 24, [1949] 2 All E.R. 621 (H.L. 1949). The plaintiff, a Czechoslovakian national who had been resident in Czechoslovakia, was a customer of a Czechoslovakian bank and he had bought on the London Stock Exchange some shares in a Canadian company. The shares were held on his behalf by the Czechoslovakian bank. However, the actual certificates were held by the Midland Bank in London in an account in the name of the Czechoslovakian bank. After the German occupation of Czechoslovakia the plaintiff, as a condition of obtaining permission to leave Czechoslovakia for the United States, transferred his shares to a new bank in Czechoslovakia. The initial Czechoslovakian bank wrote to the Midland Bank and asked it to transfer the shares to the account of the new bank. At this time the beneficial ownership of the shares became known to the Midland Bank and they were recorded in the plaintiff's name. After the war, the plaintiff sought to obtain his shares from the Midland Bank but the Midland Bank refused to deliver them on the ground that delivery was forbidden by Czechoslovakian exchange control restrictions which had been in effect throughout the period. The courts held that the proper law was Czechoslovakian and that the rights of a person now resident in the United States to obtain share certificates in a Canadian company from a London bank were subject to foreign exchange restrictions in Czechoslovakia. As in the Kleinwort case, jurisdiction was not an issue; however, the decision shows that the English courts were prepared to defer to the Czechoslovakian courts on the disposition of securities held for safekeeping in a London bank.

ian banks the only English features to the transaction were that England was the place of payment.

There are also useful analogies for a securities law to be found in the law of torts. Again the rule is that a writ may be issued for service outside the jurisdiction if a tort has been committed within the jurisdiction.[66] Interesting situations arise when the persons involved in the tort are located in different jurisdictions.

Defamation cases provide a good starting point for discussion of the tort rules. In *Kroch v. Rossell*[67] the English Court of Appeal held that a libel was committed in England by the distribution there of newspapers published in Belgium and France.[68] Similarly, in *Jenner v. Sun Oil Co.*,[69] McRuer, C.J.H.C., held that a defamatory broadcast in New York heard in Ontario constituted a tort committed within Ontario. The *Jenner* case was followed by the Supreme Court of Canada in *CAPAC v. International Good Music Inc.*[70] where the issue was whether a Canadian court in British Columbia had jurisdiction with respect to transmissions from a television station in Washington State.

Another case involving transmission of words was *Original Blouse v. Bruck Mills.*[71] In this case the tort alleged was deceit. The defendant was a Montréal cloth manufacturer which had represented to the plaintiff in Vancouver that it could supply certain material conforming to a sample. The material proved to be unsuitable and the plaintiff sued to recover damages resulting from its inability to meet its commitments to its own customers. Aikins, J., stating an increasingly common view on interjurisdictional transactions, said:

> "I think in these circumstances that the lack of any act literally done by an officer or servant of the defendant in this jurisdiction is immaterial because such officer or servant of the defendant who wrote or spoke on the telephone was putting in motion a chain of events which he knew would result in the representations reaching the plaintiff in Vancouver."[72]

In essence, the judges in the foregoing "words" cases have been applying the impact test when claiming jurisdiction over foreign defendants.

However, the courts have been surprisingly slow to apply the

66 B.C.S.C.R., Marginal Rule 64(ee); A. Dicey, *supra* note 48, at 188-89; 1 W. Williston & R. Rolls, *supra* note 30, at 340 (Ont. Rule 25(1)(g)).

67 [1937] 1 All E.R. 725, 156 L.T. 379 (C.A.).

68 *See also* Bata v. Bata, [1948] W.N. 366, 92 Sol. J. 574 (C.A.).

69 [1952] 2 D.L.R. 526 (Ont. H.C.).

70 [1963] S.C.R. 136.

71 45 W.W.R. (N.S.) 150, 42 D.L.R. (2d) 174 (B.C.S.C. 1963).

72 *Id.* at 158.

impact theory to cases where a product is carelessly manufactured in one jurisdiction and then sold to a person who is injured in another jurisdiction.[73] In a recent decision, *Moran v. Pyle National (Canada) Ltd.*,[74] the Supreme Court of Canada decided in favour of a wider basis of jurisdiction. The plaintiff was an electrician who received an electric shock in Saskatchewan when removing a light bulb manufactured by the defendant. He claimed that the defendant was negligent in the manufacture and construction of the bulb. The defendant did not carry on business in Saskatchewan, and had no assets, salesmen or agents there. All of its manufacturing and assembling took place in Ontario. Dickson, J., reviewed the authorities in considerable detail, including a similar recent case decided by the Privy Council in favour of an injured plaintiff.[75] In concluding that the Saskatchewan courts had jurisdiction, Dickson, J., said:

> "[T]he following rule can be formulated: where a foreign defendant carelessly manufactures a product in a foreign jurisdiction which enters into the normal channels of trade and he knows or ought to know both that as a result of his carelessness a consumer may well be injured and it is reasonably foreseeable that the product would be used or consumed where the plaintiff used or consumed it, then the forum in which the plaintiff suffered damage is entitled to exercise judicial jurisdiction over that foreign defendant. This rule recognizes the important interest a State has in injuries suffered by persons within its territory. It recognizes that the purpose of negligence as a tort is to protect against carelessly inflicted injury and thus the predominating element is damage suffered. By tendering his products in the marketplace directly or through normal distributive channels, a manufacturer ought to assume the burden of defending those products wherever they cause harm as long as the forum into which the manufacturer is taken is one that he reasonably ought to have had in his contemplation when he so tendered his goods."[76]

In short, the conflict of laws cases involving torts support a theory of jurisdiction based on the defendant's knowledge that his act within one jurisdiction will have effects within another. The analogy between these cases and the securities law area is strong,

73 A. Dicey, *supra* note 48, at 188-89; Hebenton, *Jurisdiction: The Place Where a Tort Is Committed*, 2 U.B.C. L. Rev. 361, 364-75 (1966).

74 43 D.L.R. (3d) 239 (S.C.C. 1973); noted in Hurlburt, note, 52 Can. B. Rev. 470 (1974).

75 Distillers Co. (Bio-Chemicals) Ltd. v. Thompson, [1971] 1 All E.R. 694 (P.C.).

76 43 D.L.R. (3d) 239, 250-51 (S.C.C. 1973).

particularly with respect to rules governing filings, disclosure, insider reporting and the like, where an erroneous statement made in one jurisdiction foreseeably will have an adverse economic effect in another.

Another way in which courts of one state obtain jurisdiction over persons resident in another is through treaties specifically negotiated for that purpose between the respective governments. Such treaties are beginning to appear in certain specialized areas such as transportation,[77] although they remain less common in civil areas than in criminal.

C. ECONOMIC REGULATION

Before discussing the present use of domestic securities laws to control activities outside the country, we shall consider other laws relating to economics and finance which are extraterritorially enforced. When regulating economic activity the territorial principle is most often asserted as the basis of jurisdiction. However, one interesting phenomenon of recent years has been the proliferation of prosecutions by nations under their own laws where the only claim of jurisdiction is that the proscribed acts have effects within the state. The use of the "impact" justification has been especially marked in the area of regulation of commerce, perhaps because of the growing interdependence of national economies.

States are less willing to accept their neighbours' use of the impact or objective territoriality principle to assert jurisdiction in the economic area as opposed to the criminal.[78] There is some justification for this resentment of the impact theory to justify control of the economic activity of persons abroad. In the economic area national interests are much more diverse and there is less likelihood of general agreement than there is on the question of prohibition of conduct leading to injury of persons or property.

The most frequently discussed problem in the extraterritorial application of economic laws is the American antitrust legislation.[79] It is unfortunate that antitrust regulation has been taken

77 *See* A. DICEY, *supra* note 48, at 171-72.

78 A good example is the nylon litigation in which an English court enjoined an English company (which had been a party to U.S. antitrust proceedings) from complying with an American judgment where such compliance would have affected the rights of another British company which was not a party to the American litigation. *See* United States v. Imperial Chemical Industries (I.C.I.), 100 F. Supp. 504 (S.D.N.Y. 1951); United States v. I.C.I., 105 F. Supp. 215 (S.D.N.Y. 1952); British Nylon Spinners v. I.C.I., [1953] ch. 19, [1952] 2 All E.R. 780 (C.A. 1952); and British Nylon Spinners v. I.C.I., [1955] ch. 37, [1954] 3 All E.R. 88.

79 The basic statutes are the Sherman Act, 26 Stat. 209 (1890) *as amended*, 15 U.S.C. ss.

to epitomize extraterritorial economic regulation because monopolies are given very different legal treatment in different countries. The U.S. position is set out by Learned Hand, J., in the *Alcoa* case, as follows:

> "We should not impute to Congress an intent to punish all whom its courts can catch, for conduct which has no consequences within the United States....On the other hand, it is settled law...that any state may impose liabilities, even upon persons not within its allegiance, for conduct outside its borders which the state reprehends...."[80]

The American cases have focused on the question of effect on that country, and have either ignored or considered very briefly how far such laws should be extended or at what point the interest of the United States in the conduct complained of is less than that of other states.[81] If the judges were applying a criminal law that was basically the same in each state this might be sufficient. Unfortunately, they were attempting to enforce a law unique to the United States[82] against persons, many of whom were operating as they were allowed, and sometimes encouraged to do, abroad.[83]

One approach a court may take when faced with the problem of the application of a local law to foreign nationals is to consider whether there is a mandate from the local legislature to apply the law outside the jurisdiction and the probable efficacy of such an application. For example, in *Airline Stewards & Stewardesses Association, International v. TWA*,[84] the union certified for the stew-

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1, 2 (1964); the Clayton Act, 38 Stat. 730 (1914) *as amended*, 15 U.S.C. ss. 12-27 (1964); and s. 5 of the Federal Trade Commission Act, 38 Stat. 717 (1914) *as amended*, 15 U.S.C. s. 45. The basic cases are American Banana Co. v. United Fruit Co., 213 U.S. 347 (1909); United States v. Aluminum Co. of America, 148 F.2d 416 (2d Cir. 1945); and for a selection of comments *see* P. AREEDA, ANTITRUST ANALYSIS (1967); INT'L LAW ASSOC., REPORT ON 51ST CONFERENCE 304-592 (1965); K. BREWSTER, ANTITRUST AND AMERICAN BUSINESS ABROAD (1958).

80 United States v. Aluminum Co. of America, 148 F.2d 416, 443 (2d Cir. 1945).

81 An excellent discussion of this problem is contained in Trautman, *The Role of Conflicts Thinking in Defining the International Reach of American Regulatory Legislation*, 22 OHIO ST. L.J. 586 (1961), although the suggested reform is limited to a dominant interest approach. On European antitrust *see* Jacquemin, *Application to Foreign Firms of European Rules on Competition*, 19 ANTITRUST BULL. 157 (1974); and INT'L BAR ASSOC., 1974 CONFERENCE REPORT ON EXTRATERRITORIAL APPLICATION OF NATIONAL LAWS WITH SPECIAL REFERENCE TO ANTITRUST LAW (1974).

82 In degree if not always in form. *But see* the discussion of this problem from the point of view of discovery of documents in Smith, *Discovery of Documents Located Abroad in U.S. Antitrust Litigation*, 14 VA. J. OF INT'L L. 747 (1974).

83 One particularly startling example of the insensitivity of some Americans to the antitrust laws is the proposal to charge OPEC under them; *see* The Wall Street Journal, May 20, 1975, at 22, col. 4.

84 173 F. Supp. 369 (S.D.N.Y. 1959), *aff'd*, 273 F.2d 69 (2d Cir. 1959), *cert. denied*, 362 U.S. 988 (1960).

ards of Trans World Airlines sought to compel TWA to recognize it as agent for fifty stewards who were foreign nationals, based abroad and serving flights wholly outside the United States. The court dismissed the application, enumerating sixteen criteria to be considered when the extraterritorial application of federal law was in question. Its review of these criteria led the court to its identification of the dominant interest in the activities to be controlled and to its conclusion that the United States did not have the dominant interest. The *Airline Stewards* case is an extension of the leading case of *Lauritzen v. Larsen,* in which the court held that the Jones Act (seamen's welfare legislation) would not be applied for the benefit of a seaman when another country had a greater interest in controlling the liabilities that arose from his injury.[85]

Another potentially important case is *Securities and Exchange Commission (SEC) v. Myers,*[86] a case in which the district court granted a SEC petition to enjoin a Canadian investment dealer from soliciting American clients without registration under the Investment Advisers Act. The court recognized that the defendant intended to disregard the order, but it pointed out that the Alberta Securities Commission had aided the SEC in the past and there was reason to expect further cooperation in the interests of reciprocity.[87] The *Myers* case is interesting, and, it is hoped, prophetic, because it goes one step beyond the dominant-interest analysis of *Lauritzen v. Larsen* and the *Airline Stewards* case. Can conflicts between jurisdictions really be settled satisfactorily by identification of the jurisdiction with the dominant interest? If a state identifies itself as having the dominant interest should it apply its rules without further consideration? While a dominant interest analysis is only now being recognized as a consideration in tort and economic regulation, it has not the magic properties sometimes ascribed to it. There remains the problem of making the rules to be applied tolerable if not fair to all the states concerned.

It is difficult to identify the interests and policies of all the jurisdictions involved, and even when they are identified the analysis gives no method by which they may be resolved. Even if,

85 345 U.S. 571 (1953); *see also* Reynolds, *Extraterritorial Application of Federal Antitrust Law: Delimiting the Substantive Law under the Sherman Act,* 20 VAND. L. REV. 1030 (1967); note, *Extraterritorial Application of the Antitrust Laws: A Conflict of Laws Approach,* 70 YALE L. J. 259 (1960); Steele v. Bulova Watch Co., 344 U.S. 280 (1952) (application of Lanham Trademark Act proper in view of fact that Mexico has expunged trademark and extraterritorial application would not interfere with its sovereignty).

86 285 F. Supp. 743 (D. Md. 1968).

87 Other interesting examples of accommodations to foreign interests are set out in Kinter & Hallgarten, *Application of United States Antitrust Laws to Foreign Trade*

for instance, the United States finds it does not have a dominant interest in some transaction, can it not still decide to regulate it? Myres McDougal commented on the *Alcoa* case (American and Canadian companies controlling sale of aluminum) and the *Swiss Watch-makers* case (a government-promoted watchmakers' cartel in Switzerland) by saying:

> "When Switzerland or Canada or any other country employs its governmental processes to protect business entrepreneurs in activities which impair the healthy functioning of community processes within the United States, it is interfering with the internal domestic affairs of the United States fully as much as the United States may be interfering with the internal affairs of such other country in applying its antitrust laws to the injury causing activities. Agreements made by private entrepreneurs in Switzerland and Canada, and ostensibly protected by the laws of those countries, may affect or determine the prices which I must pay within the United States for aluminum and watches. In an interdependent world interference by States in each other's community processes, including economic affairs, is inescapable. The question is by what principles and procedures such interference can be moderated and made reciprocally tolerable in the maintenance and expansion of an international economy."[88]

The problem is not which interest is dominant but how the impact of one state on another is to be made reciprocally tolerable. We can offer little assistance.[89] We only point to the problem and recommend that the rules be drawn with it in mind.

D. CONCLUSION

There are a number of bases of jurisdiction upon which Canada may extend the ambit of its securities laws. Criminal jurisdiction may be based on the territorial, nationality or impact princi-

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and Commerce - Variations on American Banana since 1909, 15 B.C. IND. & COMM. L. REV. 343, 360-67 (1973).

88 INT'L LAW ASSOC., *supra* note 79, at 331.

89 One of the most sensitive discussions of the international regulation of securities is Jones, *An Interest Analysis Approach to Extraterritorial Application of Rule 10b-5,* 52 TEX. L. REV. 983 (1974). This article attempts to analyze all the 10b-5 cases discussed in the next chapter in terms of conflicts of laws principles and dominant interest analysis. The problem of reconciling American principles of competition with other people's notions of state enterprises is arising again, as this paper is written, in relation to the role of the Saskatchewan government in the marketing of potash.

ples. We do not recommend resort to the passive personality or universality principles. Using the three bases we recommend, a system of criminal securities law rules can regulate persons in Canada, Canadians wherever located and persons producing detrimental effects in Canada.

In the civil law area there are similar precedents, notably rules based on territorial and impact justification. More particularly, there are rules which allow an action to be brought if there are assets within the jurisdiction or where the proper law of the transaction is that of the jurisdiction. The civil jurisdiction may be accepted or submitted to by contract. Both the civil and criminal law areas can be expanded by treaty.

However, as our section on economic regulation indicates, the extension into other jurisdictions of rules affecting their commerce and economics can create great difficulties. We recommended that economic regulation affecting conduct in other countries should be circumspect and based on sound, practical justification.

Chapter IV
Extraterritorial Application of Securities Laws - The Example of Other Jurisdictions

A. UNITED STATES FEDERAL SECURITIES LAW

From the time of the New Deal the United States has striven to maintain a securities market in which large numbers of investors, even those with a small amount of money, may participate with some degree of protection. Both to protect the small shareholder and to give him confidence that the value of his share is not being manipulated, the SEC has set up a system of relatively complete disclosure of corporate information. While the federal law in the United States has not gone as far as those state laws which empower a commission to decide which securities will or will not be sold, it does create a very comprehensive scheme of initial and continuing disclosure for issuers of stock.

The American securities laws are the most highly developed in any free enterprise country and at the same time the most restrictive of corporate activity. It seems to be a characteristic of highly developed national schemes of regulating any activity, whether it be antitrust, tax collection or labour legislation, that the administrators try to reach out beyond their own borders. This outreach is certainly characteristic of American securities regulation. We can learn about the difficulties the Americans have encountered, and perhaps what we will need to regulate, from

looking at some segments of the American securities laws and their application abroad.[90]

1. *United States and the Foreign Issuer*

a. *Which Foreign Issuers Are Subject to U.S. Rules?*

Prior to 1964, the U.S. federal securities legislation applied to a foreign issuer only if the issuer either made a distribution of securities to the American public or listed a class of its securities on a national stock exchange in the United States.[91] In what was essentially a reform of domestic law governing over-the-counter markets, Congress in 1964 passed amendments to the Securities Exchange Act of 1934 (the "Exchange Act") enacting a new section 12(g) which extended the application of that act to the securities of an issuer engaged in a business affecting interstate commerce (which includes foreign commerce) with more than $1 million in assets and a class of equity securities owned by at least 500 shareholders.[92] Recognizing that the expansion of the regulatory net could result in unfairness, Congress in section 12(g)(3) authorized the SEC to exempt the securities of a foreign issuer if the commission found that an exemption was in the public interest and was consistent with the protection of investors.[93] After protracted negotiations including, at one point, diplomatic protests from Canada, the SEC promulgated Rule 12g3-2 to reduce the number of foreign issuers whose securities had to be registered. The rule exempts foreign securities if there are fewer than 300 American shareholders and exempts the foreign issuer from registration under section 12(g) pursuant to 12g3-2(b) if the foreign issuer registers its securities under a less onerous regime created by the rule. To qualify for a 12g3-2(b) exemption, a foreign

90 A short summary of the Canadian-U.S. relationship from the American point of view is Loss, *International Securities*, in NATIONALISM AND THE MULTINATIONAL ENTERPRISE 257 (H. Hahlo, J. Smith & R. Wright eds. 1973). A short summary of U.S. federal securities law from the point of view of a Canadian corporation wishing to issue shares in that country is Sobie, *The Canadian Corporation and Wall Street: Application of the United States Securities Laws to Canadian Issuers*, 6 WESTERN ONT. L. REV. 93 (1967). A longer and more detailed summary of American law (including state laws) is contained in J. WILLIAMSON, c. XII. The application of American law to Canadian companies issuing in the United States is also discussed in J. WILLIAMSON, SUPP. at 312-37.

91 Hovdesven, *Applicability of the Registration and Reporting Requirements of the Securities Exchange Act to Foreign Issuers*, PLI, SIXTH ANNUAL INSTITUTE ON SECURITIES REGULATION 353, 354 (R. Mundheim, A. Fleischer Jr., J. Schupper, J. Jewett & J. Thomson eds. 1975).

92 Securities Exchange Act of 1934, as amended by Securities Exchange Act of 1934 Amendment of 1964, Pub. L. No. 88-647, 78 Stat. 565 (1964). *See* Hovdesven, *supra* note 91, at 354-55.

93 *Id.* at 355.

issuer must furnish to the SEC the information that it makes public under its domestic law, files with a securities exchange or distributes to its shareholders. The information need not be in English though if an English translation has been made, it must be supplied instead of the foreign version.[94]

The commission publishes a list of foreign issuers which have submitted material pursuant to 12g3-2(b)[95] to bring to the attention of brokers, dealers and investors that some current information concerning the issuers is available in the public files of the commission. As of July 31, 1976, 152 foreign issuers have qualified under Rule 12g3-2(b).[96]

The commission has not aggressively pursued foreign issuers which have not applied for the exemption but it does maintain a list of foreign issuers which are offering or selling securities to American investors without complying with the registration provisions of the Securities Act.[97] The list, referred to as the Foreign Restricted List, is intended to alert brokers, dealers and others to the fact that the issuer has not complied with the registration provisions and is an indirect means of controlling foreign issuers, since American brokers and dealers generally will refuse to participate in a transaction involving an issuer on the list[98] in order to avoid involvement in an unlawful distribution. Control by listing on a list of offenders has been judicially approved; in *Kukatush Mining Corp. v. SEC*,[99] the Circuit Court dismissed a Canadian company's action for a declaratory judgment that the inclusion of its name in the list was invalid. The court held, *inter alia*, that the list was not a blacklist and did not state or imply that the Canadian company was involved in any illegal act. Rather, it was simply a warning to brokers and dealers to make sure that *their* transactions were not illegal.[100] Moreover, the Post Office Department has, on occasion at the SEC's suggestion, issued "foreign fraud orders" barring the use of the mails to companies on the list.[101] As L. Loss points out, this request is "presumably on the theory of an

94 *Id.* at 357-58.
95 *Id.* at 359.
96 369 BNA SEC. REG. & L. REP., May 5, 1976, at A-16. The names are set out in SEC, Securities Exchange Act of 1934 Release No. 12762, September 2, 1976; *see* 10 SEC Docket 358.
97 1 L. Loss at 706-07.
98 4 L. Loss at 2676 citing 31 SEC 138 (1965). The SEC has issued a release to this effect; SEC, Securities Exchange Act of 1934 Release No. 8066, April 28, 1967, [1966-1967 Transfer Binder] CCH FED. SEC. L. REP. ¶77,443.
99 198 F. Supp. 508 (D.D.C. 1961), *aff'd*, 309 F.2d 647 (D.C. Cir. 1962).
100 309 F.2d at 650.
101 4 L. Loss at 2676.

implied misrepresention of marketability though this is by no means automatic for securities on the restricted list".[102]

b. *The Rules Applicable to Different Classes of Foreign Issuer*

The American system has developed piecemeal and is rather complicated. The type of registration and disclosure depends on the nature of the foreign issuer's activity in the United States and on its place of origin. The Americans have concluded that more can be demanded of Canadians than most other issuers in view of the similarities in corporation law and accounting practice in the two countries. Technically, Canada is not singled out; the different category is "North American and Cuban". Because virtually all the issuers in this category are Canadian,[103] this paper refers to it as "Canadian".

Public offerings in the United States by foreign issuers are governed by the Securities Act of 1933.[104] The registration form and the requirements including those relating to financial statements are the same for a foreign as for a domestic issuer.[105] Concessions with respect to prospectus requirements have been made in such areas as disclosure of management compensation, financial reporting and independent audits.[106] But even though some leeway is granted to the foreign issuer, substantial compliance with the U.S. domestic disclosure standards is generally required of foreign issuers who offer their securities to the American public.[107]

Greater deviation from domestic norms is accorded foreign issuers who list their securities on an American stock exchange without an offering to the American public. A Canadian company which lists on a U.S. exchange must register with the SEC and thereby becomes subject to the reporting requirements of section 13, the proxy requirements of section 14 and the insider trading provisions of section 16 of the 1934 act. The reporting requirements are substantially the same for a Canadian as for an American issuer.[108] A non-Canadian issuer, on the other hand, registers on a significantly less burdensome form and is exempt from the

102 *Id.*
103 Hovdesven, *supra* note 91, at 354, n. 2.
104 *See generally* Bator, *Offerings of Foreign Securities in the United States*, in PLI, *supra* note 91, at 309.
105 *Id.* at 316-17.
106 Gerard & Lerman, *Foreign Securities Trading*, 7 Rev. Sec. Reg. 871, 872 (September 23, 1974).
107 Bator, *supra* note 104, at 325.
108 Hovdesven, *supra* note 91, at 362-63.

proxy and insider trading provisions.[109] The registration form does not require the extensive and detailed disclosures required of domestic and Canadian issuers. For example, it does not require line of business, product line, backlog, research and development, environmental and customer identification disclosures. And it requires less disclosure of controlling shareholders, management remuneration and transactions with management.[110] Furthermore, such companies are not required to file the same annual report form, quarterly statement form or the form for monthly reports of material events. Instead, they file an abbreviated annual report form and furnish to the SEC on another form whatever they report to their home government, any stock exchange, or make public to their security holders.[111] However, in practice the more favourable legislative treatment for non-Canadian firms is offset by the rules of the exchanges which require foreign companies to provide substantially the same information as is provided by American companies.[112]

Above we have considered American treatment of companies making public offerings (essentially the same as domestic treatment) and American treatment of companies listing on American exchanges (essentially the same for Canadian companies but significantly relaxed for non-Canadian companies). It remains to consider the third category, the company affecting interstate commerce, having assets in excess of $1 million and more than 300 American shareholders which must register under the regime created by Rule 12g3-2(b). Such issuers are exempt from the proxy solicitation, insider trading and reporting rules but they must provide the information they make public pursuant to the law of their place of domicile or organization, file with foreign exchanges or distribute to their security holders.[113]

109 *Id.* at 364.

110 *See* Stephens, *Foreign Issuer Disclosures*, 9 REV. SEC. REG. 893 (July 27, 1976); and Hovdesven, *supra* note 91, 364, 368. *See also* H. STEINER & D. VAGTS, TRANSNATIONAL LEGAL PROBLEMS 967-73 (1968); Buxbaum, *Securities Regulation and the Foreign Issuer Exemption: A Study in the Process of Accommodating Foreign Interests*, 54 CORNELL L. REV. 358 (1969); Phillips & Shipman, *Analysis of the Securities Acts Amendments of 1964*, [1964] DUKE L.J. 706; Goldman and Magrino, *Foreign Issuers and Section 12(g) of the Securities Exchange Act of 1934*, 23 BUS. LAW. 135 (1967); Stevenson, *The S.E.C. and International Law*, 63 AM. J. INT'L L. 278 (1969).

111 *See* Gerard & Lerman, *supra* note 106, at 872; Stephens, *supra* note 110, at 893; Hovdesven, *supra* note 91, at 364, 369.

112 *See* Stephens, *supra* note 110, at 873; Hovdesven, *supra* note 91, at 364-65.

113 *See* Gerard & Lerman, *supra* note 106, at 872.

2. *The United States and Foreign Brokers*

a. *Which Foreign Brokers are Subject to U.S. Rules?*

The American position on foreign brokers has become clouded by the amendments resulting from the Securities Reform Act of 1975 which are intended to increase SEC control over domestic brokers. Section 15(a)(1) of the Exchange Act as amended makes it unlawful for any broker or dealer to make use of the mails or any means or instrumentality of interstate commerce to effect a transaction in, or to induce or attempt to induce the purchase or sale of any security (subject to certain exceptions) unless the broker or dealer is registered in accordance with the act. Section 15(a)(2) authorizes the SEC to exempt individuals or classes conditionally or unconditionally from the registration requirement as it deems consistent with the public interest and the protection of investors. (Prior to 1975 the legislation contained a further exemption for transactions which took place through an American stock exchange which, as a practical matter, must have applied to most foreign transactions.)

The reference in section 15(a)(1) to use of the mails and interstate commerce suggests that the jurisdictional standard under the section is one of conduct within the United States. However, when those expressions are coupled with other terms of the section, namely, those dealing with the purchase and sale of a security, it is clear that the jurisdictional standard is impact. In a pre-1975 ruling, the SEC concluded that activities such as selling securities into the United States or purchasing securities in the U.S. for sale to American investors abroad required a foreign broker to register under the Exchange Act.[114]

There is also an exemption for a foreign broker-dealer who participates as an underwriter in a distribution of U.S. securities being made abroad or abroad and in the United States. The exemption applies only if the foreign broker limits its activity to taking down securities which it sells outside the United States to persons other than American nationals and participates solely through its membership in the underwriting syndicate in activities of the syndicate in the U.S. such as sales to the selling group members, stabilizing, over-allotment and group sales, which activities are carried out for the syndicate by a managing underwriter who is registered with the SEC.[115] This exemption fits within the

114 SEC, Securities Exchange Act of 1933 Release No. 4708, July 9, 1964, 17 C.F.R. s. 231.4708 (1964); 1 CCH Fed. Sec. L. Rep. ¶1363.

115 *Id.*

SEC's general philosophy that the U.S. federal securities legislation exists to protect American investors.

Section 15(a)(1) requires registration by a Canadian broker who places an order with an American broker to acquire shares on an American exchange, even if the customer is a Canadian. The statutory language is anomalous in that it places a foreign broker in violation of the law for doing what a foreign investor could do with impunity, namely phone an American broker to place an order. Writing prior to the 1975 amendments, Professor L. Loss stated that, "the commission has never taken exception to the common practice of American firms effecting transactions in the United States for *customers* who are unregistered Canadian broker-dealers".[116] It remains to be seen whether the commission's attitude will change now that the stock exchange exemption has been removed.

The firms involved have developed a procedure to conform to the SEC's approach. Generally the American broker attending to the purchase or sale does not split the commission with the Canadian broker. Instead of splitting that commission, the American broker often remunerates the Canadian by a "contra" of some sort, perhaps reciprocating through a transaction on a Canadian exchange or perhaps providing some research or other service. Practicality suggests that the SEC may tolerate the *status quo* and attempt to bring about its regulatory goals in such situations through its control over the domestic U.S. broker and not through pursuit of foreign brokers. Of course, if the foreign broker establishes an office in the United States with a view to carrying on a brokerage business there, it must comply with the American domestic system.

b. *The Rules Applicable to Foreign Brokers*

A non-resident broker or dealer applying for registration with the commission must furnish a written irrevocable consent and power of attorney designating the SEC as agent on whom civil process can be served[117] and must satisfy the commission's record-keeping requirements either by keeping copies of its records in the United States or by filing an irrevocable undertaking to furnish copies when demanded by the SEC.[118]

The registration requirements under the American system are undergoing some revision in view of the changes made by the Securities Amendment Act of 1975 which expanded the authority

116 5 L. Loss, at 3356.
117 J. Williamson at 344-45.
118 J. Williamson at 346.

of the SEC with respect to the control of brokers. For example, the commission in section 17(f)(1) of the Exchange Act is authorized to require brokers and dealers to request information about missing, lost, counterfeit or stolen securities. The commission is engaged in a study in this area, the result of which will eventually be incorporated in specific rules.

Other features of the control of brokers established by U.S. legislation are the registration procedure itself, a provision for a six-month inspection of a newly registered broker, competency requirements for employees, rules about disclosure of financial statements to the commission and to customers, rules about capital requirements and hypothecation of customer securities.[119]

The legislation does not contain all the rules governing the conduct of brokers in the United States. Other rules are established by the various stock exchanges and the National Association of Securities Dealers.[120] When this paper was being written there was considerable controversy over the proposal by the New York Stock Exchange to alter its membership rules to permit membership by foreign brokers only where in the reverse situation an American firm would be entitled to become a member of the foreign exchange. In its release dated August 25, 1976, the SEC disapproved the proposed NYSE rule conditioning foreign membership on such reciprocity. The release in effect instructed the NYSE to repeal from its constitution other rules limiting the membership rights of non-citizens. The SEC decision was founded upon a U.S. national policy, articulated by the Treasury Department in representations to the commission, supporting the elimination of burdens on international competition. We comment no further on this issue since, as we have stated above, we believe that a federal securities act is not the place to enact rules of economic nationalism. In our view, these rules should be contained in separate legislation which can be adjusted in response to changing pressures for and against providing Canadians with the benefits and burdens of international competition.

3. *U.S. Treatment of Trading Rules: Rule 10b-5 – the Anti-Fraud Section*

The position of the United States on the extent to which its trading rules should apply extraterritorially has been developed in

119 *See generally* ss. 15 and 17 of the Securities Exchange Act of 1934; Rowen, *Securities Act Amendments of 1975*, 8 REV. SEC. REG. 889-90 (June 27, 1975). For the pre-1975 law *see* J. WILLIAMSON at 343-47; J. WILLIAMSON, SUPP. at 330-33.

120 *See e.g.* Pergam, *Foreign Firms and Broker-Dealer Activities in the United States*, in PLI, INTERNATIONAL SECURITIES REGULATION, 1975 145 (H. Dale, Chairman, 1975).

a number of decisions, largely in the Second Circuit Court of Appeals. The jurisdictional provision of the Securities Exchange Act of 1934 section 30(b) states:

> "The provisions of this title or of any rule or regulation thereunder shall not apply to any person insofar as he transacts a business in securities without the jurisdiction of the United States, unless he transacts such business in contravention of such rules and regulations as the commission may prescribe as necessary or appropriate to prevent the evasion of this title."

Though the technical language of 30(b) "without the jurisdiction of the United States" fairly presents the courts and the SEC with the authority to apply the securities rules extraterritorially within the permissible limits of international law, the phrasing suggests that the chief thrust of the section is to confine the operations of the securities laws to regulating conduct within the United States.

Conduct within the jurisdiction seems to be the guiding principle of the most significant trading rule, Rule 10b-5, under the Securities Exchange Act of 1934. That rule provides:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> "(a) to employ any device, scheme or artifice to defraud,
>
> "(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> "(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person
>
> "in connection with the purchase or sale of any security."[121]

The rule contains phrases commonly employed by American draftsmen seeking to establish federal jurisdiction in an area where there is a claim to jurisdiction by the states, namely, "interstate commerce", "the mails", and "any facility of any national securities exchange". Though domestic jurisdictional problems may have been uppermost in the minds of the drafters of Rule 10b-5, again the language fairly can be interpreted as applying extraterritorially. "Interstate commerce" suggests a conduct justification since it includes commerce between the United States and foreign countries. Jurisdiction based on an impact principle

121 17 C.F.R. s. 240.10b-5 (1977).

may be derived from the reference to "the mails" since mail travels to the United States from foreign ports of origin.

One preliminary point should be made concerning Rule 10b-5; the section operates not only as a rule to govern conduct between persons buying and selling securities but has also been interpreted by the courts as creating a private cause of action by which a shareholder of a company can complain of conduct by the directors. This feature complicates analysis of the 10b-5 cases since, as we shall see below, they may involve issues of shareholders' rights rather than of trading rules. In a typical case a plaintiff shareholder asserts that a corporation has been fraudulently induced by its directors to buy worthless or overpriced property. The shareholder seeks to press the corporation's claim against its directors in a derivative action. However, the use of an anti-fraud rule as a rule creating shareholders' rights within a company presents the possibility of a clash between federal securities law and the law of the state of incorporation of the company.[122]

122 In discussing the law which governs the internal affairs of the corporation, we have assumed that this is the law of the state of incorporation. It would be more precise to say it is the personal law of the corporation which governs the corporation, in much the same way that the personal law of an individual governs matters such as legal capacity, succession and domestic relations.

Internal affairs of a corporation are generally considered to be structural matters concerning the organization of the company, the composition of the board and its powers to act, and the liabilities of directors and shareholders for activities of the corporation which injure creditors or third parties. Internal affairs also include financial structure, solicitation of proxies and the power of directors to issue new shares, matters which in some circumstances may also be subject to securities laws.

In common law countries, the personal law of the corporation is taken to be the law of the state of incorporation. While this solution is justifiable on the ground of certainty, it can lead to the situation in which a corporation is incorporated in one state and has all of its assets, employees, activity and management in another state. Common law jurisdictions, except for a few states in the U.S.A., have refused to pay attention to the actual location of a corporation; *see* Latty, *Pseudo-Foreign Corporations*, 65 YALE L.J. 137 (1955); Reese & Kaufman, *The Law Governing Corporate Affairs*, 58 COLUM. L. REV. 1118 (1958).

However, the European countries do not use the law of a state of incorporation but the law of what the French call the *siège social*, and the Germans the *Geschäftssitz*. Determination of the *siège* is by no means easy and there is extensive French case law on the subject. In general, the most important factor is taken to be the location of the management of the enterprise, hence the translation of *siège social* as "head office" or "business seat". Often a court accepts the place of incorporation as the *siège* unless that place is entirely separate from the real activity of the corporation; *see generally*, note, *Nationality of International Corporations under Civil Law and Treaty*, 74 HARV. L. REV. 1429 (1961). The consequences of finding that the *siège social* of a company is not the same as its state of incorporation vary. Some cases have gone so far as to hold that the corporation is "void" because of its fraudulent creation, but more often the court applies the legislation of the *siège* to the corporation without questioning the validity of the incorporation.

Even if a state cannot question the "nationality" of a corporation, it can sometimes treat a foreign corporation as domestic when it has substantial links with the citizens of the state. For example, the American Foreign Asset Control Regula-

A shareholder was the plaintiff in the first major case involving the extraterritorial application of Rule 10b-5, *Schoenbaum v. Firstbrook.*[123] An American stockholder in a Canadian corporation, Banff Oil Ltd., brought an action under Rule 10b-5 alleging that insider controlling shareholders of Banff, acting on inside information, had issued to themselves treasury stock at a price below fair market value. The sale had taken place within Canada but the plaintiff argued that the U.S. federal court had jurisdiction because Banff stock was listed on the American Stock Exchange and was traded by American investors. The District Court dismissed the suit. The Court of Appeals for the Second Circuit reversed, holding that:

> "Congress intended the Exchange Act to have extraterritorial application in order to protect domestic investors who have purchased foreign securities on American exchanges and to protect the domestic securities market from...'improper foreign transactions in American securities'."[124]

The Court of Appeals found jurisdiction based on an impact principle. It held that the anti-fraud provision:

> "reaches beyond the territorial limits of the United States and applies when a violation of the Rules is injurious to United States investors."[125]

but it limited its holding somewhat:

> "We hold that the district court has subject matter jurisdiction over violations of the Securities Exchange Act although the transactions which are alleged to violate the Act take place outside the United States, at least when the transactions involve stock registered and listed on a national securities exchange, and are detrimental to the interests of American investors."[126]

In the next major case to test the extraterritorial application of

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tions, 31 C.F.R. 500329 (1968), affect corporations "wheresoever organized or doing business" that are owned or controlled by U.S. citizens or other persons present in the United States. While such laws such as these are difficult to enforce, it is possible to attain some indirect control over foreign corporations owned by nationals by a state's power to make laws for its nationals.

123 405 F.2d 200 (2d Cir. 1968), *rev'g*, 268 F. Supp. 385 (S.D.N.Y. 1967), *cert. denied*, 395 U.S. 906 (1969). The legislative limits of the American securities acts in the light of Schoenbaum are considered in Goldman & Magrino, *Some Foreign Aspects of Securities Regulation: Towards a Re-evaluation of Section 30(b) of the Securities Exchange Act of 1934*, 55 VA. L. REV. 1015 (1969).

124 405 F.2d 200, at 206.

125 *Id.*

126 *Id.* at 208; *see also* note, *Extraterritorial Application of the Securities Exchange Act of 1934*, 1 L. & POL. INT'L BUS. 168 (1969).

Rule 10b-5, *Leasco Data Processing Equipment Corp. v. Maxwell,*[127] the court based its jurisdiction on conduct within the jurisdiction. The plaintiffs, shareholders of Leasco, alleged that the defendants had conspired to cause Leasco to buy stock of Pergamon Press Limited at a price greater than its real value in violation of Rule 10b-5. Pergamon was a British company, owned and controlled by Maxwell, a British citizen. Its stock was not listed on an American exchange, nor was it traded in the U.S. The purchase took place on the London Stock Exchange through a subsidiary of Leasco, but the contract of sale had been signed in New York. The *Leasco* court could not employ the impact rationale of *Schoenbaum* because there had been no purchase on an American exchange and no effect on American securities markets.

But the court relied on conduct within the United States as the basis of jurisdiction. It found the meetings in New York and the closing of the transaction in New York constituted conduct within the United States. Its dicta went further. In discussing what constituted "conduct within the United States" the court said:

> "[W]e see no reason why, for purposes of jurisdiction to impose a rule, making telephone calls and sending mail to the United States should not be deemed to constitute conduct within it. On what is now before us it is impossible to say that conduct in the United States was not an essential link...in leading Leasco into the contract of June 17, 1969."[128]

If this test were applied, any correspondence with an American in the United States would be sufficient to give jurisdiction to U.S. courts even though the defendant had never entered the United States.

The result of *Schoenbaum* and *Leasco* was that a foreign defendant could be caught by either the effect or the conduct test, and both of them were widely drawn.[129]

127 468 F.2d 1326 (2d Cir. 1972), *aff'g in part,* 319 F. Supp. 1256 (S.D.N.Y. 1972). For a case comment on *Leasco see* note, *Securities Law - Extraterritorial Application,* 8 TEX. INT'L L.J. 430 (1973).

128 468 F.2d 1326, at 1335.

129 Note, 6 VAND. J. TRANSNAT'L L. 678; Becker, *Extraterritorial Dimensions of the Securities Exchange Act,* 2 INT'L L. & POL. 233 (1969). One of the best articles on *Leasco* and subsequent cases is Jones, *supra* note 89. An especially forceful presentation of the impact test is in the SEC's brief before the Ninth Circuit Court of Appeals in SEC v. United Financial Group Inc., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶93,747 (9th Cir. 1973), a case involving an offshore mutual fund which the SEC felt was being mismanaged to the detriment of foreign investors, the American balance of payments, the reputation of the American financial community and the reputation of the SEC. In another recent case involving

A case in which both conduct and impact were considered and which is of particular interest to Canadians is *Travis v. Anthes Imperial Ltd.*[130] This case involved a takeover bid by Molson Industries Ltd. to the Canadian shareholders of Beaver Lumber Ltd. The plaintiff American shareholders alleged that Molson had represented to them that if they held their shares a separate offer would be made to them; no separate offer was made and the shares declined in price after the bid. The district court found that all the parties were Canadian except for the plaintiffs, all the relevant actions had taken place in Canada, the offer was only for Canadian shares and that there was no listing on an American exchange. Thus there was no effect on a domestic securities market. Further, the only conduct in the U.S. was use of the mail. The court, noting that the communications containing the misinformation had been initiated by the plaintiffs, found the use of the mail to be insufficient to give jurisdiction. The Eighth Circuit reversed. It held that the use of interstate commerce was sufficient conduct to found jurisdiction and it observed that even if it were assumed that all dealings took place in Canada, Rule 10b-5 would still be applicable since:

> "any state may impose liabilities, even upon persons not within its allegiance, for conduct outside its borders that has consequences within its borders which the state reprehends."[131]

In two cases arising from the Investors Overseas Services (IOS) affair, *Bersch v. Drexel Firestone Inc.*,[132] and *IIT v. Vencap, Ltd.*,[133] the Second Circuit further refined the impact and conduct tests. The court held that the impact principle does not establish jurisdiction where the evidence establishes only generalized harm to the nation's economic interests. There must be direct injury to a significant number of buyers or sellers of securities. Conduct within the United States does not entitle foreigners to the protection of the American securities laws unless the acts or omissions in the United States directly cause the losses in question. Though confirming the point that the United States is not to become a base for the export of fraud,[134] the court held that the U.S. courts are

offshore mutual funds, the SEC chose to emphasize the contacts with the United States; *see* SEC briefs in SEC v. Vesco (S.D.N.Y.).

130 473 F.2d 515 (8th Cir. 1973), *rev'g*, 331 F. Supp. 797 (E.D. Mo. 1971).

131 473 F.2d 515, at 528, *quoting*, U.S. v. Aluminum Co. of America, 148 F.2d 414, 443 (2d Cir. 1945). *See generally* Zimmerman, *Extraterritorial Application of Section 10(b) and Rule 10b-5*, 34 Ohio St. L.J. 342 (1973).

132 519 F.2d 974 (2d Cir. 1975).

133 519 F.2d 1001 (2d Cir. 1975).

134 *Vencap, id.* at 1017. The Canadian and American position on the extent to which the

not open to foreign plaintiffs if the activity in the United States was merely preparatory. On the other hand, if the plaintiff is American, whether resident or non-resident, acts which are merely preparatory may provide the basis for jurisdiction.[135]

B. EUROPEAN SECURITIES LAW

Outside North America, capitalism has a different history and different premises and there is less emphasis on facilitating investment in securities by a large part of the population. In Europe, trading and investing in securities, particularly equity securities, is regarded as the province of a small number of individuals and banks who are in relatively continuous but informal contact. Even companies that are not wholly family-owned place a great deal of emphasis on secrecy. The widespread feeling that disclosure will aid competitors has more validity in Europe than the United States because it is possible for firms in different countries to be close rivals while the close competitors of an American firm probably will be other American firms subject to the same disclosure rules.[136]

In addition, there are significant historical and economic differences between Europe and America. For instance, insurance and pensions are much less important in Europe than in North America, government control over the issue of securities is much stronger and banks play a larger role in securities matters. There

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domestic system should protect foreign plaintiffs from the export of fraud is discussed in ch. V and particularly in the text accompanying note 144, *infra*.

135 There is a wealth of comment on recent developments in the United States; *see e.g.* Grosser, *Extraterritorial Application of Section 10(b) of the Securities Exchange Act of 1934*, 33 WASH. & LEE L. REV. 397 (1976); Martin, *From Schoenbaum to Scherke: The Continuing Question of Subject Matter Jurisdiction in an International Securities Transaction*, 12 HOUS. L. REV. 924 (1975); Mizrack, *Recent Developments in the Extraterritorial Application of Section 10(b) of the Securities Exchange Act of 1934*, 30 BUS. LAW. 367 (1975); Parker, *Securities Regulation and Subject Matter Jurisdiction under Securities Exchange Act of 1934, Section 10(b)*, 11 TEX. INT'L L.J. 173 (1975); note, *American Adjudication of Transnational Securities Fraud*, 89 HARV. L. REV. 553 (1976); note, *Extraterritorial Application of the Securities Acts*, [1974] WASH. U. L.Q. 859. The Bersch decision was followed in F.O.F. Proprietary Funds Ltd. v. Arthur Young & Co., [1975-1976 Transfer Binder] CCH FED. SEC. L. REP. ¶95,296 (S.D.N.Y. 1975), in which the court denied relief to a foreign corporation alleging fraud in the sale to it of securities on the ground that the transaction was predominantly foreign, and in Recaman v. Barish, [1976-1977 Transfer Binder] CCH FED. SEC. L. REP. ¶95,608 (E.D. Pa. 1975) a case involving the U.S.I.F. (Gramco) mutual fund.

136 On disclosure in European securities law *see* Jackson, *Public Offerings: A Comparative Study of Disclosure in Western Europe and the United States*, 16 W. RES. L. REV. 44 (1964). Although a little out of date, this article is a well written and comprehensive guide. *See also* E. STEIN, HARMONIZATION OF EUROPEAN COMPANY LAW: NATIONAL REFORM AND TRANSNATIONAL COORDINATION 209-82, 354-64 (1971).

is, however, a growing trend in Europe to the use of methods of financing similar to American ones because of a belief that it is possible to tap a larger pool of savings with an active securities market. Indeed, Bernard Cornfeld's IOS profited by the inability of European investors to invest in their own securities markets; it found a large group of investors eager to buy mutual funds based on American stocks. Consideration of European securities regulation is hindered by the fact that European laws on securities are scattered throughout commercial, corporate and penal codes and banking laws and in the rules of private bodies or stock exchanges. No country has a single centralized agency comparable to the SEC.[137]

In European countries a prospectus with a public issue is either mandatory or customary, but it is not as complete or detailed as is common in North America. Also, much accounting and auditing is internal and few countries have a developed body of independent accountants. There is little attempt to regulate use of corporate information or the trading practices associated with it. Proxies are not often solicited and if they are, little information accompanies the solicitation. Disclosure in general is less detailed and financial statements are often given for a group of companies without being consolidated.[138]

As to the extraterritorial application of European securities laws, in 1972 the International Bar Association, Committee on Issue and Trading in Securities set up a subcommittee on the Extraterritorial Application of Securities Laws under Manuel F. Cohen. The subcommittee reported in January 1974 that "we have not so far found any major developments in decisional law affecting the extraterritorial application of securities laws except in the United States".[139] The committee points out that none of the states surveyed, other than the U.S., had special rules relating to foreign security sales and none made a special attempt to regulate them except with respect to criminal sanctions.

137 Belgium comes closest with its Commission Bancaire. Japan has a SEC-type body created by a securities law modelled on those of the U.S.A. It is discussed in Misawa, *supra* note 18. France is also considering a regulatory agency; *see*, *Sharpie's Heaven*, The Wall Street Journal, October 6, 1975, at 1, col. 6.

138 For a summary of the securities regulation systems of most countries *see* 1 L. Loss at 429-54; 4 L. Loss at 2463-84; for Europe *see* Brock, *Securities Regulation in Selected European Countries*, [1969] VAND. INT'L 21 (Winter). On the Eurobond market *see* Knauss, *E.E.C. Progress toward Establishing European Capital Markets*, [1969] VAND. INT'L 35 (Winter); Bodolus, *supra* note 15, at 107. An interesting case study of the problems of British securities regulation is Davies, *An Affair of the City: A Case Study in the Regulation of Take-Overs and Mergers*, 36 MOD. L. REV. 457 (1973).

139 *See* Cohen, *The Extraterritorial Application of Securities Laws*, [1975] INT'L BUS. LAW. 173, 174. Included in the report is a summary and analysis of the U.S. law which is among the best available.

Australia has recently been prompted by a series of collapsed mining promotions to set up a comprehensive national securities law.[140]

C. CONCLUSION

The only really useful model for the extraterritorial application of securities law for Canadian purposes is that of the United States. Although the United States makes some very wide jurisdictional claims, it is significant that American treatment varies to a marked degree from situation to situation and that a number of the American domestic rules are relaxed when foreigners are involved.

Chapter V
Present Jurisdictional Claims in Canadian Securities Laws

The regulation of the Canadian securities markets is achieved through two separate systems: the federal criminal law and provincial securities acts. Aggressive extraterritorial thrust is not a feature of either.

A. CRIMINAL CODE

A general denial of extraterritoriality is contained in section 5(2) of the Criminal Code:

> "Subject to this Act or any other Act of the Parliament of Canada, no person shall be convicted in Canada for an offence committed outside of Canada."

The prefatory language of section 5(2) indicates that there are some exceptions to the principle, both in the Criminal Code and in other statutes. Some of the Criminal Code exceptions are discussed in this chapter. Some of the exceptions in other statutes are discussed in chapter VI.[141]

There are two sections in the Criminal Code relating to securities offences which contain an extraterritorial reference. Section 341(1) provides:

> "Every one is guilty of an indictable offence and is liable to imprisonment for five years who, with intent to make gain or profit by the rise or fall in price of the stock of an

140 The Corporations and Securities Industries Bill, 1974. *See Murphy's Super SEC,* The Australian Financial Review, December 6, 1974, at 1.

141 For an excellent analysis of Canadian extraterritorial legislation containing a list of the statutes which create extraterritorial crimes; *see* T. Pickard, *supra* note 29; *see also* Zucker, *supra* note 27.

> incorporated or unincorporated company or undertaking, whether in or out of Canada, or of any goods, wares or merchandise,
>
> "(a) makes or signs...an agreement for the purchase or sale of shares without the *bona fide* intention of acquiring or selling the shares."

The placing and punctuation of "whether in or out of Canada" is curious. Applying ordinary rules of grammatical construction, one can easily interpret the phrase as applying to "every one" in the first line. Thus the section could prohibit a person in Seattle from gaming in stocks on the Vancouver Stock Exchange or even on the New York Stock Exchange. The expression "whether in or out of Canada" may apply only to the words "incorporated or unincorporated company or undertaking". The more probable interpretation is the latter so that the section makes it a crime for a person in Canada to game in the shares of a company which has been incorporated in Canada or elsewhere. This interpretation is supported by the succeeding section, section 342:

> "Every one is guilty of an indictable offence and is liable to imprisonment for five years who, being an individual, or a member or employee of a partnership, or a director officer or employee of a corporation, where he or the partnership, or corporation is employed as a broker by any customer to buy and carry upon margin any shares of an incorporated or unincorporated company or undertaking, whether in or out of Canada, thereafter sells or causes to be sold shares of the company or undertaking for any account in which
>
> "(a) he or his firm or a partner thereof, or
>
> "(b) the corporation or a director thereof,
>
> "has a direct or indirect interest, if the effect of the sale is, otherwise that unintentionally, to reduce the amount of such shares in the hands of the broker or under his control in the ordinary course of business below the amount of such shares that the broker should be carrying for all customers."

The expression "whether in or out of Canada" is the same as that appearing in section 341 and it follows in the same sequence, following the expression "an incorporated or unincorporated company or undertaking" which is the same in both sections. The purpose of this section is to prohibit a broker from reducing his holdings of a particular stock below the levels required to meet the claims of his customers by selling shares for his own account. One interpretation of the section is that it applies to all brokers everywhere in the world. The more reasonable explanation is that it

applies to Canadian brokers but applies to the stock of any corporation, irrespective of the place of incorporation. After considering the language and possible interpretations of sections 341 and 342, we conclude that neither section is intended to have extraterritorial effect.

There does not appear to be any attempt to regulate extraterritorial conduct in the four major provisions of the Criminal Code intended to prohibit securities frauds: section 338, fraud (including fraudulently affecting the public market price of shares); section 339, using mail to defraud the public; section 340, fraudulent manipulation of stock exchange transactions; and section 358, publishing a false prospectus. The fraud and mail fraud sections were subject to analysis in *Re Chapman*[142] where the Ontario Court of Appeal upheld counts under the two sections charging the accused with defrauding the public in a scheme involving home sewing kits. The accused remained in Canada throughout but the scheme was aimed only at consumers in the United States. With respect to the fraud charge under section 323(1) (now section 338(1)) the court said:

> "The recital of facts herein, referable to the Canadian phrase of Jamster's operations, shows the initiation and consummation of a scheme in Canada through the dispatch of letters from Canada and the receipt in Canada of money or valuable securities by way of cheques and money orders. This is enough to support a charge of the substantive offence in Canada, subject only to the construction of the phrase 'defrauds the public or any person'. On the facts before this Court, the only members of the public or persons who could be said to have been defrauded were residents of the United States.
>
> "The completion of the offence under s.323(1) lies in the obtaining of the fruits of the fraudulent means or inducement. What is said in *R. v. Brixton Prison Governor, Ex p. Rush,* (1969) 1 All E. R. 316 at p.322, also points to this conclusion. If there is an initiation of a fraudulent scheme in Canada (as was the case here in the mailing out of the letters of solicitation) and a realization thereof in Canada through receipt of money or securities intended to be brought in through the scheme, the offence has been committed in Canada although the inducement has extended only to persons outside Canada. In short, 'the public or any person' in s.323(1) are not limited to the

142 11 C.R.N.S. 1 (Ont. C.A. 1970).

Canadian public or to persons in Canada: see *Shulman v. The King* (1946), 2 C. R. 153."[142a]

The *Chapman* court similarly interpreted the expression "public" in the mail fraud section.

We do not expect *Chapman* to be used as a basis by which Canadian Criminal Code rules relating to securities trading will be applied to persons outside the country. As the quotation indicates, the court relied heavily on the fact that the accused's acts all took place within Canada.

A similar approach was adopted by Munroe, J., in *Re Bennett and Schuette and The Queen.*[143] The accused were charged under section 340 with fraudulent manipulation of transactions on the Calgary Stock Exchange and the Crown alleged that the offence was committed at Vancouver, B. C. The court dismissed an application for a writ of *certiorari* to quash the committal for trial, reasoning that the overt acts of placing the orders with a Vancouver broker which initiated the transactions in Calgary were sufficient to vest jurisdiction in the courts of British Columbia.

In neither *Chapman* nor *Bennett and Schuette* was the court attempting to protect persons within the jurisdiction by applying rules of conduct to persons outside. Rather, the courts' venture into extraterritoriality was for the purpose of protecting a person outside the jurisdiction from acts committed within it. We conclude that a Canadian federal securities law should include the principle established in these two cases so that Canada does not become a base for the export of fraud. The principle that the domestic system should be activated to protect foreign victims from wrongs initiated within the jurisdiction has been accepted by the courts in Britain and the United States.[144]

142a *Id.* at 6-7.

143 50 D.L.R. (3d) 730, 19 C.C.C. (2d) 61, [1974] 6 W.W.R. 193 (B.C.S.C.).

144 In Treacy v. D.P.P., [1971] 1 All E.R. 110 (H.L. 1970), the House of Lords upheld a conviction where the accused posted a letter in England blackmailing a person abroad. The Second Circuit Court of Appeals affirmed the principle in a case arising from the IOS affair; IIT v. Vencap, 519 F.2d 1001, 1017 (2d Cir. 1975), *noted in* note, *Transnational Transactions - Transnational Application of the U.S. Securities Laws*, 11 Tex. Int'l L.J. 208 (1976). A similar decision was reached in Ferland v. Orange Groves of Florida, Inc., [1974-1975 Transfer Binder] CCH Fed. Sec. L. Rep. ¶94,821 (M.D. Fla. 1974). In *Vencap*, the Second Circuit ruled that jurisdiction would not be accepted when mere preparatory activities or the failure to prevent fraudulent acts took place in the U.S. and the bulk of the activity occurred in a foreign country. In a case arising from the Manitoba forest industry fraud, a District Court in New Jersey held that the American securities laws should not apply with respect to activity in the United States when the only persons who suffered damages as a result of that activity were non-residents; SEC v. Kasser, 391 F. Supp. 1167 (D.C.N.J. 1975). The case is described without criticism in note, *Securities Regulation - Transnational Reach of Securities and Exchange Acts*, 11 Tex. Int'l L.J. 204 (1976).

There are two offences having extraterritorial features which could be employed in the securities area. Sections 312 and 315 make it an offence to have in Canada or to bring into Canada anything which has been obtained within or without Canada by an act or omission which, if it had occurred in Canada, would have constituted an offence punishable by indictment. These sections could be used to convict a person possessing share certificates obtained by him or to his knowledge by acts in another country equivalent to false pretences. However, while the sections could be employed in such circumstances, they certainly do not represent a parliamentary intention to create rules having extraterritorial application to securities laws.

In addition to the six sections discussed above, there are a number of other sections of the Criminal Code which could be employed in the prosecution of a securities fraud: section 320, false pretences; 321, obtaining execution or endorsement of valuable security by fraud; 326, uttering forged document; 332, making or executing document without authority; 333, obtaining by instrument based on a forged document; 336, falsification of document; and 383, giving or receiving secret commissions. None of them applies extraterritorially.

There are two sections applicable in the securities area which specifically create rules of conduct in Canada designed to protect persons in other countries. Section 324 prohibits the making of a false document with intent that it be used or acted upon as genuine to the prejudice of anyone whether in Canada or not, and section 334 prohibits the use of false marks and stamps which are defined to include marks and stamps of a foreign government as well as Canada.

There is one notable but recent exception to Parliament's restraint in the criminal law field. Section 36 of the Criminal Law Amendment Act, 1975, enlarges the scope of criminal conspiracy to include conspiracies in Canada which are intended to be effected outside Canada and conspiracies outside Canada which are intended to be effected inside Canada. This enlargement permits prosecution in Canada of persons who have conspired abroad to violate Canadian securities laws.[145]

Subject to this one exception, Parliament has not exercised the full extraterritorial jurisdiction in the criminal law area to which it is entitled under international law and as far as the criminal law regulation of securities is concerned, the outreach approaches insignificance.

145 Commentary on this feature of the Criminal Law Amendment Act, 1975, is contained in CANADIAN BAR NATIONAL, September, 1975, at 3.

B. PROVINCIAL SECURITIES LAWS

The provincial securities acts have been slightly more expansionist than the Criminal Code in attempting to regulate conduct beyond provincial borders.[146] Nevertheless, their emphasis is on regulating conduct within the province. With respect to stock exchanges, for example, the statutes carefully spell out the obvious, that they apply only to the stock exchanges in the province.[147]

As if signalling an awareness that conduct in other jurisdictions will be regulated by other institutions, the provincial securities acts authorize the courts in the home province to endorse warrants issued in other provinces for the arrest of persons who have contravened securities statutes of those provinces so that enforcement officers from the issuing and endorsing province may both execute the warrant in the endorsing province and take the accused person to the province in which the offence was committed.[148] A system for the interprovincial enforcement of subpoenas which would compel the attendance at court within a province of a witness who resides outside the province is also developing.[149]

This concept of interdependent enforcement is strengthened by provisions such as that of National Policy No. 17 by which securities registrants are warned that violation of the securities laws of any jurisdiction is considered in principle to be prejudicial to the public interest and may affect fitness for continued registration.

The concern for establishing jurisdiction based on physical presence is also demonstrated by provisions such as those requiring applicants for registration to provide an address for service in the province where all notices under the act may be sent.[150] The provincial statutes also contain special discretion by which registration may be refused to non-resident applicants.[151] Although the main reason for such provisions is probably protection of local business dressed up as economic nationalism, a supporting argu-

146 In this paper we do not discuss the constitutional issue. It is discussed in *Anisman & Hogg*; *see also* J. WILLIAMSON and J. WILLIAMSON SUPP., chs. VII, VIII.

147 *See e.g.* B.C. Securities Act, s. 137; Ontario Securities Act, s. 140; Ontario Bill 98, s. 22.

148 *See e.g.* B.C. Securities Act, s. 144; Ontario Securities Act, s. 149; Ontario Bill 98, s. 120.

149 *See* Interprovincial Subpoena Act, Bill 19, 31st Parl. B.C., 1st Sess., 1976 (based on a uniform act adopted by the Uniform Law Conference of Canada in 1974).

150 B.C. Securities Act, s. 12; Ontario Securities Act, s. 11; Ontario Bill 98, s. 29.

151 B.C. Securities Act, s. 15; Ontario Securities Act, s. 14; Ontario Bill 98, s. 31.

ment may have been that residents are the only persons whom a regulatory system can reach effectively.

The principal regulatory sections of the provincial acts are those prohibiting trading without registration[152] and requiring a prospectus for trading in the course of distribution to the public.[153] Although there is no overt limitation in these sections to conduct within the province, their general language and context suggest that they were intended to have narrow geographical application. Support for this proposition can be found in the limited situations where extraterritorial effect is invoked. Thus, the regulation of telephone solicitation is carefully drawn to apply to the making of telephone calls from the province to persons within and persons outside the province; the prohibition does not apply to persons outside the province telephoning residents of the province.[154]

However, in the past decade there have been significant examples of outreach achieved by judical interpretation. The leading case is *R. v. W. McKenzie Securities Ltd.*[155] where the accused were convicted under the Manitoba Securities Act of unlawfully trading in securities in Manitoba because they were not registered under the Manitoba act. The accused were both registered in Ontario from which province they made telephone solicitations to a resident of Manitoba. The solicitations were held to fall within the Manitoba definition of trading. The court explained the ambit of the statute as follows:

> "The Securities Act of Manitoba is not designed to reach beyond provincial borders and to restrain conduct carried on in other parts of Canada or elsewhere. Its operation is effective within Manitoba, and nowhere else. For a person to become subject to its restraint he must trade in securities in Manitoba. This is not to say that a non-resident of Manitoba can never become subject to the controls of the statute. If the activities of such a non-resident can fairly and properly be construed as constituting trading within the Province, then they fall within the purview of the act. Thus examined, the act cannot

152 B.C. Securities Act, s. 7; Ontario Securities Act, s. 6; Ontario Bill 98, s. 24.

153 B.C. Securities Act, s. 37; Ontario Securities Act, s. 35; Ontario Bill 98, s. 54.

154 B.C. Securities Act, s. 65(1)(b); Ontario Securities Act, s. 68(1)(b); Ontario Bill 98, s. 37. A recent decision in which a salesman's licence was revoked for violation of the B.C. statute is Re Ginnetti, B.C. Corporate and Financial Services Commission Weekly Summary, August 22, 1975, at 1.

155 56 D.L.R. (2d) 56 (Man. C.A. 1966), *leave to appeal refused, sub nom.* West and Dubros v. The Queen, [1966] S.C.R. ix.

> justly be considered as designed in any way for the regulation of interprovincial trading."[155a]

The court went on to construe the activity of the accused in the following terms:

> "Solicitation of subscriptions to the capital stock of various corporations is precisely what the accused were engaged in doing in the present case. Can it effectively be denied that such solicitation took place, at least in part, in Manitoba? I think not. It was to Mr. McCaffrey in Manitoba that the accused sent their letters and other literature in which subscriptions for the purchase of capital stock were solicited. It was to Mr. McCaffrey in Manitoba that telephone calls for the same purpose were made by the accused. I think it completely unrealistic to suggest that when the accused sent their letters by mail from Toronto, Ontario, to Shilo, Manitoba, the act of solicitation there represented took place only in Toronto or at most within the borders of Ontario. Such an approach ignores completely the nature and character both of a letter and of the postal service. The invitation put forward by the accused in their letters was a continuing one. It started when written in Toronto; it continued when deposited in the post box there; it did not cease to exist during the period when it was being transported through the postal service (the agency selected for that purpose by the accused); and it retained its validity and spoke with special effectiveness to McCaffrey at the time when he opened and read the letter in Shilo in Manitoba. It was in this Province that McCaffrey was solicited by the accused to purchase the shares in question, and it was in this Province that McCaffrey responded favourably to such solicitation. I would agree with the learned Magistrate and the learned County Court Judge that what took place in the present case constituted an act of trading in securities within the definition of the Securities Act of Manitoba."[155b]

Although expressly purporting to regulate activity within the province of Manitoba, the court, in effect, applied Manitoba rules of behaviour to govern conduct in Ontario.

The *W. McKenzie Securities* case was followed in *R. v. Jaasma*,[156] an Alberta case involving remarkably similar facts. In

155a 56 D.L.R. (2d) at 62-3.
155b *Id.* at 64.
156 [1974] 1 W.W.R. 245 (Alta. Prov. Ct. 1973).

that case the telephone solicitations originated in British Columbia and were made to customers in Alberta. The court quoted at length from *W. McKenzie Securities* and concluded that even though the telephone calls were made from British Columbia the offence was committed in Alberta.

This type of analysis provides a fertile field for persons wishing to draw rules having extraterritorial application in the securities area. As the above cases suggest, one can draft a statute prohibiting within the jurisdiction any act which, taken with other acts outside the jurisdiction, constitutes a forbidden transaction. This device can be used to create rules whose effect is to govern extraterritorial conduct though they purport to apply only within the jurisdiction.

There are guarded attempts to regulate conduct outside the province in the parts of the provincial securities acts dealing with solicitation of proxies, insiders, financial disclosure and takeover bids. The first three are set out in much the same way so we shall consider the proxy provisions as an example.

The proxy rules (set out in part X of the British Columbia and Ontario acts) apply to external conduct in that they apply to persons outside the province who send proxy material to shareholders within the province. However, the basis of regulation is consensual in that the mandatory proxy rules do not apply to all foreign corporations but only to foreign corporations which have filed a prospectus with the provincial commission or whose shares are listed for trading on a stock exchange within the jurisdiction.[157] This consensual approach is buttressed by other provisions of part X which state that the commission may order the director to refuse to issue a receipt for a prospectus until the company delivers undertakings satisfactory to the commission in which the company, its directors and officers, undertake to comply with the various provisions of part X.[158] Further, both the British Columbia and Ontario statutes provide that they cease to apply in a case where, jurisdiction having been founded on the filing of a prospectus, the corporation ceases to have shareholders in the province.[159]

Part XI, Insider Trading, and part XII, Financial Disclosure, are set out in the same way. That is, jurisdiction is claimed only where there has been a filing of a prospectus in the jurisdiction or a listing on the stock exchange within the jurisdiction.[160] There

157 B.C. Securities Act, ss. 98(a), 99; Ontario Securities Act, ss. 101(a), 102. A more far-reaching ambit is provided for in Ontario Bill 98, s. 86.

158 B.C. Securities Act, s. 104; Ontario Securities Act, s. 107.

159 B.C. Securities Act, s. 101(3); Ontario Securities Act, s. 104(3).

160 B.C. Securities Act, ss. 106(1)(b), 116; Ontario Securities Act, ss. 109(1)(b), 118(1)(b).

are similar provisions for undertakings[161] and for termination of regulation in the case where jurisdiction is founded upon registration of a prospectus and there is no longer a shareholder within the jurisdiction.[162]

Uniform Act Policy No. 2-01 indicates that the commissions have directed the director to refuse to issue a receipt for a prospectus until the company proposing to distribute the shares has delivered undertakings with respect to proxies, insider trading and financial disclosure as referred to above.

The takeover bid requirements to be found in part IX of the British Columbia and Ontario acts do not have the same element of consent. Demonstrating a purpose to protect shareholders residing in the jurisdiction, part IX defines both "offeree" and "takeover bid" in terms of a shareholder having an address within the province.[163] The provincial statutes have thus claimed a wider jurisdiction in the area of takeover bids than they have in the proxy, insider trading and financial disclosure areas. Part IX provides that an offeror who does not comply with the provisions is guilty of an offence and on summary conviction is liable to a fine of not more than $25,000 or to imprisonment for not more than one year, or to both.[164] The Ontario act also grants a right of rescission to the offeree.[165]

The only other section of the provincial acts worth including in this discussion is the provision, similar to the Criminal Code section 342, prohibiting a sale by a broker for his own account which would reduce his holdings of margined securities below the amount that he should be holding for his customers.[166] The drafting creates the same problem as in the Criminal Code section, namely, that one cannot tell whether the expression "either in Canada or elsewhere" applies to the broker, customer, the securities issuer or some combination of them. Section 47 of Ontario Bill 98 is clearer. That section makes it apparent that "in Canada or elsewhere" applies to the issuer of the securities. Probably the other provincial sections should be interpreted the same way.

After surveying the provincial administrators in 1958, J. Williamson concluded that while the majority of the administrators felt they had the power to control interprovincial solicitation, most did not attempt to enforce their registration requirements in

161 B.C. Securities Act, ss. 115, 130; Ontario Securities Act, ss. 117, 133.

162 B.C. Securities Act, ss. 114(2), 129(2); Ontario Securities Act, ss. 116(2), 132(2).

163 B.C. Securities Act, ss. 78(c), 78(g); Ontario Securities Act, ss. 81(c), 81(g).

164 B.C. Securities Act, s. 97; Ontario Securities Act, s. 100.

165 Ontario Securities Act, s. 100a.

166 B.C. Securities Act, s. 75(1); Ontario Securities Act, s. 78(1). The Criminal Code, s. 342, is discussed in chapter V *supra*.

the absence of egregious breaches of standards of conduct in selling.[167] The Canadian administrators cooperate by cancelling registrations for fraudulent or "high pressure" selling even if it occurs outside the province.[168] Saskatchewan and Québec will also cancel registrations for breaches of American laws.[169]

In summary, the federal Criminal Code does not reach out as far as international law would permit in order to protect Canadian investors from fraudulent schemes created abroad. The provincial statutes have a somewhat broader external reach, generally built upon either a segmentation of a transaction to find a part of it within the jurisdiction or a quasi consensual relationship between the corporation which is expected to comply with the domestic provisions and the domestic institution wishing to safeguard the interests of investors.

Chapter VI
Canada's Foreign Policy and Its Attitude to National Jurisdiction

It is a commonplace that until 1968 Canada's foreign policy was "internationalist" in approach, with an emphasis on altruism, Canada's world responsibilities, and Canada's potential as a contributor to solutions for the world's problems. A feature of this internationalism was a deference to foreign countries marked by very limited exercise of our right under international law to legislate extraterritorially. The former policy was reflected in legislation such as section 5(2) of the Criminal Code which establishes the general principle that a person should not be convicted in Canada for an offence committed outside Canada.[170] In her paper on extraterritoriality in Canadian legislation,[171] Professor T. Pickard points out that Canada makes little use of its power to legislate over nationals abroad, that Canada has made little use of the protective or impact principle, and that it has made no use of the passive personality principle.[172]

Interestingly, Canadian judges have been aggressive in

167 J. WILLIAMSON at 207.

168 An example involving a broker-dealer and an unregistered associate promoting shares in Italy is Re Donaldson Securities Ltd., B.C. Corporate and Financial Services Commission Weekly Summary, March 7, 1975.

169 J. WILLIAMSON at 302. American jurisdictions have done as much or more for Canadians. After the many years of high pressure selling from Canada it is ironic that American courts have had to extend the protection of Securities Acts to Canadians defrauded by American promoters; *see e.g.* Ferland v. Orange Groves of Florida, Inc., *supra* note 144.

170 For a discussion of some of the exceptions to this general principle *see* ch. V *supra*.

171 T. Pickard, *supra* note 29.

172 *See id.* at 101, 115-16, 118.

claiming jurisdiction over acts taking place outside the jurisdiction. There are a number of cases where the judges have employed protective principle reasoning. One of the earliest is *R. v. Gillespie (No. 2)*[173] which held that the Québec courts had jurisdiction to try a charge of publishing false statements in a letter sent to Montréal from the accused who was in Ontario. Ouimet, J., stated at 311:

> "The essential ingredients of this offence are:
>
> "(1) the falsity of the statement made by an officer of an incorporated company;
>
> "(2) the circulating or publication of such statement so that it may reach the parties or party intended to be defrauded. In the present case the parties intended to be defrauded resided in Montréal, and it is here they were intended to be reached by the accused and the intended fraud was to be achieved and did in effect take place.
>
> "The defendant has of his free will accepted the jurisdiction of this Court by doing an act the intended result of which was to take place here. In the same way A, standing within the limits of a judicial district and shooting across the boundary of the district at B, standing on the other side of it, within another judicial district, with intent to kill him, would bring himself within the jurisdiction of the courts of the latter district. In the same way C, writing from Montréal, a threatening letter to E, a citizen of Toronto, to whom the letter is sent by mail, could be tried either at Toronto or Montréal."

In the foregoing passage Ouimet, J., neatly blends the protective and impact principle by dissecting the transaction complained of, finding some feature of it within the jurisdiction, and claiming jurisdiction over the whole by virtue of jurisdiction over the part.

The *Gillespie* case was followed by the Supreme Court of Nova Scotia in *R. v. Scott.*[174] The accused, who had apparently never left Montréal, was convicted of sending liquor into Nova Scotia contrary to the provisions of the Canada Temperance Act. The Nova Scotia court expressly followed *Gillespie* and employed the same type of blended reasoning. More recently in *R. v. Trudel,*[175] the Manitoba Court of Appeal, in 1968, held that the courts of Manitoba have jurisdiction to try an accused on a charge of conspiracy to commit the offence of forging documents when the only overt acts in Manitoba are the delivery of a parcel by the post office and its receipt by one of the accused. In the foregoing criminal cases, of

173 2 C.C.C. 309 (Qué. Q.B. 1898).

174 [1924] 2 D.L.R. 277 (N.S.S.C.).

175 [1969] 3 C.C.C. 95 (Man. C.A.).

course, the "foreign" acts nonetheless took place within Canada. However the decisions can all be justified on the basis that one aspect of the complete transaction took place within the province.

Some indication that Parliament may be becoming more aggressive with respect to extraterritoriality appears from the provisions of Criminal Law Amendment Act, 1975, relating to "internationally protected persons". Section 3 utilizes the nationality principle, the passive personality principle and the universality principle.

In 1968 the Trudeau government completed a review of foreign policy that was published as *Foreign Policy for Canadians.*[176] The review began a new direction which emphasized national self-interest and the development of national goals on the assumption that foreign policy is "the extension abroad of national policy"[177] and national policy should be directed to such things as economic growth, social justice and the quality of life.

This shift in emphasis has changed both the direction of our foreign policy and the means we use to pursue goals in this area. The emphasis has been shifted from global security to problems such as fisheries, pollution and resource development and the means used to attain foreign policy goals shifted from collegial bodies such as NATO, NORAD and the United Nations to a reconsideration of international law and unilateral assertions of sovereignty. A sense of vulnerability awakened in the minds of Canadians new interest in the problems of control and of jurisdiction to control such global problems as multinational corporations, ocean exploitation and ocean pollution. Especially in relation to the seabed and marine pollution, Canada has in recent years been aggressive in asserting sovereign and custodial rights where it considers protection necessary and international agreement impossible.[178] The new approach is not yet reflected in a wide range of legislation. Nonetheless the individual examples are important because of their value as a precedent for a federal securities law.

A feature of special importance in recent Canadian initiatives has been the claims of jurisdiction for a particular purpose as opposed to claims of full sovereignty. Claims of jurisdiction for a particular purpose are functional, that is, they are related to a particular need; and they are custodial in that they are justified by

176 CANADA DEPARTMENT OF EXTERNAL AFFAIRS, FOREIGN POLICY FOR CANADIANS (1970) (6 booklets).

177 *Id.* at 32 n. 3 (general booklet).

178 Gotlieb & Dalfen, *National Jurisdiction and International Responsibility: New Canadian Approaches to International Law,* 67 AM. J. INT'L L. 229 (1973). *See also* Alexandrowicz, *Canadian Approaches to the Seabed Regime,* in CANADIAN

the assertion that Canada acts in the interest of and on behalf of the international community to preserve some geographical area or other special interest. These claims have been especially important in relation to marine pollution and fisheries and are a type of claim that Canada has made with more force and effectiveness than any other state.[179]

Along with its custodial claim, Canada has developed the idea of delegation of powers from the community of nations to the most interested nation for resource and territory management of areas.

L. H. J. Legault has summarized Canada's position on the law of the sea:

> "Finally, it is important to note that Canada has sought to accommodate as much as possible the interests of other countries affected by Canada's unilateral initiatives often at the cost of severe domestic political criticism. This accommodation of the interest of other countries has led, first of all, to restrictions on the qualitative scope of the Canadian claims. Thus they have been limited generally to extensions of functional jurisdiction for special purposes and cannot be said to have had any significant impact on freedom of navigation responsibly exercised. By way of further accommodation, Canada has not sought to terminate unilaterally either treaty fishing rights or traditional fishing practices; the former have become the subject of new arrangements and the latter are being phased out gradually and by agreement.
>
> "In these preparations Canada has sought to devise a new way of approaching the problems of the law of the sea and to establish new ground for an accommodation in the increasingly sharp conflict between coastal interests, on the one hand, and flag or distant-water interests on the other. To this end Canada has advanced the concepts of 'custodianship' and 'delegation of powers' as vehicles for the development of the future law of the sea. The essence of the policy summarized in the terms 'custodianship' and 'delegation of powers' is simple but nevertheless of fundamental importance: first, the primary or priority interests of the coastal state in all activities in areas of the sea adjacent to its shores must be reflected in international

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PERSPECTIVES ON INTERNATIONAL LAW AND ORGANIZATION, *supra* note 1, at 410; Lowry, *Maritime Pollution: Canada's Approach*, 4 INT'L BUS. LAW. 365 (1976).

179 *See* L.H.J. Legault, *Maritime Claims*, in CANADIAN PERSPECTIVES ON INTERNATIONAL LAW AND ORGANIZATION, *supra* note 1, at 384-94. *See also* Ocean Dumping Control Act, S.C. 1974-75-76, c. 55.

law; second, much of the administration of the law of the future must be 'delegated' to the coastal state and must be based on resource management and environmental management concepts; third, the basis for an accommodation between conflicting interests in the uses of the sea must lie in a better balance between the rights and consequent responsibilities of states, and hence the coastal state must exercise both its existing sovereign powers and its future 'delegated' powers not only in its own interests but as 'custodian' of vital community interests in the uses of the sea, on the basis of internationally agreed principles to this end."[180]

The tone of the passage is self-congratulatory. Yet the approach to maritime problems described in it summarizes what is best among present Canadian initiatives in international law. It is more flexible and more responsible than traditional assertions of jurisdiction and provides a useful example for claims about jurisdiction in matters of securities.

Canadian economic regulation has also recently become more assertive and unilateral. The Foreign Investment Review Act demonstrates that it is now Canadian policy to control the purchase by foreigners of securities of Canadian corporations.[181] This legislation also controls the sale by one foreign company to another of a Canadian subsidiary and applies when a reorganization abroad involves the transfer of shares of the Canadian subsidiary even where there is no change in the beneficial interest.[182]

An interesting example of Canadian reaction in the area of economic regulation is the recent response to the problems of offshore mutual funds.[183] Canada does not have as great an inter-

180 Legault, *supra* note 179, at 391-92.

181 S.C. 1973-74, c. 46.

182 *See id.* s. 3(6)(h); and *see* Spoliansky & Easton, *Beware of Canadian Subsidiaries*, 30 Bus. Law. 1053 (1975).

183 Offshore mutual funds are usually funds incorporated in tax haven jurisdictions and concentrate their selling and trading activities in countries other than the one in which they are incorporated. There are offshore hedge funds, leverage funds, real estate funds and other specialty investment funds but the mutual fund is most common. These funds have caused problems for regulatory authorities in most jurisdictions by managing to operate in the interstices between sets of regulations or in countries without laws regulating securities trading. Recent publicity concerning Investors Overseas Services (IOS) and Gramco International has emphasized the danger inherent in their conduct.

The offshore mutual fund is the creation of Bernard Cornfeld, an American who began his career by selling American mutual funds to American servicemen in Europe but who quickly developed his own funds using European capital, and in the early years, flight capital from politically unstable areas of South America, Africa and Asia. (Of the several descriptions of Cornfeld's rise and fall, the best is C. Raw, B. Page & C. Hodgson, Do You Sincerely Want to Be Rich? (1971).) Once the

est in offshore mutual funds as the U.S., but it was implicated in the IOS fiasco because some companies of the IOS group were incorporated in Canada. Canada's reaction was to attempt to clear its "good name" by increased regulation in future. The federal government commissioned the *Proposals for a Mutual Fund Law for Canada,* which recommended that all Canadian funds be regulated with respect to selling of shares, custody of assets, etc., and that the more speculative funds be prohibited from selling abroad.[184] The only area left unregulated under this scheme is transactions in shares in Canadian companies abroad by foreign-based funds.

Several European countries have reacted to activities of IOS by setting up schemes requiring foreign funds to meet specified requirements before they can sell securities there. This requirement may be enforced by forbidding the sale of domestic securities to a fund or broker for a fund that fails to register.[185] This kind of enforcement provision could also be used by Canada if it were discovered that foreigners or Canadians were trading in Canadian securities abroad in violation of Canadian mutual fund or securities laws.

The 1975 Amendments to the Combines Investigation Act are also more expansive than the former provisions. The new sections 31.5 and 31.6 empower the Restrictive Trade Practices Commission to order individuals and companies in Canada to disobey applicable foreign judgments and legislation and failure to comply with such an order constitutes a criminal offence in Canada.[186] The Canadian Human Rights Act asserts the passive personality principle in declaring that the Canadian Human Rights Commission

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funds were established, Cornfeld found there was great interest among the European middle classes in a fund investing in American securities, and his, and other funds, became so large that their circumvention of disclosure and trading requirements, their creation of fund holding companies and their large-scale "dumping" of securities posed a serious threat to the system of regulation set up by the SEC. At the same time the U.S. government was very interested in importing foreign capital to reduce its own balance of payments deficit, and the Foreign Investors Tax Act of 1966, 80 Stat. 1541, spurred on the sales of the offshore funds among Europeans by providing tax exemptions for U.S. earned income. The SEC sought to reconcile its desire to control IOS with the government's desire to increase foreign investment by requiring IOS to refrain from selling shares in interstate commerce. The complex negotiation between IOS and the SEC is outlined in note, *Offshore Mutual Funds: Possible Solutions to the Regulatory Dilemma,* 3 L. & POL. INT'L BUS. 157, 166-69 (1971). *See also* comment, *Offshore Mutual Funds: Extraterritorial Application of the Securities Exchange Act of 1934,* 13 B.C. IND. & COMM. L. REV. 1225 (1973). IOS continued to do business by using the London offices of a U.S. broker and many of the abuses continued as before.

184 2 MUTUAL FUND PROPOSALS, s. 7.06.

185 *See* the discussions in note, *supra* note 183, at 200-03.

186 *See* S.C. 1974-75-76, c. 76, s. 46.1.

has jurisdiction when a Canadian citizen or person admitted to Canada for permanent residence is subjected in any part of the world to any discriminatory treatment which is proscribed by the act.[187] By passing this act the government has indicated that it is not unduly troubled by multiplying problems of what might be termed "inevitable jeopardy", namely, a situation in which a person may be punished under Canadian law for performing an act which he is positively required to do by a foreign law.

It might be argued that in order to develop a maximum of international freedom and flexibility, legal systems should generally contain exemption provisions creating a defence of compliance with a foreign law and perhaps simplifying conflicts by permitting the law of the jurisdiction of incorporation to govern. However, there are a number of arguments against that position. In the name of sovereignty, states prefer to retain control of acts occurring within their jurisdiction, notwithstanding international conflicts. As a result, persons who carry on affairs in several jurisdictions are now inured to the problem of "inevitable jeopardy" and it can be argued that an increasing amount of control by Canada will cause little additional difficulty for the multinational enterprises which are most subject to conflicting jurisdiction. In fact, it would be fair to conclude that the recent policy by which foreign business has been challenged by Canadian legislation seems to have worked; no foreign government has yet tried to defend its corporations by retaliating in a significant way against Canada or Canadian corporations.[188] At the time of writing, there are signs that the United States may cease to preserve its unruffled calm as opposition in that country mounts against two Canadian initiatives: Saskatchewan's nationalization of potash mines and the federal government's decision to disallow as expenses for Canadian businesses the cost of advertisements in certain periodicals and on television stations in which foreigners hold the predominant number of shares. It is too early to tell whether foreign reaction will stunt this new growth in Canadian foreign policy.

Nevertheless problems which arise when a situation of "inevi-

187 S.C. 1976-77, c. 33, s. 32(5)(b).

188 In the United States the SEC has opposed the proposed restrictions by the New York Stock Exchange restricting access to the exchange by foreign-owned securities firms. One of the exchange's arguments has been that access of foreign brokers to the exchange should be conditional on reciprocal rules in the foreign jurisdiction permitting access to the foreign market by American firms. In February 1976, it was announced that the SEC in conjunction with the Departments of State and Treasury would conduct a study of how American securities firms have been treated in foreign countries. It is too early to predict what effect, if any, this study will have on access by Canadian firms to American exchanges. *See* Inter-Agency Group

table jeopardy" has been created are serious. Many consider it a basic principle of fairness that persons who have acted in compliance with the laws of one jurisdiction should not be punished in another jurisdiction. A recent Canadian constitutional law decision is illustrative. In *Interprovincial Co-operatives Ltd. v. The Queen in Right of the Province of Manitoba,*[189] the appellants were prosecuted in Manitoba for polluting streams in Manitoba with mercury. The mercury entered the streams in Saskatchewan and in Ontario in both of which provinces the discharge took place in compliance with permits issued by government agencies. The Supreme Court of Canada by a majority of six to three held that the Manitoba statute under which the appellants were charged was *ultra vires.* Though the case turned on the interpretation of the BNA Act, both majority judgments emphasized the feature that Manitoba was treating as unlawful water contamination which had occurred at a place where it was lawful.

Obviously there are situations where the principle that one should not punish a person for an act which was lawful at the place where he did it should not apply. We do not suggest that it be established as a generalized defence. We do urge that the principle be kept in mind when drafting and applying the provisions relating to the extraterritorial enforcement of a federal securities law. However, it would be wrong to recommend an undue deference to foreign sensitivities which might restrain Canada from taking any extraterritorial action at all.

Another limitation to a policy of unilateral extraterritorial expansion is the practical code of conduct known as the "do unto others" rule. In the securities area, for example, Canada may be reluctant to impose on non-residents rules about trading in Canada which Canada would not want imposed on Canadians if the parties were reversed. An interesting example is a recent case in the Supreme Court of Ontario. McIntyre Porcupine, a Canadian company, had its shares listed on two American stock exchanges as well as on the Toronto and Montréal exchanges. American federal securities law contains a provision known as the "short swing" rule, the purpose of which is to protect shareholders from insiders trading in the securities of the company; an insider who profits by selling securities within six months of acquiring them is liable to the company for the profits. This rule is a trading rule, designed to protect both domestic and foreign shareholders. Yet in the *McIntyre Porcupine* case, Keith, J., of the Supreme Court of

Backs SEC-Led Study on Access to Foreign Exchanges, Securities Week (New York), February 23, 1976, at 2.

189 [1976] 1 S.C.R. 477, [1975] 5 W.W.R. 382.

Ontario, refused to apply it against a Canadian resident insider, even though that Canadian resident insider filed insider trading reports in the United States and therefore might have been considered to know the U.S. rule.[190] If Canadian courts are to grant such exemptions to Canadians, is it fair to purport to impose our trading rules on non-resident shareholders of Canadian companies?

The mutual fund problem illustrates to some extent our national interest in control over the activities of Canadian nationals and Canadian companies abroad. Some speculative ventures bring no benefit to Canada, but damage Canada's reputation and that of its legitimate business enterprises.[191] The IOS disaster was directed by an American resident in Europe, Bernard Cornfeld, who, with a large number of other people (Americans, Canadians and Europeans) in Europe brought enormous financial losses to investors in Europe and North America. Some of Cornfeld's vehicles were Canadian corporations, and a number of Canadians, and certainly many foreigners, now point at Canada and argue that financial losses would not have occurred if Canada had deprived the Cornfeld group of the use of Canadian vehicles. Though that position may strike some people as unrealistic, the fact remains that it is held. We conclude that Canada should be prepared to take action internationally when Canadian institutions are being abused to the detriment of Canadians and to Canada's reputation.

Chapter VII
Conclusions and Recommendations - Part I

A. SUMMARY

In this part we consider the extent to which a federal securities law, if enacted, should attempt to reach beyond the territorial limits of Canada. Foreign involvement in the Canadian securities markets is of significant magnitude, and we conclude that any new regulatory system must take cognizance of this and attempt

190 In a recent case a U.S. court reached the same result in an action by American shareholders under the short swing rule against Canadian directors of a Canadian corporation which was registered with the SEC and whose shares traded on the American Stock Exchange; *see* Wagman v. Astle, 380 F. Supp. 497 (S.D.N.Y. 1974). Wagman is discussed in Walters, *Extraterritorial Application of Section 16(b) of the Securities Exchange Act of 1934*, 32 WASH. & LEE L. REV. 699 (1975).

191 This seems to be commonly recognized by Canadian securities administrators. The QSC recently issued a cease trading order against a company run by Americans and advertising only in Europe but giving a Montréal address as a contact point; *see* The Montreal Gazette, May 7, 1975, at 15.

to regulate it. Some features of this foreign involvement can be adapted neatly into an essentially domestic system of regulation. However, as individual transactions are examined in detail, there are foreign features which would be very difficult to reach through an essentially Canadian system and there are foreign features which there is probably no point in reaching.

A broad measure of outreach is permitted by international law. Though legal thinking and legal systems (both civil and criminal) are founded on a concept of territoriality, there is considerable extraterritorial scope permitted in international law. Thus, if a Canadian federal securities law were to adopt criminal law rules, international law would recognize their enforcement against Canadian nationals abroad, against persons in Canada and notionally in Canada, and against persons abroad who could be brought within the protective or impact principle, namely, persons who conduct activities outside the jurisdiction knowing that their activities will have consequences within it.

A parallel pattern is apparent in the civil system. There is widespread recognition of a universality principle, namely, that a person can be brought before the courts of a jurisdiction if he is present in that jurisdiction, notwithstanding that his action took place prior to his arrival there. The civil system also reveals a number of ways in which a person who is outside the state can be treated notionally as being within it if he consents to be so treated or if he has some asset within it over which the domestic authorities can exercise control. There is also precedent for assuming jurisdiction on the basis of impact within the state when the actor, although outside, intends that his acts take place within it. The real problem is to find a meaningful limit on the exercise of external jurisdiction so that the interests of the different states can be accommodated. An obvious possibility is the dominant interest analysis. In the most sophisticated of the existing systems of securities regulation, that of the United States, there is very broad international outreach. The outreach actually exercised varies with the circumstances, more effort being made to reach the fraudulent trading transaction than to reach non-fraudulent transactions which might actually have greater economic impact on American investors. European countries, on the other hand, have not sought to expand their securities laws extraterritorially.

The existing Canadian legislation in general is drawn within narrow compass. The present provincial securities laws have limited extraterritorial scope, largely because in the areas in which most effort has been concentrated, regulation of issuers and brokers, control can be secured by requiring registration. The provincial departments in charge of securities have not been eager to

regulate to the limits of their powers and so their extraterritorial powers remain untested and largely unused. Similarly, the Criminal Code sections are subject to the general philosophic principle that criminal law should not be applied extraterritorially. However, in cases decided under the provincial statutes and the Criminal Code, there have been cases where the courts have been willing to apply the techniques for outreach which were discussed in chapters III and IV.

Finally, the national regulatory mood seems to be one of expansion, at least in areas where Canada's economic interests are concerned. This new mood in itself would probably justify a securities law which reaches as far abroad as international law allows. A second argument in favour of broad outreach is a philosophical one on which reasonable people could disagree: if we are going to do something, we should do it well and thoroughly.

A third ground is fairness, that all the players in the game should be governed by the same rules. Since there are a number of international players in the Canadian securities game they should be governed by the same rules as the domestic players. However the principle of fairness, if carried too far, can have unjust consequences, for example, if the effect is so far-reaching that the foreign person has no reasonable notice of the rule or if its terms are such that compliance with the Canadian rule will require him to violate a domestic rule in his home jurisdiction. Finding the correct compromise between universality and unjust consequences is very difficult. Two examples illustrate the dilemma. One is the potash controversy. Many people in Saskatchewan feel very strongly that the potash within their soil is theirs and that they should be free to make whatever marketing arrangements most benefit Saskatchewan. Many people in the United States feel very strongly that all price fixing is bad, domestic or foreign, by government or by private industry. It is not easy to reconcile these strongly held and divergent views. The second example is a contrasting one, the question of insider trading. Profiting on insider information is abhorred both in Canada and the United States. Yet as we saw in chapter VI,[192] courts in both countries have refused to apply against Canadian directors the short swing rule which is little more than a strict liability form of the rule against insider trading. These difficulties lead us to conclude that although our approach to securities regulation should be expansive it should, at the same time, be thoughtful.

The one missing link in our argument for an expansive approach to securities regulation is the statistical one. We have no

192 *See* text accompanying note 190 *supra.*

evidence, or even an estimate, of the deleterious effect, if any, of transactions with foreign features on the Canadian securities markets. But need for control reasonably may be inferred from the volume of such transactions and from their susceptibility to manipulation. (See chapters VIII and IX.)

B. RECOMMENDED JURISDICTIONAL PRINCIPLES

1. *Nationality*

If Canadian federal securities rules are enacted, we recommend that they be made applicable on the basis of nationality to Canadian citizens and landed immigrants. Though Canada has relied very little on the nationality principle in the past, there is little international objection to it. On the contrary, there is some international expectation that a nation will police its cheats wherever they may roam. Although unrealistic expectations that Canada will be successful in policing Canadians (wherever they may be) who violate Canadian securities laws should not be encouraged. Canada can protect some of its legitimate interests and win international approval by adopting the stance that it will enforce its securities laws against its nationals whether within or outside Canada. We would restrict the scope of the new jurisdiction which would be achieved by adoption of the nationality test by requiring that there be some significant connection with Canada in the underlying transaction.

2. *Territoriality*

Our second recommendation is that Canada exploit to the fullest the principle of territoriality. In its simplest form that means that Canadian rules apply to all acts on Canadian territory without regard to whether or not there are victims in Canada. We should not hedge the rule, as some U.S. courts have done,[193] by ignoring conduct which is merely preparatory or which is less significant than foreign conduct. Further, we recommend that the territorial rule be based upon any feature of the transaction rather than the whole transaction. It should not be necessary that all constituent parts of the whole transaction take place in Canada, so long as some part takes place in this country.

3. *Impact*

Our third recommendation is that jurisdiction be claimed on

193 *See* text accompanying note 135 *supra*.

the basis on impact within Canada. There are a number of important differences in the way in which this principle can be stated. We prefer the formulation adopted by the American Law Institute (ALI Federal Securities Code)[194] which sets out the impact principle in this way:

> "Within the limits of international law, this Code applies with respect to...
>
> "(C) an attempt, solicitation or conspiracy outside the United States to commit a violation of this Code within the United States; and
>
> "(D) any other prohibited, required, or actionable conduct (i) whose constituent elements occur to a substantial (but not necessarily predominant) extent within the United States or (ii) some or all of whose constituent elements occur outside the United States but cause a substantial effect within it (of a type that this Code is designed to prevent) as a direct and foreseeable result of the conduct."

We considered whether proof that the actor intended that his act have consequences within Canada should be required. We rejected the idea because of our dissatisfaction with the treatment of intent by the courts in Canadian securities cases such as *Lampard* and *Jay*.[195]

C. RECOMMENDED JURISDICTIONAL RULES

Different problems emerge when one attempts to apply these three basic principles of jurisdiction to the four separate classes of rule referred to in chapter I. C. Those four classes are: the registration of the issuer and its securities, registration of dealers and

194 ALI FEDERAL SECURITIES CODE, Reporter's Revision of Tent. Drafts Nos. 1-3, at 233, *as amended by*, Tent. Draft No. 5, at 230.

195 The *Lampard* and *Jay* cases are discussed in ch. VIII commencing with the text accompanying note 231. A formulation of the impact test, largely parallel to the rule we have quoted above but incorporating the element of intent was developed at the 55th conference of the International Law Association and is set out in W. Brown, Extra-Territorial Application of National Laws with Special Reference to Antitrust Law (July 1974) (unpublished paper delivered at the 15th conference of the International Bar Association at Vancouver). Its provisions are as follows (at 3):

> "Article 5
>
> "A State has jurisdiction to prescribe rules of law governing conduct that occurs outside its territory and causes an effect within its territory if:
>
> "(a) the conduct and its effect are constituent elements of activity to which the rule applies;
>
> "(b) the effect within the territory is substantial; and

advisers, trading rules, and rules governing stock exchanges. We shall consider each class in turn.

1. *Registration of Issuer and Its Securities*

The nationality of an issuer derives from the place where it is incorporated. A company incorporated in Canada should be subject to Canadian rules concerning registration as an issuer and registration of its securities. An argument might be made that an issue of securities may have no domestic impact; for example, a Canadian company with extensive operations elsewhere may decide to borrow at an American bank to meet an immediate need for cash for its American operations. The issue of the note evidencing the indebtedness may fall within sections of the law requiring registration of securities. It is arguable that in the circumstances the issue of the note has no relevance to the Canadian shareholders or to Canadian regulatory authorities and that the expense of registration should be spared. There is some strength to such a contention. However, we think that the law should be drawn to cover the issue of a note by a Canadian multinational wherever it occurs, but the exemptions to registration established either by statute or by regulation should exclude transactions which have no demonstrable effect on Canada or the Canadian shareholders. In contrast to debt issues, issues of equity shares, whether to residents or non-residents, would have a significant influence on the Canadian shareholders in that most new issues reduce the interest of the existing shareholders in the company.

What about the foreign issuer? Where an issuer is a foreign incorporated company and it plans an offering of securities which will be purchased by Canadian investors, then it may become involved in Canada in a number of ways. It may retain a Canadian underwriter. Such activity would justify regulation under the territorial principle. The impact principle may justify regulation where the issuing company conducts no physical activity in Canada but in which a number of shares are acquired by Canadians through such routes as immigrants bringing shares to this country or by Canadian individuals buying shares through American brokerage firms or Canadian branches of American brokerage firms.

The general principle should be that foreign companies making a distribution of their securities in Canada or whose securities

"(c) it occurs as a direct or primarily intended result of the conduct outside the territory."

are traded on a Canadian stock exchange should provide the regulatory agency with appropriate information by whatever system applies to similar issuers in Canada. The regulatory agency should have the authority to, and should be encouraged to accept, in satisfaction of the technical Canadian requirements, documentation prepared to fulfil substantially similar requirements under foreign legislation. Like the SEC it should also have the power to grant partial exemptions to foreign issuers both by regulation and on a case by case basis. With respect to "inadvertent issuers", those which have neither distributed nor listed in Canada but whose shares are owned by significant numbers of Canadians, we recommend a tiered system such as that obtaining in the United States. If the number of Canadian shareholders is substantial, perhaps over 2,000, Canada should require registration on the same basis as if the company had issued shares in a Canadian offering or had listed on a Canadian exchange. A middle tier should be created, possibly from 2,000 down to 500, for which filing only the material filed publicly in the issuer's own country and with stock exchanges or regulatory authorities in other parts of the world is required. "Inadvertent issuers" with fewer than 500 Canadian shareholders should not be subject to any filing requirements in this country.

We recommend that Canada adopt a requirement like the American one, that a foreign issuer be required to consent to service of process on it in Canada.[196]

2. *Registration of Brokers, Dealers and Investment Advisers*

Again we begin by considering the nationality test. Clearly a Canadian broker or adviser who carries on business in Canada must comply with whatever registration system is established. If that Canadian broker establishes a branch office in another country, information relating to the operation of the branch should be included in any filings or in any calculation of capital filed in accordance with Canadian requirements since the business is as much affected by its foreign liabilities as it is by its domestic liabilities. A more complex case is presented if the foreign branch is operated not by the Canadian broker but by a foreign subsidiary. Whether the foreign subsidiary itself should register in Canada should depend, in our view, on whether it does business in Canada. Registration should not be required on some theory of affiliated nationality. Whether the position of the subsidiary should be "consolidated" with the position of the parent for the purpose of

196 *See* Panel, *Securities Problems Relative to United States and Canadian Business Transactions*, 31 BUS. LAW. 801 (1976).

registration and purposes such as calculation of minimal capital, in our view should be decided by general legal and accounting principles. For example, if the Canadian parent has no legal responsibility for the liabilities of the foreign subsidiary, then such liabilities should not affect the registration in Canada of the Canadian parent.

The next test of the nationality principle is to consider whether registration should continue to be required when the broker or adviser emigrates from Canada and starts business afresh, for example, in San Diego. Such a person should not be expected to register in Canada unless he is doing business in Canada; in other words he should not be required to register in Canada merely because he is a Canadian citizen who advises Americans in San Diego about the purchase of American stocks. Nor should registration be required if his advice in San Diego is to Canadians resident in San Diego with respect to Canadian stocks. In the case of brokers and investment advisers, we would require that there be a substantial connection with Canada before registration is required on the basis of nationality. A requirement of substantial connection underlay our discussion of the registration of the issuer in chapter VII.C.1 above, but remained implicit because the substantial connection test is always met when a Canadian company issues a security, whether at home or abroad.

Irrespective of nationality, persons who carry on business as brokers, dealers or investment advisers in Canada should register because they are inside Canada and subject to territorial jurisdiction. To give an example, if a broker is required to file a notice of participation in an underwriting then a brokerage firm doing business in Canada should make such a filing, even if it is a completely non-Canadian transaction. The registration and disclosure scheme must be designed to reveal the worldwide position of a registrant and not merely its Canadian activities. The difficult question is the definition of what constitutes doing business in Canada. In deciding whether a foreign broker or adviser is doing business in Canada, one should have regard both to the territorial and impact principles. Whether the Canadian system should require registration of a brokerage firm in Seattle should depend on whether there is significant conduct within Canada by members or employees of that firm and whether, absent any such physical conduct, there is foreseeable impact in Canada of conduct taking place only within the United States. Registration of persons who, while physically outside the country, solicit orders in this country by mail or telephone or give investment advice to persons resident in Canada should be required. We concede that such a requirement might be difficult to enforce and that unthinking extrapolation of

the Canadian system could have absurd consequences, for example, if there were a Canadian ownership or Canadian management requirement for brokers and dealers. However, if the Canadian system establishes rules to protect investors from self-interested touting by a broker with an excessive supply of securities, the investor should be protected whether the touting originates in the same city or crosses an international border. This is an area where close attention will have to be directed to drafting the rules and where time-consuming discussions and negotiations with regulatory agencies in other jurisdictions will have to be undertaken. Again we recommend that Canada follow the American example[197] and require foreign brokers and advisers to file consents to service and to provide the Canadian regulatory authority with financial statements and other types of information as are required of domestic brokers and advisers.

3. *Trading Rules*

To what extent should the trading rules created by a Canadian federal securities law follow Canadians around the world and bind them to Canada's standards of business conduct in their transactions with other persons? It is easy to conclude that a Canadian resident in Toronto who engages in wash trading on the Toronto Stock Exchange should be subject to the Canadian law. But what about the Canadian emigrant living in Manhattan who, to assist some friends in stabilizing a market in shares being traded on the American Stock Exchange engages in wash trading on that exchange? Does Canada wish to claim jurisdiction over this transaction or should it be left to the attention of the New York Regional Office of the SEC? In our view, the requirement of a significant connection with Canada is equally as important in this area as it is in the rules governing brokers and advisers discussed in chapter VII.C.2 above.

The territorial principle should be exploited to the fullest in applying Canada's trading rules. There is already precedent for applying Canadian rules of trading conduct to activity taking place in the jurisdiction even when the victims of the dishonest act are outside it. The U.S. courts have retreated to some degree from this principle, partly as the result of the actions which have been brought in the United States in the IOS affair. In the *Bersch* case,[198] the court went so far as to articulate its concern that the precious resources of the U.S. courts were being unduly burdened

197 *See* text accompanying note 118 *supra*.
198 *See* text accompanying note 135 *supra*.

by foreign plaintiffs. In 1976 an excess of foreign plaintiffs seeking to apply Canadian rules to international transactions is not a burden under which we labour. If it becomes so in the future it can be dealt with at that time.

Our point is that if we have rules about fair dealing by buyers and sellers of securities, then those rules should be applicable for the protection of Canadian buyers and sellers irrespective of whether the other party to the transaction is in Montréal or in Montevideo. We should accept jurisdiction where a person in some other country plans some transaction to take place within Canada which will violate our laws. As we have seen above in chapter V, Parliament has recently amended the Criminal Code to give Canadian courts jurisdiction to try persons who, being abroad, conspire to violate Canadian criminal law.[199]

4. *Stock Exchanges*

A Canadian federal securities law does not need any extraterritorial rules about stock exchanges located in Canada. Stock exchanges may have special rules for foreigners. And one may need rules about the activities of foreigners affecting stock exchanges - for example, listing securities on them, buying and selling the stocks listed on them or affecting takeover bids through Canadian stock exchanges. To some degree such rules can be enforced by sections directed to the exchange in Canada. But these situations are covered by the types of rules we have discussed in C.1, 2 and 3 above and not by stock exchange rules as such.

Nor can a Canadian securities law control in any realistic way a stock exchange located abroad. There may be features about such exchanges which have impact in Canada: if their margin requirements are different from those in Canada, investors or Canadian brokerage houses may be attracted to transactions on those exchanges and the flow of business will have an effect in Canada. However, the way to control such activities is through rules affecting the Canadian investor or broker rather than attempting to regulate the foreign exchange.

In the foregoing pages of this chapter we have described the system of regulation which we think should be established in a Canadian securities law. There is another important feature to any system, namely, the way in which it is administered. Though it makes sense to write a statute claiming broad outreach under international law, it is less reasonable to exercise all of the claimed jurisdiction from the outset. The administrators of a Canadian

199 *See* text accompanying note 145 *supra*.

federal securities law should start with situations in which jurisdiction is least subject to controversy and should pay close attention to the effect of their attempts to apply Canadian rules extraterritorially, keeping in mind that Canada should not claim jurisdiction over persons in other states which it would not want to grant to the other states over persons in Canada.

Part II
International Enforcement

Chapter VIII
Special Characteristics of Securities Offences

In this part we discuss the investigation and enforcement of Canadian securities laws which have application abroad. Although L. H. Leigh's paper in this volume[200] more closely relates to the problems of detecting and punishing offences against existing rules, we include in this paper a brief description of those problems as an introduction to the issue of international enforcement.

A. DIFFICULTY OF INVESTIGATION

Many features of the securities markets make investigation of crimes such as market manipulation difficult. For example, consider the problem of beneficial ownership. Tracing transactions through transfer agents and brokerage houses is laborious even where the records of the transaction reveal the true names of the parties involved. It requires much police work to discover who the real persons behind the trades have been.[201] The difficulty is increased where certificates are in street name[202] and nominee

200 *See, Leigh, Sanctions.*

201 In the United States the SEC has proposed new rules to increase disclosure of beneficial ownership and to require disclosure of foreign ownership. The commission received more than 225 letters of comment on its proposals and expects to take final action by the end of 1976; *see* Hoffman, *Beneficial Ownership*, 8 REV. SEC. REG. 813 (December 16, 1975); *Comment Letters Run Heavily against Commission's Proposals to Expand Disclosure of Beneficial Owners*, 329 BNA SEC. REG. & L. REP., November 26, 1975, at A-1; *The S.E.C.'s Beneficial Ownership Proposals: You Can't See the Forest for the Trees*, 365 BNA SEC. REG. & L. REP., August 11, 1976, at B-1.

202 In the United States, the Securities Reform Act of 1975 authorized the SEC to undertake a study and investigation of the practice of recording ownership in the name of a person other than the beneficial owner of a security. The final report is due in December 1976. In December 1975, the commission filed its preliminary report in which it stated that the practice was necessary to the efficient processing of securities transactions and that, though there might be some abuse of the

accounts are used and by the fact that stock exchanges themselves keep records of trades only by brokerage houses and not beneficial owners. An investigation into manipulation of a stock that trades, for example, on both the Toronto and Vancouver stock exchanges involves combing the records of scores of brokerage houses in two provinces. Even this process can be complicated by jitneyed trades, that is, the practice by which one broker trades on behalf of another. Yet another problem is that many accounts are opened in brokerage houses subject to the condition that persons other than the named customer have the right to authorize trades in them. In addition, Canadian chartered banks often trade on behalf of customers without disclosing beneficial ownership.

Even where persons deal directly in the market it is difficult to follow their transactions. Innocent persons may be used as a screen for fraud as in the device of "warehousing". The organizer of a warehousing scheme bribes individual salesmen in brokerage houses through payment of secret commissions to purchase or sell stocks on behalf of accounts over which they have control, either through their personal relationship with the customer or through some more formal arrangement. Typically the stock is bid up and when it falls, the customer usually does not suspect his broker since most customers accept some losses as well as some gains.[203]

Innocent persons may also be used as a screen for fraud when the manipulator can convince an investment adviser or a publication reporting on business affairs to publish inaccurate information which influences the price of a security; and a financial writer may be bribed to publish false information or use his position of public confidence to influence the price of securities in which he himself has an interest.[204]

Theft of stock is a problem of some significance. If one compares the physical and market characteristics of stock certificates

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system, the most desirable remedial course of action would be to improve access to the underlying records for those with legitimate concerns rather than to ban the practice or create a new reporting system; SEC, PRELIMINARY REPORT OF THE S.E.C. ON THE PRACTICE OF REVEALING THE OWNERSHIP OF SECURITIES IN THE RECORDS OF THE ISSUER IN OTHER THAN THE NAME OF THE BENEFICIAL OWNER OF SUCH SECURITIES (December 1975).

203 Warehousing is discussed in a decision of the B.C. Corporate and Financial Services Commission; *see* Re Cerney, B.C. Corporate and Financial Services Commission Weekly Summary, June 27, 1975, at 1. The payment of additional compensation to a salesman for "placing" stock is considered in Re Ewing, B.C. Corporate and Financial Services Commission Weekly Summary, June 6, 1975, at 3. *See also* Re Beech, B.C. Corporate and Financial Services Commission Weekly Summary, July 25, 1975, at 1. For a complete description of warehousing in another context, *see* P. ANISMAN at 108-41.

204 *See, Writers Charged with Touting Stocks for Gain,* Vancouver Sun, October 29, 1974, at 37.

with those of, say, a television set, the advantages of dealing in stolen securities are obvious particularly at the disposition phase. Securities can be mailed from city to city and even from country to country with virtually no risk of detection. Moreover, as a representative of the American securities industry has pointed out, securities are especially vulnerable to theft because they are constantly in transit for the completion of transactions or for transfer from one person to another.[205]

As of 1976 the most widespread securities offence in Canada is market manipulation.[206] This sin comes in many forms, varying from wash trading to essentially invisible arrangements by which corporations acquire or transfer assets in transactions with their "friends" for dubious consideration. There have been some instances in Canada of a more sophisticated technique which is now the most common type of securities offence in the United States, namely, the use of false assets as collateral to create a credit base with a bank or brokerage institution.[207]

A false asset may be merely a balance sheet of a company whose books show mining claims, notes, mortgages or other assets which are valueless intrinsically or because they, in turn, depend on the credit-worthiness of a shell corporation.[208] Having obtained credit from the institution, a firm may draw funds from the institution itself or use the credit so established as a means of speculating in the stock market. If the speculation is successful the invalidity of the "security" may never come to light. But if it is unsuccessful, the speculator disappears leaving his worthless "security" behind him. The "security" may also be used as the basis for the loan fee swindle, by which one or more potential borrowers put up a loan fee to a supposed lender who then disappears with the fee and never issues the anticipated loan.[209]

Depositing stolen or counterfeit securities with banks or brokerage houses as collateral is easier than transferring them in a

205 *Organized Crime, Securities: Thefts and Frauds: Hearings before the Permanent Subcomm. on Investigations of the Senate Comm. on Government Operations*, 93d Cong., 1st & 2d Sess., 2d ser., pt. 4, at 615 (1973-74) (witness William J. Fitzpatrick) [hereinafter cited as *Organized Crime Senate Hearings*].

206 *See* the description of the mechanics of a typical manipulation in COORDINATED LAW ENFORCEMENT UNIT, INITIAL REPORT ON ORGANIZED CRIME IN B.C. 26-27 (1974).

207 One expert has testified that the pledging of worthless securities at American banks is now declining because it leaves traces of a crime. Most stolen securities are now taken outside the U.S. where tracing is difficult. *See, Organized Crime Senate Hearings, supra* note 205, pt. 2, at 150 (witness L.P. Mastriana).

208 For a general description, *see* the evidence of an investigator for the Senate subcommittee, P.R. Manuel, *Organized Crime Senate Hearings, supra* note 205, pt. 2, at 125-34.

209 On methods of converting securities to cash *see* Securities Unit, Dept. of Justice, *Let's Blow the Whistle on the Securities Game*, 60 ABA J. 461 (1974).

sale. It is becoming increasingly difficult to obtain cash for stolen securities through direct sale, since the brokerage industry is tightening its procedures for detecting worthless securities.[210] Where a brokerage house expects to pay cash to a seller of securities, it normally inquires into his title to them. But current business practice does not always include a thorough inquiry into the ownership of collateral.[211] A number of American banks now follow a procedure by which they transfer securities taken as collateral into the name of the bank itself or the name of a nominee.[212] Canadian banks do not seem to have adopted this procedure. Criminals in the U.S. have reacted in two ways: they now take stolen securities out of the country where tracing is more difficult and they find ways of establishing trust accounts or safekeeping accounts in banks and obtaining receipts or other forms of validation from the bank which can, in turn, be used to obtain credit. Swindlers also put stolen, counterfeit of worthless paper in insurance company portfolios or pension plan funds because of their more relaxed accounting standards.[213] Even in banks the normal practice of bank examiners is to verify the existence but not the validity of securities. One of the difficulties is that banks and brokerage houses in local communities often are hesitant to report securities as stolen until they are certain a theft has occurred because of the possibility of legal liability for inaccurate reporting and also because of adverse public relations.[214]

In the United States there were two separate computer systems to which a person seeking to validate the ownership of stock could turn. The only system now functioning is the Federal Bureau of Investigation's National Crime Information Center (NCIC) which contains information about stolen securities. The estimated value of the stolen securities listed on NCIC in 1973 was approximately $156 million. Law enforcement agencies, including local, state and federal agencies throughout the United States and Canada have direct access to the NCIC and the industry has access

210 *Organized Crime Senate Hearings*, *supra* note 205, pt. 4, at 614.

211 *Id.*, pt. 1, at 36; pt. 4, at 572-73.

212 *Id.*, pt. 4, at 581. On December 23, 1974, the U.S. Attorney-General, William Saxbe, issued a long press release describing the Department of Justice's recommended methods for detecting forged or stolen securities as well as for preventing other types of securities frauds.

213 *Id.*, pt. 2, at 150. An example of a case in which a swindler cleverly used the problems of international communication to defraud a Swiss bank by transactions in British Columbia is Bank Fur Handel v. Davidson & Co., 46 D.L.R. (3d) 3 (B.C.S.C. 1974), *appeal dismissed* 55 D.L.R. (3d) 303 (B.C.C.A. 1975), *leave to appeal refused,* 5 N.R. 367 (S.C.C. 1975).

214 *Organized Crime Senate Hearings*, *supra* note 205, pt. 4, at 586, 610.

to NCIC only through them.[215] The NCIC system includes securities stolen in Canada.

The other computer system was the Sci-Tek system of the Securities Validation Corporation (SVC) which listed lost and missing certificates as well as stolen ones. The SVC computer facility contained approximately nine times as many items as that of the FBI. Access to the SVC computer was direct but the person seeking the information had to pay a fee. By 1974 the value of the securities in the SVC system had grown to $11.1 billion. In early 1975 it went out of business because of poor broker and bank support.[216] The RCMP is now putting into operation a computer system known as the Canadian Police Information Centre (CPIC) which will list stolen, lost and missing Canadian securities.

Some American estimates suggest that only 10% of the stolen securities are listed on the computer system[217] and the securities industry has not thrown itself wholeheartedly into an effort to make the computerized system work more thoroughly. This results in part from the feeling that more diligent work would be too expensive, in part from the difficulty created by the size of the problem. It is also clear that, as a percentage of sales, the value of lost and stolen securities is fairly low. Though there had been cause for concern in the early 1970s, by 1974 stock thefts had become less of a problem and insurance rates were dropping.[218] Moreover, security systems had become much better by 1974, at least in the bigger brokerage houses.[219] However, there is support in the American securities industry for a mandatory system by which persons who receive negotiable instruments must check their validity against a centralized information system such as the NCIC system.[220] The American banking industry, on the other hand, opposes a system of compulsory validation.[221] The banks argue that mandatory validation would be unwieldy for them, that it would be expensive and would duplicate satisfactory procedures which the banks already have implemented. The banks have experienced fewer incidents of disappearing securities than the brokerage industry and are able to demonstrate that the problem is minor as far as they are concerned.[222] Another argument the

215 *Id.*, pt. 1, at 47; pt. 4, at 483.

216 *See* Securities Week (New York), January 13, 1975; The Wall Street Journal, January 7, 1975, at 7.

217 *See e.g.* Securities Unit Department of Justice, *supra* note 209, at 461. This estimate predated the failure of the SVC system.

218 *Organized Crime Senate Hearings*, *supra* note 205, pt. 4, at 632, 655.

219 *Id.*, pt. 4, at 603-04, 612-13.

220 *Id.* at 605, 618, 620, 646.

221 *Id.* at 535, 537, 540, 543, 550.

222 The various arguments can be found *id.* at 535-84.

banks advance is that the really sophisticated thief will soon learn that stolen securities can only be passed if they are sold prior to their discovery from the institution in question.[223]

There are allegations that one of the chief reasons for bank opposition to mandatory validation is the fear by the banks that they would lose their status as holder in due course, a change which could cause them significant loss. But the banks have generally denied this has any significant part in their opposition to compulsory validation.[224]

The 1975 amendments to the Securities Act permit the SEC to require brokers and dealers promptly to report missing, lost, or stolen securities, require fingerprinting of all brokers and dealers and permit the SEC to enter into an agreement to use the facilities of the NCIC.[225] A proposed rule would require reporting of lost, counterfeit or stolen securities within a certain time; in addition, specified persons receiving securities would be forced to inquire from a central data bank as to their status. An impact study of the proposed rule, undertaken by the Securities Industry Association, suggests that the proposed reporting requirements would be manageable but urges that the time limit be extended. But the association concluded that the proposed inquiry procedure would be very costly and suggested modifications to reduce the burdens, the cost of which would fall on the retail clients of the firms involved. At the time of writing, the proposed rule has not been adopted by the commission.[226]

An ultimate solution may be to adopt a system in which certificates are never delivered but remain in a centrally located depository. There is wide support for such a system in the United States, based in part on favourable experience with the Federal Reserve Bank depository system for federal government securities.[227]

223 Other reasons for bank opposition to mandatory verification may be found *id.*, pt. 1, at 45.

224 *Id.*, pt. 4, at 485, 584. *See id.* at 494 for a description of the reluctance of some segments of the American securities and banking industries to become involved in the SVC system and for a description of the legal problem concerning holders in due course status. On the success of the SVC system, *see id.* at 503, 505, 511.

225 *See* Securities Exchange Act of 1934, s. 17(f)(1); Rowen, *supra* note 119, at 889. Pursuant to that power the SEC has proposed Rule 17f-1 on reporting and inquiry with respect to missing, lost, counterfeit or stolen securities. *See* SEC, Securities Exchange Act of 1934 Release No. 12030, January 20, 1976.

226 *See, SIA Urges SEC to Modify Missing Securities Inquiry Proposal, Following Impact Study,* Securities Week (New York), June 7, 1976.

227 *Organized Crime Senate Hearings, supra* note 205, pt. 4, at 533, 544, 551, 556, 567, 605, 617, 620, 623. A description of the progress to date in creating such a system in Canada through the Canadian Depository for Securities Ltd. is contained in *Cleland, Applications of Automation.*

Another factor which contributes in some way to the difficulties of securities enforcement is that it is by reaction to complaints by individuals. Such enforcement, by definition, is after the event, and means that schemes are not apprehended in their formative stages before damage can develop. Some preventive work is being done in Canada through the Crime Investigation Unit of the RCMP, but on the whole, enforcement in this country is by reaction.

B. DIFFICULTY OF PROVING VIOLATION

Under their authority to stop trading,[228] the commissions have the power to act unilaterally and swiftly. However, a cease trading order is often an inappropriate remedy. It does not make sense to stop trading in the shares of MacMillan Bloedel Ltd. because a widow has bought a few hundred shares in a falling market on the representation by a broker that the company has found a way to turn wood into gold. At the other end of the scale, there is no point in stopping trading in a penny mine when its stock returns to the normal trading range after having been run up by a fraudulent scheme. In these situations, it is important to focus on the individual wrongdoers.

Though it is possible to reach individual wrongdoers with individualized administrative sanctions, normally they are inappropriate and one must resort to the criminal law, with all its technical defences for the accused, including the hurdle of proving guilt beyond a reasonable doubt.

Securities offences by their nature are usually complicated, and proving what happened in a manipulation may be very difficult. It is one thing to read an entry on a computer printout which shows the trades which caused the movement of the stock in question. But it is another thing to prove the transactions shown on that tape connecting the principals to the brokerage houses and connecting the documents prepared in them, and in a stock exchange, with the final result on the tape. Bank records, too, are being increasingly computerized and there is little experience in making computer records admissible in courts.[229] Enforcement officers are also concerned about the ease with which evidence on computer tapes can be destroyed.

Enforcement officials point out that disapproval of so-called "white collar" crimes is not as strong as for other offences such as

228 *See e.g.* B.C. Securities Act, s. 77A.

229 Evidentiary problems arising from computer-generated evidence are discussed in

theft and robbery which have the same effect.[230] Sentences often seem light when compared with the amount of money involved. Enforcement officials argue that harsher penalties can be justified in securities cases because the offence normally involves prolonged and consistent criminal intent.

In addition to the factual problems such as those referred to above, securities cases often involve complicated evidentiary and psychological problems of intent. An illustration is the *Lampard* trial.[231] The accused was acquitted after a trial on an indictment containing twenty-nine counts alleging wash trading under section 325(a) (now section 340(a)) of the Criminal Code which provided:

> "Every one who, through the facility of a stock exchange, curb market or other market, with intent to create a false or misleading appearance of active public trading in a security or with intent to create a false or misleading appearance with respect to the market price of a security,
> "(a) effects a transaction in the security that involves no change in the beneficial ownership thereof...
> " is guilty of an indictable offence and is liable to imprisonment for five years."

The accused had been in the brokerage business for many years and was president of a broker-dealer firm Lampard & Company Limited which had two other employees, Teresa Murray, the secretary-bookkeeper and H.K. Roberts who was employed to run a publicity campaign in connection with the shares of Dominion Leaseholds. The Crown showed that on six different days in January and February 1963, large numbers of wash trades were made by the accused in the shares of Dominion Leaseholds. On the buy side the accused employed seven different brokers, and placed orders in the name of Lampard & Company as buyer. Most of the sell orders were by a different brokerage house on the accused's instructions through accounts in the names of the two employees, Murray and Roberts. Murray received payment and transferred it to the accused. The accused established a bank account in the name of Roberts and cheques payable to him were deposited in it and the

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Mock Trial Admissibility of computerized Business Records, 15 JURIMETRICS J. 206 (1975).

230 *See e.g.* McNeill, *Commercial Criminals Face RCMP Crackdown*, Vancouver Sun, September 24, 1975, at 47, where it is asserted that a "history of judicial wrist-slapping has made commercial crime an attractive proposition in Canada..." *But see* the fines imposed in R. v. Armco Canada Ltd. (No. 2), 8 O.R. (2d) 573, (H.C. 1975), *modified*, 13 O.R. (2d) 32 (C.A. 1976); R. v. Ocean Construction Supplies Ltd., 61 D.L.R. (3d) 323 (B.C.C.A. 1974). And *see*, *A.J. Lefferdink Gets Eight-Year Sentence in $5 million Fraud*, The Wall Street Journal, April 28, 1976, at 30.

231 R. v. Lampard, [1968] 4 C.C.C. 201 (Ont. C.A.), *rev'd*, [1969] 3 C.C.C. 249 (S.C.C.).

proceeds used to pay for purchases of shares in Dominion Leaseholds or were transferred by cheque to Lampard & Company. The trading constituted a significant percentage of the daily trading. On one day the total trading was 152,000 shares and the Lampard trades amounted to 32,000 shares. This was the lowest percentage of "Lampard trades" of the days for which evidence was given. On another day the total trading was 72,000, the wash trades 69,500 and on the four other days the wash trades amounted to more than 75% of the total trading. Over the two-month period the price moved from 48-1/2¢ to 74¢.

The trial judge concluded that the accused effected the transactions without changing beneficial ownership and that he did so intentionally. However, the trial judge decided that there was reasonable doubt whether the accused had committed the foregoing acts with intent to create a false or misleading appearance of active public trading and explained his doubt on the question of intent by referring to three factors. First, he was not convinced of the Crown's theory that the accused was motivated by profit because the judge reasoned that the accused might not be able to dispose of the stock at its highest price. Second, there might be some other motive. Third, the evidence was confined to six of the thirty-one trading days in the period between January 7 and February 18. There being no evidence of the volume of trading on the days other than those specified in the indictment, it was not clear to the trial judge that there was a false and misleading appearance of active public trading over the period.

The Crown appealed the acquittal. The only appeal lay on a question of law. The Ontario Court of Appeal concluded the proper inference to be drawn from the facts in the record was a question of law and reviewed the record. It said:

> "Considering the transactions proved in the twenty-nine counts, their proximity in time, the manner in which they were executed, including the subterfuge with respect to most of the sales, the employment of Roberts to run a publicity campaign with respect to the shares of Dominion Leaseholds, I can come to only one conclusion – and in my opinion it is an irresistible one – that the respondent was engaged in a scheme or plan to create a false and misleading appearance of active public trading in the shares of Dominion Leaseholds."[231a]

However, the Supreme Court of Canada allowed the appeal and restored the verdict of acquittal, holding that the question of the

231a [1968] 4 C.C.C. at 208.

accused's state of mind was purely a factual matter not subject to appeal.[232]

232 Another case illustrating the difficulties caused in securities cases by the elusive criminal law doctrine of intent is R. v. Jay, [1966] 1 C.C.C. 70 (Ont. C.A. 1965) which involved a charge under para. 325(b) of s. 325, now s. 340(b):

> "Every one who, through the facility of a stock exchange, curb market or other market, with intent to create a false or misleading appearance of active public trading in a security or with intent to create a false or misleading appearance with respect to the market price of a security...
> "(b) enters an order for the purchase of a security, knowing that an order of substantially the same size at substantially the same time and at substantially the same price for the sale of the security has been or will be entered by or for the same or different persons,
> "is guilty of an indictable offence and is liable to imprisonment for five years."

Section 325 referred to two types of intent, one to create a false or misleading appearance of active public trading and the other to create a false or misleading appearance with respect to the market price. The accused was convicted by a jury on a charge alleging the former, namely, intent to create a false or misleading appearance of active public trading. During August and September 1960, the accused acquired a substantial number of the shares of National Hosiery Mills Ltd. and in the course of doing so bought and sold extensively pursuant to purchase and sale orders entered by him. In reviewing the evidence, the Court of Appeal compared the purchase and sale orders, and its comparison revealed that in only one instance were there matching orders. Sometimes the orders differed on quantities and at other times on price; many of the purchase orders preceded the sale orders in time. The Court of Appeal, emphasizing the Crown's failure to prove intent, stated that the Crown had not proved its case. The court's comments were somewhat alarming; there was evidence that the accused was seeking election to the board of directors through becoming a holder of a substantial quantity of shares. The stock had been comparatively inactive on the Toronto Stock Exchange. Roach, J.A., said (at 72):

> "A purchaser intending to accumulate a portfolio of shares in a given company at the most advantageous price would be interested in preventing a continuing rise or skyrocketing in the market caused by his own continuing buying and, as a brake against that possible result, would be justified in his own interest in putting some of his own shares on the market in an effort to have the supply offset the demand. In other words he would try to stabilize the price for his own advantage and if that alone was his purpose, then he would not have the intent which is an element of the offence created by 325(b). To put it otherwise, he would not thereby intend to create a false appearance of active public trading. His purposes would be legitimate. There was no evidence in this case to negative that legitimate purpose."

One startling aspect of the foregoing is that s. 325 is also directed at creating a false or misleading appearance with respect to the market price of a security. The Court of Appeal in Jay has stated that manipulating the market is legitimate provided that a person is "stabilizing" it. Surely the evil is as great if the manipulator is thwarting the normal market processes by making the stock price stable as it is if he causes the price to rise or fall? Secondly, the evil inherent in an artificial volume of trading is demonstrated by the Jay case itself, where the increased volume was used as a shield for the price manipulation which so pleased the Ontario Court of Appeal. "Stabilizing" is a virtually essential step in a fixed-price underwriting. Its use to eliminate peaks and valleys in a market is defended and even advocated by distinguished securities law experts whose integrity is beyond question. But "smoothing a valley" is nonetheless manipulating, even if blessed with the appella-

The *Lampard* and *Jay* cases are but illustrations of the difficulties facing enforcement officials. There is insufficient space in this paper to refer to the various other problems but some general points can be referred to in passing. Proving the real value of assets being bought or sold by a corporation in a transaction with another corporation related by common shareholding or even by the "friendliness" of the principals involved may create difficulties. Directors of legitimate businesses must have some discretion in valuing the consideration upon which assets are bought and sold and it is difficult to create a system which prevents the unscrupulous from taking advantage of this leeway. It is also often difficult to prove that certificates have been stolen. While the custodian can testify that a particular certificate now produced is "missing", its officers are often unable to say on oath that the certificate was stolen. Where a stolen certificate is blank, a complication arises from the fact that its intrinsic value is low and, accordingly, the penalty meted out to the thief is lower if he is caught before he has had a chance to fill in a dollar amount or number of shares. Parliament has now dealt with this situation so that there is a sanction available when the police arrive too late and find that the certificates have been sold for cash or find that Canada is being used as a place to "launder" the proceeds of certificates stolen elsewhere. Section 312(1) of the Criminal Code makes it an offence to possess property or any proceeds of such property if it was obtained by conduct constituting an indictable offence whether the conduct took place in or out of Canada.[233]

Difficulties also arise in proving volume. Records are not readily available where a transaction occurs in the over-the-counter market. Though the information turned up by investigations under the securities acts is useful in a subsequent prosecution, it does not itself constitute a "business record" so that it is not admissible as such but must be proved laboriously. Offences involving securities, particularly fraud cases, take a long time to prepare, compared to many other types of criminal case. The amount of legwork is extensive.[234] The investigators must be experienced in the ways of the market and the persons who manipulate it. Many police forces just do not have the resources to be able to take on securities investigations. How much money should be dedicated to

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tion "stabilizing". We leave to those experts the task of defining permissible manipulation.

233 The then Minister of Justice's remarks on this feature of this legislation (then in bill form) are quoted in part in Mackie, *Gov't Turns in Ticket on "Laundered Money"*, Vancouver Sun, August 1, 1975, at 6.

234 *See* the discussion of the difficulty in marshalling sufficient manpower and resources in COORDINATED LAW ENFORCEMENT UNIT, *supra* note 206, at 27.

the problem of enforcement? It may be cheaper for society as a whole to accept a certain amount of dishonesty in the securities markets than to attempt to stamp it out completely.

Yet there is some reason for optimism. Most experts in the enforcement of securities laws believe that success in prosecution requires only the continued and concentrated attention of enough experienced people,[235] and that a major innovative overhaul of the types of offences is not required. More prosecutions are successful now than they were in the past because there is now greater expertise among investigators and prosecutors. There is also a higher level of enforcement and a greater level of cooperation between the members of the industry, the stock exchanges and the police.

Chapter IX
Special Problems of International Offences

A. STRUCTURAL DIFFERENCES

The special problems of investigation and proof of securities offences referred to in chapter VIII are exacerbated in the international situation. In the domestic situation a great deal of information is obtainable even though combing through it may be time-consuming and proof of an offence may be complicated. For example, the Criminal Code authorizes peace officers to search premises and to seize and retain documents relating to a criminal offence which has been committed or is suspected of having been committed.[236] In domestic cases legislation specifically facilitates proof of financial transactions shown in entries in books or records of deposit-taking institutions incorporated in Canada.[237]

In addition, the provincial securities acts typically contain very broad powers of investigation.[238] Section 23 of the British Columbia Securities Act, for example, authorizes the Superintendent of Brokers to investigate contraventions of the act or the regulations and offences committed under the Criminal Code in

235 *See* on the history of the RCMP Commercial Crime Branch, Moon, *Canada's Top Criminals Move into Big Time Fraud*, The Globe and Mail (Toronto), April 2, 1975, at 3, col. 5.

236 *See* Criminal Code, ss. 443-446.

237 *See e.g.* Canada Evidence Act, s. 29(3).

238 For a more extensive discussion of the process of information collecting *see* Baillie, *Discovery-Type Procedures in Security Fraud Prosecutions*, 50 CAN. B. REV. 496 (1972). Further, the provinces are moving to create a system of interprovincial subpoenas so that witnesses can be subpoenaed in one province to give evidence at a trial in another province; *see* Interprovincial Subpoena Act, Bill 19, 31st Parl. B.C., 1st Sess., 1976.

connection with a trade in securities. The legislation defines the scope of investigation in the following broad language:

> "For the purposes of an investigation ordered under this section, the person appointed to make the investigation may investigate, inquire into, and examine
>
> "(a) the affairs of the person or company in respect of which the investigation is being made and any books, papers, documents, correspondence, communications, negotiations, transactions, investigations, loans, borrowings, and payments to, by, on behalf of, or in relation to or connected with the person or company and any property, assets, or things owned, acquired, or alienated in whole or in part by the person or company or by any person or company acting on behalf of or as agent for the person or company: and
>
> "(b) the assets at any time held, the liabilities, debts, undertakings, and obligations at any time existing, the financial or other conditions at any time prevailing in or in relation to or in connection with the person or company, and the relationship that may at any time exist or have existed between the person or company and any other person or company by reason of investments, commissions promised, secured, or paid, interests held or acquired, the loaning or borrowing of money, stock, or other property, the transfer, negotiation, or holding of stock, interlocking directorates, common control, undue influence, or control or any other relationship."[239]

The legislation vests in an investigator the same power granted to the Supreme Court to summon and enforce the attendance of witnesses and compel them to give evidence on oath or otherwise, and to produce documents, records and things. Failure to testify or to produce information makes a person liable to be committed for contempt by a judge of the Supreme Court.[240] An investigator is also authorized to search for and retain any document, record, security or other property from the person or the company whose affairs are being investigated.[241]

The various filing and disclosure requirements ensure that a great deal of information is available to investigators since the securities commissions collect information on a regular basis for other purposes which is available to investigators. For example, the acts typically require registration of individual persons in-

239 B.C. Securities Act, s. 23(3).

240 *Id.* s. 23(4).

241 *Id.* s. 23(6).

volved in the securities industry[242] and require registration and disclosure by issuing companies.[243] James C. Baillie points out that often companies disclose more than they are legally bound to because of the importance of maintaining good relations with the securities commissions.[244]

The self-regulating organizations within the industry also collect information which is available to the regulatory commissions.[245] And, finally, in major cases, royal commissions have been convened to investigate suspected securities offences.[246]

The situation is rather different when a Canadian enforcement agency wishes to investigate a company incorporated in a foreign jurisdiction.[247] It goes without saying that Canadian subpoenas do not run to foreign jurisdictions. Generally speaking Canadian investigators cannot obtain documentary evidence or testimony from unwilling foreign persons. A Canadian investigator still has access to the foreign disclosure system and in some jurisdictions the information available is even more extensive than that required in Canada of Canadian companies. A familiar anomaly is that a Canadian investor or investigator sometimes can find out more about a Canadian company in the files of the SEC in Washington than he can in Canada.

On the other hand, many foreign jurisdictions require much less disclosure than Canada. Often records of a foreign jurisdiction show only the incorporators of the company; there is no information on the beneficial owners of the shares or even subsequent registered owners. Thus a foreign corporation may carry on an active business in Canada with records showing only the initial nominee subscribers who acted for the incorporating lawyer.[248] Some jurisdictions permit the incorporation of institutions which are named and exist as banks but which in fact are nothing more

242 *Id.* s. 7(1).

243 *Id.* ss. 7(1), 38.

244 Baillie, *supra* note 238, at 500.

245 *Id.* at 498.

246 *Id.* at 497.

247 Obviously the difficulty of obtaining information abroad is not unique to Canadian enforcement agencies. An illustrative account of the difficulties in securing foreign business records relating to the regulation of foreign shipping and of national sensitivity to enforcement of foreign laws may be found in Magnusson, *The Need for International Agreement in Obtaining Evidence from Foreign Countries*, 26 FED. B.J. 232 (1966). As this paper is being written, the SEC is pressing for greater authority and additional sanctions because of the difficulty it is experiencing in enforcing U.S. laws when there is a foreign aspect to a transaction; *see*, *Hills Says S.E.C. Needs More Tools to Catch Securities Violations by Foreign Holders*, The Wall Street Journal, June 29, 1976, at 4.

248 Even when records are available they do not provide essential information such as the identities of controlling shareholders; *see* Starks, *Bahamian Bank Intrigues Canadian Investigators*, The Financial Post (Toronto), February 14, 1975, at 36.

than shells.[249] Finally, nominee shareholders are more common in the international situation. A 1975 study of investment in the United States shows that of $25 billion in stocks held by foreign investors, only $8 billion was registered in the name of foreign persons. About $17 billion was held by United States holders of record. Of this amount, nearly $9 billion was held for foreign nominees and an additional $3.6 billion was held for foreign investment companies and other institutional holders. Foreign resident individuals held $2.5 billion and foreign official institutions $0.8 billion.[250]

B. BANK SECRECY

One of the great difficulties encountered in foreign investigations is bank secrecy. Switzerland is the country normally associated with bank secrecy but in fact many other countries have similar laws. As the bank secrecy laws have made a significant contribution to Switzerland's economy by assisting it in becoming an international banking centre, the trend to bank secrecy is likely to increase. Singapore, for example, recently passed a law similar to that of Switzerland with the express intention of becoming the Switzerland of the Far East. Other examples of countries with bank secrecy laws are Hong Kong, Lebanon and Panama.

Switzerland provides the most convenient example for discussion since so much has been written about it. A secret bank account is useful for a host of things: tax evasion, "cleaning" stolen money, evasion of insider trading and other rules regulating the disclosure of share ownership.[251] The size of foreign holdings in Switzerland is not known, but it has been calculated that Switzerland, a relatively small country, makes about one third of all the purchases in long-term securities by foreigners in the United States and that about one half of European purchases in U.S. securities come from Switzerland as opposed to 20% from Britain and 10% from France, the next two largest purchasers.[252] Even if normal incentives to

249 *Organized Crime Senate Hearings, supra* note 205, pt. 2, at 248-50.

250 UNITED STATES TREASURY DEPARTMENT, INTERIM REPORT TO THE CONGRESS ON FOREIGN PORTFOLIO INVESTMENT IN THE UNITED STATES 14 (1975) (pursuant to Foreign Investment Study Act of 1974, Pub. L. 93-479).

251 *See* Ise, *Secret Swiss Bank Accounts As a Mechanism for Violating United States Securities Laws: An Analysis of Proposed Solutions*, 11 B.C. IND. & COMM. L. REV. 194, 203 (1970) for a description of their use to violate securities laws. *See* the references to the use of Swiss bank accounts in *Organized Crime Senate Hearings, supra* note 205, pt. 1, at 59, 60; *see also* the reference to the difficulty of obtaining information because of Bahama banking secrecy *id.* at 27.

252 *See* Ise, *supra* note 251, at 195. Switzerland maintained its lead into 1975; *see*, *Foreign Commissions Reach $20.8M on NYSE*, The Commercial and Financial Chronicle (New York), March 3, 1975, at 1.

bank in a stable country with a strong currency are discounted, it still seems that a large part of this investment must come from the United States through the Swiss banks. The American regulatory authorities are confident that Swiss banks are being used by American residents to evade American securities laws, including the insider trading provisions.[253]

The Swiss banking law derives from a deep-seated historical view that a bank account is merely an extension of the bank customer's personal property, and that it is the customer (not some bank or government official) who shall decide whether it shall be open to another person. That concept of property is the subject of unique protection in Switzerland: Article 47 of the Swiss Banking Law makes it a crime for a banker to divulge information to third parties concerning the account of a client. There are limits to the duty of silence set by the various procedural codes of the Swiss cantons, and these concern bankruptcy, family law and inheritance matters. In Swiss criminal cases, information on a defendant's accounts only may be disclosed; information on persons indirectly affected remain privileged. Switzerland will not provide information to foreign governments in criminal prosecutions unless the matter is also criminal under Swiss criminal legislation. The areas in which information will be given are limited since Switzerland does not have criminal laws corresponding to our conspiracy, securities and tax laws.[254]

Between 1969 and 1973 Switzerland and the United States negotiated a treaty relating to the locating of criminals and the securing of information about criminal activity. The treaty contains provisions which lift to some degree the veil of Swiss bank secrecy. Switzerland delayed approving the treaty until January 1976, and U.S. approval followed swiftly. Instruments of ratifica-

253 *See, Hills Says SEC Needs More Tools to Catch Securities Violations by Foreign Holders, supra* note 247. Hill's statement in its entirety and much additional information on the use of foreign financial facilities are provided in *Oversight Hearings into the Operations of the IRS (Administration of Bank Secrecy and Reporting Act): Hearings before a Subcommittee of the House Committee on Government Operations*, 94th Cong., 2d Sess. (June 28, 29, July 1, 1976).

254 Ise, *supra* note 251, at 201-03: Cutbush, *The Swiss Banking Secret*, [1976] J. Bus. L. 197. It is possible that the Swiss may expand the reach of their criminal law; *see, Switzerland Moves to Make Tax Fraud a Criminal Offense*, The Wall Street Journal, March 18, 1976, at 15. It is interesting to note, by way of comparison, and as an example of a domestic control device that the United States also has a Bank Secrecy Act, 12 U.S.C. ss. 1730d, 1829b, 1951-59 (1970) and 31 U.S.C. ss. 1051-1122 (1970). The statute requires financial institutions to maintain records useful for criminal, tax or regulatory investigations or proceedings (which records are available to the government through the legal process) and requires the institutions and individuals to report certain transactions including transactions with foreign financial institutions. The statute is described in a note on a recent case challenging its constitutionality, Supreme Court, 1973 Term; note, 88 HARV. L. REV. 188 (1974).

tion have been exchanged and the treaty becomes effective on January 23, 1977.[255]

The result of the structural differences between the domestic and international situation is that a number of persons have moved into the international area to operate dishonest and fraudulent schemes. They are aided, not only by the legal differences described above, but also by a number of different features of international life. There is no point in going into great detail in this paper, but we should refer to some of the features briefly.

In his testimony before the U.S. Senate Subcommittee on Organized Crime in 1975, P. Manuel, an investigator for the subcommittee, explained a number of reasons why some sophisticated swindlers were moving into the international area. These include the increasing span of international banking and the necessary reliance of business upon paper credit, the difficulty of verifying the authenticity of assets when such assets are located in a foreign jurisdiction, bank secrecy or lack of government control in offshore jurisdictions, mobility so that a swindler may operate in three or four jurisdictions with no single jurisdiction which effectively can detect and curtail these crimes, and the absence of legal controls on international transactions, under U.S. law and foreign laws.[256] Manuel's testimony was supported by other witnesses who explained the tendency to take stolen securities out of the United States because tracing is more difficult abroad[257] and the difficulty of obtaining credit information and otherwise verifying information when the business or person is abroad.[258]

C. INVESTIGATION AND COLLECTION OF EVIDENCE

In chapter X, we discuss the formal methods by which evidence is collected from abroad. In this chapter we shall deal with informal cooperation among policemen, a method not formally recognized by law. It is useful to discuss this subject here in order to complete the description of the factual context before proceeding to the legislative devices which deal with it.

It is not unusual for the police in one country to convince those

255 Treaty on Mutual Assistance in Criminal Matters, May 25, 1973, U.S.A.-Switzerland, T.I.A.S. no. 8302. Switzerland has come under similar pressure from France; *see*, *Swiss Defend Bank Secrecy*, The Wall Street Journal, August 21, 1975, at 26, col. 1, and under internal pressure caused by the rise of the franc due to capital inflows, *see*, *Pressure in Switzerland*, The Globe and Mail (Toronto), June 18, 1975, at B2, col. 7.

256 *Organized Crime Senate Hearings*, *supra* note 205, at 124-25.

257 *Id.* at 150.

258 *Id.* at 199, 228. *See also* Hutchinson, *Swiss Now Willing to Help in Tracing Chemalloy Funds?*, The Financial Post (Toronto), February 21, 1976, at 36.

of another to undertake an investigation of a person in their country. Information relating to an offence in the latter country may well help the police of the requesting country to obtain evidence against a person being investigated. In some cases working relationships of a permanent nature are established between police forces of different countries.[259] However, the system is far from perfect, as often cooperation depends on personal relationships which are of necessity limited and episodic.

The agency through which most international investigation is conducted is the International Criminal Police Organization, Interpol.[260] Its office and staff are in France and its chief function is to help domestic police forces locate wanted persons. Member countries which are federations, such as Canada and the United States, are represented by the national police, the RCMP and FBI, respectively. In Canada some delay is experienced by local police forces since they cannot work with Interpol directly. Interpol, it should be noted, is interested only in the enforcement of criminal law; it is not concerned with civil law. Its principal aim is exchange of information on subjects such as criminal records and descriptions, stolen property and technical assistance, especially where crimes such as drugs, smuggling, counterfeiting and fraud are international in scope.

Gathering information and evidence abroad, whether through Interpol or through direct contact with foreign policemen, is time-consuming and difficult. Some of the difficulty could be cured by additional training of enforcement personnel or by modest budgetary realignments and increases. For example, one difficulty with foreign enforcement is to obtain funds from the regular enforcement budget to pay for the time spent in investigation in foreign countries and for the assistance of foreign experts. The SEC, as well, is restricted by budget limitations from vigorously pursuing the foreign situations with which it becomes concerned.

It is a fact of international life that some countries do not find such economic crimes as tax evasion and securities fraud as reprehensible as Canadians do. Investigators from this continent often run into lack of sympathy from their counterparts abroad. Foreign police cooperation may depend on whether the crime is referred to in an extradition treaty. Thus a Canadian investigator must

259 *See* G. MUELLER & E. WISE, *supra* note 42, at 429. In one case the Swiss police assisted Canadian police in a Canadian stock fraud case, *see*, *Swiss Bank 'Co-operative' in Aquablast Fraud Case*, The Financial Post (Toronto), July 3, 1975, at 2.

260 *See* International Criminal Police Organization Constitution and General Regulations. For a general description of its activities, *see* INTERPOL, 50TH ANNIVERSARY, 1927-1973 (1973).

prove that the transaction meets the test of double criminality, that is, it violates the laws of Canada and of the other jurisdiction. Unless the Canadian investigator learns the foreign law early in his investigation, he may not obtain evidence that can satisfy the requirements of both jurisdictions. The problem might be solved in part by giving Canadian policemen free access to foreign prosecutors for it is often merely a matter of obtaining foreign legal advice without having to find funds in a domestic budget.

The ease of investigation may therefore depend on the judicial and public prosecution systems of the country in which there is to be an investigation. In England, Canadian police have been given the legal advice they require without charge through English crown attorneys. In the United States, on the other hand, where crime, generally speaking, is a matter of state law, a Canadian prosecutor often has to find a knowledgeable attorney in private practice. Better libraries would help Canadian investigators find out foreign law themselves.

The obstacles described above are often overcome. In many cases Canadian investigators are able to conduct full investigations abroad through the cooperation of foreign institutions or enforcement agencies. But even then technical problems can arise. In one particularly ironic case, a Canadian policeman was allowed to inspect entries in Swiss banking records but he was not qualified to give evidence in a Canadian court about those records since his qualifications were those of a Canadian policeman not of a Swiss banker. This particular problem could be solved in a number of ways: by extending the operation of section 29(3) of the Canada Evidence Act to include foreign institutions or by adopting a system such as that in Switzerland by which certified documents are admissible in court to prove the contents of records. In some cases is would be effective to recognize as a competent witness in a Canadian court an employee or agent in Canada of a foreign corporation or its parent.

D. ENFORCEMENT

The most glaring diffence between the domestic and international situations is the inability of an administrative agency to employ unilaterally the swift and draconian remedies such as cease trading orders,[261] freezing of bank accounts and other property,[262] and *ex parte* appointment of receivers,[263] in the provincial

261 B.C. Securities Act, s. 77A.
262 B.C. Securities Act, s. 28.
263 B.C. Securities Act, s. 29, *See* Re Centennial Mortgage Corporation Ltd., 9 D.L.R.

securities acts. This difficulty with the international situation will remain. A Canadian enforcement agency is not likely to obtain the power to freeze accounts in Lebanese banks unless the Canadian government grants similar authority to the Lebanese with respect to Canadian banks operating in Canada. Such international cooperation seems unlikely.

Chapter X
Obtaining Information from Abroad

There are a number of ways in which existing legal processes can be used to obtain information from persons in foreign jurisdictions. Four of these are discussed below, namely, commission evidence, letters of request, civil actions and Walsh Act proceedings. We also discuss informal cooperation among policemen and international treaties.

A. COMMISSION EVIDENCE

Where the person to be examined is willing to answer questions, the cheapest and most expedient device available to obtain his evidence is the appointment of an examiner or a commissioner. An examiner administers an oath, examines the party on questions prepared by the other party, seals the documents, swears his affidavit and returns the commission. An application for an examiner or a commissioner must be made by a party in a proceeding who bears the burden of showing that the evidence he seeks to obtain is relevant and cannot be obtained in the jurisdiction. He must also show that his request is *bona fide* and likely to result in securing the evidence he needs. Even so, the granting of his request is within the discretion of the court and the court will consider such matters as the importance of credibility and cross-examination and whether the person to be examined is a party or a witness.[264]

Although it is common to appoint a single examiner and to use the procedure described above, it is possible to appoint a commission containing representatives of both parties empowered to conduct *viva voce* examinations. This technique allows a questioner to develop previous answers and thus is more useful.[265]

(3d) 357 (B.C.C.A. 1969) where the section was interpreted as granting the commission authority over private as well as public companies.

264 *See* Castel, *International Civil Procedure*, in CANADIAN PERSPECTIVES ON INTERNATIONAL LAW AND ORGANIZATION, *supra* note 1, at 843-45.

265 *See* for examples of the difference in powers, forms 35, 37 in Appendix K, B.C.S.C.R., Marginal Rules 487, 488.

An interesting combination of the examiner and commissioner methods occurs in the Criminal Code which authorizes a judge to appoint a commissioner to take evidence of a witness out of Canada, and allows him to make provisions for attendance by the accused or his counsel at the examination.[266]

The 1939 Draft Convention on Judicial Assistance prepared by Harvard Reseach in International Law contains a useful additional feature.[267] Article 5(3) provides that a commissioner may petition a competent tribunal in a receiving state to compel the attendance of witnesses and production of evidence. Article 8(2) provides for a similar petition in criminal cases but only in relation to witnesses; the procedure is not available against an accused or in the case of political offences.

The European Convention on Mutual Assistance in Criminal Matters provides that if a requesting state considers a personal appearance of a witness "especially necessary" the requested party "shall invite" the witness to appear.[268] Article 11 of the European Convention provides for the transfer of persons in one state to give evidence before the courts of the requesting state, but only in special circumstances and with the consent of the person examined.[269]

B. LETTERS OF REQUEST

Where a country will not allow the taking of evidence within its jurisdiction by commission or where a witness is unwilling to testify, letters of request or letters rogatory may be used both in criminal and civil cases. Letters rogatory are formal communications through diplomatic channels from one country to another, requesting that the second country use its courts to secure the testimony of an individual or a corporation and return the testimony to the court of the requesting country.[270] The grant of a letter

266 *See* Criminal Code, ss. 637(b), 641; and *see* ss. 640, 642.

267 The text of the draft convention may be found in 33 AM. J. INT'L L. SUPP. 11 (1939), and in G. MUELLER & E. WISE, *supra* note 42, at 375.

268 European Convention on Mutual Assistance in Criminal Matters, *reprinted in* G. MUELLER & E. WISE, *supra* note 42, at 391; Europ. T.S. No. 30, art. 11.

269 European Convention, *supra* note 268, art. 11. The convention is discussed in Mueller, *supra* note 42, at 410. Article 23 of the U.S.-Swiss treaty on Mutual Assistance in Criminal Matters, *supra* note 255, also provides for limited transfer of consenting witnesses.

270 *See e.g.* arts. 3-6, 14-15 of the European Convention on Mutual Assistance in Criminal Matters, G. MUELLER & E. WISE, *supra* note 42, at 391. Under the European convention the communications are between ministries of justice rather than through diplomatic channels. The European convention also provides for the transmission of records and documents to the requesting state. The 1939 Harvard Research Draft Convention on Judicial Assistance provides that letters rogatory

of request is discretionary and is only granted where it is absolutely necessary in the interest of justice.[271] It is expensive and slow and its utility varies with the procedural code of the country where the witness is located.[272] The great advantage of a letter of request is that a witness can be compelled to answer the questions put to him. Canada grants the same right to requests from foreign states in the Canada and provincial evidence acts.[273]

Canada has a number of bilateral conventions on civil procedure which include provisions specifying the form and the authorities to whom letters of request should be addressed. The conventions also provide for use of the requested court's compulsory process, for other matters of procedure and costs.[274]

The Hague Convention on the Taking of Evidence Abroad in Civil or Commercial Matters signed in 1970 is an international master convention which codifies much of the law in this area and will probably be the basis from which new Canadian conventions will be negotiated.[275] Canada is now a member of the Hague Convention and might choose to adopt the Hague Convention on Taking Evidence Abroad, thereby giving us treaties with the approximately twenty members of that conference.

There is a limitation on all of these treaties and conventions that makes them of little use to securities investigators. Assistance in Canada, for example, is only given to a proper foreign court, and this does not include administrative tribunals such as the SEC.[276] Moreover, a witness may only be examined in a trial and

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may contain, in addition to the usual list of interrogatories to be put to the witnesses, a request for oral examination of the witnesses; *see id.* art. 4(3).

271 *See* Castel, *supra* note 264, at 845-46; B.C.S.C.R., Marginal Rule 488(a) (authorizing Letters of Request). The discretion was not exercised in a recent case; *see* Xerox of Canada Ltd. v. IBM Canada Ltd., [1976] 1 F.C. 213 (F.C.T. 1975).

272 For a description of the American federal and state rules on taking depositions under foreign letters rogatory and commissions, *see* Mueller, *supra* note 42, at 421-25. As one would expect, a witness retains his constitutional right against self-incrimination, *id.* at 424. Mueller discusses the execution of foreign letters rogatory in Italy, *id.* at 425. For a description of the situation in Switzerland, *see* Pohl, *Discovery of Swiss Bank Records: Procedural Tools for Tunnelling into the Bank*, 35 U. PITT. L. REV. 435 (1973).

273 *See* B.C. Evidence Act, R.S.B.C. 1960, c. 174, s. 51; Canada Evidence Act, R.S.C. 1970, c. E-10, ss. 43-48. These rights are not contained in the proposed new Evidence Code; *see* LAW REFORM COMMISSION OF CANADA, REPORT ON EVIDENCE (1975). The commissioners state that the rules that deal with evidence relating to proceedings in courts out of Canada should be retained in a separate statute, *id.* at 108.

274 *See* the examples in Castel, *supra* note 264, at 846, 847.

275 On the subject of the Hague convention generally, *see* Castel, *Canada and the Hague Conference on Private International Law 1893-1967*, 45 CAN. B. REV. 1 (1967). Castel also discusses some of the constitutional problems the signing of the convention would raise.

276 Re McCarthy, 38 D.L.R. (2d) 660 (Ont. C.A. 1963).

not as part of an investigation or pre-trial proceeding such as an examination for discovery.[277]

C. CIVIL ACTIONS

A person can be compelled to provide evidence against himself if a civil action is commenced against him. Thus, when the rules of procedure allow one party in a civil action to compel the other to produce records and documents within his control, the latter person can be required to bring records even from places where bank secrecy prevails. The usual rationale for bank secrecy is that the bank records belong to the customer and not to the bank, and therefore the jurisdiction in which the bank is located has no interest of its own to protect if a customer "voluntarily" reveals his own records.[278] If a non-resident chooses to defy a subpoena or other civil law process for production of information, the judicial system is not entirely powerless. U.S. courts have held under Rule 37 of the Federal Rules of Civil Procedure that they will draw inferences of fact against a party who fails to produce documents and excuses himself on the ground that production is illegal under the law of the state where the documents are located. This indirect method has proved to be a very effective technique to produce records.[279]

277 Re Radio Corp. of America v. Rauland Corporation, 5 D.L.R. (2d) 424 (Ont. H.C. 1956); Re Contesse, 23 D.L.R. (2d) 506 (Ont. H.C. 1960); Re Raychem Corp. v. Canusa Coating Systems Inc., 8 D.L.R. (3d) 614 (Ont. H.C. 1970); Re General Fire Service Ltd. v. Foundation Co. of Canada Ltd., 17 D.L.R. (3d) 501 (Sask. Q.B. 1971).

278 The fact that the client is "master of the secret" and can release it if he wishes is often not appreciated. While Swiss law might not recognize a request for release which has been coerced, it does contain reverse onus laws that encourage a person to disclose facts himself by making presumptions against him which he must rebut by revealing his records. It is possible for the country of the national having the Swiss account to put a great deal of pressure on him to authorize release of his bank information. This can be done by reverse onus clauses or even by more direct sanctions for failure to release information. *See* Mueller, *The Swiss Banking Secret from a Legal View*, 18 INT'L COMP. L.Q. 360 (1969); Pohl, *supra* note 272.

An interesting example of the way in which the use of Swiss banks can be frustrated is *Ruling Pursuant to Section 56 - Undisclosed Principals* B.C. Securities Commission Weekly Summary, July 19, 1974 (Superintendent of Brokers). The ruling concerns purchases by undisclosed principals during primary distribution. The commission refused to allow the purchase as Canadian investors would receive less information if purchasers could use Swiss accounts, however honest the purchasers.

279 *See* the discussion in pt. IV of Smith, *supra* note 82, at 761; *see also* the discussion of the civil antitrust action involving the Beecham companies in Brown, *supra* note 195, at 45-47.

D. AMERICAN WALSH ACT PROCEEDINGS

An interesting way of securing the attendance of witnesses is the U.S. Walsh Act.[280] The act was prompted by the need to investigate a Mr. Blackmer with respect to the Teapot Dome scandal and provides that an American citizen or a person domiciled in the United States can be subpoenaed abroad when the Attorney-General requires his attendance. The subpoena is addressed to the U.S. consul and the consul serves it and tenders expenses. If a witness refuses to attend, he can be judged in contempt and fined up to $100,000 and his property in the United States can be seized to satisfy the judgment.

The act was upheld in *Blackmer v. United States*,[281] an action taken to challenge a fine of $60,000 imposed on Blackmer under the act. The court held that Blackmer had a civic duty to respond to a subpoena, which is not surprising when we consider that states often tax nationals abroad or subject them to criminal penalties.

E. INFORMAL COOPERATION AMONG POLICEMEN

Evidence is obtained by police or other investigating authorities of one country if they convince officers in another country that the latter should undertake investigation of a person in that second country. While this informal cooperation often has satisfactory results in individual cases, there are a number of disadvantages.[282]

F. TREATY

An obvious technique for obtaining evidence abroad is to enter into a treaty aimed precisely at the problem. An example is the Treaty between the United States of America and the Swiss Confederation on Mutual Assistance in Criminal Matters.[283] Beginning with a general elaboration of the duty to assist in investigation and to return property which may have been the subject of an offence,[284] the treaty goes on to establish a duty to testify,[285] to

280 An Act Relating to Contempts, 28 U.S.C. s. 1783 (1970). *See* Dickinson, *Notes: The Recall of Witnesses under the Walsh Act*, 25 AM. J. INT'L L. 723 (1931).

281 284 U.S. 421 (1932).

282 *See* ch. IX *supra* for a more detailed description.

283 The treaty was not approved by the two countries until 1976 but the ratifications were exchanged on July 27, 1976, and the treaty comes into effect on January 23, 1977.

284 U.S.-Swiss Treaty, *supra* note 255, arts. 1, 4.

285 *Id.* art. 10(1).

provide information from bank accounts,[286] formalize arrangements by which police forces assist each other in locating wanted persons,[287] and provide for a wide range of other matters.

Another treaty which is designed to facilitate the obtaining of information and evidence is the European Convention on Mutual Assistance in Criminal Matters. Article 15 of the convention provides for direct communication between judicial authorities in cases of requests for mutual assistance, particularly requests for investigation preliminary to prosecution.

There are not a great number of international treaties in force for mutual assistance in criminal matters.[288] Negotiation by Canada of a series of such treaties, though a slow process, would provide a clearer and firmer foundation for investigative and enforcement programs than the present imperfect collection of devices. A number of European countries have acceded to the European Convention on Mutual Assistance in Criminal Matters mentioned above. As one might expect of such a convention, it is more general than the bilateral Swiss-U.S. treaty but addresses itself to some of the same problems, including providing signatory states with evidence from persons or documents in other countries.[289] An example of a treaty in which Canada is involved is the Canada-U.S. Tax Convention,[290] under which the authorities in each jurisdiction use their domestic investigation powers to obtain information for their foreign counterparts.[291]

There are other agreements and quasi-treaties which provide instructive models. One is the agreement between Canada and the United States known as the Basford-Mitchell Understanding on Antitrust Notification and Consultation Procedure which provides for consultation prior to extraterritorial enforcement of antitrust laws and seems to work well.[292]

286 *Id.* art. 10(2).
287 *Id.* art. 11.
288 *See* Mueller, *supra* note 42, at 410, 411, 414.
289 The text of the convention is contained in G. MUELLER & E. WISE, *supra* note 42, at 391; *see also* Europ. T.S. No. 30.
290 *See* H. STIKEMAN, INCOME TAX ACT 673 (6th ed. 1975-76) (art. XIX, XXI).
291 A recent instance in which these powers were exercised is referred to in CCH CAN. TAX TOPICS, September 10, 1976, at 1-2.
292 Canadian-American procedures for notification in antitrust cases are discussed in two articles; *see* Henry, *The United States Antitrust Laws: A Canadian Viewpoint*, 8 CAN. Y.B. INT'L L. 249, 267 (1970); Henderson, *Foreign Courts and the National Interest*, 3 INT'L BUS. LAW. 133 (1975).

G. CONCLUSION

Perhaps the most significant omission from the methods described above is a procedure for bringing witnesses from one state to give evidence in another. Extradition treaties facilitate the international transfer of accused persons. It would be useful if similar agreements were developed for the international transfer of persons who can give relevant testimony.

Chapter XI
Transferring International Offenders from One State to Another

A. EXTRADITION

The law of extradition is found primarily in bilateral treaties.[293] Extradition has always been regarded as a concession to another state, almost as a derogation of sovereignty, and consequently no uniform practice concerning it has developed in traditional international law. While states realized that international cooperation was necessary for some regulatory purposes and were prepared to make some concessions to cooperation with other states, the concessions were often niggardly and narrow. In addition, criminal law has been extended into areas of economic activity, so that it is no longer referrable to a clearly defined and widely shared moral standard, and this fact has made states even more reluctant to allow extradition of criminal offenders unless the crime is clearly reprehensible by its own standards.

There are a number of general features common to most extradition treaties in force.[294] An extraditable offence is generally defined either by listing the extraditable offences or by providing that only offences involving some minimum penalty are extraditable.[295] The first method is more direct but leads to prob-

293 Extradition between Commonwealth countries is founded not on extradition treaties but on parallel Fugitive Offenders Acts; *see e.g.* R.S.C. 1970, c. F-32.

294 Model extradition treaties, the 1973 Inter-American Convention on Extradition and the 1935 Harvard Research Draft Convention on Extradition are set out conveniently in G. MUELLER & E. WISE, *supra* note 42, at 442.

295 *See e.g.* Treaty on Extradition between Canada and the United States of America, December 3, 1971, *amended by* Exchange of Notes, 1974, in force March 22, 1976, [1976] Can. T.S. No. 3; T.I.A.S. No. 8327 [hereinafter referred to as 1971 Canada-U.S.A. Extradition Treaty] (30 listed offences, one of which is "Offences against federal laws relating to the sale or purchase of securities"); Fugitive Offenders Act, R.S.C. 1970, c. F-32, s. 3 (offences punishable by imprisonment with hard labour for 12 months or more).

lems of definition for it becomes necessary to find general labels for groups of particular crimes.

Most extradition treaties contain the principle of double criminality – that is, the offence for which extradition is requested must be punishable under the criminal law of both the requesting and the requested states.[296] Various treaties limit the right to extradite or rights after extradition in various ways. A common provision requires the requesting state to forego the death penalty, and another to provide due process in regular courts.[297] Also common are exemptions for political crimes, military crimes and fiscal crimes.[298] This last may have been understandable in an era of economic independence of states, but it is rapidly losing whatever justification it had. Extradition is often excluded if the person already has been tried or penalized for the offence in the requested state.[299] One of the most obvious differences between extradition in common law and civil law systems is that many civil law systems will not allow the extradition of nationals and sometimes even residents. This refusal may be tempered by the fact that often their own system allows them to try nationals for offences wherever committed.[300]

B. EXTRADITION FROM CANADA

In the early 1800s Canada surrendered fugitives without a treaty, but the view gradually developed that there should be surrender only by treaty and in accordance with its terms.[301]

296 *See e.g.* 1971 Canada-U.S.A. Extradition Treaty, *supra* note 295, art. 1(1); and *see* the narrow exception *id.* in art. 1(3). On the other hand double criminality specifically is excluded by the Fugitive Offenders Act, R.S.C. 1970, c. F-32, s. 4.

297 1971 Canada-U.S.A. Extradition Treaty, *supra* note 295, art. 6 (no reciprocal death penalty). A short account of extradition procedures from the U.S.A. is contained in G. Mueller & E. Wise, *supra* note 42, at 439-40.

298 1971 Canada-U.S.A. Extradition Treaty, *supra* note 295, art. 4(1)(iii); political offences, military and fiscal crimes are not contained in the schedule.

299 *Id.* art. 4(1)(i).

300 *See* Schultz, *The Principle of the Traditional Law of Extradition*, in Legal Aspects of Extradition among European States (Council of Europe, 1970); Duk, *Principles Underlying the European Convention on Extradition*, *id.* Canadian law on trials in Canada of Canadians abroad is not as wide as the law in most civil law jurisdictions; *see e.g.* R. v. Shulman, [1974] 6 W.W.R. 354 (B.C.S.C.), *aff'd*, 58 D.L.R. (3d) 586, [1975] 4 W.W.R. 490, 23 C.C.C. (2d) 242 (B.C.C.A.). One alternative to extradition that is made necessary by the European practice referred to above is the European Convention on the International Validity of Criminal Judgments (Council of Europe, 1971), which allows the imposition of criminal sanctions by one state if they are directed by another state where extradition is not possible. The convention also grants a measure of effect to judgments of other states in matters of *res judicata* and sentencing.

301 Green, *Immigration, Extradition and Asylum in Canadian Law and Practice*, in

Extradition in the absence of a treaty is dealt with by part II of the Extradition Act of Canada[302] which includes its own schedule of offences for which extradition will be allowed. However, part II has limited application since it has been proclaimed in force only with respect to extradition to the Federal Republic of Germany.[303] Thus, extradition from Canada to countries outside the Commonwealth is governed largely by treaty and in most cases extradition to Canada is also by treaty. The procedure is relatively slow and complex.[304] It requires that the requesting country establish before a Canadian judge that the crime is within the treaty, that it is a crime in the requesting country and that there is evidence sufficient (by Canadian standards) to commit the accused for trial.[305] A number of defences are open to an accused, the most common being that the act was a political crime, that the treaty is invalid or inapplicable or that the offence is not criminal under both the law of Canada and of the requesting state.[306]

In the case of a fugitive from a Commonwealth country, extradition may be ordered when evidence has been presented to the magistrate raising a presumption that the fugitive committed the offence. The act applies to persons who are unlawfully at large after conviction and to persons charged with an offence punishable by imprisonment with hard labour for a term of twelve months or more. The offence need not be an offence under Canadian law and there is no exception for political crimes. However, the magistrate may discharge the fugitive in trivial cases or in cases where it would be "unjust or oppressive or too severe" to return him.[307]

A commentator recently has described the Canadian Fugitive Offenders Act as "quite inadequate" in view of its definition of offences by twelve months' hard labour instead of by listing particular crimes.[308] The more modern practice is to pattern extra-

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Canadian Perspectives on International Law and Organization, *supra* note 1, at 272-76.

302 R.S.C. 1970, c. E-21.

303 S.I./74-40 (108 Can. Gazette, pt. II, 1270) (April 10, 1974).

304 For details, *see* Green, *supra* note 301, at 278-79. The Canadian extradition court has no power to compel foreign affiants to appear and be cross-examined or to issue a rogatory commission to take the evidence of foreign witnesses; Re United States of America and Sheppard (No. 1), 19 C.C.C. (2d) 32 (Qué. Q.B. 1974).

305 *See e.g.* 1971 Canada-U.S.A. Extradition Treaty, *supra* note 295, arts. 2(i), 10.

306 For bilateral treaty provisions, *see* Green, *supra* note 301, at 289-94.

307 *See* Fugitive Offenders Act, R.S.C. 1970, c. F-32, ss. 3, 4, 5, 12, 17. *See also* Brown-John, *Commonwealth "Extradition": The Case of Duncan Crux*, [1970] Can. Y.B. Int'l L. 324.

308 *See id.* at 330.

dition treaties and statutes on the 1957 European Convention on Extradition.[309]

The history of the extradition treaties between the U.S. and Canada with respect to securities is one of frustration. The Webster-Ashburton Treaty of 1842 between the U.S. and Great Britain was amended in 1890, 1922 and 1925. In 1931 Canada took over its own negotiations but not until 1952 were new sections added dealing specifically with false pretences and mail fraud. The change was prompted by the case of *Re Lamar*[310] in which an Alberta extradition judge held that the mail fraud provision of the Securities Act of 1933[311] was not a crime under the treaty nor equivalent to the false pretences section of the Criminal Code. In 1942 a new treaty was negotiated which provided for simplified proof of foreign law and removed the double criminality requirement, but the treaty was not ratified by Canada because of Canadian sensitivity to expansionist pressure from the United States. In 1952 a Supplementary Convention which reworked the previous fraud provisions to make them more explicit was signed instead. The change was made in the expectation that Canadian issuers of securities would be granted the right to use the special short form of registration in the United States, later made available by regulation D.[312]

Although the 1952 convention reduced the promotion of worthless securities by Canadians into the U.S., much of its deterrent effect was removed by the decision in *United States v. Link and Green*.[313] In this case two Canadian defendants were indicted for violation of the U.S. mail fraud statute and the Securities Act of 1933. The judge held that the Canadian and American mail

309 *See id.* For a discussion of the European convention, *see* Karle, *Some Problems concerning the Application of the European Convention on Extradition*, in LEGAL ASPECTS OF EXTRADITION AMONG EUROPEAN STATES, *supra* note 300, at 49.

310 [1940] 1 D.L.R. 701, [1940] 2 W.W.R. 471 (Alta. S.C.).

311 S. 17(a).

312 For the history of the negotiations and some problems in the 1952 convention, *see* J. WILLIAMSON, c. XIII; a short discussion can be found in 3 L. LOSS at 1995-2004; 6 L. LOSS at 4138-40. *See also* J. WILLIAMSON, SUPP. at 345-47.

313 [1955] 3 D.L.R. 386 (Qué. Q.B.) (extradition). An extensive review of the extradition treaties between Canada and the United States and a critique of the *Lamar* decision can be found in Timbers & Pollack, *Extradition from Canada to the United States for Securities Fraud: Frustration of the National Policies of Both Countries*, 24 FORDHAM L. REV. 301 (1955). The article also contains a short history of the problem of "boiler-room" promoters operating from Canada into the U.S. Another article with a tone just as indignant is: note, *Enforcing United States Securities Regulation against Canadians*, 66 HARV. L. REV. 1081 (1953). This article considers the civil remedies open to American investors for frauds committed by Canadians as well as problems with criminal law and extradition. The problem is described from the point of view of the OSC in Bray, *Ontario's Proposed Securities Act: An Overview, Its Purpose and Policy Premises*, [1975] OSC Bull. 235 (October).

fraud provisions were not the same, the Canadian requiring the mailed communication to be fraudulent, the American requiring only that any step be fraudulent in a scheme involving the mail. Because of the double criminality principle extradition for use of the mails can only take place for fraudulent mailings, and most of the cross-border promoters used the mail only to receive funds and not for fraudulent promotion.

Recently the securities commissions have relied less on formal agreements and more on informal cooperation. Improved cooperation from the Ontario and Québec securities commissions has substantially reduced the amount of cross-border fraud and the western provinces have tightened their control in the same way. The 1971 Extradition Treaty attempts to cure the problem found by the *Link and Green* court (see article 2(3)) and specifies a number of offences which might be alleged in a securities fraud case.[314]

Until the creation of the Federal Court of Canada, interpretation of the extradition treaties was the province of single extradition judges with no provision for appeal except on an application for *habeas corpus*. Consequently there was no consistent body of law on the subject. Recent Supreme Court decisions have held that there is an appeal from an extradition judge under section 28 of the Federal Court Act,[315] dealing with review of the decisions of a "federal board, commission or other tribunal".[316] There might now develop a more rational body of precedent in extradition cases involving securities offences.

C. KIDNAPPING

The kidnapping of accused persons in foreign jurisdictions and bringing them to the domestic jurisdiction for trial is a procedure with a longer and rather more distinguished history than one might expect.[317] However, it does not commend itself as a weapon

314 *See* Schedule, items 11 (embezzlement), 12 (false pretences, defrauding the public), 13 (fraud by certain corporate officers), 19 (false affidavits), 27 (mail fraud) and 28 (offences against federal securities laws). For difficulties with the convention subsequent to Link and Green *see* J. WILLIAMSON, SUPP. at 345-47.

315 R.S.C. 1970, 2d Supp., c. 10.

316 Commonwealth of Puerto Rico v. Hernandez, [1975]1 S.C.R. 228 (1973); Cotroni v. Attorney-General of Canada, 50 D.L.R. (3d) 291, [1976]1 S.C.R. 219 (1974).

317 Bassiouni, *Unlawful Seizures and Irregular Rendition Devices As Alternatives to Extradition*, 7 VAND. J. TRANSNAT'L L. 25 (1973). This article discusses informal repatriation and expulsion as well as kidnapping; *see also* O'Higgins, *Unlawful Seizure and Irregular Extradition*, 36 BRIT. Y.B. INT'L L. 279 (1961); note, *Extraterritorial Jurisdiction and Jurisdiction following Forcible Abduction*, 72 MICH. L. REV. 1087 (1974); Cardozo, *When Extradition Fails, Is Abduction the Solution?*, *in* G. MUELLER & E. WISE, *supra* note 42, at 465. Some Canadian authority for kidnapping

which should be included in the armoury of enforcement procedures and devices in a Canadian securities law.

Chapter XII
Enforcement Systems Other Than Criminal Law

A. CIVIL LAW

In the preceding chapters we examined the ways in which Canadian securities laws can be applied through criminal sanctions against persons who are outside Canada. In this chapter we examine the ways in which persons outside Canada who have failed to comply with Canadian securities law can be reached by means of civil law techniques.

Civil claims in contract and in tort must be examined. The tort of deceit, sometimes referred to as false representation or fraud, is most likely to be involved. We shall therefore focus our attention on it as the closest analogy to the type of civil remedy most likely to be granted by a securities statute, namely, the awarding of civil damages where loss has been caused by improper conduct such as misrepresentation.

A civil action can be brought either in Canada or abroad. We examine the former situation first and treat the plaintiff himself as the injured person, though the discussion is equally applicable to a federal administrative agency prosecuting claims on behalf of injured persons, either derivatively or in its own right, under statutory authority.

1. *Suit in Canada*

Three questions arise in a civil suit brought in Canada against a defendant outside Canada: Does the Canadian court have jurisdiction? What law should apply to the transaction? and how will the Canadian judgment be enforced in the jurisdiction where the defendant resides or has assets?

a. *Jurisdiction*

We discussed jurisdiction in chapter III.[318] As we stated there,

is provided in Williams, *Criminal Law - Jurisdiction - Illegal Arrest - Due Process - Violation of International Law*, 53 CAN. B. REV. 404 (1975). A note on two recent cases involving the trial of kidnapped persons in the United States appears at 88 HARV. L. REV. 813 (1975).

318 *See* especially ch. III.B.2, C *supra*.

the *Gibbons*[319] and *Brenner*[320] cases suggest that a securities system might utilize the device of requiring foreign registrants to leave deposits within the jurisdiction to satisfy judgments against them. Canadian courts are prepared to accept jurisdiction on this basis and to recognize it when it is employed by courts in other countries.[321]

There is also general acceptance of the principle that the jurisdiction of incorporation has power to adjudicate with respect to a corporation. In 1883 the Supreme Court of the United States held in *Canada So. Ry. v. Gebhard*[322] that American bondholders of a Canadian railway undergoing a reorganization involving a substitution of bonds could not sue on their bonds in the United States. The court stated:

> "[E]very person who deals with a foreign corporation impliedly subjects himself to such laws of the foreign government, affecting the powers and obligations of the corporation with which he voluntarily contracts, as the known and established policy of that government authorizes. To all intents and purposes, he submits his contract with the corporation to such a policy of the foreign government, and whatever is done by that government in furtherance of that policy which binds those in like situation with himself, who are subjects of the government, in respect to the operation and effect of their contracts with the corporation, will necessarily bind him. He is conclusively presumed to have contracted with a view to such laws of the government, because the corporation must of necessity be controlled by them, and it has no power to contract with a view to any other laws with which they are not in entire harmony. It follows, therefore, that anything done at the legal home of the corporation, under the authority of such laws, which discharges it from liability, there, discharges it everywhere."[323]

The foregoing doctrine was undermined in the United States by the more recent decision in *Kohn v. American Metal Climax, Inc.*[324] The *Kohn* case arose out of misrepresentations in violation of Rule 10b-5 of the Securities Exchange Act of 1934 in connection with a reduction of capital of a Zambian company approved by a Zambian court. Minority shareholders brought the action to recov-

319 *See* text accompanying note 55 *supra.*

320 *See* text accompanying notes 57-59 *supra.*

321 *See e.g.* Jones v. Smith, [1925] 2 D.L.R. 790 (Ont. C.A.).

322 109 U.S. 527 (1883).

323 *Id.* at 537-38.

324 458 F. 2d 255 (3d Cir. 1972), *cert. denied* 409 U.S. 874 (1972).

er damages from another American shareholder who had benefitted from the transaction. Although the court held that inquiry into the fairness of the arrangement was foreclosed by the Zambian decree, it found violations of Rule 10b-5 and ordered compensation not only for American minority shareholders but also for all minority shareholders. The case does not purport to invalidate the reduction of capital, but it indicates that the U.S. courts at least are not prepared to accept a foreign judgment in the jurisdiction of incorporation as granting wholesale immunity from U.S. federal securities laws. There is Canadian authority for the proposition that the place of incorporation has jurisdiction over a corporation,[325] but facts similar to those in the *Kohn* case have not as yet arisen.

Another ground for assuming jurisdiction which has broad judicial acceptance is that the foreign party has contracted to submit to the jurisdiction.[326] Provisions requiring non-resident registrants to consent to service in Canada should be included in a Canadian securities law. There is precedent for such a system in that registration as a broker-dealer, salesman or securities adviser under the provincial statutes requires the filing of an address for service; some of these statutes provide that notices may be sent to the special address, others that legal process may be served there. The latter wording implies that registration entails accepting service in the jurisdiction; the former does not.

The American federal securities laws create a more complex procedure. Registration with the SEC entails signing a consent to service which makes the commission an agent of the registrant for the service of process and allows an action to be brought in the United States by serving the SEC and then having it notify the registrant at his most recent address on its files. J. Williamson states that the American consent to service provision has not been tested in a Canadian court.[327] However, there is precedent in other areas of law which suggests that procedures like the SEC's will be approved in Canada. Choice of forum clauses in commercial contracts are generally accepted as valid and J. Castel states that where such contracts provide for service upon a designated person

325 *See* Pickles v. China Mutual Insurance Co., 10 D.L.R. 323 (S.C.C.1913), *aff'g*, 3 D.L.R. 766 (N.S.S.C. 1912).

326 Emanuel v. Symon, [1908] 1 K.B. 302 (C.A.), *foll'd*, Mattar v. Public Trustee, [1951] 3 W.W.R. (N.S.) 287 (Alta. S.C.), *aff'd*, [1952] 3 D.L.R. 399 (Alta. C.A.). These cases are codified to some extent in the Foreign Judgments Act; CONFERENCE OF COMMISSIONS ON UNIFORMITY OF LEGISLATION IN CANADA, MODEL ACTS (1962).

327 J. WILLIAMSON at 221.

the court acquires jurisdiction and the defendant afterward cannot question the validity of the judgment.[328]

In chapter III we also noted that in British Columbia and Ontario contract claims may be brought against persons outside the jurisdiction if a breach has occurred within it. We also described the broader English rule accepting jurisdiction if English law is the proper law of the contract and referred to the *Kleinwort*[329] and *Kahler*[330] cases which demonstrate the possibilities presented by this particular doctrine. Special rules have also been developed in the law of torts. As the discussion in chapter III indicates, there is now a broad range of precedent supporting the proposition that a person who has received false representations or defective material in one jurisdiction can sue there a wrongdoer outside it. The impact theory now seems to be firmly established.

b. *Choice of Law*

Once a court has accepted jurisdiction over a person who is outside the jurisdiction, the question arises as to what law will be applied. Differing results are reached depending on whether the claim is in contract or in tort.

i. *Torts*

The Canadian choice of law rule derives from English law. The rule was first established by Willes, J., in the case of *Phillips v. Eyre*:

> "As a general rule, in order to found a suit in England for a wrong alleged to have been committed abroad, two conditions must be fulfilled. First, the wrong must be of such a character that it would have been actionable if committed in England.... Secondly, the act must not

328 J. Castel, Conflict of Laws, Cases, Notes and Materials 724-25 (1974). Choice of forum clauses were enforced in the following cases: E.K. Motors Ltd. v. Volkswagen Canada Ltd., [1973] 1 W.W.R. 466 (Sask. C.A. 1972); The Eleftheria, [1969] 2 All E.R. 641 (P.D.A.); Bremen v. Zapata Off-Shore Co., 407 U.S. 1 (1972). The court declined to stay proceedings before it and defer to a choice of forum clause in A. S. May & Co. Ltd. v. Robert Reford Co. Ltd., 6 D.L.R. (3d) 288 (Ont. H.C. 1969). An excellent discussion of choice of forum is contained in Cowen & Mendes da Costa, *supra* note 49. Consent to service provisions have had mixed reception in the courts; *see* J. Williamson at 221; *see also* Hughes v. Sharp, 70 D.L.R. (2d) 298 (B.C.S.C. 1968) where the judge of first instance was prepared to enforce a foreign judgment founded on questionable consent to service circumstances. The Court of Appeal reversed on the ground that there was a triable issue of fact whether the defendant had a good defence to the action on the merits; 5 D.L.R. (3d) 760 (B.C.C.A. 1969). English courts give effect to consent to service provisions in contracts; *see* A. Dicey, *supra* note 48, at 168-69.

329 *See* text accompanying note 64 *supra*.

330 *See* note 65 *supra*.

> have been justifiable by the law of the place where it was done."[331]

This rule has been widely attacked by commentators and was reexamined but not clarified in the House of Lords decision in *Chaplin v. Boys.*[332] As a result of *Chaplin v. Boys*, the best that can be said about the English position is that it is not settled; there is support for the *Phillips v. Eyre* test and for a test similar to the American one described below.

Unfortunately some of the confusion of the English law was incorporated into Canadian law by the decision of the Supreme Court in *McLean v. Pettigrew*[333], adopting the *Phillips v. Eyre* formula, as expressed in *Machado v. Fontes.*[334] The substance of the Canadian position is that a foreign tort must be tortious under Canadian law and not innocent by the law of the place where it occurred in order for it to be actionable in Canada.[335]

Until recently the choice of law rule employed in most states in the United States was that the governing law was that of the place where the act occurs. In 1963 the New York Court of Appeals adopted a new approach in *Babcock v. Jackson.*[336] Mr. and Mrs. Jackson were residents of Rochester, New York, and they invited another New Yorker, Miss Babcock, on a weekend drive in Ontario. The car to be used was insured, operated and licensed in New York. While in Ontario, Miss Babcock was injured as a result of Mr. Jackson's negligent driving and she sued him in New York. New York law permitted recovery but the law of Ontario prevented a gratuitous passenger from recovering from a host driver. The court concluded that despite the certainty and ease of application of the *lex loci delicti* rule, the law of the place of the tort should not invariably govern the availability of relief. Fuld, J., offered an alternative rule:

> "Justice, fairness and 'the best practical result' may best be achieved by giving controlling effect to the law of the jurisdiction which, because of its relationship of contact

331 L.R. 6 Q.B. 1, 28-29 (1870). It is noteworthy that by this formula the residence and nationality of the parties are irrelevant.

332 [1969] 3 W.L.R. 322 (H.L.). *See* MORRIS, THE CONFLICT OF LAWS 268-74 (1971) for a summary of the case and references to articles.

333 [1945] 3 D.L.R. 65, [1945] S.C.R. 62.

334 [1897] 2 Q.B. 231.

335 Two recent notes on developments in Canadian law are Baer, *Conflict of Laws - Torts - A Blind Search for a "Proper" Law*, 48 CAN. B. REV. 161 (1970); Castel, *Conflict of Laws - Torts - Time for a Change*, 49 CAN. B. REV. 632 (1971).

336 12 N.Y. 2d 473, 191 N.E. 2d 279 (1963). For collected comments *see* 63 COLUM. L. REV. 1212 (1963).

> with the occurrence or the parties, has the greatest concern with the specific issue raised in the litigation."[337]

This rule, most often called the "most significant connection rule" is now widely accepted in the United States and many scholars favour its incorporation into Canadian law. So far, however, there has been little judicial inclination to accept it.[338]

One problem with the *lex loci delicti* rule and the rule in *Phillips v. Eyre* is that they both require a decision on where the tort occurred. Determining where the tort occurred is especially difficult in economic torts which involve sales and communications across borders. In the United States the general rule is that the place of a tort is the place where the last act is committed. The Canadian cases on the subject relate to service out of the jurisdiction when the plaintiff alleges that a tort has been committed within it. Although these cases offer some guidance to the location of a tort, they do not deal with this problem in relation to choice of law.[339]

As expressed in the cases concerning service out of the jurisdiction, the rules on location of the tort vary for different types of torts. The tort most likely to be relevant in the securities context is deceit. The B.C. Supreme Court has held that deceit occurs where a false statement is acted upon.[340] This decision is in accord with the defamation cases which hold that the tort occurs at the place of publication and not at the place of posting or uttering. However, one should note that the British Columbia decision is contrary to the English rule.[341]

Our conclusion is that a tort action brought in Canada against a violator of Canadian securities laws who is outside the country is a useful though imperfect weapon. As long as the rule in *Phillips v. Eyre* remains in effect, any action will have to be founded upon an act which is wrongful where committed and where the action is brought. Therefore, any statutory civil action will have to be in the simplest and most general terms and not be restricted to particularly complicated or technical provisions.

337 12 N.Y. 2d at 481, 191 N.E. 2d at 283.

338 Some judicial authority for this approach may be found in Gronlund v. Hansen, 69 D.L.R. (2d) 598, 65 W.W.R. 485 (B.C.S.C. 1968), *aff'd on other grounds*, 4 D.L.R. (3d) 435, 68 W.W.R. 329 (B.C.C.A. 1969). *See also* LeVan v. Danyluk, 75 W.W.R. 500 (B.C.S.C. 1970), *noted in*, Castel, *supra* note 335.

339 *See* Moran v. Pyle National (Canada) Ltd., 43 D.L.R. (3d) 239 (S.C.C. 1973); Hebenton, *supra* note 73. *See also* Interprovincial Co-operatives Ltd. v. The Queen, [1975] 5 W.W.R. 382 (S.C.C.).

340 Original Blouse v. Bruck Mills, 42 D.L.R. (2d) 174, 45 W.W.R. 150 (B.C.S.C. 1963).

341 Cordova Land Co. Ltd. v. Victor Brothers Inc., [1966]1 W.L.R. 793 (Q.B. 1964).

ii. *Contracts*

Determining the proper law to be applied is somewhat simpler if an action is brought in contract. English and American courts at one time relied on the law of the place of contracting as the law governing a contract, but this principle has been supplanted by the proper law doctrine. Lord Wright defined the proper law as:

> "depending on the intention of the parties to be ascertained in each case on a consideration of the terms of the contract, the situation of the parties, and generally on all the surrounding facts. It may be that the parties have in terms in their agreement expressed what law they intend to govern, and in that case *prima facie* their intention will be effectuated by the court. But in most cases they do not do so. The parties may not have thought of the matter at all. Then the court has to impute an intention, or to determine for the parties what is proper law which, as just and reasonable persons, they ought or would have intended if they had thought about the question when they made the contract."[342]

There has been some argument about whether the test is objective or subjective but the common modern approach is to treat it objectively and to use the law by "which the contract was made or with which the transaction had its closest and most real connection".[343] Many factors are considered in determining the proper law; the most significant are the place of contracting, the place of performance, the places of residence or business of the parties and the nature or subject matter of the contract. The proper law of the contract test is also used in Canada.[344]

c. *Enforcement Abroad of a Canadian Judgment*

Like so many areas of private international law, the recognition and enforcement of foreign judgments is very complicated. Of necessity, our discussion will be compact. The problem is to predict whether a judgment by a Canadian court against a non-resident defendant for violation of Canadian securities law would be entered against that non-resident by a court where he resides. To answer that question thoroughly, we would have to study the law

342 Mount Albert Borough Council v. Australasian Assurance Society Ltd., [1938] A.C. 224, 240 (P.C.).

343 Lord Simonds in Bonython v. Commonwealth of Australia, [1951] A.C. 201, 219 (P.C.).

344 *See* Imperial Life v. Colmenares, [1967] S.C.R. 443; Sharn Importing v. Babchuk, 21 D.L.R. (3d) 349, [1971] 4 W.W.R. 517 (B.C.S.C.).

of every jurisdiction from Alabama to Zambia. This we cannot do. But we can offer some useful generalizations.

In deciding whether or not to recognize a foreign judgment, a court will generally not consider the substantive nature of the foreign laws involved, but it will consider the jurisdiction exercised by the foreign court over the parties in dispute.[345]

The foregoing generalization should not be taken to indicate that recognition of foreign judgments is straightforward, logical and free from technicality. To some degree courts have been grudging in that they impose narrower limits of jurisdiction for foreign courts than they claim for themselves.[346] An illustrative Canadian case is *Gyonyor v. Sanjenko*.[347] The defendant, resident and domiciled in Alberta, had been involved in a car accident in Montana. The plaintiff commenced an action in Montana and, pursuant to an order of the Montana court, the defendant was personally served in Alberta, but did not appear and default judgment was entered against him. If the facts had been reversed, an Alberta court would have asserted jurisdiction over the Montana defendant as a result of an accident in Alberta,[348] yet the Alberta court refused to recognize the Montana judgment.

Fortunately there is a trend toward greater acceptance of foreign judgments. English family law cases have firmly established the principle that English courts will recognize foreign decrees in circumstances where they would have asserted jurisdiction to grant the decree had the facts been reversed.[349] An alternative found in Canadian family law cases is the flexible and functional recognition test of looking to see whether there was a "real and substantial connection" between the foreign court and the parties.[350] There is also more legislation designed to facilitate

345 *See* A. Dicey, *supra* note 48, at 1018 (Rule 184); von Mehren & Patterson, *Recognition Enforcement of Foreign Country Judgments in the United States*, 6 L. & Pol. Int'l Bus. 37 (1974); Re Hughes v. Sharp, 70 D.L.R. (2d) 298, 305-06 (B.C.S.C. 1968); J. Williamson at 222; J. Williamson, Supp. at 237. In Canada treatment has varied from province to province, there being greater willingness to inquire into the merits on the part of some Canadian courts.

346 *See e.g.* how much more narrow are the recognition rules set out in A. Dicey *supra* note 48, at 993 than the cases in which courts assert jurisdiction described in ch. III *supra*.

347 23 D.L.R. (3d) 695 (Alta. S.C. 1971).

348 *See* Alta. R.C. 30(h), authorizing service of the writ out of the jurisdiction when a tort has been committed within the jurisdiction.

349 Travers v. Holley, [1953] 2 All E.R. 794 (C.A.); Indyka v. Indyka, [1967] 2 All E.R. 689 (H.L.); and *see* Castel, note, 45 Can. B. Rev. 140 (1967).

350 Bevington v. Hewitson, 47 D.L.R. (3d) 510 (Ont. H.C. 1974); MacNeill v. MacNeill, 6 O.R. (2d) 598 (Co. Ct. 1974).

the enforcement of foreign judgments either generally or with reciprocating jurisdictions.[351]

Our conclusion is that, though there may be technical problems in individual cases, civil actions founded in contract or tort can be used against non-resident defendants as a means of enforcement of Canadian securities laws. Private lawsuits are likely to be brought by private litigants only in cases in which fairly large sums are at stake. It would therefore be useful to insert in any statute which might be enacted provisions authorizing a federal administrative agency to bring such actions or to support them financially or otherwise, when brought by private litigants. The technical difficulties which we have described above could also be minimized by treaties between Canada and other nations.

2. *Suit Abroad*

If a civil suit against a foreign defendant is brought where the defendant resides, there is no problem of jurisdiction and there is no difficulty with enforcing a judgment. The only issue remaining is the choice of law which in this case would mean convincing a foreign court that it ought to apply to one of its residents the securities law of Canada. What would be the result if a Canadian plaintiff went directly to the foreign jurisdiction and brought his action there? Obviously our answer can again be only of the most general kind since the answer will depend on the law of the various jurisdictions. Most jurisdictions have legal rules permitting suits with foreign elements. A Canadian plaintiff can obtain a fairly clear appreciation of his chances of success in a foreign jurisdiction before he commits himself too heavily. Breach of contract or deceit (or a parallel statutory version of the tort of deceit) is likely to give rise to a cause of action in most jurisdictions. The complicated nature of choice of law rules indicates that if there is to be a statutory cause of action designed to permit actions abroad it should be kept simple. We suggest that it be created from the general principles of the tort of deceit. There is little point in attempting to export a technical rule such as a margin requirement but there is every reason to expect that a foreign court will give fair hearing to a case where the plaintiff pleads fraudulent misrepresentation causing damage.

Not every case brought abroad will be won. A Canadian plaintiff suing in a foreign court on a claim founded on a securities

351 *See e.g.* Reciprocal Enforcement of Judgments Act, R.S.B.C. 1960, c. 331 *as amended;* Weser, *Some Reflections on the Draft Treaty on Execution of Judgments in*

law will have to face the judicial hostility which seems to pervade cases in which the economic regulation of one country is considered in another. The English reception of the U.S. antitrust decrees affecting the nylon industry,[352] and the common law rule that domestic courts cannot be used by foreign states to enforce their revenue[353] laws illustrate this hostility. Consequently it would make sense to attempt to conclude treaties with foreign countries so that suits in their courts for recovery of liabilities created by the Canadian securities laws will become treated as though domestic, and hence likely to receive more favourable judicial treatment.

B. ICSID – THE IBRD CONVENTION ON THE SETTLEMENT OF INVESTMENT DISPUTES AND OTHER ARBITRAL SOLUTIONS

In 1966 the International Bank for Reconstruction and Development sponsored a Convention on the Settlement of Investment Disputes. The convention was designed primarily to deal with problems of expropriation and confiscation but it is sufficiently broad that it or one like it might be useful in settling problems of international securities regulation. The convention provides for arbitration and conciliation of investment disputes between states and nationals of other states and it creates an International Center for the Settlement of Investment Disputes (ICSID) with a staff of legally and commercially trained arbitrators.[354] The parties can provide their own procedure and their own substantive rules.

Several benefits could be provided by the convention. It would prevent conflicts over extended claims of national jurisdiction. It might facilitate gathering of information and, by using arbitration, it surmounts the problem of non-recognition and unenforceability of domestic judgments.

Effective use of the convention would require some sort of

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the E.E.C., in INTERNATIONAL TRADE, INVESTMENT, AND ORGANIZATION 377 (W. LaFave & P. Hay eds. 1967).

352 *See* note 78 *supra*.

353 In U.S.A. v. Harden, [1963] S.C.R. 366, the Court refused leave to permit the U.S. government to enforce a consent judgment under which the taxpayer had agreed to pay a far lesser sum than the amount claimed by the tax authority. Cartwright, J., at 370-71, justifies the rule as one of public policy and neatly buttresses that description by referring to the decision of an American judge. A more recent Canadian decision that is easily distinguishable on its facts displays a less hostile attitude to the revenue laws of another jurisdiction; *see* Weir v. Lohr, 62 W.W.R. 99 (Man. Q.B. 1967).

354 Previous attempts to secure such a convention are discussed in G. SCHWARZENBERGER, FOREIGN INVESTMENTS AND INTERNATIONAL LAW 135-38 (1969).

acquiescence in advance by all investors and corporations buying or selling securities in Canada. A submission to jurisdiction would be operative even if secured in advance of the dispute.[355] It would be possible to require each investor and seller to sign a consent in advance and reserve the consent of Canada until local administrative and judicial remedies have been exhausted.[356] As the convention has yet to be tested on securities matters its utility is still unknown. However, it provides a useful model that at some future time might be used to deal effectively with international securities problems.[357]

Chapter XIII
Conclusions and Recommendations - Part II

In part II we have been concerned with the investigation of violations of securities laws and their enforcement against persons who are outside Canada.

In chapter VIII we discuss the problems of detecting and investigating securities offences to demonstrate their difficulty in the domestic context. We also discuss the application of the judicial process to complex transactions and the difficulty of satisfying a criminal burden of proof.

In chapter IX we consider the difficulties introduced into the investigation and enforcement of securities offences when they occur on an international scale. We outline the problems created by the lack of investigatory powers and by such features of international commerce as bank secrecy.

The problem of obtaining evidence abroad is the great initial hurdle in international securities offences. In chapter X we outline the methods that can be used to obtain such information. The readily available methods, commission evidence, letters of request and civil discoveries all have limited application.

In chapter XI we discuss extradition and the history of frustration in connection with extradition from Canada to the United States for securities offences.

In chapter XII we review the non-criminal approach to enforcement. We examine the civil law and describe how civil actions

355 On jurisdiction generally, *see* Broches, *The Convention on the Settlement of Investment Disputes: Some Observations on Jurisdiction*, 5 COLUM. J. TRANSNAT'L L. 263 (1966).

356 *Report of the Executive Directors of the IBRD*, 60 AM. J. INT'L L. 892 (1966) (¶24).

357 There is also the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, 330 U.N.T.S. 4739, which might be used in some unusual securities transactions. Some investment contracts provide for arbitration. Some of the case law is discussed in: note, *Arbitration of International Securities Transactions* 16 B.C. IND. & COMM. L. REV. 491 (1975).

can be brought either in Canada or abroad against persons located abroad who have failed to comply with Canadian securities laws. We also examine the IBRD convention as a potential forum for the settlement of some international securities disputes.

There are two themes to our recommendations. The first and most important is that, to the greatest extent possible, international enforcement of a Canadian federal securities law should be capable of being effected unilaterally and domestically. The regulation of international transactions should be part of the regulation of domestic transactions. Local regulation is more certain, easier to change and enforce and speedier than external regulation. It also minimizes conflict with other jurisdictions since it takes place within Canada.

There are some techniques to make a securities law more effective against non-resident participants in the Canadian securities markets. It would be useful to require non-residents trading in Canada to consent to the jurisdiction of the Canadian courts and regulatory agencies. Unfortunately this will be effective only against persons who must comply because they wish to trade in Canada. The technique does not reach a foreign issuer or salesman who remains in a foreign jurisdiction and makes fraudulent solicitations by correspondence or telephone into Canada.[358]

Another weakness with a consent to jurisdiction is that it does nothing toward enforcing a judicial decision by obtaining money or some specific action from the offending person. One way to minimize the difficulty of enforcing a judgment is to require a potential offender to maintain within Canada assets such as a forfeitable deposit or bond which can be used to satisfy a money claim or to substitute for specific performance of obligations. We treat deposits as a suggestion and not as a recommendation. Deposits increase the cost of doing business and thus favour large firms over smaller ones. And like so much of our paternalist legislation, they punish the innocent instead of the guilty since the reputable person complies with the deposit system and the disreputable person, from whom a deposit should be extracted, ignores the requirement just as he ignores other laws designed to promote honesty in dealing. We suggest that the issue of deposits be de-

358 Yet sometimes the domestic law will have practical outreach where it is least expected, for example, where a non-resident's transaction is conducted through an independent agent. For an interesting illustration, see the no action letter granted Morgan Guaranty Trust by the SEC to permit the transmittal of proxy material to holders of ADRs where the matter to be voted on concerned receipt of unregistered shares as a dividend: *see* [1974-1975 Transfer Binder] CCH Fed. Sec. L. Rep. ¶80, 075.

ferred for consideration to a time when specific legislation is being considered.

It is of course essential that international law in this area be developed. International law grows as the practice of states comes to be accepted by the world community. Therefore it is in our own interest to make reasonable and responsible claims with respect to jurisdiction abroad. It is equally in our own interest to accept these claims when made by others. However, in the interests of efficient and effective protection of the Canadian public, we would do well to use, wherever possible, domestic sanctions.

Our second general theme is that Canadian securities laws should be extended in a number of areas by treaty even though the effort may be time-consuming.[359] Treaties would ensure that Canada had some control over non-residents and would reduce the resentment which individual countries manifest about the external regulations of other countries applying within them. In the arena of private lawmaking, it is always preferable to take steps by consent rather than by force. The same preference applies among nations.

We now turn to our specific recommendations. To assist in the collection of information, a useful initial step would be to obtain additional information in Canada on the activities of Canadian residents abroad. The proposed Australian Securities Act has an interesting feature – the requirement that an Australian buying or selling securities keep a record in Australia of all his transactions and notify the Securities Commission of the location of the record. The proposed act would prohibit an Australian in Australia from buying Australian stocks through a foreign intermediary.[360]

The converse of securing information about the activities of nationals abroad is securing information about the activities of non-residents in this country. We suggest that the rules on registration by non-resident persons who do business as brokers, dealers or advisers in this country be expanded. For example, the SEC requires non-resident investment advisers to keep current books and records in the United States and to furnish them on demand.[361] Similarly the right to issue securities or to carry on the business of trading in securities in Canada should be conditional on maintaining in Canada books and records equivalent to those

359 The complications created by the Canadian constitution are discussed by Morris, *Canadian Federalism and International Law*, in CANADIAN PERSPECTIVES ON INTERNATIONAL LAW AND ORGANIZATION, *supra* note 1, at 59.

360 *See* Corporations and Securities Industry Bill, 1974, s. 108 (Commonwealth of Australia).

361 *See* 305 BNA SEC. REG. & L. REP., June 4, 1975, at A-3; *id.* Oct. 1, 1975, at A-16,

which must be maintained by domestic Canadian persons and institutions.

A simple way to improve "access" to foreign information is to amend the provisions of the Canada Evidence Act to simplify the introduction of foreign business records as evidence before Canadian courts. Foreign business records, particularly documents from financial institutions, should be made admissible on the basis of proper certification and reasonable notice to the defence.[362] Another approach would be to recognize as a compellable witness concerning foreign records a person in Canada who is an employee or agent of the foreign organization, its parent or subsidiary. This would shift to the Canadian witness the onus of obtaining from his Canadian employer or principal business records kept outside Canada by the company or its affiliates.

There are also a number of ways in which use of existing sources of information by Canadian enforcement officers can be improved. Existing facts about lost, missing, counterfeit and stolen securities should be gathered. We recommend that a federal administrative agency have the power to create rules relating to reporting of such securities. Although the agency would have to balance the cost of such a requirement against the expected benefits, we believe that criminal activity in securities is sufficiently

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reporting SEC, Investment Advisors Act of 1940 Release No. 477 (Adoption of Rule 204-2(j)).

362 The Evidence Code proposed in LAW REFORM COMMISSION OF CANADA, *supra* note 273, contains several provisions which may simplify the introduction of foreign business records into evidence before Canadian courts:

"(a) Section 31(a) is perhaps the most important. This section simplifies the law relating to business records and does away with many of the requirements which do not add appreciably to the reliability of the record. Under the proposed Code, reliability is the prime consideration. Thus any foreign record of a fact or opinion (not necessarily even a 'business' record) would be admissible provided that the person making the record made it:
(i) in the course of a regularly conducted activity,
(ii) at or near the time the fact occurred or existed or
(iii) at a subsequent time if compiled from a record so made at or near such time.

"(b) Section 31(g) states that market quotations, tabulations, lists, directories or other compilations generally used and relied upon by the public or by persons in particular occupations are admissible. This section represents a significant addition to the law in that these documents are clearly hearsay. However, the Law Reform Commission considers them sufficiently trustworthy and the inconvenience of obtaining them in other ways so great as to justify an exception.

"(c) Finally, section 47(h) provides that foreign public documents are presumed to be authentic if they are accompanied by the certification specified in the Code. Note that section 47(3) proposes to give a judge the discretion to dispense with the certification if reasonable opportunity has been given to investigate the authenticity and accuracy of the foreign public documents."

widespread to warrant continued supervision of this area by the agency. A great deal of information is accessible if the enforcement officers effectively can match together the domestic sources of information with that already available internationally. Canada has a number of experienced enforcement officers and their work can be made more effective by providing them with more money and resources. Libraries containing better collections of foreign material would be a useful resource. Enforcement officers also need access to attorneys or prosecutors in other countries.

Another useful program, though one which would not become productive for years, would be to work for greater uniformity in legislation among nations. Uniformity would simplify the test of double criminality for the purpose of extradition. It would also provide a greater incentive for enforcement officers of differing nations to cooperate informally with each other if they both consider the same conduct contrary to law.

International investigations would benefit if Canada were to sign the Hague Convention on obtaining evidence abroad and if it were to attempt to work out new bilateral treaties on the model of the U.S.-Swiss treaty. Bilateral treaties would assist in obtaining information about the financial dealings of residents abroad. Such treaties may grant the right to examine business records abroad and oblige nationals of one state to testify in another state. Another well tried government approach to increasing effectiveness would be to hire more staff for international enforcement.

Some changes relating to international securities fraud need not await legislation or treaty. Individuals involved in enforcement in Canada can work in the traditional ways to develop greater cooperation with their counterparts in the enforcement agencies abroad. Another domestic device which would not involve international assistance would be to change domestic laws to require disclosure of transactions involving international elements. For example, it would be possible to require banks to disclose their principal when they act as an agency for a nonresident person. Legislation in Canada similar to the United States Walsh Act is likely to be limited in its usefulness.

Canada's extradition treaties could also be substantially improved, both by expanding the number of offences covered and by increasing the resources put into extradition cases. More particularly, the various extradition treaties and the Fugitive Offenders Act should provide expressly for extradition for securities offences. Of course one should note that this country cannot expect to gain cooperation from foreign countries without an effort to render them the same degree of cooperation.

With respect to sanctions in international securities offences,

it is not our function to decide what sanctions a Canadian federal securities law should include. We believe that the system should contain every conceivable enforcement weapon and that the law should leave to the person having the interest to be enforced the choice of selecting the remedy or group of remedies which appear most appropriate in a given situation. As noted earlier, sanctions are considered by Leonard H. Leigh in his paper in this volume. The discussion of sanctions above and in this chapter does not mesh perfectly with the list of sanctions discussed by Leigh.[363] We think it preferable to describe the general framework in which sanctions will apply internationally rather than to examine the operation of any individual sanction in detail.

We examined the criminal law relating to securities and civil law remedies brought both within and outside Canada by individuals and by the administrative agency on their behalf. Leigh also discusses class actions, administrative sanctions including stop orders, and civil actions brought by the agency to enforce statutory standards even when there is no damage shown to a private person.[364] As we stated above, we believe in the proliferation of remedies and that the general approach should be to apply to non-resident offenders the same sanctions as one applies to domestic offenders, at least to the greatest extent possible.

As we noted in chapters X and XI, it is important that criminal law provisions be retained since the present international system for gathering information and extraditing offenders in foreign countries is geared to the criminal law to maximize compliance by non-residents. Though one of the advantages of the civil law is that it can be enforced without direct cost to the taxpayer through private action, we recommend that the statute provide that the agency can bring actions on behalf of individuals or support suits financially or otherwise. We see a number of advantages in the proposal discussed by Leigh that there be a private remedy for breach of the statute. By itself, this feature might be of limited international effectiveness in view of the complexity of civil actions. To meet the international civil enforcement difficulties we suggest that the statute contain a simplified private remedy analagous to the common law tort of deceit.[365] One of the long-

363 *See, Leigh,* for discussion of specific sanctions.

364 For a recent discussion of American enforcement devices *see* Farrand, *Ancillary Remedies in SEC Civil Enforcement Suits,* 89 HARV. L. REV. 1779 (1976). This article is especially useful for its discussion of the SEC's use of receivers, injunctions and restitutionary remedies.

365 There is some question whether this suggestion can survive the January 1976 decision of the Supreme Court of Canada in MacDonald v. Vapor Canada Ltd., 66 D.L.R. (3d) 1 (S.C.C. 1976), *noted in* Hogg, *Constitutional Law - Trade Marks Act*

term projects of government should be to develop a treaty system which includes civil remedies so that in appropriate cases the Canadian securities laws become, in effect, part of the foreign domestic legal system. The treaty should also provide procedures for simplifying and clarifying the process of enforcing abroad judgments which have been obtained in Canada.

There has been emphasis in the foregoing recommendations on our general theme of accomplishing a number of international enforcement objectives through treaties. But we should keep to the fore our other general assumption: that a great deal can be accomplished in international enforcement entirely within a Canadian domestic system. At the risk of lengthening an already long paper, we wish to demonstrate by an example the extent to which outreach can be obtained without additional treaties. For the purpose of illustration we shall take the first class of rules discussed in the paper, namely, those relating to the registration of an issuing company or of its securities.

We shall take the case of a corporation incorporated in Canada which has no assets and no officers in Canada. Assume that the corporation issues securities abroad and does not comply with a disclosure requirement which under the Canadian law would be applicable. We shall consider the application of each of several types of enforcement device: administrative sanctions, a stop trading order, criminal proceedings, an injunction, a class action brought by the federal regulator for damages on behalf of injured individuals (if any) and private actions for damages and rescission.

(1) Administrative sanctions taken against the company challenging the issue itself, previously existing or newly issued stock, or even the corporate good standing of the company, are likely to have significant practical effect in the jurisdiction where the stock is being issued, especially if the authorities and the people engaged in the securities business there follow the custom of requiring opinions of counsel on the validity of stock and certificates of government authority from the incorporating jurisdiction. Although there may be jurisdictions in which the chilling effect of a negative counsel's opinion or the absence of a government certificate would not stop a transaction, Canada's interest in protecting investors in those countries is probably less strong than it is in countries, such as the United States, where such standards of corporate responsibility are maintained.[366]

Unfair Competition Provisions - Criminal Law and Civil Remedy - Trade and Commerce - Treaty - Stare Decisis, 54 CAN. B. REV. 361 (1976).

366 American attorneys can be expected to be particularly scrupulous in view of their

(2) A stop trading order is a particularly effective type of administrative sanction but deserves slightly different treatment in view of its undisciplined effect.[367] In the present example, the regulatory agency may not wish to cause losses for Canadian investors trading in previously issued securities of the company merely to prevent the company from proceeding with an issue in some distant place. Although the Canadian stop trading order may have no effect abroad, it is likely to be recognized in countries which are desirable as a source of funds.

(3) If Canadians were involved in criminal proceedings, jurisdiction could be claimed on a nationality principle. If not, the claim can be grounded on the impact principle, assuming, of course, that there is significant effect within Canada. However, both the jurisdiction and the extradition hurdles could be insuperable.

(4) An injunction obtained in a Canadian court against the company or an individual director or officer will be effective only if it is either respected by the government or the securities community in the foreign state (if it is against the issuing company) or respected by the individual director or officer because of his ties in this country, that is, ties in the form of assets which can be attached here or in the form of a desire to return to this country. Though we have no statistics on which to base this view, we believe that, in fact, very few people who have family and business connections in this country actually leave to avoid prosecution under the law. The general success of the bail system indicates that most people choose to comply with Canadian laws notwithstanding the ease of foreign travel. These generalizations, of course, are no comfort when the

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exposure to SEC action; *see, Securities Regulation - Professional Responsibility - An Attorney May Be Enjoined in an Action Brought by the SEC for Negligence in Preparing an Opinion Letter Exempting Stock from Registration under the Securities Act of 1933,* 87 HARV. L. REV. 1860 (1974). It is also possible to secure some control by denying domestic remedies to foreigners suing Canadians where the transaction involves a breach of Canadian law; *see e.g.* the refusal of U.S. courts to allow a suit by a Swiss bank against an American investor where the bank had taken losses on a transaction involving grants of credit in excess of U.S. margin allowances; Ufitec S.A. v. Carter, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶94, 841 (Cal. Sup. Ct. L.A. Co. 1974).

367 An example of the use by a Canadian regulatory body of its administrative power to prevent international transactions is the cease trading order of the Quebec Securities Commission to United International Bank and Trust Co., a company which was offering securities to European investors but not to Canadians and advertising only in the International Herald Tribune; *see, Q.S.C. Stops Trading in United International,* The Globe and Mail (Toronto), May 7, 1975, at B2, col. 8.

persons engaged in the management of a company have no connection with this country.

(5) Since in the example the issuing company has no assets in Canada with which to satisfy damage claims brought by Canadians, the success of a class action by the regulatory agency for damages on behalf of injured individuals will depend entirely on the foreign rules of recognition of foreign judgments. On the other hand, the rules of the foreign country might permit a class action to be brought there by an individual shareholder for breach of some local requirement of fair dealing and full disclosure if not for breach of the Canadian statute.

(6) A private person suing a Canadian corporation for damages suffered as a result of the corporation's failure to comply with a disclosure law would run into the same difficulty described in (5) above, namely, enforcing his judgment in a jurisdiction where the company has assets. While the success ratio should be high, one cannot assume success in every case.[368]

We conclude that a very large measure of control can be achieved over actions of non-residents by Canadian authorities using Canadian laws. Where these laws will not reach, we must endeavour to secure some protection for Canadians by treaties and reform of our securities law.

368 The other type of remedy, rescission, may prove to be more effective. The right of rescission would be claimed by the Canadian in a foreign action brought to compel him to pay for the stock. This requires convincing a foreign court to apply a choice of law rule by which a Canadian defence can be pleaded. Convincing a foreign court to apply a foreign choice of law rule is easier than asking it to enforce a foreign judgment, since it has the opportunity during the case itself to monitor whether the application of that rule coincides with its own public policy and sense of fairness.

Appendix
List of Persons Interviewed

We express our gratitude to the persons listed below for their assistance in providing us with information and comments on the problem of international enforcement of securities laws. Neither of us has had any practical experience in the area and we sought to mitigate this deficiency by interviewing people who had had a wealth of such experience.

None of the persons referred to has had the opportunity to review our paper. Hence we must accept full responsibility for all errors of fact and interpretation and, in particular, for any change in circumstances which may have occurred between the interview dates in August 1974 and the submission of this paper in December 1976.

Eugene G. Anguilla
Investigator
Securities and Exchange Commission
New York

Norman W.H. Cox
Chief Investigator (Retired)
Ontario Securities Commission
Toronto

Mahlon M. Frankhauser
Kirkland, Ellis & Rowe
Washington, D.C.

Inspector K. Kereluk
Commercial Crime Branch
Royal Canadian Mounted Police
Ottawa

David Lewis
Attorney
Division of Enforcement
Securities and Exchange Commission
Washington, D.C.

Jerald A. Lanzotti
Chief, Branch of Investment Company
Examinations and Investigations
New York Regional Office
Securities and Exchange Commission
New York

William D. Moran
Regional Administrator
Securities and Exchange Commission
New York

Sergeant Detective Henryk Nowak
Montréal Urban Community
Police Department
Montréal

Herb. S. Thurston
Law Reform Commission of Canada
Toronto

The Licensing of Securities Market Actors

Mark Q. Connelly

March 1978

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Chapter I
Introduction: The Goals of Licensing

It is now well accepted in North America that various participants in the securities markets – generally (though not precisely) speaking, those who make a "business" of participating in the securities markets – must be licensed by the state as a precondition to carrying on their activities. Furthermore, mythology notwithstanding, securities market licensing statutes in North America antedated the Great Depression by a good many years, although the rapid-fire succession of economic calamities following October 1929 did give birth to much more elaborate licensing schemes than theretofore known.[1] The first Canadian province to impose a licensing requirement for the sale of securities was Manitoba, in the Sale of Shares Act of 1912, which required agents of issuers and other sellers of securities to obtain licences.[2] Manitoba's Act followed by one year the first of the "blue sky" statutes in the United

1 *See* 1 L. Loss at 3-22. Throughout this paper the term "licensing" is used to refer to licensing of those engaged in the securities business - for example, brokers, dealers, salesmen, investment advisers and underwriters - and not to encompass the prospectus requirement, compliance with which might aptly be said to confer a "licence" to issue securities to the public.

2 J. Williamson at 12. Ch. 1 of Williamson's book gives the history of provincial licensing statutes in considerable detail.

States, that of Kansas.[3] By 1930, all of the then nine Canadian provinces had statutes imposing a licensing requirement on sellers of securities,[4] and the near half century intervening has seen a spate of securities market licensing statutes and amendments throughout North America and elsewhere.[5]

In the face of the apparently complete acceptance in concerned quarters today of the fact that the securities market occupations are subject to a licensing requirement,[6] and since the occasion for this paper is the proposal to fashion yet another statute which may well regulate those occupations, it is well to bear in mind that licensing is in fact a deprivation of individual freedom. In a "free enterprise" economy, such as Canada's, as a rule the individual is at liberty to make his living at whatever occupation he chooses;[7] the constraints or barriers to entry are not by way of a legislatively decreed exclusivity but rather are of a financial or know-how nature imposed by market forces. One is at liberty to choose his occupation, subject of course to the risk of failure. This is not the case, obviously, with the licensed occupations: one enters into them only with the positive permission of the state or, as in the case of law and other "professions", with the permission of a nongovernmental self-regulatory body. As the Ontario Royal Commission Inquiry into Civil Rights (McRuer Commission) stated:

> "We start from this basic premise. It is an infringement of the civil rights of an individual to prohibit him, without government approval, from engaging in a lawful activity....
>
> "As a general principle that which is not prohibited is, in the eyes of the law, permitted. There is a personal and public interest that the law should not unnecessarily

3 *Id.* at 11.

4 *Id.* at 11-28.

5 One of the more notable recent examples is the U.S. Securities Reform Act of 1975 which amended substantially the licensing provisions of the Securities Exchange Act of 1934. Ontario's proposed new Securities Act, Bill 7, would make a number of quite important changes in the licensing area. Provisions of both the recent U.S. legislation and the Ontario bill (as at 1st Reading, February 28, 1978) are referred to throughout this paper. *See also* SECRETARY OF STATE FOR TRADE, AMENDMENTS TO THE PREVENTION OF FRAUD (INVESTMENTS) ACT 1958, A CONSULTATIVE DOCUMENT, CMD. No. 6893 (U.K. July 1977).

6 *But see* M. FRIEDMAN, CAPITALISM AND FREEDOM 137-60 (1962).

7 *But see* Trebilcock, *Winners and Losers in the Modern Regulatory System: Must the Consumer Always Lose?*, 13 OSGOODE HALL L. J. 619, 627 (1975):

> "Three myths surrounding the present nature of public regulation widely persist. The first is that our economy is largely unregulated and is disciplined mainly by competitive forces. In fact, in Canada, there are over one hundred Federal regulatory agencies and in most provinces more than fifty regulatory agencies."

> fetter the individual's basic right to engage in any lawful means of earning a livelihood that he sees fit and to develop what ever talents he may have to this end. This principle bears on both the basic legislative decision to license and on the standards which should be imposed to implement the licensing power."[8]

The trend toward restricting entry into various occupations by means of licensing appears definitely to be up; and in the province of Ontario alone there are scores of occupations for which a licence is necessary.[9] These go well beyond such traditional professions as law, medicine, architecture, and engineering.

The growth of the licensing requirement sharply inhibits personal mobility in the geographical as well as in the occupational sense. Professor W. Gellhorn has noted disapprovingly this restriction of mobility with respect to licensing statutes in the United States.

> "Movement from place to place to place in pursuit of advancement or congeniality has always been an American prerogative. Observers from more static societies, noting our mobility, think of us as almost rootless. But licensing laws may soon anchor Americans to a degree not otherwise experienced. Despite occasional judicial remonstrance, many statutes and ordinances require antecedent local residence as a condition of license eligibility."[10]

The sentiments expressed would appear equally applicable to Canada, where mobility is no less prized and no less a part of the national tradition than in the United States. Furthermore, the hobbling of individual occupational and geographic mobility may be costly in terms not only of individual freedom but for the economy as a whole.

Gellhorn has pointed out that occupational licensing may diminish "the right not to conform" because the licensing authori-

8 ONTARIO ROYAL COMMISSION INQUIRY INTO CIVIL RIGHTS, 3 REPORT NO. 1 at 1095-96 (1968) [hereinafter MCRUER REPORT].

9 According to MCRUER REPORT, *supra* note 8, at 1095, more than 60 trades or occupations are required to be licensed under by-laws passed under the authority of the Ontario Municipal Act, R.S.O. 1970, c. 284. There are also a number of separate licensing statutes such as the Ontario Securities Act; the Farm Products Marketing Act, R.S.O. 1970, c. 162; the Real Estate and Business Brokers Act, R.S.O. 1970, c. 401; the Mortgage Brokers Act, R.S.O. 1970, c. 278, *etc.* Finally MCRUER REPORT, *supra* note 8, at 1160, lists 22 self-governing professions and occupations. At the time of writing, a Professional Organizations Committee has been constituted in the Ministry of the Attorney-General of Ontario. This committee is expected to report sometime in 1978 or 1979 and doubtless will have a great deal to say about the operation of occupational licensing statutes in the province.

10 W. GELLHORN, INDIVIDUAL FREEDOM AND GOVERNMENTAL RESTRAINTS 126 (1968).

ties may demand a kind of "normalcy" in the candidate that has little or nothing to do with the skill required to practice the occupation.[11] This pressure toward "normalcy" may exist in any licensing scheme where the general character of the applicant is made an issue and where the discretion of the licensing authority in terms of evaluating suitability is broad, as, for example, under section 7(1) of the Ontario Securities Act, (OSA), which provides: "The Director shall grant registration or renewal of registration to an applicant where in the opinion of the Director the applicant is suitable for registration and the proposed registration is not objectionable."[12] Section 24 of the Quebec Securities Act (QSA) is

11 Gellhorn, *Occupational Licensing - A National Dilemma*, 109 J. ACCOUNTANCY 39 (1959).

12 There may be some cause for concern that a type of nonconformity has upon occasion been costly to registrants in Ontario. Thus, in *In re* Michael Avram Thomas, [1972] OSC Bull. 118 (June), a registered salesman took a vacation abroad, during which time his registration lapsed. Upon return to Ontario, he applied for and was granted reregistration. It then developed that on the application for reregistration he had answered "no" to the question "has the applicant... ever been charged, indicted or convicted under the law of any province, state or country... in any part of the world?" In fact while travelling in Afghanistan the applicant had been taken into custody for possession of marijuana and had to pay a sum of money to secure his release. Upon revelation of these facts, the commission cancelled Thomas' registration as a salesman, not, the opinion is careful to point out, for possession of marijuana in Afghanistan but for lack of candor in the application and equivocation in his testimony at the revocation proceeding concerning the events in Afghanistan. The commission said, "We cannot be certain that he will not apply the same standards in his dealings with the public." With respect, it seems that the commission, if it was indeed satisfied that the events in Afghanistan could not reasonably be denominated anything other than a charge or a conviction, might have been on firmer ground had it looked to Thomas' history as a salesman to determine the appropriate sanction, and it appears that that cancellation of registration was an unduly severe penalty. While there is a well established and eminently reasonable rule that failure to disclose prior convictions will itself be a bar to registration in Ontario, *see* Cowan, *The Discretion of the Director of the Ontario Securities Commission*, 13 OSGOODE HALL L.J. 735, 751 n. 118 (1975), where a party is already registered the commission has at its disposal better grounds than a rule of thumb for determining the appropriate sanction, if any.

In *In re* Lafferty, Harwood & Partners Ltd., [1974] OSC Bull. 125 (June), *aff'd*, 8 O.R. (2d) 604 (Div'l Ct. 1975), an applicant for membership in the Toronto Stock Exchange appealed under OSA, s. 140(3) from an adverse decision of the exchange's board of governors. The board of governors had made their decision ostensibly on the basis of certain conduct of the applicant firm occurring several years earlier involving, in one instance, window dressing financial statements in order to deceive the Montreal Stock Exchange as to the applicant's capital position and, in the other instance, public criticism impugning the integrity of an Ontario judge. Despite the applicant's good record in the intervening years and its president's expressed contrition for the prior offensive acts, the Toronto exchange refused to admit the firm to membership and the commission declined to disturb the exchange's decision. The applicant claimed that the real reason why the exchange had denied it membership was its president's public record of vigorous criticism of various segments of the Canadian financial establishment.

Probably the most notorious example of the pressure for "normalcy" in a licensee

phrased even more broadly: "The granting or renewal of registration is at the discretion of the Director."[13]

Gellhorn would reserve imposition of the individual and societal costs of licensing for occupations which meet two criteria: first, that consumers of the service in question cannot judge its quality at the time of consumption; and, second, that the harm that may reasonably be expected from dishonest or incompetent performance is grievous.[14] That the activities of selling and advising upon the merits of securities bear these characteristics is amply testified to by history and by reference to the disciplinary proceedings before any securities commission.

The goals of licensing of securities market participants are usually expressed as the achievement of a triumvirate of values: honesty, competence and financial responsibility.[15] In *Lymburn v. Mayland*,[16] in which the Privy Council upheld as *intra vires* the investigatory powers of the Alberta Attorney-General derived from that province's Security Frauds Prevention Act, Lord Atkin said: "There is no reason to doubt that the main object sought to be secured in this part of the Act is to secure that persons who carry on the business of dealing in securities shall be honest and of good repute, and in this way to protect the public from being defrauded."[17]

In an article on the unfixing of commission rates on stock exchanges in the United States, Professor Baxter has summarized the preventive goals of exchange oversight of their members in a manner that equally well describes some of the salient goals of licensing. He writes:

> "Exchange regulations must guard against several types of potential evil: First, unduly thin capitalization of member firms poses the risk that investors might find themselves in the position of unsecured creditors of an insol-

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occurred in a nonsecurities context. In Roncarelli v. Duplessis, [1959] S.C.R. 121, the Premier of Québec had ordered that province's liquor commission to revoke a restaurateur's liquor licence because the restaurateur had served as surety bail for a great number of Jehovah's Witnesses who had been arrested for distributing their proselytizing literature. The Witnesses' religion was anathema to the province's Roman Catholics.

13 Quebec Securities Act [hereinafter QSA].

14 Gellhorn, *supra* note 11, at 41-42.

15 "[R]egistration is used to ensure the adequacy of capital of persons dealing with the public in securities; to prevent untrained persons from engaging in such dealings; to impose operational and procedural rules considered necessary in the public interests; and to enforce compliance with certain ethical standards"; Toronto Stock Exchange, Submission to the Ontario Securities Commission on Bill 75, the Securities Act, 1974, at 34 (October 11, 1974).

16 [1932] A.C. 318 (P.C.)

17 *Id.* at 324.

vent brokerage house; second, brokerage houses might abuse their fiduciary relationships and sell to investors, at unreasonably high prices, securities owned either by the brokerage house or by a favoured customer, or they might misappropriate the funds or securities left in their custody by customers; and third, members, having direct access to the exchange mechanisms, might engage in manipulation of those facilities, generate ticker indications of security value that did not correspond to 'true' value, and then turn such indications to the manipulator's advantage in other transactions. *To guard against the evils of insolvency, dishonesty and manipulation,* the exchanges have customarily exercised supervisory control over those members of the industry who deal with customers and have access to the exchange mechanisms."[18]

In addition, licensing seeks to protect brokerage firms' customers against the dangers that the broker will recommend to and purchase for the customer securities not appropriate to the customer's financial situation and investment objectives; that the broker, whose fee is based on commission, will cause excessive trading in the customer's account; and that the broker will be just plain incompetent in securing prompt and accurate execution of a customer's order.

Numerous commentators have criticized the trend toward licensing requirements in an increasing number of occupations as indicative of a desire of those already in an occupation to gain a public mark of "professional" status – and to keep others out.[19]

18 Baxter, *NYSE Fixed Commission Rates: A Private Cartel Goes Public,* 22 STAN. L. REV. 675, 680 (1970) (emphasis added). The possibility of manipulation of "market" price is not limited to securities traded on exchanges. Dealers in the over-the-counter market have upon occasion caused to be published fictitious bid and ask quotations bearing no relationship to any independent market price for the security. *See e.g. In re* Goldmack Securities Corp. Ltd., [1966] OSC Bull. 14 (January); *In re* W.D. Latimer Co. Ltd., [1967] OSC Bull. 9 (August).

19 *See e.g.* W. GELLHORN, *supra* note 10; Gellhorn, *supra* note 11; M. FRIEDMAN, *supra* note 6; Trebilcock, *supra* note 7; Reich, *The New Property,* 73 YALE L.J. 733, 766 (1964); Moore, *The Purpose of Licensing,* 4 J.L. & ECON. 93 (1961); *see also* MCRUER REPORT, *supra* note 8, at 1172, where the following observations are made concerning the self-governing occupations:

> "We have made it clear that the power to admit a licensee is not conferred to protect the economic welfare of the profession or occupation. Those professions or occupations which are granted self-governing status are charged with a responsibility not only to see that persons licensed are qualified, but that all qualified applicants are licensed....
>
> "[I]t must be recognized that each of the self-governing bodies has been given a statutory monopoly through its licensing powers. What has to be guarded against is the use of the powers of license for purposes other than

That is, licensing requirements are seen to be a result of pressure from those within the occupation to upgrade their economic and social standing rather than as responsive to a public need for protection. It does not appear that such a view of licensing in the securities industry would be historically accurate; rather licensing appears to serve legitimate needs of public protection.

Participants in the securities industry, or at least certain of them, do, however, wish to think of themselves as "professionals" and seek to project a "professional" image. For example, the *Manual for Registered Representatives*, a publication of the Canadian Securities Institute,[20] in the section on "Code of Ethics and Conduct for Registered Representatives" states that "the representative should fit himself to the best of his ability for his profession".[21] Typically the term "registered representative" is used in industry sponsored publications, as opposed to the word "salesman" used in the relevant statutes.[22] A publication of the New York Stock Exchange states: "Like a doctor or lawyer, the representative should determine pertinent facts concerning his client's situation prior to giving advice."[23] Some years ago, in a criminal prosecution in the United States involving securities fraud, the former president of the National Association of Securities Dealers testified for the government as follows:

> "Q: Is the securities business a specialized business or not, in your opinion?
>
> "A: I think it is a profession like medicine or the law.... I think you have a fiduciary relationship with your customers which is a position of trust with them, and that is where it distinguishes it from any other business."[24]

One team of commentators in the United States has proposed the "professionalization of the stockbroker" as a guide toward resolv-

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establishing and preserving standards of character, competence and skill."

20 The Institute is jointly sponsored by the Investment Dealers Association of Canada and the Montreal, Toronto and Vancouver stock exchanges.

21 CANADIAN SECURITIES INSTITUTE, MANUAL FOR REGISTERED REPRESENTATIVES 14.

22 *E.g.* OSA, s. 6.

23 NYSE DEPARTMENT OF MEMBER FIRMS, SUPERVISION AND MANAGEMENT OF REGISTERED REPRESENTATIVES AND CUSTOMER ACCOUNTS 7 (1962), *quoted in* Levin & Evan, *Professionalism and the Stockbroker*, 21 BUS. LAW. 337, 351 (1966).

24 Testimony of Harold E. Wood in United States v. Pandolfo, Crim. Nos. 95, 105 (D.N.D. September 28, 1959), *quoted in* Mundheim, *Professional Responsibilities of Broker-Dealers: the Suitability Doctrine*, [1965] DUKE L.J. 445, 447 n. 4. *See also* Ontario District of the Investment Dealers Association of Canada, Submission to the Industry Ownership Study of the Ontario Securities Commission 8-13 (1971).

ing the various conflicts or roles and consequent conflicts of interests faced by the stockbroker.[25]

If thinking of their occupation in terms of a profession increases the sense of a fiduciary relationship with their clients in the minds of securities salesmen and underwriters and other licensed members of the securities industry, that is all to the good. It is only realistic, however, for securities market licensees, their regulators and, most importantly, their customers (or "clients") to bear in mind that at bottom the securities business is a merchandizing business.[26]

A commentator in the United States has put succinctly the dilemma inherent in considering the securities industry licensed occupations as professions:

> "Basically the industry is a merchandizing industry, and it's hard to consider it professional no matter how well qualified its personnel may be, because there is an ever present conflict of interest. This is true even in pure brokerage transactions. By stressing the idea of living up to a professional image, the regulatory authorities may be doing a disservice to the investing public if that professional status is not there."[27]

Chapter II
The Licensed Activities

In Ontario and the other provinces the activities in the securities market generally subject to a licensing requirement are three: trading in securities, whether as principal or agent; underwriting securities issues; and advising with respect to the merits of investing in securities.[28] Section 6 of the OSA provides that no person or company shall engage in any of these activities unless such person or company is registered with the Ontario Securities Commission (OSC) to carry on the particular activity.

A. TRADING

"Trading" is defined in OSA section 1(1)24 to include "any sale or disposition of or other dealing in or any

25 Levin & Evan, *supra* note 23, at 350-54.

26 *See* Mundheim, *supra* note 24, at 446; SECURITIES AND EXCHANGE COMMISSION, REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS 240-42 (1963) [hereinafter SEC SPECIAL STUDY].

27 Remarks of Harry Heller in CONFERENCE ON SECURITIES REGULATION 100 (R. Mundheim ed. 1965), *quoted in* Spiro, *Securities Salesmen, Investor Protection and Professional Responsibility*, OSGOODE HALL L.J. 431, 457 (1970).

28 OSA, s. 6(1).

solicitation in respect of a security for valuable consideration...and any act, advertisement, conduct or negotiation in furtherance of any of the foregoing."

The definition appears to encompass only the sale side of securities transactions, to the exclusion of the purchase side, although the concept of purchase could obviously fall within the literal reach of "other dealing in".[29] In *Prudential Trust Co. Ltd. v. Forseth,*[30] the Supreme Court of Canada said that the definitions of "trade" in the Saskatchewan Securities Act, which is very similar in this respect to the Ontario Act, "seem to contemplate the soliciting of subscriptions for or the making of sales of securities by the person trading and do not contemplate the soliciting for or making of purchases of securities by such a person".[31] This construction appears correct, since, had the legislature intended to include purchases within the coverage of "trade", one would have expected it to insert the words "purchase or" immediately before the word "sale" in the definition and not to rely upon the vague phrase "or other dealing" to do the job. Bill 7, the proposed new Securities Act for Ontario, is explicit on this point. Section 1(1)42 states that "trade" includes "any sale or disposition of a security for valuable consideration...but does not include a purchase of a security...".[32] As a practical matter, the inclusion or non-inclusion of "purchase" may be of little importance since those persons whose business is the trading of securities (and, as discussed below, it is the *business* of trading that triggers the licensing requirement) must buy *and* sell securities.

In United States federal securities regulation, the definitional focus for licensing purposes is not on the concept "trade" but rather on the concepts of broker and dealer. The Securities Exchange Act of 1934 (Exchange Act) defines a broker to be "any person engaged in the business of effecting transactions in securities for the account of others" and a dealer to be "any person engaged in the business of buying and selling securities for his

29 *See* J. WILLIAMSON, SUPP. at 116.

30 [1960] S.C.R. 210, 30 W.W.R. (N.S.) 241, 21 D.L.R. (2d) 587.

31 21 D.L.R. (2d) at 601. The definition of "trade" in the Saskatchewan Securities Act, s. 2, included "any solicitation or obtaining of a subscription to, disposition of, transaction in, or attempt to deal in, sell or dispose of a security or interest in or option upon a security, for valuable consideration...and any underwriting of an issue or part of an issue of a security, and any act, advertisement, conduct or negotiation directly or indirectly designated as 'trade' or 'trading' in the regulation".

32 *See* Bray, *Ontario's Proposed Securities Act: An Overview, Its Purpose and Policy Premises,* [1975] OSC Bull. 235, 261 (October). Under the Québec Securities Act, s. 14, "trading in securites" is "any alienation or disposal, for a valuable consideration, of a security" - again equating "trade" with "sell".

own account".[33] Under section 15(a) of the Exchange Act, it is unlawful "for any broker or dealer...to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security...unless such broker or dealer is registered" with the Securities and Exchange Commission (SEC).[34] Thus there emerge two distinctions between the United States and the Canadian approaches to licensed securities activities. First, the distinction between trading for one's own account (dealer) and trading for the account of others (broker) has greater importance in the structure of the United States securities legislation than in the Canadian legislation. The triggering definition in the licensing parts of the Canadian securities statutes makes no such distinction.[35] More importantly, by limiting the coverage of the terms broker and dealer to those engaged *in the business of* effecting transactions in securities, the Exchange Act's definitions do much of the work left for the exceedingly lengthy exemptions catalogues in the Canadian statutes.[36]

33 15 U.S.C. ss. 78c(4), (5) (1970).

34 Until the Securities Reform Act of 1975, brokers and dealers who conducted their businesses exclusively on an exchange which was registered with the commission (pursuant to s. 6 of the Exchange Act) did not themselves have to be registered with the commission. Registration with the commission was required only for those brokers and dealers who transacted business in the over-the-counter market. Since the vast majority of exchange members also conduct some business in the over-the-counter market, even under the pre-1975 law most exchange members as well, of course, as all nonmember brokers and dealers, had to be registered with the commission. In practice, under the prior law such exchange members as floor traders, specialists and odd-lot dealers were not registered with the commission. These members did not carry accounts for the public; *see* Cohen & Rabin, *Broker-Dealer Selling Practice Standards: The Importance of Administrative Adjudication in their Development*, 29 LAW & CONTEMP. PROBS. 691, 697 (1964). The requirement in the 1975 amendments that all brokers and dealers be registered with the commission is characteristic of two themes of the recent U.S. legislation: first, a decided shift in the balance of power between self-regulatory organizations and the commission toward the latter and, second, the concept that all persons enjoying similar privileges in the securities industry, performing similar functions, and having the potential for similar market impact should be treated equally; *see* SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, S. REP. No. 94-75, 94th Cong., 1st Sess. 15-16, 22-23 (1975).

35 Until amendments passed in 1968 (S.O. 1968-69, c. 116), however, s. 6 of the Ontario Securities Act did distinguish between brokers and dealers. Now, categorization of traders has been left to the regulations; *see* discussion in Ch. III.B *infra*. Other provincial acts continue to distinguish between broker and dealer in the statutes themselves. In a variety of particulars, however, the Ontario act continues to observe the distinction between agency (broker) and principal (dealer) transactions. Thus, confirmations of trades must disclose whether the registrant has acted as principal or as agent, OSA, s. 67(1), and where a registrant proposes to act as a principal in a transaction, he must so state in any written solicitation; OSA, s. 70. The distinction between whether a registrant has traded as principal or as agent is important in connection with determining the limitations periods on its customers' rights of withdrawal and rescission under OSA, ss. 64(5), 65(6).

36 *See* J. WILLIAMSON, SUPP. at 117-18. What constitutes "the business of effecting

The Exchange Act in the United States appears to pose the question "Is the person proposing to trade in the business of trading securities?", whereas the approach of the Canadian statutes, when the terms of coverage are read together with the exemptions, is to pose the question "Does the person proposing to trade need the intermediation of a person whose business it is to trade securities?".

Under the Canadian statutes the exemptions from the requirement that a person trading securities be registered or licensed are defined in terms of one or a combination of three variables: the identity of the person trading, the identity of the person to whom the trade is made, and the nature of the security being traded.

1. *Persons Who May Trade without Registration*

The exemptions in Ontario that relate primarily to the identity of the person trading are as follows:

(1) a trade by an executor, administrator, guardian, committee, trustee or assignee or by a receiver or custodian under the Bankruptcy Act or by a receiver under the Judicature Act or by a liquidator under the Corporations Act, the Business Corporations Act or the Winding-up Act;[37]
(2) an isolated trade in a specific security by or on behalf of the owner and not made by a person or company whose usual business is trading in securities;[38]
(3) a trade where one of the parties is a chartered bank, a loan corporation, a trust company, an insurance company or a government agency;[39]
(4) a trade of a pledged security to liquidate a *bona fide* debt;[40]
(5) an occasional trade in a security by employees of a registrant who do not ordinarily sell securities to the public and who have therefore been designated as "non-trading" employees by the OSC director;[41]

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transactions in securities" under the Exchange Act is discussed in Rice, *The Expanding Requirement for Registration as a "Broker-Dealer" Under the Securities Exchange Act of 1934*, 50 NOTRE DAME LAW. 201 (1974); Kirshberg & Schild, *What is a Broker?*, 6 REV. SEC. REG. 844 (1973).

37 OSA, s. 19(1)1.

38 OSA, s. 19(1)(2). *See* R. v. McKillop, [1972] 1 O.R. 164 (Prov. Ct.).

39 OSA, s. 19(1)3.

40 OSA, s. 19(1)4.

41 OSA, s. 19(1)5.

(6) a trade to an underwriter acting as purchaser, and trades between underwriters;[42]

(7) a trade in a security by a person or company acting through a registrant.[43]

It appears that all of the second, fourth, fifth and seventh exemptions listed above could be dispensed with in a statute which defined the activity subject to licensing as the *business of* trading in securities.[44] With respect to the first exemption, certain of the professional executors and trustees (*e.g.*, trust companies) and certain frequently appointed receivers (*e.g.*, trust companies and firms of chartered accountants) might well trade securities in these capacities with sufficient regularity such as to be considered to be "in the business of" trading securities. Similarly, the sixth category of exempt persons, underwriters, most certainly are "in the business of" securities trading, although the exemption is necessary only for those very few underwriters who do not also hold registration in one or more trading capacities.

Probably the most important and certainly the most controversial of the exemptions relating to the identity of the trader is the third, insofar as it exempts trades where one of the parties is a chartered bank, a loan or trust company or an insurance company.[45] At first blush, the exemption might appear necessary to enable the financial institutions to deal directly with their customers in the ordinary course of business, without need either to be registered themselves under the Securities Act or to deal through registered intermediaries, since the investment devices initiated by these institutions would appear to be, at least in some cases,

42 OSA, s. 19(1)6.

43 OSA, s. 19(1)7.

44 Under the U.S. Exchange Act, however, where there is no exemption similar to the s. 19(1)7 exemption in Ontario, difficult questions may arise as to whether certain persons who deal with registered broker-dealers on behalf of others are themselves brokers or dealers, *e.g.* corporate treasurers who purchase stock in the market for company employees pursuant to a stock purchase plan, trustees who have basic responsibility for managing the portfolios of trust estates to which they have title as trustees, and investment advisers who act as intermediaries for their customers in placing orders with the customers' brokers and dealers; *see* E. Weiss, Registration and Regulation of Brokers and Dealers 6-7 (1965).

45 OSA, s. 19(1)3 provides that "registration is not required in respect of a trade where one of the parties is a bank to which the Bank Act applies, or the Industrial Development Bank incorporated under the Industrial Development Bank Act (Canada), or a loan corporation or trust company registered under the Loan and Trust Corporations Act, or an insurance company licensed under The Insurance Act, or is an officer or employee, in the performance of his duties as such, of Her Majesty in right of Canada, or of any province or territory of Canada, or of any municipal corporation or public board or commission in Canada, or any other trade where the purchaser or proposed purchaser is a person, other than an individual, or a company recognized by the commission as an exempt purchaser".

securities under the legislation.[46] Debt instruments of or guaranteed by a chartered bank, trust company, loan corporation or insurance company are, however, exempt securities under OSA section 19(2)1 and therefore registration is not required to trade in such instruments.[47]

Whatever might be the need to exempt financial institutions from the registration provisions in order to leave them unimpeded in offering investment opportunities originated by them to their customers, that is not what makes the exemption controversial or, more accurately phrased, unpopular with the investment industry.[48] The sticking point is that the term "party" to a trade in section 19(1)3 includes not only buyer and seller but also *agent.* The fear of the brokerage industry in Ontario and of the Toronto Stock Exchange (TSE) is that the broad terms of the exemption would enable the exempted institutions, more particularly the banks,

46 *E.g.* a guaranteed investment certificate issued by a trust company or a similar type of term instrument issued by a chartered bank would appear to be a "document constituting evidence of...interest in the capital, assets, property, profits or earnings" of the issuing institution (OSA, s. 1(1)22.ii), if not an "instrument ...commonly known as security" (OSA, s. 1(1)22.i). An investment certificate may also be viewed as a species of promissory note issued by a bank or trust company, as the case may be (OSA, s. 1(1)22.v). In the United States, where the definitions of the term "security" in the Securities Act of 1933 and in the Securities Exchange Act of 1934 are very similar to that in the OSA, inconsistent results have been reached on the question whether a certificate of deposit or other term savings instrument issued by a financial institution is a security. The affirmative answer has been given in SEC v. First American Bank & Trust Co., 481 F.2d 673, 678 (8th Cir. 1973) (Securities Act); Garner v. Pearson, 374 F. Supp. 591, 596 (M.D. Fla. 1974) (Exchange Act). *Contra,* Burrus, Cootes & Burrus v. MacKethan, 537 F.2d 1262 (4th Cir. 1976) (Exchange Act); Bellah v. First National Bank of Hereford, 495 F.2d 1109 (5th Cir. 1974) (Exchange Act).

47 As for insurance companies, in particular, the expression "document constituting evidence of ...interest in the capital, assets, property, profits, earnings or royalties of any person or company" (OSA, s. 1(1)22.ii) would appear to include a contract of straight life insurance, although "any income or annuity contract...issued by an insurance company" is specifically excluded from the definition of security (OSA, s. 1(1)22.xii). On the other hand, Ontario's Bill 7 provides specifically in s. 34(2)2 that registration *is* required to trade in those variable payment contracts issued by insurance companies that do not guarantee to return on the termination of the policy an amount equal to at least 3/4 of the premiums paid up to the date of termination. This provision is a codification of an understanding reached among the life insurance industry, the insurance regulatory authorities and the securities regulatory authorities after variable insurance contracts first appeared in Canada in the 1960s to the effect that a variable insurance contract that guaranteed at death or maturity a return of at least 75% of premiums paid would be deemed to contain a guarantee of sufficient substance to include it in the securities acts' exemptions for debt obligations guaranteed by an insurance company. *See generally* Memorandum of the Canadian Life Insurance Association to the Ontario Securities Commission Re Bill 75 (1974); Ontario Securities Regulations, Form No. 19.

48 The following observations are made without reference to the constitutional difficulties that might stand in the way of the provinces seeking through their securities statutes to regulate the activities of federally chartered financial institutions.

with their vastly greater financial resources as compared with brokerage firms, to enter the brokerage business, no holds barred.[49] The banks do in fact accept orders to buy and sell securities for their customers; they claim that they accept orders on an unsolicited basis only and that they always execute transactions through the medium of a registrant, with no part of the brokerage commission accruing to the bank.[50] Indeed, in the case of transactions on an exchange, the banks would have to buy or sell through a registrant since only members or their representatives may trade on an exchange[51] and no entity is eligible for exchange membership unless its principal business is that of a broker or dealer in securities.[52] Furthermore, there is not in Canada, as there is in the United States, much of a third market – that is, an over-the-counter market in exchange-listed securities.[53]

In Bill 75, an earlier version of the currently proposed OSA amendments, the trading exemption for the banks, insurance companies, and loan and trust companies was limited to trades where they purchase as principal.[54] The bankers' brief argued for the economic necessity of the banks' providing a brokerage service in the smaller communities where securities brokers do not maintain offices. The brief asserted that to require all the officers, and perhaps even tellers, in the banks' thousands of branches to register as securities salesmen under the non-exemption that would have been established by Bill 75 would have been totally impractical. Furthermore, the bankers made a not too heavily veiled threat of constitutional challenge to Bill 75, presumably on the ground that it constituted provincial interference with the powers of federally chartered and comprehensively regulated entities.[55]

In Ontario Bill 7, the exemption has been liberalized to a form which is not so broad as in the present act but which conforms to what the banks claim to be their actual practice. In addition to the exemption allowed in Bill 75, section 34(1)11 of Bill 7 exempts from the registration requirement

49 Toronto Stock Exchange Submission, *supra* note 15, at 29-46.

50 Canadian Bankers' Association, Brief to the Ontario Securities Commission on Bill 75, The Securities Act 1974 at 4-5 (1974).

51 TSE by-laws, ss. 3.05, 8.26, 8.27, 3 CCH CAN. SEC. L. REP. ¶¶ 89-200, 89-340, 89-341.

52 TSE by-laws, s. 5.01, 3 CCH CAN. SEC. L. REP. ¶ 89-271.

53 ONTARIO SECURITIES COMMISSION, REPORT OF THE SECURITIES INDUSTRY OWNERSHIP COMMITTEE 43 (1972) [hereinafter OSC OWNERSHIP REPORT]. Furthermore, the development of such a third market is effectively thwarted by rules of the exchanges that generally prohibit their members from participating in a transaction in a listed security anywhere except on the floor of an exchange whereon the security is listed. *See e.g.* TSE by-laws, ss. 11.01, 12.01, 3 CCH CAN. SEC. L. REP. ¶¶ 89-391, 89-496.

54 Ontario Bill 75, s. 35(3).

55 Canadian Bankers' Association Brief, *supra* note 50, at 3-6, 8-9, 33.

> "the execution of an unsolicited order to purchase or sell through a registered dealer by a bank to which the *Bank Act* (Canada) applies or a trust company registered under *The Loan and Trust Corporations Act* as agent for a person or company and the trade by such person or company in placing the unsolicited order with the bank or trust company."

Thus the insurance companies and loan companies are excluded from the brokerage business (if ever there was any chance of their entering it) and the banks and trust companies are limited for the future to provision of the service that the banks now claim to provide.

The issue of banks' participation in the securities business arose before the OSC in 1974 in *In re Canada Development Corporation*.[56] The Canada Development Corporation (CDC) is a government sponsored corporation established "to assist in the creation or development of business...of Canada" and "to expand, widen and develop opportunities for Canadians to participate in the economic development of Canada" by making investments in business enterprises in Canada.[57] The corporation planned in the spring of 1974 to sell its securities to Canadian citizens and, in order to obtain the widest dissemination among eligible residents of Canada, it proposed to distribute its securities through the network of offices of the Canadian chartered banks as well as through the normal channels of registered dealers. In brief, the banks were to act as part of the underwriters' selling group, a prospect likely to be a source of scant comfort to the traditional, licensed investment community. It is not clear from the commission's opinion whether and in what amount the banks were to be compensated for selling the CDC securities. After describing briefly the protections that are supposed to flow to investors from the requirement that securities dealers be licensed under the Securities Act and the role that banks usually take in selling securities (in accordance with what has been described above), the commission proceeded to place its *imprimatur* on the proposed distribution scheme. The order was styled as an exemption under section 20 of the Securities Act, but the applicability of that section is not entirely clear. Under section 20, the securities commission may, where in its opinion such action is not prejudicial to the public interest and subject to such terms and conditions as it may impose, order that section 6 does not apply to a trade, security or company, as the case may be. However, as we have seen, section 6 does not in

56 [1974] OSC Bull. 76 (April).

57 Canada Development Corporation Act, S.C. 1970-71-72, c. 49, s. 6.

any event apply to a trade where one of the parties is a bank, and if the banks' role was viewed as that of "underwriters", banks are free to act as underwriters without registration by the terms of OSA section 6(d).[58]

The commission's order was, nonetheless, remarkable in its permissive breadth. For the banks were to be permitted to act as the "underwriters' agents" in the sale of the securities without any obligation to comply with the "know-your-client" or "suitability" rules for the protection of securities purchasers,[59] notwithstanding that the securities were described with prospectus as "speculative".[60] The riskiness of CDC common stock may be contrasted, for example, to Canada Saving Bonds which also are distributed through the chartered banks. While the banks' role in the sale was to be limited to distribution of the prospectus and acceptance of orders - and in particular the banks were not to make purchase recommendations - one could well imagine that in the minds of many of the banks' customers a "blue chip" halo would surround the securities simply as a result of the banks' participation in the distribution.

The approach of the Exchange Act in the United States is specifically to exclude banks, but not loan or insurance companies, from the definitions of broker and dealer.[61] Most deposit-taking financial institutions styled "trust companies" would also be excluded from the definitions of broker and dealer by virtue of the very wide definition given to the term "bank" in the Exchange Act.[62] In the U.S. there is not the sharp distinction between banks and trust companies that exists in Canada and most banks in the U.S. perform the full range of fiduciary services reserved to trust companies in Canada. Under provisions of the Banking Act of 1933 (popularly known as the "Glass Steagall Act"), national banks and state banks that are members of the Federal Reserve System or are insured by the Federal Deposit Insurance Corporation are generally excluded from the business of brokering, dealing and underwriting securities, except that they may engage in all of these functions insofar as securities representing obligations of the federal, state and municipal governments are concerned and

58 Moreover, viewed as participants in a selling group, the banks' role would not seem to bring them within the definition of "underwriter" in s. 1(1)25 of the act since presumably their compensation, if any, would be "limited to receiving the usual and customary distributors' or sellers' commission payable by an underwriter"; OSA, s. 1(1)25.

59 These rules for the conduct of brokers and dealers are described in Ch. IV.C.2, IV.E.2 *infra.*

60 [1974] OSC Bull. 77 (April).

61 Exchange Act, ss. 3(a)(4), (5).

62 Exchange Act, s. 3(a)(6).

they may purchase and sell securities "solely upon the order and for the account of customers".[63] Notwithstanding statutory provisions that appear sharply to limit it, the participation of banks in the securities industry is as perennially contentious a topic in the U.S. as in Canada.[64]

2. *Persons to Whom Trades May Be Made without Registration*

The exemptions that are a function primarily of the identity of the party to whom the trade is made are, in Ontario, as follows:

(1) a trade by a company of securities of its own issue to holders of its securities as a stock dividend, or pursuant to the exercise of a right to purchase additional securities;[65]
(2) a trade by a company of securities, whether of its own issue or not, pursuant to a *bona fide* reorganization or winding up;[66]
(3) a trade by a company of securities of its own issue to its promoters or employees;[67]
(4) a trade to a purchaser whom the Commission has declared to be an exempt purchaser;[68]
(5) a trade to a purchaser, who takes for investment and not with a view to resale securities having an acquistion cost of at least $97,000;[69]

63 12 U.S.C. ss. 24, 378 (1970), *See* Investment Company Institute v. Camp, 401 U.S. 617 (1972) (a national bank may not offer its customers opportunity to invest in a stock fund created and operated by the bank).

64 *See* REPORT OF THE SENATE-HOUSE CONFERENCE COMMITTEE ON BILL S. 249, H. REP. No. 94-229, 94th Cong., 1st Sess. 110-11 (1975); *Banks and Brokers: Wall Street's Competitive Mismatch*, 285 BNA SEC. REG. & L. REP., January 15, 1975, at 1; Lybecker, *Bank-Sponsored Investment Management Services: A Legal History and Statutory Interpretative Analysis*, 5 SEC. REG. L.J. 110, 195 (1976) (for pts. I and II respectively).

65 OSA, ss. 19(1)8.i, iii. Issuance of a stock dividend would not appear to be a trade at all since no consideration is received by the issuer. In the case of a rights exercise, presumably the antecedent transaction in which the right is issued is exempt also, a point made explicit in Ontario Bill 7, s. 34(1)14. *See* Dey, *Exemptions under the Securities Act of Ontario*, in LAW SOCIETY OF UPPER CANADA, SPECIAL LECTURES: CORPORATE AND SECURITIES LAW 127, 156 (1972). For the rights exemption to operate, there must be advance notice given to the commission of the intention to distribute securities in this way. The commission may object; OSA, s. 19(1)8.iii.

66 OSA, s. 19(1)8.ii. No commission or other remuneration may be paid "to others" in connection with the transaction, "except for ministerial or professional services or for services performed by a person or company registered for trading".

67 OSA, ss. 19(1)9c and 10. The employee must not be induced to purchase "by expectation of employment or continued employment"; OSA, s. 19(1)10.

68 OSA, s. 19(1)3. Such purchaser cannot be an individual.

69 OSA, s. 19(3). The purchaser cannot be an individual - a restriction that would be removed in Ontario Bill 7, s. 34(1)5. This is the so-called "private placement" exemption; Ontario Bill 7, s. 34(1)21 would introduce an additional, much expanded private placement exemption that could involve up to 25 purchasers with no required minimum value.

(6) trades in the context of various types of corporate acquisitions and amalgamations, specifically:
(a) a trade in a security of a company made by that company to another company or the latter's shareholders in connection with any form of statutory amalgamation or merger procedure or a takeover bid;[70]
(b) a trade in a security of a company in connection with an offer to purchase shares by way of private agreement with fewer than fifteen shareholders, or an offer to purchase all of the shares in a private company;[71]
(c) a trade in a security of a company in consideration for assets of a fair market value of at least $100,000 where the person or company taking the securities agrees to hold them for investment only and not with a view to resale.[72]

There is a catch-all exemption for "trades in respect of which the regulations provide that registration is not required", [73] but to date no such regulations have been promulgated in Ontario.

Presumably the requirement that securities transactions be conducted through licensed intermediaries evidences beliefs that licensees will possess the qualities of honesty, competence and financial responsibility in high degree and that these qualities in an intermediary are essential protections for the purchasers (and sellers) of securities. If that is the rationale, then the drafting of various of the exemptions from licensure includes many irrelevant elements. These exemptions appear to be based either upon the degree of sophistication of the purchaser or else upon his familiarity with the issuer or at least with the party trading the security to him. These transactions are almost face-to-face, and that may indicate a lack of need for a licensed intermediary. Of what relevance to determining the existence of such a need (as opposed to the need for prospectus disclosure), however, is the intention of the recipient with respect to holding or selling the securities he receives,[74] the expectations or motivations of an employee in purchasing securities issued by his employer,[75] or whether promotional expenses have been paid in connection with a trade?[76] The interjection of irrelevant criteria for determining when trades

70 OSA, s. 19(1)9. A takeover bid often will involve a registrant as representative of the offeror.

71 OSA, s. 1.19(1)9a.

72 OSA, s. 19(1)9b. The person or company acquiring the securities under s. 19(1)9b may not be an individual, a limitation that has been removed in the corresponding registration exemption provision of Ontario Bill 7, s. 34(1)18.

73 OSA, s. 19(1)11.

74 OSA, s. 19(1)9b.

75 OSA, s. 19(1)10.

76 OSA, ss. 19(1)8.i and ii.

may be effectuated without the intervention of a licensee may result from the fact that exemptive categories are forced to do an inappropriate double duty. They determine the question of licensing and, via incorporation into OSA section 58, the very different question of the need for prospectus disclosure. Any new legislation should keep the different questions distinct.[77]

If new legislation were to adopt the approach of licensing those whose *business* is the trading of securities, then the need for the above exemptions would probably disappear because trading securities would not be the *business* of the companies effectuating the trades in question.[78] Companies trading securities either as stock dividends or in connection with a corporate acquisition or to their employees or promoters are likely to be industrial companies – not brokerage firms.

3. *Securities That May Be Traded without Registration*

In addition to the various exemptions that relate primarily to the identity of the trader or of the purchaser, there are a number of licensing exemptions in the Canadian legislation that relate primarily to the character of the security being traded. In the order of the various subclauses of OSA section 19(2) in which they are contained, these exemptions are:

(1) debt instruments of or guaranteed by:(a) a municipality, a province or the government of Canada or the government of any foreign country or political division thereof; (b) a federally chartered bank, a trust company or loan corporation, or an insurance company; (c) the International Bank for Reconstruction and Development;
(2) guaranteed investment certificates issued by a trust company;[79]
(3) commercial paper of less than one year maturity so long as, where traded to an individual, it has a face amount of at least $50,000;[80]
(4) mortgages not offered for public sale except by a person or

77 In Ontario Bill 7, the incorporation by reference has been eliminated and in the case of the stock traded in consideration of assets of $100,000 or over value (s. 19(1)9b of the present act) the requirement of investment intent has been removed from the registration exemption.

78 Unless they happen to be brokerage firms or mutual fund management companies.

79 This exemption appears redundant in the light of (1) above.

80 The requirement of a minimum dollar value in the case of sales to individuals was added in 1963 (S.O. 1962-63, c. 131) as a response to the activities of a number of sales finance companies that sold short term securities to the public promising high rates of interest but with little or no disclosure about the financial affairs of the compa-

company registered under The Real Estate and Business Brokers Act;[81]

(5) securities collateralizing indebtedness due under a conditional sales contract where the securities are not offered for sale to the public;

(6) securities issued by a person or corporation not organized for profit where no part of the net earnings of such person or corporation enure to the benefit of any securityholder;

(7) securities issued by cooperative corporations;

(8) credit union shares;

(9) securities of a private company;

(10), (11), (12) securities issued by a prospector or a prospecting syndicate under certain conditions relating to disclosure and to the number of persons to whom the securities are sold;

(12a) securities issued by a mining company to a vendor of mining claims where the shares are subject to an escrow agreement.

There is a catch-all exemption for "securities in respect of which the regulations provide that registration is not required".[82] A regulation has been made for the conversion of convertible securities of an issuer that is subject to continuous disclosure obligations.[83]

Under the Exchange Act in the United States, there is similarly an exempted class of securities, so that to the extent that a person in the business of trading securities trades only the exempt class, he need not be licensed to do so. The exempt group however is much smaller than under the Canadian statutes. It includes debt obligations of or guaranteed by the United States or any corporation in which the United States has a direct or indirect interest.[84] By virtue of the fact that the definitions of "broker" and "dealer" exclude banks, there is effectively in the Exchange Act an exemption for any bank-issued security not traded in a secondary market. Also exempt are certain "industrial development bonds", and interests in common trust funds maintained by banks as trustees or maintained by banks or insurance companies in connection with a stock bonus, pension, profit-sharing or annuity plan that qualifies for favourable treatment under the Internal

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nies themselves. The most notorious was Prudential Finance Corporation Ltd.; *see* Bray, *supra* note 32; D. JOHNSTON at 457-62.

81 It is generally thought that registrants under the Mortgage Brokers Registration Act, R.S.O. 1970, c. 278, were meant to be included also, as they have been in Ontario Bill 7, s. 34(2)6; *see* Dey, *supra* note 65; *In re* Western Ontario Credit Corp. Ltd., [1974] OSC Bull. 87 (May).

82 OSA, s. 19(2)13.

83 Ontario Securities Regulations, s. 87.

84 Exchange Act, s. 3(a)(12).

Revenue Code.[85] Commercial paper with a maturity when issued of nine months or less is excluded altogether from the definition "security" in the Exchange Act.[86]

Until recently, municipal securities, that is, debt obligations of state and local governments, were exempted securities under section 3(a)(12) of the Exchange Act. Therefore, the business of trading municipal securities did not attract registration requirements as a broker or dealer, although the securities themselves were subject to the antifraud provisions of the Exchange Act. In the 1975 amendments,[87] municipal securities were deleted from the exempt class, although they continue to be exempt from the prospectus requirement of the Securities Act.[88] Municipal debt financing accounts for a very large part of the total of new securities issues in the United States each year.[89] In considering amendments to the securities laws in the early 1970s, Congress concluded that there had been a sufficient record of abuses in the trading markets for municipal securities to warrant federal regulation of the municipal securities business.[90] Such regulation, how-

85 *Id.*

86 Exchange Act, s. 3(a)(10). The statutory language exempts "any note...which has a maturity at the time of issuance of not exceeding nine months". The exclusion has been interpreted with a restrictiveness that its language, taken alone, would not imply. The SEC has said that the exclusion "applies only to prime quality negotiable paper of a type not ordinarily purchased by the general public, that is, paper used to facilitate well recognized types of current operational business requirements and of a type eligible for discounting by Federal Reserve banks"; SEC, Securities Act of 1933 Release No. 4412, September 20, 1961, 26 Fed. Reg. 9158 (1961). Courts, in turn, have construed the exclusion as referring to "commercial paper" and not "investment paper" - a rather tortured distinction that attempts *post facto* to place promissory notes issued by individuals or corporations in precarious financial condition outside of the exclusion and thus under the jurisdiction of the Exchange Act and thus to give purchasers of such paper access to the considerable remedies available under that act. *See* Zeller v. Bogue Electric Manufacturing Corp., 476 F.2d 795 (2nd Cir.) *cert. denied*, 414 U.S. 908 (1973); Sanders v. John Nuveen & Co., Inc., 463 F.2d 1075 (7th Cir. 1972), *cert. denied*, 409 U.S. 1009 (1972); Bellah v. First National Bank of Hereford, 495 F.2d 1109 (5th Cir. 1976). *Contrast* the approach taken in Ontario; *see* note 80 and accompanying text *supra*. Section 3(a)(12) of the Exchange Act grants to the SEC, as do the Canadian acts to the provincial securities commissions, a regulatory authority to create new classes of exempt security. This authority has been used to permit trading without a licence in certain mortgages, 17 C.F.R. s. 240.3a12-1 (1977), and in certain obligations of issuers whose businesses are managed by a state or a political subdivision thereof; 17 C.F.R. s. 240.3a12-2 (1977).

87 Securities Reform Act of 1975, s. 3(3) *amending* Exchange Act s. 3(a)(12).

88 Securities Act of 1933, s. 3(a)(2).

89 For example, in 1974 approximately $86 face amount of long term municipal securities were issued per $100 of new corporate debt and equity; Senate Committee on Banking, Housing and Urban Affairs, *supra* note 34, at 39. Very likely the amount of new municipal financings has fallen off, however, in the wake of the New York City crisis.

90 Senate Committee on Banking, Housing and Urban Affairs, *supra* note 34, at 43 states:

ever, is a delicate business for at least two reasons: first, the political sensitivity of federal regulation of the manner in which the states and localities raise money, and, second, the predominance of commercial banks as investors in and underwriters of municipal securities and the disinclination of the bank regulatory agencies to see the SEC in their domains.[91]

Under the 1975 amendments, all brokers and dealers in municipal securities are to be registered with the SEC.[92] The Act establishes a Municipal Securities Rulemaking Board, which subject to commission oversight, is to establish rules for trading in municipal securities including rules relating to, *inter alia,* standards of competence, just and equitable principles of trade and financial responsibility.[93] The commission has plenary enforcement power over all municipal securities brokers and dealers.[94] For those that are banks or departments of banks, the appropriate bank regulatory agency also has enforcement powers[95] and the statute appears to contemplate that the enforcement initiative with respect to banks will be taken by those agencies.[96]

The list in the provincial securities acts of securities tradeable without registration is decidedly a random smorgasbord. It is hard to discern among all the exempt securities a common characteristic that decisively negatives the need to control trading in them through licensure. Probably the most generally shared characteristic is the absence of a secondary market for the exempt securities. This would eliminate some of the concerns that prompt licensing, for example, the possibility of market manipulation. In the absence of a secondary market, there is nothing much to manipulate. Also, securities for which there is little secondary market are not likely to be traded on margin or to be left with a securities dealer as collateral. That substantially reduces the potential problems of misappropriation by dealers and of the exposed position of

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"Fraud actions against municipal securities professionals during the last four years reveal that unwary investors are often exposed to sharp and illegal practices.... Perusal of the [Securities and Exchange] Commission's complaints in these actions...reveals a disturbing pattern of professional misconduct by a significant number of broker-dealers. This pattern is characterized by unconscionable mark-ups, churning of customers' accounts, misrepresentations concerning the nature and value of municipal securities, disregard of suitability standards, and scandalous high-pressure sales techniques."

91 *Id.* at 44, 46.
92 Exchange Act, s. 15B(a)(1).
93 Exchange Act, s. 15B(b).
94 Exchange Act, ss. 15B(c)(2), (4), (6)(A).
95 Exchange Act, s. 15B(c)(5).
96 Exchange Act, ss. 15B(c)(5), (6).

customers' securities in the event of a dealer's financial failure. On the other hand, in the absence of a secondary market for securities, one would think that the question of their suitability for different types of investors would become more acute. Also, to the extent that there does exist a secondary market for the exempt securities, say for certain debt issues of the governments of Canada and the provinces, one could hardly be confident that if people were free to hawk such securities on street corners they would always be offered at a fair price.

Some of the exemptions are drafted specifically so as to be available only where the purchasers will be knowledgeable about the issuer or sophisticated generally. These are the exemptions for commercial paper, collateral for conditional sales contracts, securities of private companies and certain securities of mining and prospecting companies. Effectively, these exemptions are conditional upon the identity of the purchaser. Since these exemptions do not adhere to the securities irrespective of the circumstances of the trade, the writer does not have serious reservations about their appropriateness on grounds of policy.

Other exemptions do attach to the security once and for all, and the wisdom of some of these is doubtful. Trading in some types of securities is exempt from licensing apparently on the basis of the safety of the investment and the presence of alternate systems of regulation. These include the exemptions for government issues, mortgages, guaranteed investment certificates issued by trust companies and the shares of cooperatives and credit unions. The propriety of the exemption for trust company certificates is beyond cavil, based both on the safety of the certificates themselves, which in most cases are backed by the guarantee of the federal government, and on the fact that they are offered for sale exclusively by the trust companies themselves which are highly regulated entities.

Certain reservations concerning the exemption enjoyed by government issues have been expressed above. As we shade off from securities of the federal government to those of the provinces, the question of safety perhaps requires more examination, but for constitutional reasons, if for no others, the provincial exemption will have to be maintained, especially in a federal statute. The wisdom of the present exemption insofar as it applies to the securities of or guaranteed by foreign governments and political divisions thereof is problematical indeed. This is a point that need not be laboured by extensive annotation of the financial problems of New York City. It should suffice to point out, for example, that at the present moment American municipal securi-

ties may be sold in Canada with a freedom from regulatory constraint that they do not enjoy in the United States.[97]

With respect to mortgages and to the securities issued by cooperatives and credit unions one can do little more than counsel caution in the absence of empirical study of the safety of such investments and the adequacy from an investor protection point of view of the legislation governing issuers of them. On mortgages, however, it can be noted that while securities legislation defers to the control of brokers effectuated under the Real Estate and Business Brokers Act,[98] that act, insofar as investor protection is concerned, is not *in pari materia* with the Securities Act.

Finally, there is the trading exemption enjoyed by not-for-profit corporations "where no part of the net earnings of such person or company enure to the benefit of any securityholder ". Here again, the writer would counsel caution in writing trading exemptions into the statute. Even on the assumption that a prospectus exemption for a particular class of security may be warranted, or perhaps especially in that case, licensing of traders may have an important role to play in investor protection. It may be more desirable to handle some kinds of exemptions on a case-by-case basis through the dispensing power of a securities commission rather than by the generality of the statute itself.

B. UNDERWRITING

Under the Canadian provincial securities statutes, underwriting is a separate activity, apart from trading, that is subject to a licensing requirement.[99] In the United States, by way of contrast, although the concept of underwriting is key in the scheme of securities regulation, it is not a licensing category.[100] An underwriter is defined by OSA section 1(1)25 to be:

97 *See* text accompanying notes 87-96 *supra*.

98 R.S.O. 1970, c. 401.

99 OSA, s. 6(1) (d).

100 Obviously, however, a person who is in the business of underwriting in the United States, since he of necessity is in the business of trading securities as principal ("firm commitment" underwriting) or as agent ("best efforts" underwriting) must have the appropriate registration as a broker or dealer - usually both.

The concept "underwriter" is important chiefly as a trigger for the registration of securities and prospectus requirements of the Securities Act, s. 5 which provides that it is unlawful to sell or to attempt to sell a security by the jurisdictional means unless a registration statement is in effect as to that security. A prospectus must be filed as part of the registration statement; Securities Act, s. 10(b). Section 4 of the act exempts from the registration and prospectus requirements all transactions except those involving a public offer by an issuer, an underwriter or a dealer. Thus where securities are being sold without a registration statement, it may become critical to determine whether an underwriter is involved. Generally, an

"a person or company who, as principal, purchases securities from a person or company with a view to, or who as agent for a person or company offers for sale or sells securities in connection with, a distribution to the public of such securities, and includes a person or company who has a direct or indirect participation in any such distribution, but does not include a person or company whose interest in the transaction is limited to receiving the usual and customary distributors' or sellers' commission payable by an underwriter."[101]

Thus, underwriting as defined is a particular form of trading: trading is a primary distribution. The only provision of the Ontario regulations bearing on the status of underwriter provides that "every person or company granted registration as a broker-dealer, investment dealer or securities dealer shall be deemed to have been granted registration as an underwriter".[102] While at first blush it is difficult to conceptualize the status of underwriter without a concomitant ability to deal in securities either as principal or agent, there are in Ontario a few registrants as underwriter only. Such registrants obviously cannot deal with the public. Their activities apparently consist in taking down securities from an issuer and then attempting to interest a registered dealer in distributing the securities.

Underwriter is not a controlled occupation in the sense that trading is. For example, there are no behavioural or educational prerequisites for underwriter registration apart from those that apply to the activity of trading in securities.

Any underwriter in a contractual relationship with an issuer

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underwriter is any person or company who takes securities from an issuer with a view to distributing them; Securities Act, s. 2(11).

101 This definition is in substance identical to the definition of underwriter in s. 2(11) of the U.S. Securities Act and in s. 2(a)(20) of the Investment Advisers Act of 1940 [hereinafter Advisers Act]. The last clause of the Canadian definition, "but does not include...", is a good example of the sometimes indiscriminate and inappropriate copying of American regulatory statutes into Canadian statute books. Underwriters in Canada are not compensated on a commission basis. In Canada, the underwriter sells to the banking group, which sells to the selling group, which sells to the public. The underwriter pays no one but the issuer, and the compensation at each level is in the form of a discount between the buying and the selling price.

102 Ontario Securities Regulations, s. 2(3). This means that a person or company whose sole registration is as a broker, under Ontario Securities Regulations, s. 2(1)1, which in turn is defined as a member of a recognized stock exchange registered exclusively to trade in securities in the capacity of agent, may not act as an underwriter - even on a "best efforts" (agency) basis. There is a similar regulation in Québec providing that registration as an investment dealer or as a securities dealer includes registration as an underwriter; *see* Quebec Securities Commission, Policy Statement No. 21, October 1, 1973, art. 2.2, 3 CCH CAN. SEC. L. REP. ¶66-032 ("conditions of Registration of Brokers").

whose securities are being offered by a prospectus must sign a certificate in the prospectus stating that to the best of the underwriter's knowledge, the prospectus constitutes full, true and plain disclosure of all material facts relating to the securities being offered.[103] However, underwriters are not presently within the ambit of statutory civil liability for damages for a material false statement in a prospectus.[104] Exposure of the underwriter to civil liability in such a case is expressly provided for in Ontario Bill 7, section 126.

The definition of underwriter in OSA section 1(1)25 specifically excludes banks. The major underwriting activity of the chartered banks is in the area of government debt issues, but apparently the banks do some corporate underwriting as well.[105] In Bill 7, section 1(1)43iv, banks have been exempted from the definition of underwriter only with respect to their activities in connection with the debt issues of or guaranteed by governments, banks themselves, trust companies, loan companies and insurance companies – in other words, that class of securities for which a *trading* exemption is recognized in the present act.[106]

C. ADVISING

A securities adviser is a person engaged in "the business of advising others as to the advisability of investing in or buying or

103 OSA, s. 53(1).

104 OSA, s. 142. It is possible that there could be liability for fraud at common law, however, where an underwriter makes a false certificate in a prospectus which certificate is relied upon by a purchaser of the securities. *Compare* Hedley, Byrne & Co. Ltd. v. Heller & Partners Ltd., [1964] A.C. 465 (H.L.) *with* Toromont Industrial Holdings Ltd. v. Thorne, Gunn, Helliwell & Christenson 10 O.R. (2d) 65, 86-95 (H.C. 1975), *reversed on other grounds,* 14 O.R. (2d) 87 (C.A., 1976).

105 Canadian Bankers' Association, *supra* note 50, at 10 fudges this point a bit. It states:

> "The participation of the banks in the area of underwriting has been largely centered on provincial and municipal issues. While the banks have acted as underwriters in the area of corporate securities to a lesser extent, this is also a significant activity, particularly in the case of issues of bank affiliated companies and funds which have been sponsored by banks."

The funds referred to presumably are bank-sponsored mutual funds and real estate investment trusts. The identity of the affiliated companies is not made very specific. At p. 14 of the brief there appears the following:

> "Through the establishment of affiliated companies, the banks have been instrumental in the provision of substantial funds to the mortgage market and increased liquidity of mortgages. The banks have also developed, and continue to develop through affiliated companies, the provision of funds for other related banking functions such as the leasing industry in Canada." *Id.* at 14.

106 OSA, s. 19(2)1. In Ontario Bill 75 the underwriting exemption for banks was eliminated completely.

selling securities".[107] It is unlawful for a person or company to act as a securities adviser unless registered with the commission as such.[108] There are, however, many exemptions from the licensing requirement for advisers. Chartered banks, loan corporations, trust companies and insurance companies are exempt.[109] So are lawyers, accountants, engineers and teachers whose performance of advisory services is solely incidental to the practice of their professions.[110] Also exempt are the publishers of (and presumably, although the statute doesn't say so, financial writers in) *bona fide* news magazines or business or financial publications of general and regular paid circulation who give advice only through such publications, have no interest in the securities advised upon and receive no commission or consideration for giving the advice, and who give the advice solely as incidental to the conduct of the publishing business.[111]

In practice, probably the most important single exemption is that available to "a person or company registered for trading in securities..., or any partner, officer or employee thereof, whose performance of [advisory] services is solely incidental to" the trading business.[112] The meaning of "solely incidental" in this context is not entirely clear. Until 1966, the licensed traders' exemption specified, in addition to the advisory services being solely incidental, that no special compensation be paid to the registrant therefor.[113] The absence of special compensation for the advisory services continues to be the test of "solely incidental" in the broker-dealers' exemption from the registration requirement of the U.S. Investment Advisers Act of 1940.[114]

107 OSA, s. 1(1)1. The definition in s. 2(11) of the U.S. Advisers Act is practically the same. Investment adviser means "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities ...".

108 OSA, s. 6(1)(e).

109 OSA, s. 18(a).

110 OSA, s. 18(b). D. Johnston at 120 n. 158 notes an anomaly in the exemption for lawyers in that "the compensation fund maintained by the profession's governing body and the compulsory insurance program in which its members are enrolled will not compensate a client for moneys he has lost by following his lawyer's advice on securities investments, whether or not the advice was given as solely incidental to the practice".

111 OSA, s. 18(d).

112 OSA, s. 18 (c). The commission may designate by regulations other exempt persons and companies.

113 *See* R.S.O. 1960, c. 363, s. 18 (c); *replaced by* S.O. 1966, c. 142, s. 18 (c).

114 In the Advisers Act, s. 202 (a) (11), exemptions generally similar to those in Ontario are provided by way of exclusion from the definition of adviser. With the introduction of fully negotiated commission rates in the U.S., however, there has been a sharp trend toward the unbundling of commission rates. That is, the charges for various services performed by broker-dealers have been separated and levied in

Until recently in Ontario the practice was that persons and companies holding registration in a trading category, no matter how substantial an advisory business they engaged in and irrespective of whether they charged separately for such services, almost never held separate registration as advisers,[115] and in fact they were prohibited by the commission from holding separate adviser registration.[116] Thus, the "solely incidental" proviso was read out of the exemption for trading registrants. In fact, there are only a handful of registrants in either of the traditional adviser categories: "investment counsel", a registrant primarily engaged in giving continuous investment advice on the basis of the individual needs of each client, and "securities adviser", a registrant giving non-differentiated advice on the merits of investing in or purchasing or selling specific securities.[117] In 1976 the OSC introduced a new category of adviser registration: "portfolio manager".[118] A portfolio manager is a registrant with the qualifications of an investment counsel who manages the investment portfolios of clients through discretionary authority granted by the clients. As an investment adviser with discretionary management authority, the portfolio manager is functionally as much a trader as an adviser;[119] in fact the number of registered portfolios managers dwarfs the other two adviser categories and many portfolio managers are affiliates of investment dealers.[120]

To the extent that an adviser in fact exercises management authority over clients' funds, the adviser is obviously a fiduciary in the most traditional, duty-laden sense of the word. This is true whether we call the adviser an investment counsel, or a portfolio adviser or a management company. As professional fiduciaries it is not difficult to see why managing advisers may appropriately be subjected to licensing control. To the extent that persons or companies licensed to trade securities also give investment advice, the multifarious conflicts of interest to which they may be subject

their constituent parts. Therefore, many broker-dealers who under fixed rates did not receive separate compensation for advisory services now do so and therefore they must be separately registered under the Advisers Act.

115 In 1972, approximately half of Ontario's registered investment dealers also carried on advisory functions for which they charged a separate fee; OSC OWNERSHIP REPORT, *supra* note 53, at 65, 169.

116 *In re* C.J. Hodgson & Co. Ltd., [1969] OSC Bull. 190 (December).

117 Ontario Securities Regulations, s. 2 (2).

118 O. Reg. No. 270/76 *amending* Ontario Securities Regulations, ss. 2(2), 3(2), 3(4), 6(20), *reprinted in* [1976] OSC Bull. 104 (April).

119 It was for precisely this reason that the separate registration category was introduced; *see In re* Fiscal Consultants Ltd., [1974] OSC Bull. 139 (June).

120 In the regulation governing portfolio managers, there is no prohibition against a portfolio manager executing transactions for managed accounts through an affiliated trading registrant; Ontario Securities Regulations, s. 6(20b).

probably also warrant control of the advising function, although obviously there is plenary authority to control the advising function of such persons and companies through their registration to trade.

What is not so clear to this writer is that the advising function taken alone, stripped of power to trade and of discretionary management, should be subject to licensing. Concededly, the merits of advice on securities are difficult to measure, as many securities analysts and mutual fund shareholders have discovered to their chagrin. That fact, standing alone, however, does not warrant the social and private costs of licensing - especially with the value of free speech standing in the background. Nothing could be more hazardous than predictions as to the state of the economy or of the weather, but so far neither economists nor meteorologists have to be licensed to ply their predictions. One does fear, of course, the scalping problem: that unregulated advisers would tailor their advice to what would aid their own, personal securities portfolios. We apparently are not overly worried by this problem at present, however, in the case of unlicensed advisers, such as the financial columnists in newspapers.[121] Moreover, there may be a relatively easy way around it: keep the "pure" adviser unlicensed but keep him "pure" by a rule to the effect that any person or company that regularly issues investment advice to others and that also holds securities for his, her or its own account, is, by definition, in the business of trading securities and therefore must be licensed as such.

The point is that the function of advising alone, shorn of the conflict of interests problems presented when it is coupled with trading or managing, is not an activity that should be regulated. Phrased differently, it may be reasonable through licensing to legislate against advice that is not *bona fide*, but not against advice that is simply incompetent. After all, at the end of several decades of regulating the advising function, we are left with a substantial body of literature which suggests that the entire search for undervalued securities is by definition incompetent.[122]

D. SHOULD WE HAVE FEDERAL LICENSING?

Perhaps the greatest weakness in the provincial system of licensing is the fact that a firm must be separately licensed to trade in each province in which it physically carries on busi-

121 *But see, Financial Columnist Agrees to Injunction Against "Further" Securities Violations,* The Wall Street Journal, October 24, 1974, at 10.

122 This literature is summarized in Pozen, *Money Managers and Securities Research,* 51 N.Y.U.L. Rev. 923 (1976).

ness,[123] and in each province where its customers reside.[124] Thus, interprovincial trading requires a licence from each province concerned, and, as a practical matter, the conduct of a substantial securities business in Canada may require a licence from each, or at least most, of the ten provinces. At the same time, the provincial securities acts typically reserve the right not to license non-residents. For example, OSA, section 14(1), provides that

> "[t]he Director may refuse registration to a person...if he is not a resident of Ontario at the date of such application unless at the time of such application such person is registered in a capacity corresponding to that of a dealer, adviser, underwriter, or salesman under the securities laws of the jurisdiction in which he last resided and has been so registered for a period of not less than one year...."

Similarly, with regard to registration of firms, section 14(2) provides that

> "[t]he Director may refuse registration to a company or partnership if every officer and director or every partner...is not a resident of Ontario at the date of such application unless at the time of such application he is registered in a capacity corresponding to that of a dealer, adviser, underwriter or salesman under the securities laws of the jurisdiction in which he last resided and has been so registered for a period of not less than one year."[125]

The use of the past tense, "last resided", seems to contemplate that the director may insist that the individual registrant or each

123 In Gregory and Co. Inc. v. Quebec Securities Commission, [1961] S.C.R. 584, it was held that a broker who maintained his office, books, records and bank account in the Province of Québec and from there by mail and by telephone initiated transactions exclusively with nonresidents of the province was subject to the jurisdiction of the Quebec Securities Commission. At that time (and presently) QSA, s. 50 provided that a sale made in any part of the province to a purchaser having its residence outside the province would be deemed to be a sale within the province, but no explicit reference was made in the opinion of the court to this provision, and it seems likely that even provinces which do not have similar statutory provisions would seek to assert jurisdiction over brokers in analogous situations.

124 In R. v. McKenzie Securities Ltd., 55 W.W.R. (N.S.) 157, 56 D.L.R. (2d) 56 (Man. C.A. 1966), it was held that an Ontario-registered broker who by mail and telephone from Ontario made a sale of securities to a resident of Manitoba was obligated to be licensed in Manitoba. *See also* R. v. Jaasma, [1974] 1 W.W.R. 245 (Alta. Prov'l Ct.).

125 *See also* Saskatchewan Securities Act, s. 15(1), which provides that "registration may, in the absolute discretion of the commission, be refused to any individual who has not been a resident of Saskatchewan for at least one year, with the intention of making his permanent home in Saskatchewan ... unless ... the individual is registered ... under the securities laws of the jurisdiction in which he last resided ...".

officer or director of a corporate registrant or each partner of a partnership registrant, as a condition of individual or firm registration, must take up residence in Ontario. That the Ontario Director has not so insisted, at least in the case of officers, directors, and partners of registered firms, may be inferred from OSA Policy 3-08, which provides that where a dealer is registered in more than one province, an officer of such dealer who does not reside in Ontario may be considered for registration in Ontario where special circumstances warrant.

In actual practice a non-resident will not be registered as a salesman in Ontario, except that Ontario and Québec will license reciprocally salesmen living in the communities contiguous to their mutual border, such as Hull and Ottawa. While a salesman may not solicit customers in a province where he is not registered, there is no law prohibiting an individual from having an account with a non-resident (and therefore non-registered) dealer. The provincial securities commissions may have little choice therefore other than to look the other way where non-resident dealers are doing business with the particular province's residents – so long as the dealer does not solicit the business.

Firms with extraprovincial head offices may usually obtain registration in a given province by opening a branch office there, but they must maintain physically within the particular province complete records of each transaction "from or within that province".[126] Presumably the purpose of the requirement is to make effective provisions such as OSA section 21(6) which provides that a person appointed to make an investigation may seize any documents or records of the person or company being investigated.

As J. Williamson suggests,[127] the prospect that a province may shut off interprovincial trade across its borders by insisting that registration is needed to sell securities even by mail or telephone into the province and then refusing to register non-residents is a disquieting one, and a federal licensing scheme for interprovincial securities transactions may be the best solution, assuming that a scheme that would survive constitutional challenge could be devised. Furthermore, a federal licensing scheme would not be an impediment to geographic mobility of licensees, at least insofar as they are engaged exclusively in interprovincial business, and, as suggested above, geographic mobility is a value worth preserving. On the other hand, even if a federal securities statute does include a licensing provision, it is unrealistic to expect that all of the provinces would abrogate their own licensing requirements, al-

126 National Policy No. 16, April 1971, 2 CCH CAN. SEC. L. REP. ¶54-853.
127 J. WILLIAMSON, SUPP. at 227.

though some of the smaller ones might. The end result will be to add another requirement without subtracting any, and the situation will be very much like that in the United States, where, in addition to SEC (and self-regulatory organizations) registration, securities market actors must also be licensed by the "blue sky" commissions in the states where they operate.

Chapter III
The Licensing Process

A. SOURCES OF LAW FOR THE LICENSING DECISION

The Canadian securities acts are anything but specific as to the prerequisites for registration. Ontario is typical of most provinces: OSA, section 7, provides simply that "[t]he Director shall grant registration or renewal of registration to an applicant where in the opinion of the Director the applicant is suitable for registration and the proposed registration is not objectionable". The Québec wording is pithier but to the same effect: "The granting or renewal of registration is at the discretion of the Director."[128] The grant of discretion in the Nova Scotia Act is simply extravagant: "The Minister may order that...any application for registration...shall or shall not be granted for any reason which he may deem sufficient."[129]

In fact, the directorial discretion is neither so broad nor so unguided as the statutory language might suggest. It has been held that where a statute commits to an agency's discretion, without more, the decision to grant, deny or revoke a licence, that discretion is not absolute. At a minimum there is implied an obligation upon the agency to discharge its public duty in good faith and to base its decision "upon a weighing of considerations pertinent to the object of the administration".[130] Furthermore, the prerequisites that must be complied with by an applicant for securities registration have to some extent been spelled out in regulations, in forms for applications and in policy statements. The commission itself has no rule-making power under the OSA but section 147 gives to the Lieutenant Governor in Council power, in terms of great breadth, to make regulations in respect of such matters as applications, renewals and expiration of registrations; classifying registrants into categories and prescribing the terms and conditions of registration in each category; regulating trad-

128 QSA, s. 24.
129 Nova Scotia Securities Act, s. 11(1).
130 Roncarelli v. Duplessis, [1959] S.C.R. 121, 140 (*per* Rand, J.).

ing of securities in the over-the-counter market; prescribing forms, fees and reports to be filed by registrants; and, generally, respecting any matter necessary or advisable to carry out effectively the intent and purposes of the act.[131] The rule-making power under the Québec act is almost exactly the same.[132] In Ontario, the rule-making power of the Lieutenant Governor in Council (Cabinet) has been used to establish registration categories, designate application forms, and establish net capital rules and rules for foreign ownership of securities firms.[133]

There are three types of policy statements under the Ontario Securities Act: national policies, of which there are about thirty, promulgated simultaneously by the securities commissions of each of the ten provinces; uniform act policies, promulgated simultaneously by the commissions in the "uniform act" provinces: Ontario, Manitoba, Alberta, Saskatchewan and British Columbia; and Ontario policies, promulgated from time to time by the OSC. The legal force of the policy statements, although not as yet challenged in litigation, is at best nebulous since the securities commissions are without rule-making power. To the extent that policy statements attempt not just simple clarification of existing legislative objectives but rather the enunciation of additional policies of the promulgator's making, their validity may be doubted.[134] While an agency may formulate guidelines in advance, it must not fetter its discretion by a rigid policy that prevents the agency from exercising its discretion in light of the facts of individual cases.[135] Legislation and validly enacted regulations must bind the agency's discretion; policy statements must not do so.[136] For the most part, the policy statements are either expressed as "guidelines"- with the

131 OSA, ss. 147(c), (d), (j), (k), (m), (u).

132 QSA, s. 83.

133 Ontario Securities Regulations, ss. 2-6(f).

134 Molot, *The Self-Created Rule of Policy and Other Ways of Exercising Discretion*, 18 McGill L.J. 310, 313-14 (1972); Lockwood, *Procedures in Cross Country Prospectus Clearance and Regulation by Policy Statement*, in Law Society of Upper Canada, *supra* note 65, at 111, 123-24; Baillie, *Protection of the Investor in Ontario*, 8 Can. Pub. Admin. 172, 214 (1965); Baillie, *Securities Regulation in the Seventies*, in 2 Studies in Canadian Company Law 354 (J. Ziegel ed. 1972).

135 Cowan, *supra* note 12, at 773, and authorities therein cited.

136 Re Hopedale Investments Ltd. v. Oakville, [1965] 1 O.R. 259 (C.A.); *see also* Molot, *supra* note 134, at 315, 330. As Molot observes, an agency's practice of adhering to a rule established by its prior decisions can present many of the same problems as are presented where the agency decides in the light of its own policy statements. *See also In re* Alan G. Gould, B.C. Corp. & Fin. Serv. Comm'n Weekly Summary, April 9, 1976, at 3; Getz, *The Corporate and Financial Services Commission - Reflections upon a Statutory Tribunal*, 11 U.B.C.L. Rev. 1 (1976). The adherence to prior agency decisions may, however, be more congenial to lawyers than adherence to policy statements since the former is an application of the well-known legal principle of *stare decisis* to administrative proceedings.

notation that the director will continue to exercise his discretion in accordance with the facts of individual cases[137] – or are merely declaratory of the policy obviously existing in the legislation. A notable exception is the series of national policy statements on mutual funds, which establish quite a full code of their own for that type of issuer – in the absence of legislation.[138]

A more typical example is Ontario Policy No. 3-10 on dual registration. That policy, which refers to "the following guidelines" states that registration may be held simultaneously as broker, broker-dealer and investment dealer; that registered salesmen may not hold any other class of registration and may not act as officers of a corporate registrant; that companies registered in the various dealer categories may not hold a second registration in the same category; that registered dealers and advisers may not hold separate underwriter registration; and that registered dealers may not hold separate adviser registration. In *C.J. Hodgson & Co., Ltd.* a registered investment dealer and broker set up a wholly owned subsidiary that applied for registration as an investment counsel.[139] The separate registration was desired because of a tax ruling that taxpayers could not deduct as business expenses fees paid for investment advice unless the principal business of the payee was advisory. The director refused registration on the basis of the policy statement. The commission reversed, holding that in the circumstances of the particular case there was a legitimate business need for the separate registration and that OSA, sections 70-72, and applicant's membership in a self-regulatory organization provided adequate safeguards against conflict of interest, the danger which the policy against this particular type of dual registration was designed to avert.[140] The commission here not only declined to be limited by the policy statement but in fact announced an amendment to it, so that henceforth registered dealers who were members of the Investment Dealers Association (IDA) (dealers) or the TSE (brokers) would be able to hold separate adviser registration.

A more recent decision of the Corporate and Financial Serv-

137 *See e.g.* OSC Weekly Summary, May 30, 1974, at 1A; [1971] OSC Bull. 175 (November) (Amending OSC Policy No. 3-03 on Mining and Oil Companies); [1976] OSC Bull. 36 (February) (Amending OSC Policy No. 3-02 on Junior Mining Exploration and Development Companies).

138 National Policies Nos. 6, 7, 8, 9, 10, 11, 19, 23, 24, 26, 28, 29, April 1971, *as amended,* 2 CCH CAN. SEC. L. REP ¶¶54-843-54-848, 54-856, 54-860, 54-861, 54-863, 54-866, 54-867.

139 [1969] OSC Bull. 190 (December).

140 OSA, s. 70 provides that a dealer must advise his customer where he is acting as principal; s. 71 gives a right of rescission in the absence of compliance with s. 70; and

ices Commission of British Columbia illustrates, in the securities licensing context, the maximum legal force that may properly be attributed to policy statements. In the matter of *Alan G. Gould*,[141] the commission reviewed a decision of the Superintendent of Brokers revoking the registration of a securities salesman who was found knowingly to have aided a well-known stock swindler in a market manipulation. The commission, in affirming the sanction, expressly found one of the superintendent's grounds to be unsupportable. The superintendent had taken the position that whenever a registrant knew of specific fraudulent activity in the marketplace, the registrant was under a duty to advice the authorities of what he knew, notwithstanding that the registrant himself was in no way implicated. Failure so to notify the authorities would, *ipso facto*, result in revocation of registration. The commission pointed out that the duty that the superintendent was enunciating was to be found nowhere in the legislation and that for the superintendent on his own authority to announce that on a given set of facts he would always cancel a registration conflicted with the superintendent's duty as a judicial officer to consider each case on its individual merits.

> "The point is that...the superintendent is entrusted with a quasi-judicial, not a rule-making function, and he cannot carry out the latter function disguised as the former."[142]

On the other hand, the commission said that is was "entirely proper for the superintendent to warn registrants that concealment of knowledge of manipulative schemes is *a factor* that will be taken into account in determining fitness for continued registration".[143]

Recently the OSC's policy statements on educational qualifications of salesmen (No. 3-06) and on part-time salesmen (No. 3-07) have been repealed and replaced by regulations promulgated by the Lieutenant Governor in Council.[144] The change signifies that the commission's positions in these matters have advanced in status from guidelines to firm rules.

In the United States, the SEC, which unlike Canadian securities commissions, may itself promulgate rules,[145] is no less fond of

s. 72 compels an investment adviser to disclose his financial interest in any securities he refers to in his advice or in any transactions he recommends.

141 B.C. Corp. & Fin. Serv. Comm'n Weekly Summary, April 9, 1976, at 3.

142 *Id.*

143 *Id.* (emphasis added).

144 O. Reg. 14/75, *amending* Ontario Securities Regulations, s. 6, *reprinted in* [1975] OSC Bull. 49 (February).

145 Exchange Act, s. 23(a).

policy statements, called by the SEC "interpretive releases", than are its Canadian counterparts.[146] While all the same observations as to the legally nonbinding nature of these policy statements may be made as with the Canadian policy statements, the SEC is liberal in citing them as authority in its adjudicatory opinions and in briefs to the courts, and sometimes the courts themselves will cite SEC releases as precedential authority.[147] The use by the SEC of interpretive releases has been criticized as an attempt to make rules without observing the procedural requirements laid down in the Administrative Procedure Act.[148]

In addition to the generalized policy statements issued by the commission itself, the staff of the SEC issues "no-action" letters. Most frequently, a no-action letter is solicited by – or by counsel on behalf of – a person who wishes to sell securities without filing a prospectus under the Securities Act of 1933. In other situations issuers, broker-dealers or securities advisers may request no-action letters as well, inquiring whether a proposed course of action would in the staff's view involve a violation of the federal securities laws. A favourable response from the SEC staff would recapitulate the facts recited in the applicant's letter and then state that, on the basis of the facts as stated, the staff would not recommend to the commission that enforcement action be taken if the proposed course of action were carried out. The commission appears to take the position that the staff's no-action letters are not binding upon it as precedent.[149] At the same time, it would be inconceivable for

146 Examples would include SEC, Securities Act of 1933 Release No. 5168, July 7, 1971, 2 CCH FED. SEC. L. REP. ¶22,760 and SEC, Securities Act of 1933 Release No. 4445, February 2, 1962, 2 CCH FED. SEC. L. REP. ¶¶22-753-22-759 (obligations of broker-dealers and others in connection with distributions of unregistered securities). Also noteworthy is the series known as the Accounting Series Releases, which deal generally with acceptable accounting procedures in documents filed with the commission.

147 *See e.g.* Mitzner v. Cardet International, Inc., 358 F. Supp. 1262, 1267 (N.D. Ill. 1973) (*citing* Securities Act of 1933 Release No. 5211 for the proposition that pyramid sales plans often involve the sale of securities); SEC v. M.A. Lundy Associates, 362 F. Supp. 226, 231 (D.R.I. 1973) (quoting approvingly the interpretation found in Securities Act of 1933 Release No. 4412 of the commercial paper exemption from the prospectus requirement). Occasionally one of the SEC's interpretative releases comes back to haunt it, as in United Housing Foundation Inc. v. Forman, 421 U.S. 837 (1975). There the SEC appeared *amicus curiae* to urge that shares in a cooperative housing corporation constituted securities under the federal securities laws. But the Supreme Court noted that the commission's *amicus* position flatly contradicted a position it had taken two years earlier in an interpretative release; 421 U.S. at 858 n. 25.

148 5 U.S.C. ss. 551 ff. (1970). These are, principally, publications in the Federal Register of a general notice of the proposed rule and opportunity for interested persons to make submissions; *see*, Cohen & Rabin, *supra* note 34, at 719 n. 189.

149 *See* Lockhart, *SEC No-Action Letters: Informal Advice as a Discretionary Administrative Clearance*, 37 LAW & CONTEMP. PROBS. 95, 96 (1972).

enforcement action to be undertaken contradictory to a no-action letter – so long, of course, as the facts do not deviate from those stated in the request for the letter.[150] Since, however, all requests for no-action letters as well as the responses thereto have been made public by the SEC for some time,[151] one would expect the responses to begin to take on some precedential value for the securities bar generally as they always have had for the SEC staff.[152]

B. THE REGISTRATION CATEGORIES

There are no less than six separate categories of securities dealer registration for persons or companies in Ontario.[153] These are (1) broker, a stock exchange member registered to trade exclusively in an agency capacity; (2) broker-dealer, a member of the Broker-Dealers' Association of Ontario (BDA) registered to trade as agent or principal; (3) investment dealer, a member of the Investment Dealers Association of Canada registered to trade as agent or principal; (4) securities dealer, registered to trade as agent or principal but not a member of a self-regulatory organization; (5) mutual fund dealer and (6) scholarship plan dealer.[154] In Québec the categories of dealer registration are similar, but there is no category of broker-dealer since the Broker-Dealers' Association is a self-regulatory creation of the Ontario legislature.[155] Also in Québec there are two categories of registration to trade in mutual funds – mutual fund broker and mutual fund dealer.[156]

Finally, both Ontario and Québec have a registration category of securities issuer, a person or company registered to trade securities exclusively of its own issue.[157] In Ontario this is not a very significant category because any issuer that distributes its securities through a registrant does not itself have to be registered to trade under the act, by virtue of the section 19(1)7 exemption. In the Québec Securities Act, on the other hand, there is no similar

150 *Id.*

151 17 C.F.R. s. 200.81 (1977). This policy was initiated in 1970; SEC, Securities Act of 1933 Release No. 5098, October 29, 1970, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶77,921.

152 Lockhart, *supra* note 149, at 122.

153 "Person" is defined in OSA, s. 1(1)12 to include both natural persons and partnerships; "company" means an incorporated body; OSA, s. 1(1)4. In this paper, the word "person" is used to denote natural person and "firm" is used to signify a partnership or a corporation.

154 Ontario Securities Regulations, s. 2.

155 Broker-Dealers Act, 1947, S.O. 1947, c. 8 (not in Revised Statutes).

156 QSC, Policy Statement No. 21, *supra* note 102, art. 2.1, 3 CCH CAN. SEC. L. REP. ¶66-032.

157 Ontario Securities Regulations, s. 2(1)7; QSA, s. 16.

exemption, although the statute provides that the commission *may* grant an exemption from registration in the case of an issue of securities sold *en bloc* to one or more registered brokers.[158] In both Ontario and Québec registration as an investment dealer or securities dealer (and, in Ontario, broker-dealer) is deemed to include registration as an underwriter.[159]

As noted above, there are two categories of investment adviser registration in Ontario: securities adviser, a registrant who advises generally as to the merits of investing in specific securities; and investment counsel, a registrant who gives advice tailored to the individual needs of different clients. In Québec all advisers are termed "investment counsel", and there are two categories of investment counsel: securities adviser, a term which has the same meaning as under the Ontario regulations, and investment adviser, which has the same meaning as investment counsel under the Ontario regulations.[160]

Partners and officers of a registrant must have the approval of the director in order to act in the registered capacity – trading, advising or underwriting.[161] Ontario Bill 7 is more stringent in this regard: a partner or officer of a dealer may not trade and a partner or officer of an adviser may not advise unless such partner or officer is registered as such with the commission.[162] Bill 75, a predecessor to Bill 7, was even more stringent; it provided that directors of a registrant had to be approved as such by the director of the commission.[163] This latter proposal was withdrawn in the face of claims that in the case of corporate registrants approval of directors by the OSC director amount to a usurpation by that official of the functions of a company's shareholders.[164]

Finally, of course, all securities salesmen, that is, the trading employees of registered firms, must be registered as such and this is by far the largest category of registration. A salesman's registration lapses automatically when he ceases to work for a given employer and it is not reinstated until the director has approved the salesman's employment by a new registrant-employer.[165] Ap-

158 QSA, s. 20.

159 Ontario Securities Regulations, s. 2(3); QSC, Policy Statement No. 21, *supra* note 102, art. 2.2, 3 CCH CAN. SEC. L. REP. ¶66-032.

160 QSA, s. 1(3) and QSC, Revised Policy Statement No. 19, s. 2, March 11, 1975, 3 CCH CAN. SEC. L. REP. ¶66-030 ("Conditions of Registration of Investment Counsel").

161 Ontario Securities Regulations, ss. 6(2), (3); QSA, ss. 17, 18.

162 Ontario Bill 7, ss. 24(1)(a), (c).

163 Ontario Bill 75, s. 24(c).

164 Blake, Cassels and Graydon, Submission to the Ontario Securities Commission regarding Bill 75 - The Securities Act, 1974, at 30 (1974). *See also* Trust Companies Association of Canada, Submission to Ontario Securities Commission on Bill 75, at 3 (1974).

165 OSA, s. 6(4); QSA, s. 19.

proval of a change in employer is by no means automatic, and the occasion has been used by at least the Ontario Securities Commission for a full scale review of the salesman's record.[166] Generally speaking, registration in any category must be renewed annually.

In the United States federal regulatory scheme, there are not the elaborate categories of registration as in the Canadian statutes. The only trading categories are broker and dealer. In fact, the form of registration is for the status "broker-dealer". A mutual fund distribution company, as with any firm whose business is trading securities, must be registered as a broker-dealer under section 15(b) of the Exchange Act.[167] After the 1975 Exchange Act amendments, municipal securities brokers and dealers that are banks or bank affiliates must register under section 15B of the Exchange Act.[168] Nonbank municipal securities brokers and dealers, like brokers and dealers generally, must register under section 15(b).

While there is no dealer category of "securities issuer" in the United States, an issuer which chooses to distribute securities of its own issue without the intervention of a registered intermediary would itself have to be registered as a broker-dealer if it were "in the business of effecting transactions in securities".[169] Generally speaking neither such an issuer nor such of its officers, directors and employees as actually sell its securities will be deemed to be in the business of effecting transactions in securities where the issuer does not hire employees especially for that purpose and where it does not give its regular officers or employees special compensation for selling its securities.[170]

Unlike the scheme of the Canadian statutes, wherein both the trading firms and their salesmen are registrants, under the Exchange Act in the U.S. only the brokers and dealers themselves,

166 *See In re* James Jeffrey Forsythe, [1972] OSC Bull. 167 (August) (transfer approval denied where salesman had participated in a public distribution of securities for which no prospectus had been filed); *In re* Harry Ramras, [1972] OSC Bull. 123 (June) (transfer approval denied where salesman had defrauded his previous employer, had failed to observe the know-your-client rule, had failed in a primary distribution to provide his customers with a prospectus, and had a very unstable employment record - 14 employers in six years); OSC, Policy Statement No. 3-09, April 5, 1971, 2 CCH CAN. SEC. L. REP. ¶54-903 (frequent transfers by registered salesmen from dealer to dealer are not considered consistent with the best interest of the public). *Compare In re* John A. Sherman and Samuel Boltman, [1949] OSC Bull. 11 (January) (salesmen whose registration had lapsed by virtue of cancellation of their employer's registration where the employer had been engaged in high pressure sales tactics not involving these salesmen would be granted reregistration under the auspices of a more responsible employer).

167 Exchange Act, s. 15(b).

168 Exchange Act, s. 15B.

169 Exchange Act, ss. 3(a)(4), (5).

170 E. WEISS, *supra* note 44, at 4-5.

generally corporations or partnerships, are registered directly with the commission. Applications by brokers and dealers for registration must disclose, however, full information concerning "associated persons".[171] These include all partners, officers, directors and employees of a broker-dealer, other than clerical employees, as well as all persons controlling, controlled by or under common control with the broker-dealer.[172] The activities of associated persons can be a ground for denying registration and for disciplining a registrant.[173] Furthermore, the commission has a statutory power to discipline an associated person independent of its authority to discipline the registrant with which such person is associated.[174] The Canadian approach, wherein securities salesmen themselves are registered with the commission, appears preferable because it makes clear the commission's authority over salesmen, and it should be retained in any new legislation. The SEC's *Special Study of the Securities Markets* had recommended that salesmen and other key securities personnel be registed directly with the commission[175] but this recommendation was not acted upon in either the 1964 or the 1975 amendments to the Exchange Act.[176]

C. QUALIFICATIONS FOR LICENSURE

The form of application for registration as adviser, dealer or underwriter seeks to elicit in some detail the applicant's history in the securities business and in any other licensed occupation in Canada or elsewhere, applicant's criminal record (if any), whether applicant has ever been accused of fraud in a civil action, the identity of each partner, officer or director of an applicant firm, and applicant's capitalization and the owners thereof.[177] An information statement to be completed by the proprietor of a sole proprietorship applicant and by each partner, officer and director of a firm applicant covers the individual's history in the securities business and in any other licensed occupation in Canada or elsewhere, criminal record (if any) as well as whether the individual has ever been accused of fraud in a civil action, a fifteen-year employment history, and character references.[178] The form for

171 Exchange Act, s. 15(b)(1).
172 Exchange Act, s. 3(a)(18).
173 Exchange Act, ss. 15(b)(1), (4).
174 Exchange Act, s. 15(b)(6).
175 SEC SPECIAL STUDY, *supra* note 26, at 160 (recommendation No. 4).
176 *See* Phillips & Shipman, *An Analysis of the Securities Acts Amendments of 1964*, [1964] DUKE L. REV. 706, 809-10.
177 Ontario Securities Regulations, Form No. 1.
178 *Id.*, Form No. 2.

application for registration as a salesman[179] is practically identical in content to the information statement for proprietors, partners, officers and directors. The salesman application in addition requires a certification from the applicant's prospective employer stating that the employer has made "due and diligent inquiry" into the background of the applicant on the basis of which the employer believes the applicant to be of good character and reputation.

Fees for registration and renewal of registration range from a low of $75 for a salesman to a high of $500 for adviser registration of an applicant other than an individual.[180]

A variety of educational, general character and financial qualifications are requisites for registration in the various categories.

1. *Standards Relating to Education, Training, Experience*

All applicants for registration as salesmen must have successfully completed the Canadian securities course[181] – a basic course on capital markets, investment instruments and strategy and securities salesmanship administered by the Canadian Securities Insititute. The course is basic but it appears that anyone who comprehends all the materials in it is reasonably well equipped at least to start as a salesman. A salesman restricted to selling mutual funds must have successfully completed either the Canadian securities course or the Canadian mutual funds course.[182] The latter course, administered by the Canadian Mutual Funds Association,[183] is about as sophisticated as an automobile driver's exami-

179 *Id.*, Form No. 5. None of the questions on any of the forms would seem to elicit whether an applicant had ever been found by a court or other competent tribunal to have sold securities in violation of a prospectus requirement, except where such a finding was made in a criminal action (ques. 8(a)) or where such finding had led to revocation or suspension of a licence or of membership in a self-regulatory association (ques. 6). Thus, for example, where an applicant who had never been licensed in the securities markets had been found in an SEC injunctive action to have violated s. 5 of the Securities Act of 1933 (registration of securities) that fact would not have to be revealed on the Ontario application. Presumably this is an unintended omission in the forms.

180 Ontario Securities Regulations, s. 8(1). Where an application is refused, the director of the commission may recommend to the provincial treasurer that the application fee or a part thereof be refunded; OSA, s. 17.

181 Ontario Securities Regulations, s. 6(14).

182 *Id.* s. 6 (15).

183 As its name implies, the CMFA is an association of mutual funds qualified for sale in Canada. As of 1969, its membership was constituted of about 1/3 by number of all mutual funds qualified for sale in Canada, but these funds accounted for the great majority of mutual fund assets by dollar value; CANADIAN MUTUAL FUND REPORT, ch. 19.

nation and could probably be dealt with successfully by the average high school student with a bit of preparation.[184] Altogether, the course would not inspire confidence in the knowledge and professionalism of a salesman whose only qualification was successful completion of it. An individual applying for registration as a salesman with a broker or investment dealer must have successfully completed, in addition to the Canadian securities course, the registered representatives examination.[185] That examination is based on the materials in the *Manual for Registered Representatives*, a publication of the Canadian Securities Institute, which summarizes generally the accepted ethical practices among members of the IDA and the Canadian stock exchanges and identifies the requirements of provincial securities legislation and of the self-regulatory organizations which may affect registered representatives in their relations with clients.[186]

An individual applicant for registration as broker, broker-dealer, investment dealer or securities dealer or an individual on whose behalf designation or approval is sought as a partner or officer of one of the foregoing must have completed successfully the new partners', directors' and senior officers' qualifying examination, also administered by the Canadian Securities Institute.[187]

An individual applying for registration as a securities adviser, or on whose behalf designation or approval is sought as a partner or officer of an adviser, must have successfully completed the Canadian securities course and the more advanced Canadian in-

184 *See* the evaluation of the mutual funds course in the CANADIAN MUTUAL FUND REPORT ¶¶14.18-14.20. Sample questions from the mutual funds course examination include the following: (Answer yes or no). "May a representative commence selling once his application for registration has been filed with the Commission?"; "Are mutual fund shares traded on a stock exchange?"; "Can a representative guarantee that the shares will be redeemed at a specific price?"; "Can the future performance of a mutual fund be guaranteed?".

185 Ontario Securities Regulations, s. 6(16).

186 CANADIAN SECURITIES INSTITUTE, *supra* note 21, at iii (Foreword).

187 *Compare In re* Liberty Securities Ltd., [1966] OSC Bull. 4 (September). At a time when there had been promulgated no specific qualifications for officers of applicant firms, the director turned down an application for broker-dealer registration because of what he deemed to be the officers' lack of experience in the securities industry and in supervisory executive capacities. On appeal to the commission registration was granted. The BDA had established a minimum guideline of two years experience for each officer, and it had accepted the applicant for membership. The commission found the BDA's favourable action to be a convincing, though not a conclusive, factor. The commission said, "it is not necessary that the experience of each officer be substantial, so long as their combined experience be substantial". It found that the applicant complied with the test as so stated.

The education requirement for approved partners or officers of or individuals registered as mutual fund dealers, scholarship plan dealer or security issuer is "such qualification and experience as in the opinion of the director is appropriate";

vestment finance course and must have performed research involving the financial analysis of investments under supervision of an adviser for at least five years.[188] These requirements, particularly the last one, are fairly rigorous and ought to be sufficient to produce at least a minimally proficient adviser.[189] For the investment counsel category the same courses are required plus at least the first year of the chartered financial analysts course. The experience requirement is similar to that for advisers with the additional requirement that there be three years of supervision by an adviser having responsibility for portfolios of aggregate value of at least $1 million.[190] Since the new Ontario category of portfolio manager is defined as a species of investment counsel,[191] an individual portfolio manager and the partners or officers of a firm must meet the qualifications for investment counsel registration. In Québec, the educational requisites for registration as investment adviser (equivalent to investment counsel in Ontario) are even more rigorous. The applicant must have five years experience in financial analysis and must either have a university degree in a related field or have obtained the title of Chartered Financial Analyst.[192] Only an investment adviser may administer discretionary accounts in Québec.[193]

2. *Good Character*

The second type of qualification, for registration generally – good character – is implicit in the statutory standard that the applicant be "suitable for registration" and that the registration be "not objectionable". It would be difficult to state the standard with more precision, although lack of suitable character has fre-

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Ontario Securities Regulations, s. 6(13). Presumably in the case of a mutual fund dealer that would be no less than the qualification for a mutual fund salesman.

188 Ontario Securities Regulations, s. 6(10). These are practically the same requirements as apply in Québec for securities adviser registration, except that in Québec the experience requirement is three rather than five years. Also in Québec the educational requirement is extended to those employees of the securities adviser who analyze securities markets; QSC, Revised Policy Statement No. 19, *supra* note 160, art. 8.

189 For registration under the Investment Advisers Act of 1940 in the United States there are no prior professional qualifications or standards; Lybecker, *Advisers Act Developments*, 8 Rev. Sec. Reg. 927 (1975). There are, on the other hand, a variety of statutory disqualifications; Advisers Act, s. 203(e).

190 Ontario Securities Regulations, s. 6(11). Any of the educational and experience requirements may be waived by the director where he is satisfied that the individual has equivalent qualifications; *id.* s. 6(17); QSC, Revised Policy Statement No. 19, *supra* note 160, art. 8(8).

191 Ontario Securities Regulations, s. 2(2)1a.

192 QSC, Revised Policy Statement No. 19, *supra* note 160, art. 8(2).

193 *Id.* art. 15(1).

quently been a ground of denial of registration.[194] At a minimum, good character comprehends observance of the securities laws.

3. *Financial Qualifications*

The third type of qualification for licensing as a securities market actor is financial, commonly known as the "net capital rules".[195] The financial condition of securities dealers is a matter of regulatory concern because the customers of a firm may be at risk with respect to their cash or securities in the event of failure of the firm. That is to say, the business of securities dealers includes important banking functions.[196] Securities dealers lend money to margin purchasers, retaining the purchased securities as collateral, or more usually, rehypothecating them at commercial banks. They receive and retain "free credit balances" in the accounts of customers. Free credit balances are those amounts of cash owed by securities dealers to customers which the customers have an immediate right to withdraw. They generally arise when a customer gives cash to a securities dealer to hold pending receipt of instructions to purchase securities, when a customer's fully paid-for securities are sold and the proceeds are held pending further investment or further instructions from the customer, or from interest or dividends on the customer's securities held by the dealer.[197] Unless restricted from doing so by the applicable regulations,[198] dealers use these funds in their own businesses. They frequently hold customers' fully paid securities either for safekeeping or pending delivery to the customers or as excess collateral not needed to secure customers' margin accounts.

In Ontario each category of dealer registrant, other than security issuer, must maintain at all times a net free capital of at least 10% of the first $2,500,000 of adjusted liabilities plus 8% of the next $2,500,000, 7% of the next $2,500,000, 6% of the next $2,500,000, plus 5% of adjusted liabilities in excess of $10,000,000 but in no event less than $25,000.[199]

Adjusted liabilities are total liabilities (but not considering subordinated debt as a liability) less certain very liquid assets:

194 *See* notes 230-36 and accompanying text *infra*.

195 For a full treatment of the topic of registrants' financial responsibility, *see*, *Honsberger*.

196 E. Weiss, *supra* note 44, at 57.

197 *Id.* at 70; *see also* H. Baruch, Wall Street: Security Risk 21-31 (1972); OSC Requirements Made Pursuant to Section 6, Ontario Securities Regulations, 2 CCH Can. Sec. L. Rep. ¶54-981 (Conditions of Registration) [hereinafter cited as OSC Conditions of Registration].

198 *See* discussion in text accompanying notes 270-77 *infra*.

199 Ontario Securities Regulations, s. 6(1)(a).

cash; cash surrender value of life insurance; accounts receivable from governments, chartered banks, loan, trust and insurance companies and credit unions; debt obligations of or guaranteed by the governments of Canada, the United States, a Canadian province or municipality; commercial paper; commercial bonds maturing within three years; bank deposit certificates and trust company guaranteed investment certificates.[200]

Net free capital is all capital (as opposed to nonsubordinated debt) employed in the firm's business, less fixed assets and assets not readily convertible into cash and less amounts required to margin fully securities in firm and customers' accounts.[201]

The margin requirement for a particular security is the dollar amount of cash or cash-equivalent assets that a customer must have in its account with a securities firm, expressed as a percentage of the market value of the security in question, in order to purchase that security on margin – as opposed to a cash basis. Margin requirements therefore control the amount of credit, and hence the amount of speculation, available for securities transactions. Setting margin requirements is therefore as much a central banking function as a function pertaining to securities regulation.[202] The difference between the margin requirement and the purchase price of the security is, of course, a loan from the securities dealer to the customer. In turn, the practice of most dealers is to obtain credit from a commercial bank on the collateral strength of the securities purchased for the margin customers. Therefore the ultimate source of credit for margin transactions is the bank rather than the securities dealer. If the value of the securities purchased on margin declines to a level below the value assigned to them as collateral, the bank will demand increased collateral for its loan to the dealer or that the loan balance be reduced and, in either event, the dealer will make a margin "call" (call for increased margin) from its customer.[203]

Margin accounts are highly profitable to brokers and are encouraged by them. One source of profit is the difference be-

200 OSC Conditions of Registration, *supra* note 197, app. 1 and schedule 1 thereto; REPORT OF THE COMMITTEE TO STUDY THE REQUIREMENTS AND SOURCES OF CAPITAL AND THE IMPLICATIONS OF NON-RESIDENT CAPITAL FOR THE CANADIAN SECURITIES INDUSTRY 44, 50 (1970) [hereinafter cited as MOORE COMMITTEE REPORT].

201 *Id.*

202 In fact, in the United States s. 7 of the Exchange Act grants authority to set margin requirements for securities transactions not to the SEC but rather to the Board of Governors of the Federal Reserve System. The margin requirements as thus set are known as Regulation T and are contained in 12 C.F.R. ss. 220.1-220.8 (1977). In Canada the central bank has no such power to set margin requirements. *See*, BANK OF CANADA ANNUAL REPORT (1956), at 34.

203 The operation of a margin account is described in Dominick Corp. of Canada v. George, 15 D.L.R. (3d) 596 (B.C.C.A. 1970).

tween the interest rate the bank charges the broker and what the broker charges its customer. Registrants who are members of the TSE or the IDA, are free to use customers' free credit balances in their business without paying interest.[204] To the extent they use such funds to finance margin accounts, the interest charge to customers is all profit. Use of margin enables customers to hold larger securities accounts than would otherwise be possible, and this obviously contributes to brokers' profits. Finally, margin accounts tend to trade with a higher turnover rate than cash accounts, thus generating increased commissions for brokers.[205]

Margin requirements are also an important determinant of the question whether a registrant is in compliance with net capital rules. The OSC rules require that in the computation of net free capital there be deducted from a registrant's liquid capital that amount of cash required to margin fully securities in firm and customer accounts. The margin requirements set by the OSC range, for example, from a low of under 1% for federal and provincial government obligations due within a year to between 5% and 10% for longer term government instruments and commercial bonds up to not less than 50% for listed securities and 100% for nonlisted securities - which means in effect that the last-mentioned group cannot be carried on margin.[206] The TSE has its own margin requirements that are at least as strict as those of the OSC.[207]

For persons and firms registered solely as underwriters the minimum net free capital requirement is $10,000;[208] for advisers it is $5,000, which in the director's discretion may be raised to up to $25,000.[209] For advisers, net free capital is defined as working capital, that is, the excess of current assets over current liabilities.[210] It is by no means apparent just why "pure" advisers - ones that do not manage customers' funds - should be subject to any minimum capital requirement. The reason may be to weed out fly-by-night operations.

Each category of registrant is subject to bonding requirements and each category of dealer, except security issuers, must

204 *See* ch. IV.B *infra*.

205 M. Mayer, Conflicts of Interest: Broker-Dealer Firms 42 (1975).

206 OSC Conditions of Registration, *supra* note 197, app. 4, schedule 1. For purposes of determining a registrant's adjusted liabilities, as part of net capital computations, those securities in a registrant's account having a margin rate of 5% or less may be deducted from total liabilities; *id.* app. 1.

207 TSE by-laws, s. 16.15, 3 CCH Can. Sec. L. Rep. ¶89-635.

208 Ontario Securities Regulations, s. 6(1)(c).

209 Ontario Securities Regulatons, s. 6(1)(b).

210 OSC Conditions of Registration, *supra* note 197, s. 6(2) (Calculation of Minimum Free Capital).

participate in a trust fund for the compensation of customers established either by a self-regulatory organization or, in the cases of registrants not members of a self-regulatory organization, by a trustee with the approval of the commission.[211]

D. THE HEARING

OSA section 7(2) provides that the director shall not refuse registration without giving the applicant an opportunity to be heard. One commentator has described the section 7 hearing thus:

> "Hearings under section 7 tend to be informal and they seem to more closely resemble an investigation than a hearing. Hearsay evidence is often presented to the Director. The commission counsel will very often refuse to disclose the source of his information. The applicant accordingly does not have an opportunity to cross-examine the real witnesses against him but, of course, can challenge whatever allegation of fact is presented. The practical effect of the introduction of some kind of an allegation of misconduct unsupported by a person having personal knowledge is to call for some kind of an explanation or denial from the applicant".[212]

From an adverse decision of the director in a section 7 hearing, the applicant may appeal to the commission and is entitled to a hearing and review by the commission of the director's decision.[213] The procedure for hearing and review, as opposed to an appeal, means that the commission may hear new evidence.[214] The commission may confirm the decision under review "or may make such other... decision...as the commission considers proper".[215] The commission's review function has been held to go "far beyond appellate jurisdiction in the strict sense of deciding merely whether a lower decision be right or wrong".[216]

From the commission, an unsuccessful applicant may appeal to the Supreme Court of the province.[217] The reviewing court's jurisdiction, in turn, has been said to be broader than on an appeal

211 Ontario Securities Regulations, ss. 6(3), (4). These subjects are dealt with fully in *Honsberger*.

212 Thomson, *Concepts and Procedures Before the Ontario Securities Commission*, in LAW SOCIETY OF UPPER CANADA, *supra* note 65, at 95, 96-97.

213 OSA, s. 28(1).

214 Re The Securities Commission and Mitchell, [1957] O.W.N. 595, 598 (C.A., single judge).

215 OSA, s. 28(2).

216 Re Chromex Nickel Mines Ltd., 16 D.L.R. (3d) 273, [1971] 1 W.W.R. 163 (B.C.C.A. 1970) *aff'd sub nom.* Hretchka v. Attorney-General for British Columbia, [1972] S.C.R. 119, 129.

217 OSA, s. 29(1).

from a lower court because the securities acts give the reviewing courts the power to confirm or set aside the order appealed from or to order the commission to make such other order "as the court considers proper".[218] In other words, the court on appeal from the commission has the same discretionary power as the commission has on appeal from the director.[219] As might be expected, however, the courts have shown much greater deference to the commissions than the commissions have shown to decisions of their directors.[220] The standard of judicial review of a decision of a securities commission that is plainly within the commission's power to make, such as a decision on registration, has been said to be that the court will uphold the commission unless there has been either a failure of natural justice in the proceedings before the commission or else the commission has made a plain and vital mistake as to the facts.[221] In *Re The Securities Commission and Mitchell*, the Ontario Court of Appeal, *per* Laidlaw, J., stated:

> "The opinion of the commission should not be set aside or altered upon an appeal unless the commission has erred in some principle of law or unless it appears that the commission has not proceeded to form its opinion in a judicial manner or unless it appears that the opinion of the commission is so clearly wrong as to amount to an injustice requiring a remedy on appeal".[222]

There is only one reported case where an unsuccessful applicant for registration succeeded in having the commission's determination overturned by a court. In *Re Larrimore Securities*,[223] the commission had refused an application for registration as a broker-dealer on the sole ground that the applicant had been refused membership in the Broker-Dealers' Association.[224] At that time

218 OSA, s. 29(5).

219 Hretchka v. Attorney-General for British Columbia, [1972] S.C.R. 119, 130 (*per* Martland, J.); *In re* Frank Slichter, B.C. Corp. & Fin. Serv. Comm'n Weekly Summary, June 30, 1977, at 4 (C.A.).

220 *See generally* Baillie, *Discovery-Type Procedures in Securities Fraud Prosecutions*, 50 CAN. B. REV. 496, 498-507 (1972); Cowan, *supra* note 12, at 766-69.

221 *In re* Maher Shoes Ltd. [1971] 2 O.R. 267 (C.A.); *see also In re* Southern Brokerage and Holding Company, Inc., [1967] OSC Bull. 5 (June) (C.A.) (otherwise unreported). It was held in Re Clark and Ontario Securities Commission, [1966] 2 O.R. 277 (C.A.) and in Re Chromex Nickel Mines Ltd., 16 D.L.R. (3d) 273 (B.C.C.A. 1971) that rules of natural justice apply in proceedings involving the denial of trading exemptions under the Securities Acts. Presumably they apply equally to hearings on the denial of registration and to disciplinary proceedings. The hearing provisions of the OSA seem more than sufficient in this regard; *see* Baillie, *supra* note 220, at 505-07.

222 [1957] O.W.N. 595, 599 (C.A.). The language was quoted approvingly by the B.C. Court of Appeal in Re Chromex Nickel Mines Ltd., *supra* note 221, at 287.

223 [1956] O.W.N. 501, 4 D.L.R. (2d) 727 (C.A., single judge).

224 *See In re* Dolford Trading Ltd., [1956] OSC Bull. 1 (July-August), where the

the statute defined a broker-dealer as "any person or company that is a member of the Broker-Dealers' Association...or that is recognized by the commission as a broker-dealer".[225] The court held that the commission had applied an erroneous standard in denying the application on the sole basis of the action of the BDA since the standards of the BDA and the standards of the commission were not necessarily the same and the proceeding before the commission was not a review of the action of the association. For one thing, the court pointed out, the commission was to determine the registration question in the public interest, and the BDA in considering applications for membership was to act in the best interests of the association.[226]

Upon remand, the commission declined again to grant registration on the basis of "indisputable evidence" that applicant was unfit for "the double privilege, first, of being licensed to trade in securities as a principal, and the further and special privilege of being allowed to trade free from the control and supervision of any branch of the organized securities industry...".[227] The commission's description of the licence as a privilege is disturbing if it meant to imply that acceptance of the application for registration was in some sense a matter of grace, a matter of governmental generosity. It is unacceptable for a government to declare that a person may not pursue a certain legitimate means of earning a livelihood except under licence and then to suggest that the grant of the licence is somehow an act of governmental generosity.[228] If, on the other hand, the commission used the world "privilege" as a shorthand means to indicate that because the character qualifications for registration cannot neatly be expressed in a verbal formula the commission has therefore, of necessity, some amount of discretion in making a determination of suitability, then it would be hard to quibble.

Under OSA, section 7(3), the director may restrict a registration by imposing terms and conditions on its grant. Frequently imposed conditions include restrictions upon the licences of mutual fund salesmen to sell only mutual fund shares and upon the licences of exchange floor traders to engage in that activity only. The power to condition a registration has been used also to enforce

commission similarly denied registration on the sole basis of a refusal of membership by the BDA.

225 R.S.O. 1950, c. 142, s. 1(1)3.

226 4 D.L.R. (2d) at 732.

227 [1956] OSC Bull. 12 (June).

228 *See* Reich, *supra* note 19.

the commission's policy against part-time registration of salesmen.[229]

The very broad discretion of the director in the registration process appears on the whole to have been exercised with restraint and along lines consistent with the underlying purposes behind the licensing requirement in the securities industry.[230] Denials of registration have been made for such reasons as criminal record,[231] previous bad record in the securities industry,[232] failure to make disclosures called for on the application form[233] and violations of the securities laws of other jurisdictions.[234] In a few of the early cases, denial appeared to turn, at least in part, upon an

229 Ontario Securities Regulations, s. 6(18) (formerly OSC Policy Statement 3-07). In *In re* Michael W.E. Blum, [1971] OSC Bull. 18 (February) the registration of a professional football player as a salesman was conditioned so as to be suspended during the football season with reinstatement at the end thereof.

230 *But see* Cowan, *supra* note 12, at 749-54, 761-65.

231 *In re* William Arthur Pike, [1966] OSC Bull. 5 (November). In *In re* Argosy Finance Co. Ltd., [1978] OSC Bull. 96 (March), the commission confronted the question of the point in time at which the disability of a criminal conviction may be overcome by a record of ways mended. In Argosy the director had refused issuer registration and a prospectus receipt to a finance company for the sole reason that the company's general manager and principal shareholder had been convicted on a guilty plea of theft by conversion seven years earlier. At the time of the conviction, the trial judge had not seen fit to impose a prison sentence. The commission concluded that the conviction should not be an absolute bar to registration. It was satisfied that the general manager had been demonstrated to be honest and of good repute.

232 *In re* Tuina Enterprises Ltd., [1968] OSC Bull. 35 (March) (decision of the commission); *In re* Robert Maurice Thorwood, [1951] OSC Bull. 12 (February); *In re* Drawson Red Lake Gold Mines Ltd., [1951] OSC Bull. 1 (January); *In re* J. Dewar McLean, [1950] OSC Bull. 8 (February); *In re* James W. Armstrong, [1950] OSC Bull. 6 (February); *In re* Sigma Securities, [1968] OSC Bull. 94 (April) (decision of the director followed by review by the commission). Sigma is an interesting case because the disabling conduct in question was on the borderline. The principal of an applicant for underwriter registration, one Fidler, had purchased some highly speculative securities in his own name; when the securities declined in value the following day, he assigned them to the account of certain public companies for which he had authority to trade. The commission concluded that while Fidler had done nothing illegal, there was at least a lingering doubt that he would have assigned the securities to the companies had their value risen. *Compare In re* Alfred Joseph Lewis, [1958] OSC Bull. 1 (October) (commission reverses director and grants salesman registration where applicant relied upon a lawyer's advice as to the legality and propriety of the prior conduct which the director had found to be a bar to registration); *In re* Percy Brand, [1965] OSC Bull. 5 (November), [1966] OSC Bull. 16 (July) (granting application for reregistration nine years after cancellation of salesman registration); *In re* Harry Price, [1952] OSC Bull. 1 (March), [1962] OSC Bull. 1 (November), [1964] OSC Bull. 3 (June) (applicant granted salesman registration 14 years after cancellation of broker-dealer registration, with a good record as a real estate salesman in the interim).

233 *In re* Edward Francis Loughrey, [1967] OSC Bull. 27 (January); *In re* Norman John Hebscher, [1950] OSC Bull. 1 (December); *In re* Francis Benedict Bianchi, [1950] OSC Bull. 2 (September); *In re* Frank Lindover, [1950] OSC Bull. 7 (February); *In re* Yvon Fradette, 9 QSC Bull., No. 8 (Decision No. 5442 February 27, 1978).

234 *In re* Larenim Securities Ltd., [1971] OSC Bull. 12 (January).

assessment by the director, without benefit of hard evidence, that the applicant was not of a character suitable for registration.[235] In one of the early cases, however, the full commission reversed the director, specifically distinguishing between evidence of wrongdoing and mere bad reputation.[236] Now that there are specific educational and/or experience qualifications in most of the registration categories the director will have less need for recourse to general but unsubstantiated character considerations.

E. COMPARATIVE NOTE ON THE U.S.

Among the many 1975 amendments to the licensing provisions of the United States Exchange Act is a provision that for the first time grants the commission authority to establish mandatory "standards of training, experience and competence and...other qualifications" for all registered brokers and dealers and their associated persons.[237] Under the prior law, the commission had authority to establish such standards only for brokers and dealers (and their associated persons) who were members neither of any exchange nor of the National Association of Securities Dealers (NASD). Such brokers and dealers are known as "SEC only" or "SECO" broker-dealers. Otherwise, the establishment of competence standards was entirely within the province of the self-regulatory organizations.

With respect to financial responsibility, under the prior law the commission's authority to establish rules extended to all brokers and dealers, but in practice the exchanges were allocated sole responsibility over their members in this regard. Congress, in considering the 1975 amendments, expressed strong dissatisfaction with this state of affairs; it concluded that an important contributing factor to the securities industry crisis of the 1969–71 period was the self-regulatory organizations' laxity in the enforcement of their own financial responsibility rules.[238] In order to

235 *In re* Maris Investment Corporation Ltd., [1968] OSC Bull. 82 (March); *In re* Norman John Hebscher, *supra* note 233; *In re* Francis Benedict Bianchi, *supra* note 233; *In re* Frank Lindover, *supra* note 233. The Maris proceeding is discussed at length in Cowan, *supra* note 12, at 753.

236 *In re* Maris Investment Corp. Ltd., *supra* 235.

237 Exchange Act, s. 15(b)7. *See* SEC, Securities Exchange Act of 1934 Release No. 13679, June 27, 1977, [1977-1978 Transfer Binder] CCH FED. SEC. L. REP. ¶ 81,219 announcing a proposed rule which would establish minimum qualification requirements for all registered brokers and dealers and their associated persons. In general, the commission's proposals rely heavily on the courses and examinations presently administered by the major self-regulatory organizations, fulfillment of whose requirements would also satisfy the commission requirements.

238 HOUSE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE, H.R. REP. No. 94-123, 94th Cong., 1st Sess. 76 (1975).

avoid a recurrence of this problem, the amended Exchange Act, in section 15(c)(3),[239] directs the commission to establish minimum financial responsibility requirements for all brokers and dealers. The commission has adopted a uniform net capital rule, effective January 1, 1976.[240] While the commission retains an exemptive power, its use is expected to be severely limited.[241]

The United States Exchange Act goes into much more detail than do the Canadian provincial statutes on the grounds upon which registration as a broker or dealer may be denied. Section 15(b) provides that a broker or dealer may be registered by filing with the commission an application accompanied by such information as to the applicant and any associated persons of the applicant as the commission may prescribe. Within forty-five days the commission shall either grant registration or institute proceedings to determine whether registration should be denied.[242] The commission "*shall* grant such registration if it finds that the requirements of this section are satisfied".[243] The "requirements of the section" refers to the various standards of operational capability, training, experience and competence that the commission is to promulgate by rule. None of the standards contemplated would appear to be as vague as "good character" or "suitability", and since they must be promulgated in advance, applicants will know the standards they must meet. The commission *shall* deny registration if either: (1) it does not find that the requirements are satisfied, or (2) it finds that if registration were granted the registration would be subject to suspension or revocation. A registration would be subject to suspension or revocation, in turn, where the commission had found such discipline to be in the public interest *and* that the registrant or a person associated with it:

(1) has willfully made a material false statement in an application for registration or in a proceeding before the commission;[244]
(2) has within the ten years preceding the application been con-

239 Exchange Act, s. 15(c)(3).
240 SEC, Securities Exchange Act of 1934 Release No. 34-11497, June 26, 1975, [1975-1976 Transfer Binder] CCH FED. SEC. L. REP. ¶80-212.
241 H.R. REP. No. 94-123, *supra* note 238, at 77.
242 Under the prior law registration was automatic if the commission took no action within 30 days from the application. In considering amendments Congress determined that all registrations should require affirmative action by the commission; H.R. REP. No. 94-123, *supra* note 238, at 75.
243 Exchange Act, s. 15(b)(1) (emphasis added).
244 "Willfully" has been construed to require that the act in question be done consciously or intentionally. It does not connote any consciousness on the part of the actor that the act is unlawful; E. WEISS, *supra* note 44, at 206; Tager v. SEC, 344 F.2d 5, 8 (2d Cir. 1965); Lipper v. SEC, 547 F.2d 171, 180 (2d Cir. 1976); Hanly v. SEC, 415 F.2d 589, 597 (2d Cir. 1969).

victed of a crime involving the securities business or involving any type of fraud, larceny, perjury or bribery;

(3) has been enjoined by a court from acting in one of the licensed occupations in the securities business or from being an employee of a bank or an insurance company or from engaging in any conduct in connection with the purchase or sale of securities;

(4) has willfully violated, or is unable to comply with, any provision of the federal securities laws or the rules and regulations thereunder;

(5) has willfully aided or abetted a violation of, or has failed reasonably to supervise another person who is subject to his supervision and who has violated, any provision of the federal securities laws or the rules and regulations thereunder.[245]

Because a registrant is subject to discipline only where he has committed one of the substantive acts *and* the commission finds such discipline to be in the public interest, a useful degree of ameliorative discretion is preserved to the commission in licensing (as in licence revocation): it might determine to permit the registration of an applicant that had incurred one of the five listed disabilities because the commission felt that issuance of the licence would nonetheless be consistent with the public interest.

As stated above, the writer does not have grounds to believe that the record of Canadian securities administrators in exercising the extremely broad and quite unguided licensing discretion committed to them by the provincial securities acts has been other than reasonably satisfactory. Nonetheless, the American approach of specifying the grounds upon which registration will be denied is an appealing alternative to committing to an administrator a broad discretion to be exercised within only the vaguest constraints. First, it is correct to start from the assumption that all applicants *shall* be licensed. The right to earn a living is not an act of governmental generosity. Second, it is desirable that applicants be made aware in a source of easy reference what attributes would likely prove to be disabilities. Third, it is preferable that the necessarily vague standard, "the public interest", be a matter to which the administrator must address himself in dealing with a presumptively unqualified applicant rather than a hurdle to be cleared by each applicant.[246]

245 Exchange Act, s. 15(b)(4). Upon precisely the same grounds registration as an investment adviser will be denied; Advisers Act, ss.203(c)(2), 203(e).

246 *See also* McRuer Report, *supra* note 8, at 1105, which found the OSA, s. 7 standard - "where in the opinion of the director the applicant is suitable for registration and the proposed registration is not objectionable" - itself objectionable. "Ideally", says

Chapter IV
Standards of Conduct and Their Enforcement

Obviously the rules of behaviour laid down for securities market participants do not fit into neat, mutually exclusive boxes labelled "honesty", "competence" and "financial responsibility", as have been designated in chapter III of this paper the "triumvirate of values" sought to be advanced by licensing. For example, while rights and obligations of the brokerage firm with respect to customers' cash and securities is treated below as an aspect of the firm's financial condition,[247] obviously the purport of the applicable rules is to prevent misappropriation by the firm, which would be a fraud against its customers. Another example is to be found in the dual aspect of the know-your-client rule which is designed simultaneously to protect clients from unsuitable recommendations by the firm and the firm from unscrupulous clients who do not have a *bona fide* intent to make good on their commitments to the firm and who could thereby endanger its capital position. Further illustrative of the interrelationships among the various values to be furthered by the standards of conduct is the very hazy line that emerges in the annals of enforcement proceedings between advice that is incompetent and advice that is fraudulent.

Just as standards of conduct for licensees in general cannot accurately be fitted into the mutually exclusive pigeonholes of honesty, competence and financial responsibility, so also it is artificial in discussing standards of conduct to break off the trading from the advising function. Categories must be made, however, and hopefully the result is not positively misleading. This section attempts to classify and discuss standards of conduct in terms of functions of licensees and not in terms of licensing categories. This is particularly important in those parts dealing with the advising function. Unless otherwise indicated, the advising standards discussed are as much applicable to trading registrants as to registered advisers.

The term "broker-dealer" is used in this section to describe generally a person or firm registered to trade in securities. Broker-dealer is in fact a fairly minor category of registrant in

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the REPORT, "legislation should establish licensing schemes wherein licences can be refused or revoked only on a basis of objective grounds clearly set out in the statute"; *id.* at 1105-06. The REPORT would tolerate what it calls "the subjective expression of licensing standards" only where absolutely necessary; *id.* at 1105. That such a standard is not absolutely necessary in securities licensing is demonstrated by the Exchange Act in the U.S.

247 Ch. IV.B *infra.*

Ontario[248] where the term originates in Canada (it is really American terminology) but it is useful because it briefly describes the two possible roles of the registered trader – principal and agent.

In this part of the paper readers of footnotes will observe the important role in the U.S., as opposed to Canada, that private litigation has played in defining the standards to be observed by registrants. This is due in the main to the receptivity of the American courts to the notion of implied private causes of action for damages arising out of breach of the anti-fraud provisions of the securities laws, especially section 10(b) of the Exchange Act[249] and Rule 10b-5 thereunder.[250] By contrast, Canadian courts seem inhospitable, if not hostile, to the implication of private remedies for breaches of the provincial securities acts.[251] Largely as a result of this difference in the availability of private causes of action as between the jurisdictions, the standards of behaviour to

248 A broker-dealer is a registrant that is a member of the Broker-Dealers' Association; Ontario Securities Regulations, s. 2(1)2. As of June 30, 1976, there were only 13 members of the BDA; [1976] OSC Bull. 192 (July). Broker-dealers have traditionally concentrated their trading in the shares of junior mining companies, and the decline in importance of the type of trader reflects a corresponding decline in importance of that class of issuer in Ontario.

249 Exchange Act, s. 10(b) provides: "It shall be unlawful for any person, directly or indirectly... [by use of the jurisdictional means] (b) to use or employ in connection with the purchase or sale of any security... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

250 In 17 C.F.R. s. 240.10b-5 (1977) the commission has prescribed that it shall be unlawful for any person, directly or indirectly [by use of the jurisdictional means]:

"(1) to employ any device, scheme, or artifice to defraud;

"(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

"(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

The cases recognizing private causes of action under the Rule are legion, the principal ones in the Supreme Court being Superintendent of Insurance v. Bankers' Life & Casualty Co., 404 U.S. 6 (1971); Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 150-54 (1972). The scope of Rule 10b-5 as an investor remedy, and even a remedy for traditional corporate mismanagement, appeared to be ever-expanding until a recent series of Supreme Court decisions limited the availability of private actions under the rule to situations involving something close to common law fraud, *see* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977), and restricted the parties to whom the remedy would be available; *see* Piper Aircraft Corp. v. Chris Craft Industries, 430 U.S. 1 (1977); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). *See generally* Castruccio, *Developments in Federal Securities Regulation – 1976*, 32 Bus. Law. 1537 (1977).

251 *E.g.* Ames v. Investo Plan Ltd., 35 D.L.R. (3d) 613 (B.C.C.A. 1973), commented upon critically in Beck, Comment, 52 Can.B. Rev. 589 (1974).

be observed by securities industry licensees are much more developed in the U.S. than in Canada.

A. NOTE ON THE INTERPLAY BETWEEN THE REGULATORY AGENCY AND THE SELF-REGULATORY ORGANIZATIONS

Although another paper in this group deals exhaustively with the subject of self-regulation in the securities industry, some mention of the relationship between licensees and the self-regulatory organizations must be made here. At least in theory, the self-regulatory organizations in the securities industry enforce against their member-licensees standards of ethical conduct; and, from the licensee's perspective, its relationship to the self-regulatory organization may be of as much practical importance as its relationship to the securities commission.

The self-regulatory organizations in Canada are the Toronto, Montreal, Vancouver, Alberta and Winnipeg stock exchanges, the Investment Dealers Association and, in Ontario, the Broker-Dealers' Association.[252] In none of the Canadian provinces is membership in one or more of the self-regulatory organizations a prerequisite to obtaining a license as a securities market participant. With respect to Ontario, Baillie has stated that there was a "self-regulatory structure envisaged by the Securities Act" which "to some extent has broken down partly because of the failure of the OSC to insist that all registrants be members of the appropriate self-regulatory organization".[253] In fact, it is highly doubtful that under present legislation it is within the regulatory authority of securities commissions to insist that all registrants must be members of a self-regulatory organization.[254] However that may be,

252 The Canadian Mutual Funds Association was at one time recognized by the OSC as a self-regulatory organization for purposes of audit responsibilities for its members; *see* OSC Conditions of Registration, *supra* note 197, Reg. 6(6) (Preparation of Financial Statements). In April 1976, however, the CMFA decided to relinquish its self-regulatory responsibility for auditing; *see* D. JOHNSTON at 112 n. 122. Earlier, the CMFA had been found in the CANADIAN MUTUAL FUND REPORT ¶¶ 19.27–19.36 not to meet the minimum requirements for recognition as a self-regulatory organization.

253 Baillie, *supra* note 134, 8 CAN. PUB. ADMIN. at 241–42.

254 *Cf.* Re Larrimore Securities, 4 D.L.R. (2d) 757 (Ont. C.A. 1956). In the United States, similarly, membership in a self-regulatory organization is not compulsory for securities market licences. The SEC SPECIAL STUDY, *supra* note 26, at 45, recommended in 1963 compulsory membership in the NASD for all broker-dealers doing an over-the-counter business, and in its legislative recommendations to Congress the commission so proposed. Congress did not adopt these recommendations in the Securities Acts Amendments of 1964, apparently as a result of opposition from non-NASD-member broker-dealers. Instead, in 1964 Congress provided the commission with rule-making authority over SECO broker-dealers parallel to the

certainly the self-regulatory organizations can take up a substantial portion of the burden of policing participants in the securities markets that otherwise would fall to the governmental regulatory agency. A good example of this is the responsibility of the TSE, the IDA, and the BDA in Ontario for the audits of their members.[255] If it were to be concluded that self-regulation has "broken down", certainly some of the blame would have to be laid upon the drafting of the statutes themselves since, apart from the audit function, they do not bestow upon the self-regulatory organizations clear responsibility for enforcing rules of good conduct as against their members.

One may contrast in this regard the role assigned to the NASD under section 15A of the Exchange Act in the United States.[256] Section 15A provides that no national securities association shall be registered – and the NASD is the only one so registered – unless the SEC is satisfied: that the association will be truly representative of the industry on a national basis; that membership is open to all registered brokers and dealers;[257] that the association has the capacity to enforce compliance by its members with the Exchange Act and with the association's own rules; that the rules of the association are designed to prevent fraudulent and manipulative practices and to promote just and equitable principles of trade; and that the rules provide that members shall be disciplined for violations of the act and the association's rules and provide a fair procedure for discipline.

The SEC has a review jurisdiction over NASD disciplinary proceedings and over proceedings wherein membership is denied or a person is barred from being associated with a member.[258] Rules of the NASD must be approved in advance by the SEC[259] and the commission has itself a reserve power to alter these rules.[260]

The effect of the 1975 Exchange Act amendments with respect to the self-regulatory role of exchanges is dramatic. For the

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NASD's rule-making authority with respect to its members; *see* Phillips & Shipman, *supra* note 176, at 799; Levin & Evan, *supra* note 23, at 352 n. 54.

255 OSA, ss. 30, 31.

256 Exchange Act, s. 15A. This section, popularly known as the Maloney Act, was enacted in 1938 – some four years after the original Exchange Act.

257 Membership must be open to all registered brokers and dealers except those which: are under a statutory disqualification (meaning generally the commission of a prohibited act); do not meet standards prescribed by the association relating to financial or operational capability or to training, experience or competence; or have engaged or are reasonably likely again to engage in acts or practices inconsistent with just and equitable principles of trade; Exchange Act, ss. 3(a)(39), 15A(g).

258 Exchange Act, ss. 19(d), (e), (f).

259 Exchange Act, s. 19(b).

260 Exchange Act, s. 19(c).

first time the exchanges are placed on a footing vis-a-vis the commission analagous to that established by the Maloney Act for the NASD. The commission now has a direct review power over the exchanges' admissions and disciplinary decisions.[261] Rules of the exchanges must receive prior approval of the commission, and the commission has a reserve power to make rules for the exchanges.[262]

The OSA gives to the Ontario Securities Commission authority over the Toronto Stock Exchange as full as that recently acquired by the SEC over U.S. exchanges.[263] Under OSA, section 140(2) the commission may make any direction, order, determination or ruling that it deems to be in the public interest with respect to: (a) the manner in which an exchange carries on business; (b) any by-law, ruling or regulation of the exchange; and (c) trading on the exchange and the securities traded on it – in short, with respect to virtually everything that an exchange does.[264] Furthermore, the commission, at the instance of a "person aggrieved", has a power of hearing and review over exchange membership and disciplinary proceedings.[265]

While traditionally the OSC has had a much more ample statutory authority over securities exchanges than the SEC, judging from the publicly available record of proceedings (that is, without regard to informal, non-public interventions), the Ontario Commission does not appear to have used this authority on the whole in a very active way. The commission has said in connection with its review of exchange disciplinary proceedings that since the

261 Exchange Act, ss. 19(d), (e), (f). Under the pre-1975 law, the commission had no authority with respect to these matters.

262 Exchange Act, ss. 19(b), (c). Under the old s. 19(b) the commission had no general approval authority over exchange rules. It was empowered, however, with respect to twelve designated subjects and similar matters to alter or supplement the rules of an exchange after making an unavailing written request to the exchange that it alter its own rules, and after notice and hearing, and after determining that such changes were necessary or appropriate for the protection of investors or to insure fair dealing upon or fair administration of such exchange. This authority was very rarely used by the commission. *See generally* PBW Stock Exchange, Inc. v. SEC, 485 F.2d 718 (3d Cir. 1973), *cert. denied*, 416 U.S. 969 (1974); Werner, *Adventure in Social Control of Finance: The National Market System for Securities*, 75 COLUM. L. REV. 1233 (1975).

263 The Ontario legislature has managed to express in about a dozen lines of print a relationship between regulatory and self-regulatory organizations that at bottom is very similar to the one that in the United States act is spread over page after page of highly convoluted verbiage; *compare* OSA, s. 140 *with* Exchange Act, s. 19.

264 *See e.g. In re* Part XV of the By-Laws of the Toronto Stock Exchange, [1976] OSC Bull. 289 (November).

265 OSA, s. 140 (3). *See e.g. In re* Edward A.P. Williams, [1972] OSC Bull. 87 (May); *In re* Lafferty, Harwood & Partners Ltd., [1974] OSC Bull. 125 (June); *In re* Baker Weeks of Canada Ltd., [1977] OSC Bull. 32 (February); *compare In re* Hill and the Vancouver Stock Exchange, B.C. Corp. & Fin. Serv. Comm'n Weekly Summary, April 18, 1975, at 1.

exchange under its enabling legislation has power to impose additional or higher standards on its members than simple compliance with the Securities Acts[266] the commission would not substitute its discretion for that of the exchange governors so long as the exchange's standards are neither inconsistent with the public interest nor applied unfairly.[267]

Generally the following sections of this paper emphasize the standards enumerated in the licensing legislation and the regulations under it and in the course of disciplinary proceedings and private civil litigation. The standards established by the self-regulatory organizations generally are not dealt with, although they are footnoted where appropriate.

B. STANDARDS OF FINANCIAL RESPONSIBILITY

There have been mentioned above the matters of minimum free capital and margin accounts.[268] Other rules relating to financial responsibility of registrants concern settlement of cash accounts, segregation of customers' securities and free credit balances and audits.

When a broker buys or sells securities on behalf of a customer, the broker becomes obligated to deliver the cash or the securities, as the case may be, to the broker on the other side, and this obligation is not conditioned upon the customer completing his obligations to his own broker. The rules on settlement of cash accounts are in reality rules which seek to control extension of credit by brokers to their cash customers. That is, since the broker by virtue of executing a transaction assumes a direct obligation to make delivery of cash or securities, he will be in the position of extending credit to his customers unless they, in turn, make delivery to him on or before the settlement date, which is ordinarily three business days after the transaction. The rules set out the circumstances under which extensions beyond the settlement date may be granted to customers, and provide that otherwise the registrant is to "sell out" (sell an equivalent number of securities

266 Toronto Stock Exchange Act, R.S.O. 1970, c. 465, s. 4(3).

267 *In re* Edward A.P. Williams, *supra* note 265, at 87; *cf. In re* Lafferty, Harwood & Partners Ltd., *supra* note 265 at 126, where the commission said that it would not exercise its review jurisdiction by interfering with an exchange decision denying membership merely on the basis that the commission would have reached a different decision, but only where

> "the Exchange has proceeded on some incorrect principle or has erred in law or has overlooked some material evidence or some new and compelling evidence ... was presented to us that was not presented to the Exchange."

But see In re Baker Weeks of Canada Ltd., *supra* note 265, discussed in ch. V *infra*.

268 *See* ch. III.C.3 *supra*.

for an account where the customer has not delivered cash on a purchase order) or "buy in" (purchase an equivalent number of securities to those sold on behalf of a customer who has not delivered them) the account or convert it to a margin account.[269]

The remaining standards promulgated by the OSC relating to financial responsibility of registrants are those concerning segregation of customers' fully paid securities and free credit balances. Customers' fully paid securities must be segregated physically and held in trust for the customers – that is, they are not available to be considered as part of the registrant's net capital.[270] Similarly, customers' free credit balances must either be covered by a bonding or insurance arrangement approved by the Commission or must be deposited in a "client's trust account". [271] Where there are either funds or securities held by the registrant on a continuing basis, at least once every three months the registrant must send to the customer a statement of account showing the debit or credit balance and the details of the securities held.[272]

The rules as to segregation of customers' securities and funds have been expressly made non-applicable to members of the TSE and the IDA "in light of the adequate compensation funds maintained by both organizations, the standards of self-regulation established and the custom of the business in the United States, the United Kingdom and Canada".[273]

The rules of the TSE and the IDA themselves compel segregation of customers' fully paid securities.[274] The important difference is with respect to free credit balances; they need not be placed in a trust account and may be used in the conduct of the member's business. The rules of the TSE and the IDA provide, however, that any member which does not segregate its clients' free credit balances must send quarterly statements of the balance to clients with a notation that clients' funds are not segregated and may be used in the conduct of the firm's business.[275] In addition to the

269 OSC Conditions of Registration, *supra* note 197, app. 5. *See also* TSE by-laws, s. 16.10, 3 CCH CAN. SEC. L. REP. ¶ 89-630. In Québec, the settlement period has recently been extended to five business days; Amendment No. 9 to Policy Statement No. 21 Respecting the Settlement Date of Transactions, 7 QSC Bull., No. 16 (Decision No. 5025, April 20, 1976).

270 OSC Conditions of Registration, *supra* note 197, app. 5; QSC, Policy Statement No. 21, *supra* note 102, art. 15.

271 *Id.*

272 *Id.*

273 *Id.* For a rather disquieting appraisal of what the custom of the business of New York Stock Exchange members is (or at least was in the 1960s) with respect to customers' securities and cash, *see* H. BARUCH, *supra* note 197.

274 TSE by-laws, s. 16.12, 3 CCH CAN. SEC. L. REP. ¶ 89-632; IDA, THE BLUE BOOK 439 (1977) (by-law 17.3).

275 TSE by-laws, s. 16.08, 3 CCH CAN. SEC. L. REP. ¶ 89-628; IDA, THE BLUE BOOK, 540 (1976) (Reg. 1400.2).

explicit warning concerning free credit balances on periodic statements to clients, both the TSE and the IDA require their members to make available to their customers, upon request, a statement of their financial condition as of the close of their latest financial year.[276] Furthermore, the TSE and the IDA each maintain compensation funds for the benefit of their members' customers, although the associations do not recognize any legally binding obligations upon themselves to compensate the customers of failed members. In the light of this attitude by the associations, it is doubtful that their members ought to be granted the privilege of using customers' funds in the conduct of the members' businesses.[277]

To ensure their compliance with the various rules relating to financial responsibility, all registrants must subject themselves to an audited examination of their financial affairs at least annually. Procedures are quite different as between members and non-members of the self-regulatory organizations. The self-regulatory organizations are responsible for the audits of their members.[278] Each self-regulatory organization selects a panel of experienced auditors and causes each of its members to select one from the panel of auditors to make such examination of the financial affairs of the member as is required under the rules and regulations of the organization, which rules and regulations must be satisfactory to the commission.[279] The panel auditor making the examination reports the results thereof to the exchange auditor or the association auditor, as the case may be.[280] The exchange or association auditor also is appointed by the relevant self-regulatory organization, subject to the approval of the commission.[281] This procedure, whereby the self-regulatory organizations designate the persons to make audits, the rules and regulations under which they are made and the official to receive the audit reports, effectively relieves the commission of all responsibility for enforcement of standards of financial responsiblity with respect to members of the self-regulatory organizations. The commission has a residual power, however, to make an examination itself or to appoint any person to make an examination of the financial affairs of any

276 TSE by-laws, s. 18.05A, 3 CCH CAN. SEC. L. REP. ¶ 89-754A; IDA, THE BLUE BOOK, 542-43 (1976) (Reg. 1600). Under the 1975 amendments to the U.S. Exchange Act, it is mandatory for all brokers and dealers to file annually a certified balance sheet and such other financial information as the commission may prescribe; Exchange Act, s. 17(e)(1)(A).

277 *See, Honsberger.*

278 OSA, ss. 30, 31.

279 OSA, ss. 30, 31.

280 OSA, s. 31(1).

281 OSA, s. 30.

registrant, whether member or non-member of a self-regulatory organization.[282] Thus it can be seen that from the commission's point of view, membership of registrants in a self-regulatory organization is to be prized.

As for non-member registrants, they are obligated to file annually and at such other times as the commission may require a financial statement certified by the registrant or an officer or partner thereof and reported upon by an independent auditor.[283] The registrant must issue standing instructions to its auditor to act at the request of the commission or the director in making an interim audit.[284]

A registrant which maintains its books and records in such manner that they are not capable of being audited will have its registration cancelled,[285] as will a registrant operating in violation of the net capital rules.[286]

C. BEHAVIOURAL STANDARDS FOR BROKER-DEALERS

1. *Shingle Theory*

The broker-dealer, by setting up business, by mounting his "shingle", makes a broad, basic representation to the public at large "that he will deal fairly with his customers and that [their] transactions will be handled promptly in the usual manner, in accordance with trade custom".[287] The application of the shingle theory to a given transaction is not predicated upon the existence of a common law fiduciary obligation on the part of the broker-dealer toward his customer, and in fact it has been applied to transactions where the broker-dealer acts as principal.[288] In substance the shingle theory represents standards of professional conduct.[289] Even though the theory is one of implied representation, it is doubtful that disclosure by a broker-dealer that he was not in fact acting in accordance with professional standards would

282 OSA, s. 33.

283 OSA, s. 32; Ontario Securities Regulations, s. 6(6).

284 *Id.*

285 *In re* Orser, Cory and Co., [1951] OSC Bull. 6 (April).

286 *In re* Ord Wallington & Co. Ltd., [1968] OSC Bull. 109 (April).

287 3 L. Loss at 1482-93; E. Weiss, *supra* note 44, at 71; *see In re* MacRobbins & Co., 41 SEC 116 (1962), *aff'd sub nom.* Berko v. SEC, 316 F.2d 137 (2d Cir. 1963); Hibbard, *Private Suits Against Broker-Dealers: A Proposal to Limit the Availability of Rescissory Relief*, 13 Harv. J. Legis. 1 (1975); Jacobs, *The Impact of Securities Exchange Act Rule 10b-5 on Broker-Dealers*, 57 Cornell L. Rev. 869, 876-81 (1972); Spiro, *supra* note 27, at 447.

288 E. Weiss, *supra* note 44, at 171; *In re* Harold Grill, 41 SEC 321, 325 (1963); *In re* William Harrison Keller, 38 SEC 900, 905 (1959).

289 E. Weiss, *supra* note 44, at 171.

excuse him.[290] The shingle theory has been adopted by the OSC in disciplinary proceedings arising out of the operations of classic "boiler shops", that is, brokerage firms that specialize in the distribution to unsophisticated investors of highly speculative, unseasoned issues via high pressure telephone sales campaigns.[291] In disciplinary proceedings before the SEC it has been used as a handle to condemn diverse types of objectionable conduct engaged in by broker-dealers, including: failure by a dealer to disclose the charging or paying of a price for a security not reasonably related to the prevailing market price for that security;[292] failure to pay for securities sold and delivered by a customer to a broker-dealer and failure to make timely delivery of a security sold to and paid for by a customer;[293] engaging in business while insolvent.[294] Under the shingle theory, the SEC has held that a broker-dealer impliedly represents that he is not engaged in boiler room activities;[295] that he will not misappropriate customers' funds or securities;[296] that he will not churn a customer's account – that is, cause a volume of trading in the account that is excessive in the light of the customer's investment

290 Cohen & Rabin, *supra* note 34, at 703.

291 Typical boiler shop activities are described in *In re* Adelaide Securities Ltd., [1968] OSC Bull. 57 (March); *In re* Goldmack Securities Corp. Ltd., [1966] OSC Bull. 21 (January).

292 In addition, the NASD has specific responsibility to make rules concerning accurate quotations of prices of securities in the over-the-counter market at the wholesale and retail levels; Exchange Act, s. 15A(b)(12). *Compare* OSC Conditions of Registration, 2 CCH CAN. SEC. L. REP. ¶ 54,935 (Over-the-Counter Trading Reports and OTC Manual for Registrants). The NASD also has promulgated policies relating to fair dealer markups, that is, the amount above the market price that a dealer may charge for a security, and markdowns, the amount below market price at which a dealer may purchase from his customer; *see* NASD Rules of Fair Practice, art. III, s. 4, CCH NASD MANUAL ¶2154. The SEC has adopted the NASD rules as applicable to SECO broker-dealers; SEC, Securities Exchange Act of 1934 Release No. 9420, Dec. 20, 1971. *See In re* Managed Investment Programs, 37 SEC 783 (1957). Mark-up policy is concerned with the difference between the market price and what the dealer charges and not the difference between what he pays and what he charges. If, for example, a dealer has held securities in inventory for a time and the market has risen in the interim, he can quite properly sell the securities at the current market; *see* Jacobs, *supra* note 287, at 939-40.

293 *In re* Reynolds & Co., 39 SEC 902, 913 (1960); *In re* W.R. Cromwell, 38 SEC 913, 915 (1959); *In re* C.J. Bliedung, 38 SEC 518, 521 (1958); *In re* L.H. Ankeny, 29 SEC 514, 516 (1949). *See also* Laskin v. Bache & Co., [1972] 1 O.R. 465 (C.A.) (without mentioning shingle theory, court awards damages to customer of broker-dealer firm where firm fails to deliver securities paid for by customer, thereby causing customer to lose advantageous opportunity to dispose of securities).

294 *In re* Thompson & Sloan, Inc., 40 SEC 451, 454 (1961); *In re* E.L. Robbins, 39 SEC 847, 849 (1960); *In re* Batkin & Co., 38 SEC 436, 446 (1958). Such conduct also would violate the applicable net capital rules.

295 *In re* Seabord Securities Corp., 43 SEC 118 (1966); *In re* MacRobbins & Co., *supra* note 287.

296 *In re* Thompson & Sloan, Inc., *supra* note 294; *In re* W.R. Cromwell, *supra* note 293.

objectives and the main purpose of which is to earn commissions for the broker.[297]

Indeed, the shingle theory might well be called the "shingle roof theory", for it capaciously houses just about every ethical shortcoming a broker-dealer could possibly be guilty of – including a number treated herein under different headings. As one commentator has aptly phrased it: the shingle theory is "ubiquitous".[298]

2. *Know-Your-Client*

The know-your-client rule is designed both to protect the broker-dealer from an unscrupulous customer who might leave the broker-dealer prey to financial loss or involve him unwittingly in improper market activity, and to ensure that the broker-dealer does not make investment recommendations to the customer that are not suitable for the customer's financial position and investment objectives.[299] Violations of the rule have frequently given rise to disciplinary proceedings in fact situations involving each of the rule's aspects.[300] The client protection aspect of the rule is considered later in this paper in connection with behavioural standards relating to the advising function.

Facts in the recent *W.D. Latimer Co. Ltd.* proceeding provide a classic illustration of the need for the firm to know its client in order to protect itself.[301] Latimer Co. is a wholesale dealer; it deals with other dealers as opposed to the public and it is one of the largest, if not the largest, market-makers in unlisted securities in Canada. The proceeding was concerned with the propriety of the firm having allowed a direct telephone wire to be installed between itself and the offices of one Gould. Gould and his friends manipulated the market for the stock of Santack Mining Co. by trading it through Latimer Co. to nominee accounts they had opened at a number of brokerage houses in Toronto. The accounts

297 *In re* R.H. Johnston & Co., 36 SEC 467, 476-80 (1955), *aff'd per curiam*, 231 F.2d 523 (D.C. Cir.), *cert. denied*, 352 U.S. 844 (1956); *In re* Norris & Hirshberg, Inc., 21 SEC 865, 890 (1946), *aff'd*, 177 F.2d 228 (D.C. Cir. 1949); *see also*, Hecht v. Harris, Upham & Co., 283 F. Supp. 417 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970).

298 Jacobs, *supra* note 287, at 930.

299 OSC Conditions of Registration, *supra* note 197, app. 5, schedule 1 (New Account Supervision - Know-Your-Client).

300 Prejudice to the firm; *see In re* Ronald M. Copeland, [1968] OSC Bull. 246, 254 (November); *In re* Bouchard & Co. Ltd., [1968] OSC Bull. 263 (November); *In re* Frederick D. Litman, [1968] OSC Bull. 266 (November). Prejudice to the client; *see In re* William R. Williamson, [1971] OSC Bull. 135 (September); *In re* John D. McNairn, [1969] OSC Bull. 24 (February); *In re* Junior Golds Securities Corp. Ltd., [1950] OSC Bull. 1 (February).

301 [1975] OSC Bull. 103 (March).

with the brokerage houses were on a delivery against payment basis, each broker having agreed to purchase Santack for a particular account and to deliver it to a bank against payment. When the Gould group failed to induce the public to purchase Santack stock, it simply walked away from the accounts. No arrangements having been made with the banks to pay for the stock, the banks refused to accept delivery. Meanwhile, the brokers, having placed orders for the stock with Latimer Co. and being obligated to accept it, had to suffer the loss – amounting to several thousand dollars. The loss was attributable in large part to the brokers' failure to verify the credit-worthiness of their clients in the nominee accounts.

3. *Supervision*

The duty of supervision encompasses the notion that a registrant is responsible for ensuring compliance within the firm with the law and all applicable ethical standards.[302] The duty of supervision will encompass such matters, among others, as: review and approval by a partner or officer of the firm of the opening of new accounts; ensuring that full and accurate information has been obtained about the client and that the arrangements, if any, for credit to be extended to the client are within the firm's policies; daily review of all transactions for the accounts of customers and for firm accounts and the accounts of partners, officers and employees of the firm; monthly review of all active accounts; and on-the-job training of salesmen and supervision of the representations they make.[303] Failure to supervise has been the subject of a large number of disciplinary proceedings against broker-dealer firms[304] – in fact, just about any dereliction by a registrant's

302 *See generally* E. Weiss, *supra* note 44, at 34-35; OSC Conditions of Registration, *supra* note 197, app. 5, schedule 2 (The Supervision of Account Activity – A Management Function). Failure reasonably to supervise a person who, while subject to one's supervision, has committed a violation of the federal securities laws is made a specific ground under the Exchange Act for denial, suspension, or revocation of registration as a broker-dealer; Exchange Act, s. 15(b)(5)(E). No person shall be found to have failed in his duty of supervision, however, where at the time of the underlying violation there had been established procedures which would reasonably have been expected to prevent such violations and the person carried out his duties under these procedures without reasonable grounds to believe that they were not being complied with; *id.*

303 OSC Conditions of Registration, *supra* note 197, app. 5, schedules 1, 2. The partner or director designated to supervise account activity shall ensure that the handling of client business is within the bounds of ethical conduct consistent with just and equitable principles of trade and not detrimental to the interests of the securities industry; *id.*

304 *In re* W.D. Latimer Co. Ltd., *supra* note 301; *In re* Diversified Investment Services Ltd., [1969] OSC Bull. 140 (July); *In re* Martell Investment Co. Ltd., [1969] OSC Bull.

employee must raise the question of adequacy of supervision. In the *Davidson & Co.* proceeding,[305] the OSC canvassed the duty of supervision thoroughly. One Williamson, a salesman at Davidson & Co., unwittingly allowed himself to be used in a scheme whereby certain senior salesmen of a mutual fund distribution company persuaded their customers to purchase shares in the fund's management company and in an affiliated life insurance company.[306] The fund salesmen, only one of whom Williamson had ever met, opened through Williamson accounts at Davidson & Co. in the names of the fund shareholders, and the fund salesmen instructed Williamson to purchase shares in the management and insurance companies for the new accounts, often on margin with the fund shares as collateral. Williamson asked next to nothing about the customers in these new accounts. Delighted with the extraordinary amount of commission revenue he was suddenly earning, Williamson was content to "hear no evil, speak no evil, see no evil". In considering the matter of Williamson's supervision by Davidson & Co., the commission absolved the partner in charge of client accounts on the grounds that when he noticed Williamson's uncharacteristically large number of new accounts he asked Williamson whether he was in touch with all his new clients and received an affirmative answer. The partner in charge of salesmen, who had the basic responsibility for approving new account cards, asked Williamson almost nothing about his extraordinary number of new accounts; in particular, although the clients were listed on the cards as "referrals", the partner did not inquire as to who had referred them. The partner in charge of the order room was found to have been lax in not having looked into a certain "office cross" that Williamson asked him to put through.[307] Finally, the managing partner was found to have violated the duty of supervision in having failed to make clear precisely who among the different partners had responsibility for what.[308]

123 (July); *In re* Frederick D. Litman, *supra*, note 300; *In re* Robertson, Malone & Co. Ltd., [1968] OSC Bull. 254 (November); *In re* James Stewart Ltd., [1967] OSC Bull. 30 (June).

305 [1972] OSC Bull. 58 (May).

306 *See In re* William R. Williamson, [1971] OSC Bull. 135 (September); *In re* United Investment Services Ltd., [1972] OSC Bull. 20 (February).

307 The seller of the shares in the management and insurance companies who was chief architect and principal beneficiary of the scheme had deposited them for sale through Davidson & Co.

308 Each of the three partners found to have been guilty of inadequate supervision was suspended from taking any part in the firm's activities for periods ranging from one to three weeks; [1972] OSC Bull. at 11.

4. *Record Keeping*

The rules governing the making, keeping and preserving of specified books and records by a broker-dealer are perhaps the most fundamental type of regulation enabling the regulatory authority to carry out its administrative and enforcement functions.[309] The necessity of properly maintained books and records for the conduct of audits and investigations is obvious. In Ontario, broker-dealers must make and maintain for specified periods records covering *inter alia* the following matters: daily blotters reflecting all purchases, sales, receipts and deliveries of securities and receipts and disbursements of cash and the accounts for which the transactions are effected; ledger accounts reflecting all assets and liabilities and income and expenses; records showing all securities borrowed, loaned, in transfer, failed to receive and failed to deliver; records of all securities long and short in customer and firm accounts; memoranda of instructions for all transactions in securities; detailed records on each margin account maintained.[310]

5. *Antimanipulative Rules*

A variety of rules may conveniently, if rather miscellaneously, be grouped under the heading "prohibitions against market manipulations". Such prohibitions seek to keep the market free and open and to prevent interested parties from manipulating market price to their own advantage. To state that market manipulations are prohibited might appear to belabour the obvious, since it is a necessary condition for the efficient functioning of an auction trading market that prices quotations be determined through the operation of impersonal forces of supply and demand and that they should in no sense be rigged.

As an example of antimanipulative rules, under the Exchange Act in the United States there are a series of rather complicated rules prohibiting persons "interested in a distribution" from dealing for their own accounts in the securities being distributed and from paying others to procure the purchase of such securities on an exchange.[311] These rules have no precise analogue in Canada

309 E. WEISS, *supra* note 44, at 39.

310 Ontario Securities Regulations, s. 6(5); OSC Conditions of Registration, *supra* note 197, app. 5 (Business Records and Procedures). In fact, the incidence of the record-keeping requirement is upon all registrants and not just those registered to trade. But, as can been seen from the list, fulfilling the requirements is most onerous for those who trade.

311 Rules 10b-6 and 10b-2, respectively, under the Exchange Act, 17 C.F.R. ss. 240.10b-6, 240.10b-2 (1977). These rules literally applied would effectively make any distri-

among rules promulgated by the regulatory authorities. A number of administrative proceedings, however, have dealt with situations wherein, in connection with a distribution, a false appearance of a market was created, for example, by publication of non *bona fide* quotations.[312] An interrelated series of disciplinary proceedings against broker-dealers in British Columbia recently has detailed the colourful and blatantly fraudulent activities of a self-confessed stock swindler named Danielson to manipulate the market for various securities on the Vancouver Stock Exchange by paying secret commissions to securities salesmen to "blow off" the stock, that is, peddle it to their customers.[313]

Stock market manipulation is the subject of two provisions of the Criminal Code: section 338(2), which makes it an indictable offence by fraudulent means to affect the public market price of securities, and section 340, prohibiting "wash trading" and matched orders.[314] "Wash trading" is the practice of entering buy and sell orders simultaneously, so that there is an appearance of market activity without any change in beneficial ownership. A matched order is a variant on the same practice; orders for offsetting transactions for a given amount of a given security are entered for different accounts under common control at the same time and the same price.

Not all tampering with free market forces receives the sinister epithet "manipulation". "Stabilization" of the market price of a security is a form of manipulation permitted during a distribution.[315] Stabilization consists in the buying of a security for the limited purpose of preventing or retarding a decline in its price in the open market. The ability to engage in stabilization enables underwriters to protect themselves against the risk of a break in

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bution of securities impossible and there are a variety of exemptions from their coverage. *See generally*, E. WEISS, *supra* note 44, at 112-55; Wolfson, *Rule 10b-6; The Illusory Search for Certainty*, 25 STAN. L. REV. 809 (1972).

312 *In re* W.D. Latimer Co., [1967] OSC Bull. 9 (August); *In re* Goldmack Securities Co., [1966] OSC Bull. 47 (January). In the more recent proceeding involving Latimer Co., *supra* note 301, the OSC prohibited the registrants from having direct telephone lines to underwriters and promoters.

313 *In re* P.H. De Lichtenberg, B.C. Corp. & Fin. Serv. Comm'n Weekly Summary, April 23, 1976, at 3; *In re* Alan Gould, *supra* note 136; *In re* Larry Groberman, B.C. Corp. & Fin. Serv. Comm'n Weekly Summary, January 9, 1976, at 7; *In re* W.R. Nursey, B.C. Corp. & Fin. Serv. Comm'n Weekly Summary, July 9, 1976, at 2; *In re* Alan Savage, B.C. Corp. & Fin. Serv. Comm'n Weekly Summary, April 23, 1976, at 11; *In re* Frank Slichter, *supra* note 219.

314 *See also* Criminal Code, s. 341, prohibiting "Bucketing" (entering an order to purchase or sell stock without intention of paying for it or receiving delivery of it, with intent to make a profit from the rise or fall in price of the stock).

315 *See* Wolfson, *supra* note 311, at 813-14; Klein, *Stabilizing Securities Prices*, 5 SEC. REG. L.J. 13 (1977).

the market which would be a normal result of the selling pressure involved in a distribution. To prevent ostensible stabilization from being used to *raise* the price of the security, the applicable rules provide generally that a stabilizing bid or purchase may not be made at a price exceeding the last preceding independent transaction in the security, and in no event at a price in excess of the offering price.[316] In the United States, rules concerning the prices at which stabilizing bids may be made have not been left to the self-regulatory organizations but have been promulgated by the SEC itself.[317]

6. *Short Selling*

Short selling, the selling of a security that the vendor does not own (in the expectation that it can be purchased later at a lower price in time to make delivery), presents problems that are in a sense opposite to those involved in stabilization. Short selling can be a self-fulfilling prophecy. Those who have sold short have a vested – and urgent – interest in seeing the price of the stock decline, and the pressure on a stock's price from short selling in large amounts can be severe. Considering the practice's potential for wreaking havoc with the market, its regulation is surprisingly sparse. Under OSA section 79 any person or company who places an order through a registrant to sell a security that at the time of placing the order he does not own shall, at the time of placing the order, so declare to the registrant. Exactly what this declaration is supposed to achieve is not clear, but Uniform Act Policy 2-08 "requests" registrants to record and maintain for inspection a list of declared short sales and to report to the commission sales that were not declared as short but which a subsequent failure to deliver by a customer suggests may have been short. In order to control the downward price pressure that may be exerted by short sales, the rules of the TSE stipulate that no short sale may be made below the price of the last sale of a board lot of the security, or even at such price unless that price was above the price of the board lot before it.[318] A member receiving an order for a short sale must so indicate on his order slip and keep a record of all short trades at least for a year.[319]

A registrant may not sell short securities of the same class as

316 TSE by-laws, s. 11.11, 3 CCH CAN. SEC. L. REP. ¶ 89-401.

317 Rule 10b-7 under the Exchange Act, 17 C.F.R. s. 240.10b-7 (1977).

318 TSE by-laws, s. 11.27, 3 CCH CAN. SEC. L. REP. ¶ 89-426.

319 *Id.* In the United States the almost identical rule has been promulgated by the SEC with respect to short sales on a national securities exchange; Rule 10a-1 under the Exchange Act, 17 C.F.R. s. 240.10a-1 (1977).

are held in customers' margin accounts. OSA section 78 prohibits the partners, officers and employees of a registrant which carries margin accounts from selling, for an account in which any one of them has a beneficial interest, securities of the same issuer as are carried in the margin accounts "if the effect of such sale would, otherwise than unintentionally, be to reduce the amount of such securities in the hands of the [registrant] ... below the amount of such securities that he should be carrying for all customers". Such sales obviously would amount to the registrant betting against his customers' positions. A margin customer may void his contract with a registrant who violates section 78 and may recover all monies paid with interest thereon or securities deposited to the margin account.[320] The conduct prohibited by section 78 is in the same words made an offence under section 342 of the Criminal Code.

7. *Prohibited Representations*

OSA section 69 prohibits any person or company, not just registrants, from making three specific types of representations with the intention of effecting a trade in a security. First, except in the case of securities carrying a right of redemption or repurchase by the issuer, no representation that any person will resell, repurchase or refund the purchase price of any security may be made.[321] Second, "undertakings" as to the future value or price of a security are prohibited.[322] Third, except with the written permission of the director, representations that a security will be listed on a stock exchange or that an application to list it has been or will be made are prohibited.[323]

OSA, section 68, contains a general prohibition against any person or company calling at any residence or telephoning to any residence for the purpose of trading in any security with any

320 It is by no means apparent just how the customer is supposed to discover that s. 78 has been violated. Also unclear from the statutory language is whether the option of voiding the contract is available to all margin customers or only to those who have purchased on margin securities of the same description as those the registrant has sold.

321 OSA, s. 69(1). For a case involving violation of this prohibition, *see In re* Rosmar Corp. Ltd., [1975] OSC Bull. 30 (January). This prohibition does not apply where there is a written agreement signed by the person intending to make the trade, and the purchaser is not an individual, and the acquisition cost of the security is in excess of $50,000; OSA, s. 69(1).

322 OSA, s. 69(2). One may guess that this particular prohibition is violated with great frequence in "boiler room" type operations. *See In re* Harold D. Reynolds, [1965] OSC Bull. 1 (July-August).

323 OSA, s. 69(3). *See* Culling v. Sansai Securities, [1974] 3 W.W.R. 686, 45 D.L.R. (3d) 456 (B.C.S.C.).

member of the public.[324] There are exceptions: permitting personal or telephone calls in connection with a trade for which registration is not required; to a close personal friend, business associate or customer with whom the caller has been in the habit of trading in securities; and to a person who has requested in writing that information on a specific security be furnished to him (but the call is permitted only with reference to that security).[325] Presumably the purpose of the prohibition is to put a damper on "boiler room" activities. In Bill 7, Ontario proposes to liberalize the rule greatly: personal and telephone calls to a residence would be permitted subject to a power in the commission, to be exercised only after opportunity for hearing, to "suspend, cancel, restrict or impose terms and conditions upon the right of any person or company" to make such calls for the purpose of trading in securities.[326] The proposal seems to be an improvement as it would allow for control of high-pressure sales techniques at the same time as it would take reputable broker-dealers out of a straitjacket.

A new provision in Bill 7 will enable the OSC under certain circumstances to control all advertising and sales literature used by broker-dealers. Under proposed section 49 the commission may, after giving the registrant an opportunity to be heard, and upon concluding that the registrant's past use of advertising and sales literature makes it in the public interest to do so, order the registrant to deliver to the commission at least seven days in advance all advertising and sales literature (not including prospectuses and preliminary prospectuses) proposed to be used by the registrant.[327] Where the commission has issued such an order the director may prohibit the use of the material or require changes in it.

8. *Confirmations*

A broker-dealer must send its customer a written confirmation of each transaction in securities setting forth the quantity and description of the security; the consideration and the commis-

324 *See In re* Robert Ginetti, B.C. Corp. & Fin. Serv. Comm'n Weekly Summary, July 12, 1975, at 1.

325 OSA, ss. 68(2), (3). The last mentioned exemption has proven to be the most important one as it enables a registrant to send out cards to its entire mailing list in the form: "Are you interested in learning more about the securities of Company X? If so, sign and return this card." Once the card is returned, the registrant may then telephone the customer.

326 Ontario Bill 7, s. 36. Note that this power is reserved to the commission and not the director.

327 In Ontario Bill 75 the requirement concerning the registrant's past conduct was not included, and the TSE, *supra* note 15, at 21-22, criticized the lack of a standard.

sion, if any; whether the registrant acted as principal or as agent; the day and name of the stock exchange, if any, on which the transaction took place; the name of the salesman, if any; and, for stock exchange transactions, the name of the person or company on the other side of the transaction.[328] Also, where a broker-dealer sends written material for the purpose of effecting a transaction in securities wherein he intends to act as principal, OSA section 70(1) requires him in the written transmission to state such intention to act in that role. Where he makes an oral communication with intention to effect a trade in securities in which he intends to act as principal, he must under section 70(2) disclose in a written confirmation that he has acted as principal.[329] Violation of section 70 gives the customer a right of rescission.[330]

9. *Fiduciary Obligations*

To a lawyer, perhaps the most significant fact revealed by the confirmation slip in a securities transaction is the capacity in which the registrant has acted: principal or agent. Clearly a broker in a securities transaction, as an agent, has fiduciary obligations – as distinct from mere contractual obligations – that may be enforced by his client.[331] The extent, however, of the fiduciary obligations chargeable to the broker in a given transaction will vary according to the facts of that transaction. "To say that a man is a fiduciary only begins analysis."[332] Furthermore, as enforced by regulatory agencies many of the duties of licensed securities traders (*e.g.* shingle theory, know-your-client, net capital rules) operate irrespective of the capacity in which the licensee has operated.

And even in private damage actions, courts have held registrants to a standard of fiduciary-type obligations where the registrant, although having plainly disclosed to the customer that it was acting as a principal in the transaction, induced the customer to rely on the registrant's advice. For example, in *Burke v. Cory*,[333] the defendant broker-dealer made certain representations to the plaintiff, a doctor by profession, concerning the advisability of investing in certain mining shares. The plaintiff bought the shares, and the representations turned out to be false and the

328 OSA, s. 67. The names of the salesman and of the person on the other side of a stock exchange transaction would be of little practical use to the customer since these items may be expressed in codes which need be revealed to the commission only.

329 Section 70(2) is redundant in the light of OSA, s. 67.

330 OSA, s. 71.

331 Laskin v. Bache & Co., [1972] 1 O.R. 465 (C.A.).

332 SEC v. Chenery Corp., 318 U.S. 80, 85-86 (1943) (*per* Frankfurter, J.).

333 19 D.L.R. (2d) 253 (Ont. C.A. 1959).

shares worthless.[334] The court found that the defendant had made it clear to plaintiff that the defendant was acting as agent for the vendor, but that, notwithstanding, the defendant had assumed fiduciary obligations toward the plaintiff because the defendant

> "went to great pains to convince the defendant [sic] of his pre-eminent qualifications as an 'investment counsellor' and of his possession of vital private information in relation to the stocks which he was advising him to buy.... In fact, he went to greatest lengths to gain the plaintiff's confidence...."[335]

Speaking of the functional approach to regulating the activities of broker-dealers in the United States, a commentator there has made the following observation which, while it may not yet accurately describe the Canadian situation, represents a goal to be hoped for:

> "[A] system of regulation has been developed, through adoption of regulations and by judicial and administrative decisions, which recognizes the facts of life in the securities business: (1) that the form of a particular transaction, whether agency or principal, is in large measure accidental and under the control of the broker-dealer; and (2) that, to the extent the public requires protection against the possibility that the broker-dealer, for reasons of financial self-interest, may induce transactions improperly, such protection is required regardless of the form of the transaction. In the aggregate this system imposes a duty on the broker-dealer to act fairly in all transactions with customers regardless of the form of the transaction."[336]

While at first it may appear odd to allow the combination within a single firm of the functions of agent and principal, so long as the regulatory structure imposes a code of ethics regardless of the form of a particular transaction the conflicts of interest that result from the mixing of functions will be potentialities only. Since 1936, when the SEC decided against recommending to Congress the enforced separation of brokerage and dealership functions,[337]

334 The court found, *id.* at 256-57, that the representations made by the defendant would have supported an action for deceit, but fraud was not pleaded.

335 19 D.L.R. (2d) at 260. *See* Chasins v. Smith, Barney & Co., 438 F.2d 1167 (2d Cir. 1970) (dealer that failed to disclose its status as a market-maker in an issue it advised its customer to purchase held liable, even though confirmations revealed dealer's status as principal). *See also* Levin & Evan, *supra* note 23, at 347; Cohen & Rabin, *supra* note 34, at 703; E. WEISS, *supra* note 44, at 104.

336 Panel Discussion, *Conflicts of Interest and the Regulation of Securities*, 28 BUS. LAW. 545, 569 (1972) (Remarks of Thomas O'Boyle).

337 SEC, REPORT ON THE FEASIBILITY AND ADVISABILITY OF THE COMPLETE SEGREGATION OF THE FUNCTIONS OF DEALER AND BROKER (1936).

such a separation has not seriously been pressed.[338] In fact, the most important Canadian agency market, the Toronto Stock Exchange, probably has taken a pronounced step toward "dealerization" with the reduction in the liability trading limit from $400,000 to $100,000.[339] The small investor may think that whenever he places an order for securities that order is matched against some other small investor's opposite order. The truth often is far from that, but the lack of congruence between popular image and reality may not be important so long as the dealing is in fact fair. The dealing is decidedly not fair in those situations, encountered frequently in the reports of disciplinary proceedings, where the registrant tells his customer that "the market" price of the securities is X, whereas in fact the only "market" is what the dealer chooses to make. In such a situation the dealer is capitalizing on the public misconception of how securities markets work.

D. STANDARDS APPLICABLE TO THE ACTIVITY OF UNDERWRITING

The major responsibility of the underwriter from the regulatory point of view is signing the certificate in the prospectus stating that to the best of the underwriter's knowledge, information and belief the prospectus constitutes "full, true and plain disclosure of all material facts relating to the securities offered".[340] To the extent the underwriter is exposed either to administrative sanctions or damage actions for the truth of its representation in the prospectus, it has a strong interest in keeping the issuer "clean".[341]

In the only significant proceedings to date involving the responsibilities of an underwriter in connection with signing the section 53 certificate in a prospectus, an administrative proceed-

338 Segregation of dealer from broker functions on the TSE was recommended in the WINDFALL REPORT at 109. The recommendation, however, was premised explicitly on a perceived lack of adequate power in the OSC to regulate the conduct of business of the TSE. Since amendments to the Ontario Securities Act made after the date of the WINDFALL REPORT considerably strengthened the OSC's powers over the exchange, that recommendation would appear to have lost much of its force.

339 *See In re* By-Law 153 of the Toronto Stock Exchange, [1977] OSC Bull. 171 (July). In liability trading, an exchange member will actually purchase as principal part or all of a block of listed securities, usually from an institutional investor. The broker will later resell the securities when and as the market can absorb them without price depressing effects. The willingness of brokers to engage in liability trading in a thin market adds greatly to the liquidity of large holdings.

340 OSA, s. 53.

341 Ontario Bill 7, s. 126 fixes any underwriter who is required to sign the prospectus with liability to purchasers for rescission or damages where the prospectus contains a misrepresentation.

ing before the OSC,[342] the commission found that the president of an underwriting firm had, on the firm's behalf, caused the certificate to be signed under circumstances where a statement in the prospectus, to the effect that the underwriters had agreed not to sell to or for the account of residents of the United States, was not true.[343] The president was found not to have shown "the degree of care and diligence that is required in such a situation by the responsible trading officer of an underwriting firm". The sanction imposed against the president was a one week suspension from association with the firm. There was no sanction against the firm.[344] The chief significance of the case for present purposes is that it provided an opportunity for the commission to outline the standard of conduct it expects of an underwriter. The commission said:

> "The phrases 'to the best of our knowledge and belief' and 'full, true and plain disclosure', required by section 53 of The Securities Act, are not just pious passages that appear as a matter of form at the end of every prospectus. Each word in both phrases has a specific meaning behind which must lie a course of conduct by an underwriter before he can affirm them. The underwriter stands between the issuer and the public as an independent, expert party in bringing new securities to the market. In a sense the underwriter and the issuer are joint-venturers, but in another and more important sense they must be adversaries. That is, the underwriter must seek out and question all relevant and material facts concerning the issuer and reasonably ensure himself that these facts are fully

342 *In re* A.E. Ames & Co. Limited, [1972] OSC Bull. 98 (June).

343 A.E. Ames was the managing underwriter for an offering of common stock of Kaiser Resources Ltd., which was controlled by an American parent, Kaiser Steel Co. Because the parent and one of the lead underwriters were American and because the securities would not be qualified for sale under the U.S. Securities Act, the issuer prevailed upon Ames to insert in the prospectus the clause concerning no sale to Americans. However, American directors of the parent wished to purchase part of the offering and exclusively for this purpose the issuer's Canadian counsel caused to be incorporated a Canadian investment corporation. The investment corporation purchased a portion of the shares offered by the prospectus and the American directors purchased a corresponding number of shares in the investment company (all of its outstanding shares). The commission found that the corporate entity of the Canadian investment company was ignored by its shareholders and that they had used it as a mere agent to purchase Kaiser Resources shares for themselves. Curiously, the commission's opinion does not discuss whether the undisclosed arrangement was material to the affairs of the issuer.

344 A reprimand was issued against the firm's vice-president in charge of sales who was in charge of the distribution and sale of the issue in question; the commission found that he ordered the firm's salesmen to distribute the issue notwithstanding his knowledge of the inaccuracy in the prospectus.

and truly set before the investing public. The underwriter cannot and must not merely rely on the statements and opinions of the issuer's directors, officers and counsel. He must make such independent investigation as will entitle him to say 'to the best of my knowledge information and belief...'. Certainly the underwriter will have to, and is entitled to, rely on the issuer and its officers at many points in the investigation, but such reliance cannot be an easy, automatic thing resulting in blithe acceptance at all points. Some matters and some circumstances will call for question, challenge and thorough investigation. It is not possible in one opinion to detail all such matters and circumstances. Each case will depend on its particular facts."[345]

The concept that the underwriter in a sense polices, or at least stands behind, the integrity of the issue may provide the conceptual basis to explain why underwriting should be a licensed activity separate from the necessarily concomitant activity of trading.

There are a few other provisions of the act (in addition, of course, to the substantive regulations as to contents of a prospectus) that are of particular concern to underwriters and to members of the banking and selling groups that underwriters put together for a particular distribution. In the first place is the relief provided by OSA, section 36, from the prohibition in section 35 against trading in a security until the preliminary and final prospectuses have been filed with the director and receipts issued therefor. Section 36 provides generally that in the interval between issuance by the director of receipts for the preliminary prospectus and for the prospectus it shall be permissible to advertise the forthcoming offering and to seek expressions of interest, so long as prospective purchasers are provided with a copy of the preliminary prospectus.

Under section 54 OSA, any person engaged in distribution of a security to which the prospectus requirements are applicable must notify the director of his intention to engage in the distribution and must notify the director when he has ceased to engage in the distribution.

A person who receives a purchase order for a security in the course of a primary distribution must, unless he is acting as agent for the purchaser, deliver a prospectus to the purchaser or to his

345 [1972] OSC Bull. at 112-13. The quoted language is remarkably similar to that in the celebrated American case of Escott v. BarChris Construction Corp., 283 F. Supp. 643, 696-97 (S.D.N.Y. 1968).

agent either before making an agreement or not later than midnight of the second day after entering into an agreement of purchase and sale.[346] The purchaser has a right to withdraw from the transaction until midnight of the second day after he or his agent receives the prospectus.[347] For these purposes a person who receives any compensation from the vendor may not be considered an agent of the purchaser.[348]

The question of the mode of distribution by an underwriter arose recently in an administrative proceeding in British Columbia, in the matter of *Fisher Securities Corp.*[349] The registrant was the underwriter of shares of a mining exploration company distributed through the facilities of the Vancouver Stock Exchange. In the statement of material facts it was stated that "the shares underwritten will be sold to the public through the facilities of the Vancouver Stock Exchange". In fact, by prearrangement, the shares were sold *in toto* to sixteen purchasers who were all either insiders of the issuer or persons under the control of insiders. Thus, there was no distribution "to the public" and in fact it is doubtful that what was involved was an underwriting at all since the underwriter, Fisher Securities Corp., was at no time at risk with respect to any of the securities.[350] On the question of public distribution the B.C. Commission said:

> "[W]hen a company purports to raise funds by means of what is described as a distribution of its shares to the public..., and the funds are in fact put up by a small group of insiders and their associates, a misleading impression is capable of being conveyed to the outside investing public at large that some part of that outside investing public has had confidence in the value of those securities, when in fact that is not true."[351]

346 OSA, ss. 64(1), (5).

347 OSA, ss. 64(2), (5).

348 OSA, s. 64(7). In mining issues the custom is for the underwriter to "paper the street" with prospectuses or statements of material fact (*see* OSA, s. 58(2)(b)), that is, distribute them to all the brokers, several days in advance of the sale date. Section 64(5) provides that a purchaser shall be deemed to have received a prospectus or a statement of material facts on the date when it was received by any person who thereafter begins to act as the purchaser's agent in the transaction. The net effect, and indeed the purpose, of the practice is that the purchaser's right of withdrawal has lapsed before he even makes a purchase order. Without such arrangements in mining offerings - which are usually highly speculative - a purchaser would simply wait to see what the stock's price was at the end of the second day and decide accordingly whether to exercise his automatic right of withdrawal.

349 B.C. Corp. & Fin. Serv. Comm'n Weekly Summary, September 3, 1976, at 1.

350 The Commission made no finding on the issue of whether or not there was an underwriting.

351 *In re* Fisher Securities, *supra* note 349, at 8.

In short, a distribution that purports to be made to the public but that in fact is made to insiders of the issuer or to persons under the control of the issuer or the underwriter may be the opening step in a price manipulation.

In the *Fisher* opinion, the Corporate and Financial Services Commission castigated the Vancouver Stock Exchange for total failure to enforce its own rules which require that at least 20% of a new issue distributed through the exchange must be made available by the underwriter to other brokers for the latters' customers.

E. STANDARDS APPLICABLE TO THE ACTIVITY OF ADVISING

1. *Competence*

A cardinal rule of advising is that the adviser must have an adequate factual basis upon which to make statements as to the investment merits of particular securities.[352] This means, in particular, that he may not publish advice on the basis of unsubstantiated tips and that he must verify such facts as are subject to verification.[353] Both registered advisers and registered dealers have been the subjects of disciplinary proceedings for failure to have proper factual foundations for their recommendations.[354] The rule is an element of competence – an end sought to be served more generally by the educational and experience requirements for adviser registration discussed earlier.[355] Since registered dealers generally do not have to be separately registered as advisers in order to dispense investment advice to their clients, they are not subject to educational prerequisites in their advising capacity. It would appear, however, that a registered dealer who gives advice tailored to the needs of its individual clients and who managed clients' portfolios in accord with such advice, that is, who fits within the definition of investment counsel in Ontario and investment adviser in Québec, is not rendering advice solely incidental

352 The investment counsel shall have a reasonable and objective basis for investment recommendations or opinions, which shall be supported by appropriate research; QSC, Revised Policy Statement No. 19, *supra* note 160, art. 17(1) (Concerning Conditions of Registration of Investment Counsel). *See In re* Mitchell of Canada, [1956] OSC Bull. 5 (October), *aff'd sub nom.* Re The Securities Commission and Mitchell, [1957] O.W.N. 595 (C.A.) (single judge).

353 *In re* James Stewart Ltd., [1967] OSC Bull. 30 (June); *In re* Southern Brokerage and Holding Co. Ltd., [1967] OSC Bull. 3 (February); *In re* L. & M. Securities Ltd., [1965] OSC Bull. 6 (October); *In re* Mitchell of Canada, *supra* note 352.

354 Advisers: *see In re* Southern Brokerage and Holding Co. Ltd., *supra* note 353; *In re* Mitchell of Canada, *supra* note 352. Dealers: *see In re* James Stewart Ltd., *supra* note 353; *In re* L. & M. Securities Ltd., *supra* note 353.

355 *See* ch. III.C.1 *supra.*

to its business as dealer, and thus must be registered separately in the appropriate adviser category and meet the educational and other prerequisites thereof.

Ontario and Québec are well ahead of the United States in terms of imposing qualifications upon advisers. There are no educational or other competence related qualifications for registration under the United States Advisers Act, nor are advisers under that act required to file financial statements or periodic reports with the SEC.[356] To say that there are no qualifications in the United States is not, of course, to say that there are no standards of performance. For example, a registered broker-dealer or a registered adviser who makes specific recommendations not factually supported may be found to have violated the anti-fraud prohibitions of the respective acts.[357]

2. *Suitability*

Reference to the suitability rule is a shorthand method of expressing the principle, well recognized in securities regulation, that a broker-dealer or other registrant that gives individualized securities advice may not recommend to a customer any security which he knows, or should know, on the basis of information he has concerning the customer's net worth, obligations and investment objectives, would be unsuitable for the customer.[358] The rule has its origins in U.S. federal securities regulation, principally in disciplinary proceedings arising out of "boiler room" operations; it is now a fixture of Canadian securities regulations as well.[359]

356 In 1975 and 1976 bills to amend the Investment Advisers Act were introduced in both Houses of Congress. These bills would have given the SEC broad authority to set standards for advisers; *see generally* Lybecker, *Advisers Act Amendments*, 9 Rev. Sec. Reg. 919 (1976). The bills died in Congress and the commission's ardour for new legislation has apparently cooled; *see* 1385 BNA Sec. Reg. & L. Rep., January 12, 1977, at A-4.

357 For registered broker-dealers: Exchange Act, ss. 10b, 15(c)(1) and rules 10b-5, 15cl-2; *see* Hanly v. Securities and Exchange Commission, 415 F.2d 589 (2d Cir. 1969); Dlugush v. Securities and Exchange Commission, 373 F.2d 107 (2d Cir. 1967). For registered advisers: Advisers Act, s. 206(1); *see In re* Shortline Reports Inc., SEC, Securities Exchange Act of 1934 Release No. 9084, February 21, 1971, [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,962; *In re* Capital Gains Institute, Inc., 42 SEC 373 (1964); *In re* Bridwell & Co. Inc., SEC, Investment Advisers Act of 1940 Release No. 180, December 18, 1964, [1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,183.

358 *See generally* 6 L. Loss at 3708-23; Mundheim, *supra* note 24; Bines, *Setting Investment Objectives: The Suitability Doctrine* (pts. 1-2), 4 Sec. Reg. L.J. 276, 418 (1976).

359 *See* OSC Conditions of Registration, *supra* note 197, app. 5, schedule 1 (New Account Approval - Know-Your-Client); *id.* schedule 2 (The Supervision of Account Activity). A suitability rule appears to be imported into the definition of an investment counsel as a person or company that gives advice "on the basis of the individual needs of each client"; Ontario Securities Regulations, s. 2(2). Oblique statutory

The suitability rule could not successfully be avoided by a broker-dealer by the expedient of asking nothing about the client's situation because the know-your-client rule explicitly directs the broker-dealer to obtain information on the client's net worth and earnings, investment knowledge and investment objectives.[360] It is unclear what, if any, obligations the broker-dealer has in formulating suitable investment objectives for clients, as opposed to making recommendations consistent with those objectives. May the broker-dealer simply accept without question the investment objectives as stated by the client? Suppose, for example, that a low income wage earner or retired person tells the broker-dealer that he or she wishes to devote his or her entire savings to speculation? For an investment counsel or a portfolio manager, a registrant that holds itself out as being in the business of rendering advice or management based on clients' *individual needs*, it would appear reasonable to impose some affirmative obligations in setting prudent investment objectives for clients (although perhaps not for clients that are trusteed funds; in such cases the trustees may be relied upon to set investment objectives) as well as in selecting investments that will correspond to those objectives.[361] As one commentator has stated:

> "[T]he law places some limits on an investment manager's power to let his clients be foolhardy. Thus, the question is, given the degree of control the client contractually retains, how great a burden should the law impose on the manager to assure that the investment objectives agreed upon are in fact appropriate for the client."[362]

Returning to the broker-dealer context in particular, some clients may ask for execution only and may express no interest in

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recognition of a suitability rule would be provided in the provision of Ontario Bill 7 creating a new private placement exemption from the prospectus requirement: a placement without a prospectus may be made to up to 25 purchasers who are able to evaluate the investment "by virtue of net worth and investment experience or by virtue of consultation with or advice from a registered adviser"; Ontario Bill 7, s. 71(1)(p).

360 OSC Conditions of Registration, *supra* note 197.

361 *See generally* Bines, *supra* note 358, pt. 1. Bines suggests that the suitability rule as developed for broker-dealers ought not automatically be applied to investment managers. He argues that the suitability rule developed out of a recognition of the fact that whenever a broker-dealer makes an investment recommendation he automatically is placed in a situation of a potential conflict of interest because his compensation is dependent upon the client acting upon the recommendation. This is not necessarily true for investment managers. Investment managers that are not themselves broker-dealers "sell performance, not securities, and they earn the same fee, usually a percentage of the assets under management...whatever securities they put into the portfolios they control"; *id.* at 286.

362 *Id.* at 277.

investment advice. This situation would likely become much more common under a regime of negotiated commission rates where each separate service of the firm was charged for separately. Does that client preference relieve the broker-dealer of all suitability-type obligations if the client places an unsolicited order for a security which the broker-dealer does not believe to be suitable for that client? The OSC's know-your-client rule fudges this question by stating: "It is appreciated that some accounts require less direction than others as the client may require only prompt execution of his order rather than an investment recommendation."[363] But is the client to be the sole arbiter of what the client requires? Probably the safest solution is to say that the broker-dealer, in opening a new account, must always obtain a basic minimum of information concerning his client and the client's investment objectives, and then if the client wishes to invest in a security that the registrant feels is not suitable for him, the registrant should so advise the client but may then execute the transaction if the client persists.[364]

The problem of the unsolicited transaction in an unsuitable security arose in the case of *R.H. Deacon & Co. Ltd. v. Varga*,[365] an action by a broker against its customer for money owed. The customer called the broker, with whom he had been in the habit of dealing, and placed an order for a large number of shares of Revenue Properties Companies Ltd. The broker advised the customer that the securities in question were very speculative and suggested alternative investments, but the customer indicated that he was interested only in Revenue Properties. The broker thereupon filled the customer's order. Immediately thereafter the price of the securities dropped precipitously, and the customer refused to pay for them. In the broker's action, the customer's defence was that the broker had failed to communicate to the customer a fact known to the broker but not to the customer: that Revenue Properties was in "a highly unstable and unsatisfactory financial position".[366] The jury found that indeed the broker had had such knowledge and had failed to communicate it but it also found that the customer had not relied on the broker "to discover and make disclosure of facts necessary to enable him to give

363 OSC Conditions of Registration, *supra* note 197.

364 *Compare* Mundheim, *supra* note 24, at 449 *with* New York Stock Exchange, Department of Member Firms, Supervision and Management of Registered Representatives and Customer Accounts (1962), *quoted in* Levin & Evan, *supra* note 23, at 351 n. 52.

365 30 D.L.R. (3d) 653 (Ont. C.A. 1972), *aff'd*, 41 D.L.R. (3d) 767 (S.C.C. 1973).

366 30 D.L.R. (3d) at 657.

informed instructions".[367] Judgment was entered for the plaintiff broker. The Court of Appeal affirmed, reasoning that where the principal was not relying on the agent for advice the agent's fiduciary duties did not encompass revealing to his principal negative facts known to the agent but not to the principal concerning the advisability of the transaction proposed by the principal. The holding, it is respectfully submitted, is incorrect, and it is not supported by the sole authority cited by the Court of Appeal, the case of *Commerce Realty Ltd. v. Olenyk*.[368] For while the *Olenyk* case does indeed stand for the proposition that "if the principal authorizes his agent to act imprudently or if he acts upon his own decision without relying on his agent's advice, then he cannot complain about any resulting loss", neither *Olenyk* nor the leading English case, *Overend & Gurney Co. v. Gibb*,[369] involved an agent who failed to disclose to his principal facts known solely to the agent. The better rule would appear to be that any contract of agency must, at the least, contain an implied term that the agent will disclose to the principal all facts known to the agent that are material to the prudence of the transaction. The question that should have been asked in *R.H. Deacon* was not "did the customer rely on the broker *to discover and* make disclosure of facts necessary to enable him to give informed instructions",[370] but rather "did the customer reasonably expect the broker to reveal all facts material to the transaction *known to the broker when the customer proposed the transaction*"? The answer to the latter question, it is submitted, would be affirmative. Certainly for the broker to have stated that the proposed transaction was "very speculative" was not the same as stating "the issuer is in a highly unstable and unsatisfactory financial position".

Had the facts in the *R.H. Deacon* case been presented in the context of a disciplinary proceeding one would expect a Canadian securities commission to take the view that, under the suitability doctrine,[371] a registrant is always under an obligation to disclose

367 *Id.* at 655.

368 8 D.L.R. (2d) 60 (B.C.S.C. 1957).

369 L.R. 5 H.L. 480 (1872).

370 30 D.L.R. (3d) at 655 (emphasis added).

371 Professor Johnston says of the R.H. Deacon case: "[It] is an unfortunate blow to the extension of the know-your-client principle to the area of civil consequences and imposes a greater regulatory load on the conditions of registration"; D. JOHNSTON at 111 n. 117. *But see* Weinrib, *The Fiduciary Obligation*, 25 U. TORONTO L.J. 1, 4 (1975), wherein the author expresses the view that the R.H. Deacon case was rightly decided because, since the client gave very precise instructions to the stockbroker, the stockbroker had no discretion and therefore no fiduciary obligation.

to a customer all facts known to the registrant material to the transaction.[372]

3. *Allocation of Investment Opportunities*

Fair allocation of limited investment opportunities among many different clients can be a serious problem for securities advisers. Investment counsel registrants in Ontario and investment advisers in Québec (the types of adviser registrants in the respective province who may have managerial authority over clients' accounts) must maintain standards for ensuring fairness in allocating investment opportunities among their various clients and must file with the commission and furnish to each client a copy of the policies.[373]

The SEC in a disciplinary proceeding has taken the position that a broker-dealer firm that changes its views on the merits of a security as to which it has an outstanding buy recommendation may not communicate the change selectively only to some of its customers.[374]

F. CONFLICTS OF INTEREST IN THE SECURITIES INDUSTRY OCCUPATIONS

Because licensed securities firms and the individuals in them perform for a multiplicity of clients a multiplicity of functions – brokerage, principal dealing, underwriting and private placements, advising and investment management – the securities market participants will often find themselves in positions of conflict of interest. The term "conflict of interest" has been defined by a prominent American securities lawyer as a situation

> "involving an actual or potential preferment of one's own interest to that of another person where the former owes some type of duty to the latter. It is not essential...that a

372 A caveat must here be added: the agent has a duty of disclosure to his principal provided he is under no conflicting obligation to preserve confidentiality. *See* discussion in ch. IV.F.1 *infra*. Although the court in R.H. Deacon did not reach the issue, there could have been a conflicting duty of confidentiality in that case because a director of the brokerage firm was also a director of the issuer. If the broker's negative information concerning the issuer was confidential inside information, then he was under a duty not to disclose it; *see* National Policy No. 18, April 1971, 2 CCH CAN. SEC. L. REP. ¶ 54-855 (Registrants Acting as Corporate Directors).

373 Ontario Securities Regulations, ss. 6(20)a, 6(20b)2; QSC, Revised Policy Statement No. 19, *supra* note 160, art. 17(1).

374 *In re* Butcher & Sherrerd, SEC, Securities Exchange Act of 1934 Release No. 9894, December 11, 1972, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,135. *But see* PLI THIRD ANNUAL INSTITUTE ON SECURITIES REGULATION 293, 308 n. 25 (R. Mundheim, A. Fleischer eds. 1972).

> fiduciary relationship exist before a conflict of interest is presented. Conflicts can stem from the existence of duties which fall short of fiduciary responsibilities, but exist nevertheless as a matter of law, custom or business practice."[375]

For purposes of the discussion that follows, I would emphasize that the term "conflict of interest" describes a situation giving rise to an actual *or potential* breach of obligation. The term describes a temptation, not necessarily a yielding. A conflict situation may arise either because the party owing the duty has inconsistent interests of his own to protect – as in the conflict that arises from the commission method of compensating broker-dealers – or because the party owing the duty owes an inconsistent duty to a third party. This latter is the classic conundrum encountered by anyone who attempts to serve two masters. An example is the stockbroker who is an officer of a securities issuer.

In the discussion that follows the many conflict situations that may confront securities firms have been divided into three groups: the problem of registrants' use of inside information; the temptation to churn customers' accounts, so as to maximize profits for the registrant rather than the customer; and the problem of investment advice or investment management that is not disinterested because of the registrant's own positions in securities.

1. *Registrants with Inside Information*

As has been argued earlier in this paper,[376] a broker-dealer is generally under an obligation to disclose to its customer all material facts known to it concerning securities which it is contemplated that the customer will sell or buy. While the parameters of this obligation may be unclear with respect to transactions proposed *by* the customer where the customer is not relying on the broker-dealer for advice, the obligation is clearly spelled out under the shingle theory and the suitability and reasonable basis rules with respect to transactions proposed to the customer by the broker. In fact, where a broker-dealer makes a recommendation on a security, its obligation to disclose relevant facts concerning the issuer is not merely passive – to disclose what it happens to know – but positive – to make an investigation of the issuer.

A contrary obligation of nondisclosure is imposed, however, upon a broker-dealer that learns of material, confidential, undisclosed information (hereafter "inside information") concerning

375 Panel Discussion, *supra* note 336, at 545 (statement by K.I. Bialkin).
376 *See* text accompanying notes 365-72 *supra*.

the issuer either because the broker-dealer is an officer or director of the issuer, or because it has entered into an investment banking relationship with the issuer. A broker-dealer that learns inside information not because of a confidential relationship with the issuer but as a mere "tippee" probably is also under an obligation of nondisclosure.[377] It is to the confidential relationship problems that this discussion is directed.

The broker-director conflict is addressed by National Policy

377 The statement in the text appears to be the law in the United States pursuant to Rule 10b-5 under the Exchange Act; it appears to be a correct statement of the position under the Canada Business Corporations Act but not under the present Ontario Securities Act, which imposes no liability for tipping. The situation under Ontario Bill 7 is doubtful.

In SEC v. Lum's Inc., 365 F. Supp. 1046 (S.D.N.Y. 1973), the court considered the Rule 10b-5 liability of a brokerage firm whose salesman received adverse inside information from the president of an issuer and passed it on to certain mutual fund managers who sold out the fund's shares in the issuer on the basis of the tip. Neither the brokerage firm nor its salesman earned any revenues from the trades. The court found that the brokerage *firm* had not violated the rule because it had not failed in its duty to supervise the salesman, but the court stated repeatedly and without discussion that the salesman (not a defendant) had violated the rule.

Under s. 125 of the Canada Business Corporations Act, a person who receives specific confidential information about a corporation from a person whom the former person knows to be an insider or a tippee would be civilly liable to the corporation and to a person trading its shares where he "makes use of" the information "for his own benefit or advantage ... in connection with a transaction in a security of the corporation". Where a broker tips, it seems reasonable to hold that he is using the information for "his own benefit or advantage", at least where he expects to earn a commission or perhaps even just the tippee's good will (which may result in income for the broker later). *See generally, Anisman* at 222-25.

Section 75(1)(b) of Ontario Bill 7 provides that no person or company shall inform another person or company about an undisclosed material fact or material change in the affairs of an issuer "other than in the necessary course of business". Violation of s. 75(1)(b) is made a quasi-criminal offence by s. 118. Section 132 imposes liability in damages upon a tipper where a trade results from the tip:

> "Every person or company who sells or purchases the securities of a reporting issuer with [inside information] and every person who, directly or indirectly, knowingly informs the vendor or purchaser of the [inside information] other than in the necessary course of business is liable to compensate the purchaser or vendor for damages as a result of the trade...."

Practically speaking in a given situation the difficult point is likely to be what is "in the necessary course of business"? Since a broker-dealer is in the business of advising its clients on securities transactions, could it succeed in an argument that tipping is always in the necessary course of its business?

Ontario Bill 30, Bill 7's most recent predecessor was much clearer in this regard - if draconian. Section 77(3) of Bill 30 provided that "no person shall advise another person or company to buy, sell, hold or exchange securities of the reporting issuer with knowledge of a material change in the affairs of the reporting issuer that he knew or ought reasonably to have known had not been generally disclosed". This provision, had it been enacted, would have subjected registrants to severe difficulties. In effect, it would have prohibited not just tipping but any recommendation concerning securities of an issuer concerning which the communicator possessed

No. 18, which in turn adopts a policy of the TSE unequivocally declaring the "first responsibility" of a partner, officer or employee of a member organization that is also a director of an issuing corporation, and in that capacity privy to inside information concerning the issuer, to be to the issuing corporation.[378] An agent's duty to make full disclosure to his principal is not operative where the agent is under a superior duty of silence.[379] As between conflicting common law fiduciary duties, identifying which one is superior could be a difficult problem indeed. Where, however, one of the two duties is reflected in legislation, for example, statutory prohibitions against insider trading that effectively underscore the director's obligation to preserve corporate confidences, the legislation would appear to identify the superior duty and to amend *pro tanto* the duty that would otherwise conflict.

In the famous *Cady, Roberts* disciplinary proceeding, one Cowdin, a registered representative with a broker-dealer firm, was a director of a public corporation, Curtiss-Wright. Cowdin learned material, undisclosed, adverse information concerning the issuer. He communicated this information to Gintel, a partner in the broker-dealer firm. Gintel promptly sold the issuer's securities for accounts over which he had discretionary authority. In a proceeding against the firm and Gintel,[380] the commission first implied that Gintel, as tippee, was under a fiduciary obligation to the issuer similar to those of its director, Cowdin. Then, in language which supports the TSE position that the "higher" fiduciary duty is to the corporation, the SEC rejected as a defense the fiduciary duty owed by Gintel to the firm's customers.

> "[W]hile Gintel undoubtedly occupied a fiduciary relationship to his customers, this relationship could not justify any actions by him contrary to law. Even if we assume the existence of conflicting fiduciary obligations, there

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inside information, regardless of whether or not the inside information was an element in the formulation of the recommendation.

378 TSE, MEMBERS' MANUAL, policy 5.01 (December 5, 1968), 3 CCH CAN. SEC. L. REP. ¶92-036.

379 RESTATEMENT (SECOND) OF AGENCY, s. 381, comment E (1958).

380 *In re* Cady, Roberts & Co., 40 SEC 907 (1961); *see also In re* Shearson, Hamill & Co. Inc., SEC, Securities Exchange Act of 1934 Release No. 7743, November 12, 1965, [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,306. In Shearson, Dunbar, a partner of the firm, was also a director of the issuer. He learned certain adverse inside information which was contrary to highly favourable evaluations of the issuer being disseminated by the brokerage firm's salesmen. Dunbar thereupon sold his own securities in the issuer and advised certain of his customers to do likewise. All the securities were sold to the customers of other salesmen in the firm. The purchasers recovered their damages from the firm in an action based on breach of fiduciary duty owed by the firm to them; *see* Black v. Shearson, Hamill & Co. Inc., 266 Cal. App. 2d 362, 72 Cal. Rptr. 157 (Dist. Ct. App. 1968).

can be no doubt which is primary here. On these facts, clients may not expect of a broker the benefits of his inside information at the expense of the public generally."[381]

There is perhaps a touch of circularity in the SEC's reasoning in *Cady, Roberts*. If one is to conclude that Gintel's action in selling Curtiss-Wright shares was "contrary to law" or in breach of a fiduciary duty, such a conclusion cannot be reached by attaching to Gintel the obligations that Cowdin, the director, owed to Curtiss-Wright. For while Curtiss-Wright could successfully maintain an action for breach of fiduciary duty against Cowdin,[382] it is highly doubtful that it could do so as against Gintel.[383] Therefore Gintel's action could only be contrary to law if it amounted to a manipulative or deceptive device in contravention of section 10(b) and Rule 10b-5 under the Exchange Act, the point the SEC was attempting to demonstrate.Gintel's conduct was contrary to law precisely because in the SEC's view trading on the basis of inside information violates the Exchange Act.

It may be very well for a regulatory or a self-regulatory agency to decree that as between the fiduciary duties owed by a director to his corporation and those owed by a broker-dealer to his customers, the former shall prevail. In reality, however, it is doubtful that: (1) corporate directors who are also securities registrants will usually be able to resist the temptations to trade for their own or their best customers' accounts; and (2) the customers of brokerage firms understand that they may receive investment advice that is contrary to facts known to persons in the firm. An altogether neater solution would appear to be elimination of the conflict by a prohibition against partners, officers, directors and salesmen of securities registrants serving as directors of public companies. This appears to be the solution favoured by the British Columbia Superintendent of Brokers as well as by the Corporate and Financial Services Commission of that province, which pointed out that the practical difficulty with conflict of interest situations is in determining, *post facto*, that the conflicting obligations are conscientiously discharged "or, more accurately, to determine that they have not been conscientiously discharged".[384] The language of an opinion of the California Court of Appeals, in a case involving a director of an issuer who was also a partner of a broker-dealer

381 *In re* Cady, Roberts & Co., *supra* note 380, at 916.

382 Diamond v. Oreamuno, 24 N.Y.2d 494, 301 N.Y.S.2d 78, 248 N.E.2d 910 (1969).

383 Schein v. Chasen, 313 So. 2d 739 (S.C. Fla. 1975); *see* Frigitemp Corp. v. Financial Dynamics Fund, Inc., 524 F.2d 275 (2d Cir. 1975); *see generally*, *Anisman* at 171-72.

384 *In re* John D. Gunther, B.C. Corp. & Fin. Serv. Comm'n Weekly Summary, June 25, 1976, at 3.

firm making a market in that issuer's securities, would appear to mandate a prohibition:

> "[W]e have been given no sufficient reason for permitting a person to avoid one fiduciary obligation by accepting another which conflicts with it.... [The problem] should not be resolved by weighing the conflicting duties; it should be avoided in advance...or terminated when it appears."[385]

While the prohibition against securities registrants and their associated persons serving as officers[386] or directors of public companies would be a simple solution to that particular conflict of interest problem, it might be undesirable from the point of view of the economy as a whole. Certain issuers, and perhaps most of all junior ones, may be greatly aided by having among their directors persons expert in matters of securities and finance. Supposedly Canadian business suffers from a relative dearth of managerial talent. Therefore proposals to prohibit any class of commercially sophisticated persons from serving on boards of directors will not be greeted with much enthusiasm. Finally, a prohibition might seem to be a rather ineffectual, half-hearted attack on the conflicts problem since an equal, if not greater, opportunity for abuse of inside information exists in the fact that broker-dealer firms also underwrite new issues and perform other investment banking functions for public companies. The author is not aware of serious suggestions that the underwriting activity should be split off from broker-dealer firms.[387] On the other hand, competition among a larger number of such firms for underwriting business is seen by many as an important goal for Canadian capital markets.

Whenever a securities firm enters into an investment banking relationship with a company, whether that relationship be for purposes of underwriting a public distribution of the company's

385 Black v. Shearson, Hamill & Co., Inc., *supra* note 380, 72 Cal. Rptr. at 161. The exact significance of the quoted language has been vigorously debated by the American securities bar; *see* Chazen, *Reinforcing the Chinese Wall: A Response*, 51 N.Y.U.L. Rev. 552, 561 (1976). The California court held that the firm's duty to make full disclosure concerning securities it recommended to its clients outweighed the director's duty to maintain the confidentiality of adverse corporate information. The director also liquidated his own holdings in reliance on the inside information.

386 Service by registrants as officers of public corporations is presumably not too common since salesmen must generally be employed full-time in the securities industry (Ontario Securities Regulations, s. 6(18)) and rules of the self-regulatory organizations specify that generally the officers or partners of their members must be engaged full-time in the securities business.

387 The undesirability of such a separation was recently asserted in SEC, Statement on the Future Structure of the Securities Markets, [1972] CCH Fed. Sec. L. Rep. (Special Report). *See* Lipton & Mazur, *The Chinese Wall Solution to the Conflict*

securities or arranging for private financing or putting together a takeover deal, the securities firm is highly likely to become privy to material undisclosed information concerning its client.[388] Even though in most situations this information will be publicly disclosed before the objective of the investment banking relationship is attained, because of the "full, true and plain disclosure" requirements of the securities laws, in the interim confidentiality would be an implied term of the contract of service between the securities firm and its client.

In a leading underwriter-broker conflict case, a securities firm, Merrill Lynch, Pierce, Fenner & Smith, was the lead underwriter on a new issue of convertible debentures of the Douglas Aircraft Corporation. After the filing of the registration statement but before its effective date, Merrill Lynch was informed by Douglas management of a sharp downward revision in Douglas' publicly released earnings forecasts. Individuals in the underwriting department of Merrill Lynch, knowing that the adverse information had not been publicly disclosed, tipped certain of Merrill Lynch's institutional customers, who promptly sold large blocks of Douglas common stock through Merrill Lynch. Merrill Lynch was found to have violated SEC Rule 10b-5 in a disciplinary proceeding,[389] and investors who purchased Douglas securities between the time Merrill Lynch tipped its customers and the time the information was publicly disclosed also succeeded in a Rule 10b-5 action against the firm.[390]

After the Merrill Lynch-Douglas affair, diversified securities firms in the U.S. tended to rely upon the "Chinese wall" as a solution to the investment banking-brokerage conflicts.[391] A firm with a Chinese wall prohibits all communications from the invest-

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Problems of Securities Firms, 50 N.Y.U.L. Rev. 459, 495 (1975). *But see* M. Mayer, *supra* note 205, at 63.

388 In representing a potential acquirer in a takeover situation, the securities firm will of necessity learn material, and indeed the most material, undisclosed information concerning the target company.

389 *In re* Merrill Lynch, Pierce, Fenner & Smith Inc., SEC, Securities Exchange Act of 1934 Release No. 8459, November 25, 1968, [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶77,629. The fund's management company also was disciplined; *see In re* Investors Management Company, SEC, Securities Exchange Act of 1934 Release No. 9267, July 29, 1971, [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶78,163.

390 Shapiro v. Merrill Lynch, Pierce, Fenner & Smith Inc., 495 F.2d 228 (2d Cir. 1974). Since there is presumably no requirement of contractual privity in a rule 10b-5 action (*but cf.* Ernst & Ernst v. Hochfelder, *supra* note 250), potential liabilities of Merrill Lynch were truly staggering - surely far in excess of its profits as underwriter to Douglas. *Contrast* Ontario Bill 7, s. 132.

391 Erection of a Chinese wall was part of Merrill Lynch's consent decree negotiated with the SEC in the Douglas affair; *see supra* note 389.

ment banking department to the research and trading departments concerning issuers with which the firm has entered into an investment banking relationship. The effectiveness of the Chinese wall assumes, of course, the complete separation of functions between personnel in the investment banking department and those in all other departments. The confidence of the securities industry in the Chinese wall as a complete defense to Rule 10b-5 actions was shaken, however, by the decision of the trial court denying the defendant's motion for summary judgment in *Slade v. Shearson Hamill & Co., Inc.*[392] The plaintiff-investors had purchased shares of an issuer on the recommendation of Shearson's salesman made at a time when the firm's investment banking department possessed information which contradicted the publicly available information upon which the salesmen's buy recommendations were based. The securities firm had a Chinese wall policy prohibiting interdepartmental communications. Shearson's policies also prohibited *the firm* – as distinct from its salesmen – from recommending the securities of investment banking clients, although it is not clear in the particular case that the firm's customers were made aware of the somewhat subtle distinction. The *Slade* decision implies that a securities firm with inside information in one of its departments may not permit its personnel in other departments to solicit transactions that are imprudent in the light of the information.[393] What is the integrated firm to do, then, since clearly it may not utilize the inside information to benefit its trading clients?

Some have suggested that the answer lies in utilization of a "reinforced" Chinese wall.[394] The reinforced Chinese wall would in reality be a list of restricted securities. The firm would announce to its clients that it and its personnel would decline to offer any advice, including in particular modification of prior outstanding advice, on securities whose issuers appeared on the firm's restricted list, although the firm would continue to execute unsolicited transactions in such securities. As soon as the firm entered into a relationship with an issuer likely to make the firm privy to inside

392 [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶¶ 94,329, 94,439 (S.D.N.Y. 1974).

393 The *Slade* case is still in litigation. An interlocutory appeal from the district court's denial of summary judgment was taken, but the Court of Appeal refused to rule on the merits because the record on appeal revealed unresolved factual questions, concerning principally the impermeability of Shearson's Chinese wall; 517 F.2d 398 (2d Cir. 1974). The intriguing question which the appellate court declined to answer was: "Is an investment banker/securities broker who receives adverse material nonpublic information about an investment banking client precluded from soliciting customers for that client's securities on the basis of public information which (because of its possession of inside information) it knows to be false or misleading?"; 517 F.2d at 399.

394 *See* Lipton & Mazur, *supra* note 387.

information, it would place the issuer on the restricted list. It would be essential to trigger the restricted list procedure when the relationship was entered into, rather than when and if the inside information actually materialized, to minimize the possibility that the very appearance of an issuer on the restricted list could be interpreted as a tip. One of the relationships that might cause a securities firm to place an issuer on its restricted list, in addition to the various types of investment banking relationships, might be assumption of a directorship by a person in the firm. If so, that would be a strong disincentive to registrants serving as corporate directors.

The reinforced Chinese wall effectively places securities firms that do a substantial investment banking business at a competitive disadvantage in the trading function vis-a-vis firms that are not investment bankers.[395] The inhibiting effect on the broker-dealer activities of investment banking firms would be felt particularly strongly in Canada, where four firms are said to dominate the underwriting field (apart from junior mining issues) and those four plus another half dozen firms manage virtually all such underwritings.[396] Therefore each firm doing an underwriting business might have a substantial number of publicly traded Canadian companies on its restricted list at a given time. Taken to an extreme, the reinforced Chinese wall could mandate a virtual divorcement of the underwriting from the trading business.

At bottom, the standard of behaviour to be chosen (assuming that we do not wish a total separation of the underwriting and trading businesses) must require that reasonable customer expectations be fulfilled at the same time that inside information is not in fact used to render advice or effectuate trades in securities. Whatever customers *in fact* expect, it seems impracticable to do more than declare, as a rule of law, that "clients *may not* expect of a broker the benefits of his inside information at the expense of the public generally"[397] and that clients, at least if so advised by their securities brokers, *must* expect that advice they receive is based exclusively on publicly available data and may at times be inconsistent with confidential information known to some persons in the firm who are not at liberty to disclose it.

In the long run, the most satisfactory solution to these securities firm conflict problems, as well as to insider trading problems more generally, may lie along the affirmative path of compelling

395 *See* Chazen, *supra* note 385.

396 D Shaw & R. Archibald, 8 The Management of Change in the Canadian Securities Market 45-48, 107 (1977) (The Canadian Securities Market: A Framework and a Plan).

397 *In re* Cady, Roberts, *supra* note 380.

prompt disclosure of material changes in the affairs of publicly held companies. Also, human nature being what it is, we must anticipate that registrants will, from time to time, yield to the temptation to use inside information for themselves and favoured clients. It is doubtful that we have seen the last of the Merrill Lynch-Douglas type cases. If not, and if we are serious in prohibiting trading use of inside information, then the most realistic solution may simply be draconian sanctions against registrants when those cases come to light.

2. *Churning*

The compensation earned by a broker-dealer firm is a direct function of the quantity of buy and sell transactions conducted through the firm by its customers. This is as true for dealer transactions, in which the firm is compensated by the spread between its buy and sell prices, as for brokerage transactions, where the firm is compensated by commissions, although discussions of churning usually are in the context of agency transactions. Firms, in turn, compensate their salesmen largely, if not exclusively, on a commission basis. Firms and their salesmen are therefore under a strong economic pressure to maximize the amount of trading in the accounts of clients. Obviously, however, the profitability of the account to the client over time is not necessarily positively correlated with the volume of transactions in the account, and quite the opposite may hold. Hence the method by which securities trading firms and their personnel are compensated establishes a conflict of interest with the customers.

When a registrant, for the purpose of maximizing its profits, induces an amount of trading in a customer's account that is excessive in the light of the character of the account, the registrant is said to be guilty of "churning".[398] Although the law of churning has its origin in discretionary accounts, it is not necessary that the registrant have a formal discretionary power over the account in order that a charge of churning can be sustained.[399] If a registrant has *de facto* control over investment decisions for the account, as where its owner, while retaining the formal power to authorize trades, is in the habit of following the registrant's advice without question, a case of churning should be

398 Comment, *Private Actions for the Broker's Churning of a Securities Account*, 40 Mo. L. Rev. 281 (1975).

399 E. Weiss, *supra* note 44, at 109; comment, *supra* note 398, at 282; Newburger, Loeb & Co. v. Gross, 563 F.2d 1057, 1069-70 (2d cir. 1977). SEC rule 15cl-7, 17 C.F.R. s. 240 15cl-7 (1977), governing churning in the over-the-counter markets, appears to be directed at situations involving formal discretion.

able to be made out where the trading is excessive. Where at common law a registrant would be found to have fiduciary obligations toward its client, churning would be a violation of those obligations since the principal is advancing its own interests ahead of the inconsistent ones of its client.[400] In addition to the element of *de facto* control by the registrant, there must, of course, be established that the amount of trading was excessive in the light of the objectives of the particular account. A quantum of trading activity that would be excessive in the account of a retired person seeking security of principal and regular dividend income might not be excessive in the account of a speculator seeking profits from quick in-and-out trading.

The Toronto Stock Exchange permits only partners and directors of members to exercise discretion in handling the account of a customer.[401] While such a rule is worthwhile in alleviating churning problems induced by over-zealous salesmen in formally discretionary accounts, it cannot be completely effective to eradicate churning possibilities because firms themselves, and not just their salesmen, have a direct pecuniary interest in encouraging trading. Also, the rule prohibits formal discretion in salesmen but does not (and could not) prohibit the *de facto* control that may arise from the trust and confidence that a particular client may place in the advice of a particular salesman.

Any proposal to force securities firms to compensate their personnel on a basis of straight salary rather than commissions would seem grossly unfair to the firms, if not simply impossible, since the firms' own compensation is on a commission basis.[402] Although a number of securities firms do compensate their salesmen in part by salary, it is doubtful that any firm dependent for its own existence on commissions could long remain viable without some method of strongly encouraging its sales personnel to produce commission revenues.[403] To the extent that the danger of

400 Comment, *supra* note 398, at 294-95.

401 TSE by-laws, s. 8.31, 3 CCH CAN. SEC. L. REP. ¶89-345.

402 *But see, Let's Put Brokers on a Straight Salary,* The New York Times, September 4, 1977, at 7. The author argues that not only does the commission method of compensation present brokers with an often irresistible temptation to prefer their own to their clients' interests, but that the system is doubly iniquitous since brokers often earn the largest commissions for pushing the least attractive stocks, especially in connection with primary distributions.

403 This point is well illustrated by the example of Merrill Lynch, the largest stock brokerage firm in the world. Merrill Lynch claimed to reward its salesmen not on a straight commission basis but rather on over-all performance; Levin & Evan, *supra* note 23, at 353 n. 56. Yet the firm maintained for its salesmen a sales quota system and mandatory weekend sales solicitation sessions. Pressured to produce commission revenues, some salesmen encouraged their customers to liquidate positions in securities which were contemporaneously on the firm's own buy or hold

churning is a function of the facts that securities firms live by commissions and people trust their stockbrokers, the danger is simply a fact of life and probably little can be done about it other than to impose meaningful sanctions when the danger becomes an actuality.

On the other hand, something might have been (but is not) done in Canada to split off persons *in the business of* discretionary management from persons with a direct interest in the generation of commission revenues. For example, in Ontario's draft proposed regulation on "portfolio managers" – defined as investment counsel registered for the purpose of managing the investment portfolios of clients through discretionary authority granted by the clients – transactions were to be executed through a registrant *other than* the portfolio manager.[404] In the regulation as adopted the words "other than the portfolio manager" were dropped,[405] and in fact a number of portfolio manager registrants are affiliates of brokerage firms.[406] Similarly, Ontario's policy concerning dealer-managed mutual funds clearly contemplates that the fund's brokerage transactions will be made through the affiliated dealer.[407] Where a mutual fund manager is affiliated with a securities dealer, a possible incentive to churn the fund's assets is not the only problem to worry about. The manager that directs all of the fund's portfolio brokerage to an affiliate is foregoing the opportunity to use the fund's brokerage commissions to purchase investment advice for the fund from a variety of brokers.[408] The *Canadian Mutual Fund Report* took no position on the question whether dealers should be permitted to manage mutual funds, although it pointed up a number of problems that inhere in such arrangements.[409] The report did point up the anomaly in permitting brokers to manage mutual funds while mutual fund management companies were prohibited from joining securities exchanges.[410]

Professors D. Shaw and R. Archibald, in their study for the TSE on the future structure of Canadian securities markets, recommended that securities firms be prohibited from managing

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lists; *In re* Merrill Lynch, Pierce, Fenner & Smith, Inc., SEC, Securities Exchange Act of 1934, Release No. 11515, June 30, 1975, [1975-1976 Transfer Binder]CCH FED. SEC. L. REP. ¶80,216.

404 OSC Weekly Summary, May 29, 1975, at 1A (Draft Proposed Regulation, s. 20b(f), "Portfolio Managers").

405 O. Reg. No. 270/76, *amending* Ontario Securities Regulations, s. 6(20b).

406 *See* list of registrants in [1976] OSC Bull. 198 (July).

407 OSC, Policy No. 3-32, ¶5(a), 2 CCH CAN. SEC. L. REP. ¶54-957.

408 CANADIAN MUTUAL FUND REPORT ¶3.76.

409 *Id.* ¶¶3.72-3.79.

410 *Id.*

pooled accounts.[411] Of course, so long as there are maintained in Canada fixed rates of securities brokerage commissions which yield high profits on large trades, it may be impossible completely to split the exercise of discretion for pooled accounts from the receipt of commissions. This is so because brokers will always have an incentive to kick back part of their revenues on such profitable business to the persons who direct such business to them.[412]

In the United States, effective May 1, 1978, section 11(a) of the amended Exchange Act makes it "unlawful for any member of a national securities exchange to effect any transaction on such exchange for...an account with respect to which it or an associated person thereof exercises investment discretion".[413] The basic prohibition is subject to numerous exceptions, and it may never, in fact, take effect in a manner to force anything like a complete divestiture between money management and brokerage activities. Originally section 11(a) was passed as part of the 1975 amendments with the support of the brokerage industry. It was pushed by that industry as a sort of *quid pro quo* for the abolition of fixed rates of commission that also was legislated in the same act.[414] The basic purpose from the brokers' point of view was to prohibit institutional money managers from joining exchanges. Control of churning was another purpose but a decidedly subsidiary one, as may be gathered from an exception permitting brokerage and discretionary management to be combined in respect of "any

411 8 D. SHAW & R. ARCHIBALD, *supra* note 396, at 95. *But see* REPORT OF THE JOINT INDUSTRY COMMITTEE ON GUIDELINES FOR DIVERSIFICATION OF THE SECURITIES INDUSTRY (Sept. 23, 1976).

412 The processes by which brokers kick back some of their excess profits are called generically "soft-dollar" deals. Canadian stock exchanges generally have rules that attempt to prohibit such deals; *e.g.* TSE by-laws, s. 15.01, 3 CCH CAN. SEC. L. REP. ¶89-566; *see also* TSE, Policy on Commission Dollars, 3 CCH CAN. SEC. L. REP. ¶92-070; MSE by-law IV, s. 4401, 3 CCH CAN. SEC. L. REP. ¶85-501. The effectiveness of such rules is a matter of some doubt. *See generally* Connelly, *Fixed versus Negotiated Commission Rates on the Toronto Stock Exchange*, 2 CAN. BUS. L.J. 244(1977).

The classic situation of conflict of interest in the allocation of brokerage by a discretionary manager arises in the case of the mutual fund manager whose compensation is computed as a percentage of the fund's assets and who therefore has a direct pecuniary interest in the sale of fund shares. The manager has an incentive to direct the fund's portfolio brokerage as additional compensation to brokers who are particularly energetic in selling the fund's shares. The interest of the fund's shareholders, as opposed to its management, in the size of the fund is doubtful. *See* CANADIAN MUTUAL FUND REPORT, ¶¶ 3.65-3.71. Allocation of brokerage to benefit the fund's manager would presumably come within the prohibition of Ontario Bill 7, s. 111 against a mutual fund making any investment "in consequence of which a related person or company of the fund will receive any... compensation except ... pursuant to a contract which is disclosed in any ... prospectus...".

413 Exchange Act, s. 11(a), *as amended by* Securities Reform Act of 1975, s. 6(2).

414 Securities Reform Act of 1975, s. 4, *amending* Exchange Act, s. 6(e).

transaction for the account of a natural person".[415] As it turned out after the introduction of negotiated rates, the brokerage community had made a bad bargain. Abolition of fixed commission rates removed the incentive for the institutions to seek membership in the exchanges, but the anticipated loss of money management revenues threatened the economic viability of a number of brokerage firms for whom brokerage taken alone had become suddenly much less profitable.[416] At the time of writing, the SEC has come to the rescue of the brokers by the adoption of rules under section 11(a) that define the terms "investment discretion" and "effect" a transaction so as to blunt the prohibitory impact of the statutory provision.[417] Under the rules, a broker will be deemed not to exercise investment discretion with respect to any transaction that requires the prior approval of the owner of the account; and a broker will not be held to "effect" a transaction where he sends it to another exchange member for execution, even though the forwarding broker may, where he has disclosed to the owner of the account that he will do so, share in the brokerage commission.[418] It thus appears that the attempted legislative separation of brokerage from money management services in the U.S. is well on its way to becoming a total donnybrook. The House of Representatives has passed a bill to delay the effective date of section 11(a), and the rancour in the committee proceedings has been extreme.[419]

With respect to compensation of advisers exercising managerial responsibilities over clients' portfolios, both Ontario and Québec provide that it may be based on the value of the portfolio but not on the value or number of transactions in the portfolio – the obvious purpose of the prohibition being to remove an incentive to churning.[420] In Ontario, it is provided that compensation based upon the performance of the portfolio may be charged only

415 Exchange Act, s. 11(a)(1)E. *See* REPORT OF THE SENATE - HOUSE CONFERENCE COMMITTEE, *supra* note 64, at 105; Lipton & Mazur, *supra* note 387, at 508 n. 220.

416 *See* 445 BNA SEC. REG. & L. REP., March 22, 1978, at A-13 to A-14.

417 SEC, Securities Exchange Act of 1934 Release No. 14563, March 17, 1978, 445 BNA SEC. REG. & L. REP., March 22, 1978, at E-1 to E-16.

418 In this latter aspect of the rule, the commission may well have placed itself on a collision course with Congress. *See* H.R. COMM. ON INTERSTATE AND FOREIGN COMMERCE, SUBCOMM. ON OVERSIGHT AND INVESTIGATIONS, 95TH CONG., 1ST SESS.; REPORT: OVERSIGHT OF THE FUNCTIONING AND ADMINISTRATION OF THE SECURITIES ACTS AMENDMENTS OF 1975, at 9-11 (Comm. Print No. 95-27, 1977).

419 H.R. 11567, 95th Cong., 2d Sess. passed April 4, 1978. *See* 445 BNA SEC. REG. & L. REP., March 22, 1978, at A-17 to A-18; 447 BNA SEC. REG. & L. REP., April 5, 1978, at A-4.

420 Ontario Securities Regulations, s. 6(20b) 3; QSC, Revised Policy No. 19, *supra* note 160, art. 19(2).

upon the express written consent of the client.[421] Québec is silent on this point.

3. *Advice or Discretionary Management That Is Not Fully Disinterested*

A securities industry registrant that undertakes to give advice as to the merits of investing (or disinvesting) in particular securities thereby undertakes fiduciary obligations.[422] But be-

421 Ontario Securities Regulations, s. 6(20b) 3; With respect to mutual funds, the CANADIAN MUTUAL FUND REPORT ¶¶11.45-11.56 opted for a prohibition of performance based fees. The committee's reasoning is complex and based on technical factors, and the reader is referred to the REPORT for an explication. In brief the committee's objections to performance based fees are based on three factors: (1) it is inaccurate to judge management's success solely in terms of rate of return, especially if measured at short intervals; (2) it would be difficult to find an indicator or yardstick against which to measure the fund's performance that would be exactly comparable to the objectives of the fund; and (3) it would be virtually impossible to calculate the fee in such a way as to be completely equitable as among all of the fund's shareholders regardless of when they purchase and redeem fund shares.

422 SEC v. Capital Gains Research Bureau, 375 U.S. 180, 189-94 (1963) (registered adviser); Burke v. Cory, 19 D.L.R. (2d) 252 (Ont. C.A. 1959) (a securities dealer who referred to himself as an "investment counsellor" thereby undertook fiduciary obligations toward his customer); Elderkin v. Merrill Lynch, Royal Securities Ltd., 80 D.L.R. (3d) 313 (N.S.C.A. 1977). The facts in Burke v. Cory had a strong odour of fraud about them, but fraud was not pleaded. In the Elderkin case there was no suggestion of fraud.

In Elderkin, each one of the plaintiffs opened an account with the defendant brokerage firm and informed the firm that he would rely heavily on its advice. The firm assigned the defendant Lacas to service the plaintiffs' accounts. Each of the plaintiffs did in fact rely very heavily on Lacas's advice, although the plaintiffs retained authority to authorize each transaction and they occasionally refrained from buying a security recommended by Lacas. The trading activity in the plaintiffs' accounts was very substantial. A year or more after the plaintiffs opened their accounts, Lacas virtually besieged them with favourable reports about a new company called Multico. Each of the plaintiffs bought substantial amounts of the Multico stock on Lacas's recommendation. Much of the information about Multico turned out to be false, including, in particular, various statements made in a letter from Lacas to one of the plaintiffs in which Lacas sought (successfully) to dissuade the particular plaintiff from selling his Multico shares. The plaintiffs held on, in reliance upon the false information being communicated to them by Lacas. Ultimately the shares became worthless. Knowledge of the falsity on Lacas's part was not alleged but he made absolutely no effort to check the correctness of favourable information being fed to him by Multico insiders.

The appellate division, reversing the trial court, found that a fiduciary relationship existed between Lacas and the plaintiffs. With the fiduciary label attached, Lacas was found to have a duty to advise the client "carefully" and to have breached this duty; 80 D.L.R. (3d) at 323. Oddly, the court appears to find the fiduciary character of the relationship not so much in the general character of the securities advisory relationship between the parties as in the fact that, with respect to Multico, Lacas "represented that he was in close touch with the officers of Multico and in effect that he had inside information with respect to the company"; 80 D.L.R. (3d) at 325. The court did not explore the host of securities law problems that

cause advising registrants generally are free to invest for their own accounts in securities, including securities in which their clients are interested, they may frequently find themselves in positions of conflict of interest.[423] For example, in *Glennie v. McDougall & Cowans Holdings Ltd.*,[424] a customer requested his broker to sell out the customer's account in a certain security. The broker persuaded the customer not to sell, without disclosing that the broker itself had an enormous position in the securities of the same issuer. The Supreme Court of Canada held the broker liable for the loss occasioned to the customer by the fact that he did not sell when he was inclined to do so.

Another classic example of a conflict of interest in the advising function is the practice known as "scalping", in which an adviser purchases shares for his own account shortly before recommending the security to his clients and then immediately sells the shares at a profit upon the rise in market price following the recommendation. The practice has been held, at least in the absence of disclosure of such practice by the adviser to his clients, to be a violation of the general anti-fraud provision of the United States Investment Advisers Act of 1940.[425] The rule against scalp-

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would have been posed if Lacas had in fact been conveying true inside information. As an independent basis for Lacas's liability, the court cited (*id.* at 325) the duty of care that the House of Lords in Hedley, Byrne & Co. Ltd. v. Heller & Partners Ltd. said will arise "if someone possessed of a special skill undertakes, quite irrespective of contract, to apply that skill for the assistance of another person who relies upon such skill"; [1964] A.C. 465, 502-03 (*per* Lord Morris of Borth-y-Gest).

It is interesting to note that in Elderkin the defendant Lacas did not earn any compensation from his Multico advice since the transactions were put through a firm other than his employer. At the same time he and his family made substantial investments in Multico stock and this may have had something to do with his desire to see his clients stay with their positions in it.

In the trial court, Merrill Lynch's liability was not analyzed separately from that of its employee and in the appellate division the firm conceded that a finding with respect to the employee would be determinative with respect to itself. This may have been conceding rather too much. The firm had a policy of not acting as broker on stocks trading under $2. During most of the relevant period Multico traded at under $2 and Lacas told the plaintiffs that a broker other than Merrill Lynch would have to handle their purchases. Also, at least in the letter mentioned above if not earlier, Lacas made it clear that Multico was his personal recommendation and not that of the firm. When the firm's manager learned of the Multico purchases induced by Lacas, the manager told him - to no avail - to get the plaintiffs out of the stock. On these facts it would appear that Merrill Lynch might have been able to sustain a claim that it was not implicated in its employee's actions.

423 The U.S. Supreme Court in the *Capital Gains* decision, *supra* note 422, cites some legislative history of the Advisers Act to the effect that at least certain elements of the investment advisory industry would have supported a flat prohibition against investment counsellors trading in securities in which their clients were interested; 375 U.S. at 189.

424 [1935] 2 D.L.R. 561 (S.C.C.).

425 SEC v. Capital Gains Research Bureau, *supra* note 422. Presumably scalping could

ing is at bottom simply a recognition of the fact that advisers with a large following are often in a position to create their own inside information.

Notable in this regard would be the position of newspaper financial columnists who have in practice in both the United States and Canada been subsumed under the adviser registration exemption for newspaper publishers.[426] Recently a financial writer for a Los Angeles newspaper has been enjoined from scalping and that has led to a reconsideration of the exemption.[427] Ontario's Bill 7 specifically includes writers within the scope of the exemption for financial publishers, but a writer who engaged in scalping might thereby place himself outside the registration exemption, one of the requirements of which is that the writer "has no interest either directly or indirectly in any of the securities upon which advice is given".[428]

Ontario's regulation dealing with portfolio managers provides that the portfolio manager and its "responsible persons" may not trade for their own accounts "in reliance upon information as to trades made or to be made for the account of clients of the portfolio manager".[429] Of course, the regulation is narrower than the anti-scalping rule since it applies only to portfolio managers, that is, advisers who manage the investment portfolios of clients, and it prohibits them only from trading in anticipation of trades for their clients as opposed to a broader prohibition against trading in anticipation of one's own advice. However, governed by the rather elastic standard of "the public interest" in disciplinary proceedings, there is probably room for the securities regulatory authorities to make the type of scalping noted in *SEC v. Capital Gains Research Bureau* a prohibited practice in Canada. More importantly, it is less likely that scalping can occur if the adviser must make full disclosure of his interest in securities recommended.

The "black letter" rule is that a registrant rendering advice concerning securities must make disclosure of any interest he may have in the securities advised upon.[430] Such disclosure must be

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be worked in reverse also; first a short sale, then a sell recommendation, then covering the short sale.

426 OSA, s. 18(d); Investment Advisers Act of 1940, s. 202(a)(11)(D).

427 Lybecker, *supra* note 189, at 930. In the U.S. there would presumably be substantial constitutional objections to a proposal to license newspaper financial columnists. *See U.S. Const.*, amend. I. *See also* editorials in The Wall Street Journal, August 5, 1976, at 8, col. 1; *id.*, September 20, 1977, at 24, col. 1.

428 Ontario Bill 7, s. 33(d).

429 OSC Conditions of Registration, *supra* note 197; Ontario Securities Regulations, s. 6(20b)6.

430 Burke v. Cory, *supra* note 422; Glennie v. McDougall & Cowans Holdings Ltd., *supra*

made at the time the advice is rendered; it is not sufficient that, where the customer acts upon the advice by placing a trade through the registrant, the registrant's interest may be revealed *post facto* in a confirmation which states that the registrant has acted as principal.[431]

To the extent that the rule of full disclosure of interest in connection with investment advice has been codified, it operates more strictly against registered advisers than against registered traders who also give advice.

For example, OSA, section 72, requires a registered adviser to make in every writing he issues "a full and complete statement of any financial or other interest that he may have either directly or indirectly in any securities referred to therein or in the sale or purchase thereof". The interests that must be disclosed include: ownership of or options upon the securities; any remuneration the adviser expects to receive in connection with a trade in the securities; and any financial arrangement relating to the securities that the adviser may have with a registrant, an underwriter or any other person or company with an interest in the securities. In other words, the adviser must make full disclosure of any interest. By thinly veiled threats of revocation of registration, National Policy Statement No. 25 attempts to extend the legislation to "all classes of registrant when they recommend the purchase or sale of a security in which they have a material interest".[432] But, insofar as the statute itself is concerned, a trading registrant's only disclosure obligation is to disclose in any written solicitation of a trade the registrant's intention to act as principal, if such be the case.

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note 424; *In re* A.A. Nicholson [1952] OSC Bull. 3 (December) (revocation of registration where securities salesmen received secret compensation from issuer for touting stock); *In re* Frank S. Tobin, [1952] OSC Bull. 6 (October) (similar to Nicholson); *In re* J.H. Black, [1952] OSC Bull. 3 (July - August) (similar to Nicholson); *In re* R.H. Brondyke, [1976] Alta. Sec. Comm'n Bull. 5 (October) (salesmen suspended for recommending securities to clients without disclosure of personal holdings in and capacity as financial adviser to issuer); *In re* John D. Gunther, *supra* note 384; Chasins v. Smith, Barney & Co., 438 F.2d 1167 (2d Cir. 1970) (customer's rule 10b-5 action succeeds where broker-dealer failed to reveal status as market-maker).

431 *See* Burke v. Cory, *supra* note 422. With respect to advice contained in a writing, s. 70(1) of the OSA provides that where a person or company registered to trade in securities issues, publishes or sends a writing soliciting a transaction in respect of which the registrant proposes to act as principal, the writing must state this intention. With respect to an oral solicitation made with the intention of acting as principal, s. 70(2) provides that the written confirmation must disclose the capacity in which the registrant has acted. Section 70(2) adds nothing to the basic confirmation requirement contained in s. 67.

432 The policy goes on to state that the situation of a registrant having a material interest in a security that it recommends for purchase or sale will arise most frequently where the registrant represents a party in a takeover bid, a share exchange offer or a purchase of an issue offered through a rights offering.

In Ontario Bill 7, the disclosure rule mandated for registered advisers in their written communications has been amended in two respects, both improvements. The rule has been narrowed to apply only to securities "recommended", and it has been broadened to compel disclosure of the interests not just of the adviser itself but also of directors, officers, partners and controlling persons of the adviser.[433]

The disclosures that Bill 7 would require of registered traders making written recommendations are less onerous than in the case of advisers.[434] A trading registrant would be required to make disclosures concerning itself and its officers and directors, but it would have to disclose only whether any of those would receive fees as a result of the recommended action (presumably meaning fees other than normal brokerage commissions) or was acting or had acted within the previous year as "financial adviser" to the issuer.[435] Unlike the registered adviser, the registered trader would not be obligated under Bill 7 to disclose its ownership of securities that it recommends, unless, of course, it intended to act as principal in the recommended transaction.[436] The bill, then, does not mandate the sort of disclosure by a broker-dealer the absence of which was a predicate for the imposition of civil liability in the *Glennie* case.[437] Under Bill 7, section 40, a broker-dealer firm would not have to disclose, were such the case, that its president was the promotor or a director or had significant financial transactions with the issuer. The firm would not even have to disclose its own ownership of securities of the same issuer so long as the firm did not propose to deal as principal and was not an underwriter. Furthermore, it is highly doubtful that meaningful disclosure is conveyed in the typical "hedge clause" that reputable broker-dealers as a matter of course place on their market letters to the effect that:

433 Ontario Bill 7, s. 39.

434 In Ontario Bill 75, a predecessor to Bill 7, the rule that advisers were to disclose their interests in all securities referred to was continued and the rule for advisers was extended, without modification, to trading registrants. The TSE and the IDA in their submissions on Bill 75 opposed vehemently this extension of disclosure obligations to their members. They claimed that such onerous disclosure requirements were administratively unworkable, considering especially the enormous volumes of literature sent by many dealers to their customers and prospective customers in the form of bond letters, weekly market summaries, monthly statistical summaries and so forth. Now that the disclosure requirements for advisers are proposed to be restricted to securities as to which a recommendation is made, it is doubtful that a strong case can be made for giving more favourable treatment to trading registrants.

435 Ontario Bill 7, s. 40.

436 Bill 7, s. 38, continuing OSA, s. 70(1).

437 Glennie v. McDougall & Cowans Holdings Ltd., *supra* note 424.

"This firm and/or its individual officers and directors may from time to time have a position in the securities recommended herein and may make purchases or sales of these securities from time to time in the open market or otherwise."

There are not presently, and there would not be under Bill 7, any statutory controls on disclosure of interest when the advice is rendered orally - whether by a registered adviser or by a broker-dealer. Of course the regulatory agencies are not limited to consideration of statutory violations in weighing a registrant's continued fitness for registration "in the public interest",[438] and in a private action for damages where the plaintiff had relied to his detriment upon dishonest oral advice rendered by his broker, a court presumably would not accept as a defense the absence of statutory violation.[439]

Whatever conflicts of interest may arise in the advisory function will be accentuated in the case of discretionary management. For a registrant exercising a discretionary management role, by definition, will himself make the investment choices for the managed accounts. It is not a situation where a client weighs the value of advice based on what he is informed of concerning the adviser's interest. We would therefore expect the conflict of interest controls on registrant's exercise of investment discretion to be stringent. So they are, for *some* registrants.

In Ontario, portfolio managers and dealers who manage mutual funds are subject to the following restrictions on the manner in which they cause investments to be made for managed accounts. First, trades between the managed account on the one side and the manager or an associated person of the manager in the role of principal, on the other, are prohibited.[440] This is a more stringent rule than what applies in the U.S. where, under the Investment Advisers Act of 1940, the adviser who exercises management discretion may sell securities to or purchase securities from the client, if before the transaction the adviser makes disclosure to and obtains the written consent of the client.[441] The

438 Re The Securities Commission and Mitchell, [1957] O.W.N. 595 (C.A.) (single judge); Re The Securities Act and Gardiner, [1948] O.R. 71, [1948] 1 D.L.R. 611 (H.C.); *In re* Fisher Securities Corp., *supra* note 349.

439 *See* Burke v. Cory, *supra* note 422; Glennie v. McDougall & Cowans Holdings Ltd., *supra* note 424.

440 Ontario Securities Regulations, s. 6(20b)7; OSC, Policy No. 3-32, July 1975, 2 CCH CAN. SEC. L. REP. ¶54-957 (Dealer Managed Mutual Funds); Ontario Bill 7, s. 114 (portfolio managers).

441 Investment Advisers Act of 1940, s. 206(3). Following the introduction in the U.S. of negotiated rates of commission large numbers of broker-dealers had, for the first time, to secure registration as investment advisers because, to the extent that

American rule for advisers is analogous to the rule for corporate directors: the director may deal as principal with the corporation upon full disclosure in advance and approval of the transaction by a majority of the directors with the interested director abstaining, but the transaction is still subject to being set aside if not reasonable.[442]

There is much appeal to the flat Ontario prohibition, at least with respect to the managed accounts of natural persons. Even recognizing that investors with portfolios large enough to be committed to the individual management of a registered adviser are very likely not to be naïve little old ladies, it appears nonetheless that on the whole they would be less able to defend their interests against an overreaching manager than corporate directors are to be able to defend the corporation's interests against an overreaching colleague. Allowing advisers to trade as principals with managed accounts creates an unnecessary possibility for abuse. Where the fund under management is governed by trustees or directors who are independent of the adviser, however, one might be prepared to opt for the more lenient American rule. This might be the case of some pension funds, for example.[443]

The U.S. rule for managers trading as principal, that it is permissible with disclosure and written consent, also governs trades between different accounts under common management.[444] This is a matter on which Canadian regulation has heretofore been silent, but perhaps not wisely so. One can well imagine

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broker-dealers charged separate fees for different services in the regime of negotiated rates, they lost their exclusion from the definition of "investment adviser" under the Advisers Act. That exclusion had required that the broker-dealer not charge a separate fee for advisory services. In response to the new situation, the SEC promulgated a regulation exempting investment advisers who are registered brokers or dealers from the full rigours of the prohibitions in s. 206(3) of the Advisers Act against trading with clients as principal and against representing more than one client in a transaction except upon the basis of prior written disclosure and consent. In substance rule 206(3)-1, 17 C.F.R. s. 275.206(3)-1 (1977), exempts broker-dealers from having to comply with s. 206(3) with respect to any transaction wherein the broker-dealer is acting as an investment adviser solely by means of written or oral statements which do not purport to meet the objectives or needs of specific individuals or accounts. Even so, in any such written or oral statement the broker-dealer must disclose that it may act as principal for its own account or as agent for another person.

442 *See e.g.* Canada Business Corporations Act, s. 115; Ontario Business Corporations Act, s. 134. *See also* Howard, *Directors and Officers in the Context of the Canada Business Corporations Act*, in MEREDITH MEMORIAL LECTURES 1975: CANADA BUSINESS CORPORATIONS ACT 282, 292-93 (1976).

443 In this connection it is of interest that the CANADIAN MUTUAL FUND REPORT did not place much stock in the notion of directors independent of the management company as a solution to conflict of interest problems; CANADIAN MUTUAL FUND REPORT ¶¶6.31-6.44.

444 *See* materials in note 441 *supra*.

that an investment manager would be tempted, for example, to move investments that turned out poorly from accounts whose beneficiaries kept a close watch on the manager to those whose beneficiaries were more passive, at a price that would be unduly favourable to the former at the expense of the latter. "The wheel that squeaks the loudest gets the most grease."

Portfolio managers and dealers who manage mutual funds are prohibited from causing funds under management to make a loan to the manager or an associated person.[445] Except upon prior disclosure to and written consent from the client, neither type of manager may cause a fund under management to invest in an issuer of which an associated person of the manager is an officer or director.[446] Finally, a dealer-manager of a mutual fund may not place in the fund the securities of an issuer for whom the manager has acted as an underwriter, within sixty days following the conclusion of the distribution of the securities underwritten.[447] There is no restriction upon a portfolio manager or mutual fund manager causing a fund to invest in an issuer of which the manager or an associate is a shareholder, even a controlling shareholder, or with respect to which the manager or an associate stands in a debtor-creditor relationship.[448]

The rule on conflict of interest for managing advisers in Québec is a good deal less certain than in Ontario and the United States, and while its phraseology is an admirable restatement of the law of agency *in vacuo*, it appears to be a studied attempt to avoid coming down on one side or another of the issue. It is provided that "an investment adviser shall not give, buy or sell orders on behalf of a discretionary account when he is in a position of conflict of interest", and he is in a position of conflict of interest "when the situation is such that he can reasonably assume that his personal interest will affect his ability to act with impartiality and objectivity".[449] While an investment adviser can, indeed must, assume that where he proposes to deal for his own account with a managed portfolio his personal interest *may* affect his ability to

445 *See* materials in note 440 *supra*.

446 *Id.*

447 OSC, Policy No. 3-32, *supra* note 440. A similar prohibition does not, but should, attach to portfolio managers. A portfolio manager might well be under common control with an underwriter that from time to time might wish to place "sticky" issues through its associated portfolio manager. *See generally* N. WOLFSON, CONFLICTS OF INTEREST: INVESTMENT BANKING 53 (1976).

448 *Contrast* Ontario Bill 7, s. 107(3)(c) which would prevent a mutual fund from making an investment in an issuer in which any officer or director of the fund, its management or distribution company or an associate of any of them has a significant interest. A significant interest is ownership of more than 10% of the shares of an issuer; Ontario Bill 7, s. 106(b).

449 QSC, Revised Policy Statement No. 19, *supra* note 160, art. 18.

act with impartiality and objectivity, it is hard to say when he would have to conclude that his ability *will* be affected.[450]

In Ontario the conflict of interest rules for portfolio managers and dealer-managed mutual funds leave a great many discretionary accounts outside of their ambit namely, all discretionary accounts (apart from mutual funds) managed by broker-dealer firms. This is so because the only persons or companies required to register as portfolio managers are investment counsels registered for the purpose of managing accounts through discretionary authority.[451] Broker-dealer firms who manage discretionary accounts need not be registered as investment counsels, by the exemption in OSA, section 18, and therefore need not be registered as portfolio managers. In the result, individuals who have discretionary accounts with broker-dealers are left relatively unprotected against conflicts of interest in the management of their accounts. So far as the legislation and regulations are concerned, broker-dealers managing such accounts would be free, for example, to place in the accounts "sticky" issues they have underwritten or securities they have block positioned.[452] Where these practices resulted in detriment to managed accounts (and where the account owners were litigious) the practices would presumably be found to violate common law fiduciary duties.

In the event that fixed rates of commission on stock exchanges were to be abandoned, allocation of brokerage for discretionary accounts could become a fertile ground of conflict of interest for managers. So long as commission rates are fixed, and assuming equal competence among brokers, customers' interests (apart from avoidance of churning) are not influenced by choice of brokers and, in particular, by the choice of a broker affiliated with the manager. If commission rates were to become subject to negotiation, then, presumably, the manager would be required to select brokers on the basis of cost.[453]

450 Would it be hairsplitting to say that whenever he proposes to deal for his own account, the adviser can assume that his *ability* to act with impartiality will be *affected*, even though he believes that he can compensate for those effects and thus act with impartiality?

451 *See* definition of portfolio manager, text accompanying note 404 *supra*.

452 The CANADIAN MUTUAL FUND REPORT ¶9.07, stated that in large numbers of cases mutual funds had purchased securities underwritten by associated brokerage firms and that such transactions are particularly susceptible of abuse. *See generally* N. WOLFSON, *supra* note 447.

The temptation to place block positioned securities in discretionary accounts will presumably become more severe as a consequence of the recent lowering of liability trading limits on the Toronto Stock Exchange; *see* note 339 *supra*.

453 *But see* s. 28(e) of the Exchange Act, added by the 1975 amendments, which provides that no person having investment discretion with respect to an account shall be deemed to have breached a fiduciary duty solely by reason of having caused the

In Québec, it is prohibited for an investment counsel at any time to be in possession of or to have charge of securities or funds belonging to clients.[454] This rule would effectively prohibit an investment counsel, even if registered to trade, from itself executing transactions for clients.[455]

G. GENERAL OBSERVATIONS ON THE ENFORCEMENT PROCESS

Under the Ontario Securities Act, "the commission, after giving the registrant an opportunity to be heard, shall suspend or cancel any registration where in its opinion such action is in the public interest".[456] Just as the standards for licensing are completely general, in contrast, for example, to the United States federal legislation, so also with the grounds for disciplinary proceedings. Where in the opinion of the commission the delay necessary for a hearing would be against the public interest, the commission may make an emergency suspension without hearing, provided that it sets the matter for hearing within fifteen days.[457] As in the case of denial of registration, a decision of the director suspending or revoking registration is, at the option of the respondent, subject to hearing and review by the commission and thence by way of appeal from the commission to the Supreme Court of the province.[458] A petition for hearing and review from the director's decision to the commission does not act as a stay of that decision unless the commission rules otherwise, and, similarly, an appeal to the Supreme Court does not act as a stay of the commission's order absent grant of a stay by the commission or the divisional court.[459]

The grounds which may give rise to a disciplinary proceeding

account to pay a broker or dealer an amount of commission for effecting a securities transaction in excess of the commission another broker-dealer might have charged for effecting the transaction so long as the investment adviser or fiduciary determines in good faith that the commission was reasonable in relation to the value of the brokerage and research services provided by such broker or dealer. The provision is criticized as excessively permissive in Pozen, *supra* note 122, at 954-80. *See also* SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, *supra* note 34, at 69-71.

454 QSC, Revised Policy Statement No. 19, *supra* note 160, art. 16. Furthermore, any contract between an investment adviser and a client for management of a discretionary account must provide for a named depository, such as a bank or trust company, to hold the client's funds and securities; *id.* art. 15(2).

455 If the investment counsel may not be in possession of customer's funds and securities, then in Québec the requirement that that class of registrant comply with net capital rules seems unnecessary.

456 OSA, s. 8(1).

457 OSA, s. 8(2).

458 OSA, ss. 28(1), 29(1).

459 OSA, ss. 28(3), 29(2).

and result in cancellation or suspension of a licence are as numerous as the imaginable violations of the securities laws and, in fact, more so since, when considering whether a registration should be terminated "in the public interest", the regulatory agency is not limited to considering only statutory violations.[460]

Registration will be suspended or cancelled where the registrant has been dishonest in his application or in a commission investigation.[461]

The OSC has announced that the laying of criminal charges, particularly involving fraud or theft, may be considered as grounds for suspension of registration without prior hearing under OSA, section 8(2).[462]

Where a firm was suspended from the TSE, the commission contemporaneously suspended the firm's registration as a broker and as an investment dealer for the asserted reason that the effect of the suspension by the TSE was to cause a condition of the firm's registration with the commission no longer to exist.[463] That was doubtless so as to the firm's registration in the broker category,[464] but such reasoning does not support the suspension as an investment dealer since, so far as appears from the commission's terse announcement, the IDA had taken no action against the registrant. Perhaps what underlay the commission's decision was an unarticulated policy that registration in *any* category should be suspended or cancelled automatically where suspension or cancellation has been imposed by a self-regulatory organization. If that is the policy, then the validity and reliability of the proceedings before the self-regulatory organizations is automatically assumed. Presumably, however, the action of the self-regulatory organization does not dispense with the requirement that the commission must grant the registrant at some point opportunity for a hearing under section 8; at that point the registrant could attack the proceeding before the self-regulatory organization.[465] Furthermore, an automatic acceptance by the commission as a

460 *See* materials in note 438 *supra*.

461 *In re* Douglas G. Murdock, [1967] OSC Bull. 25 (May); *In re* Ernest Halpin, [1967] OSC Bull. 24 (June); *In re* Michael A. Thomas, [1972] OSC Bull. 118; *In re* H.R. Brondyke, *supra* note 430.

462 OSC, Policy No. 3-30, November 1974, 2 CCH CAN. SEC. L. REP. ¶54-955. The policy states that in order not to prejudice a fair trial of the criminal charges ordinarily the commission will accede to a request made under the Statutory Powers Procedure Act, S.O. 1971, c. 47, s. 9(1), that the hearing be held *in camera*.

463 *In re* Wisener, McKellar & Co. Ltd., [1972] OSC Bull. 158 (July).

464 A broker is defined in Ontario Securities Regulations, s. 2 to be "a member of a stock exchange in Ontario recognized by the commission".

465 There may be some question, however, as to whether the registrant may attack the proceeding before the TSE collaterally in the s. 8 proceeding, where he has not taken the appeal to the commission permitted under OSA, s. 140(3).

basis for its action of the evaluation of facts made by a self-regulatory organization was disapproved by the Ontario Court of Appeal in the *Larrimore* case.[466]

According to National Policy No. 17, "violations of the securities laws of any jurisdiction is considered in principle to be prejudicial to the public interest and may affect fitness for continued registration". The practice of the OSC in cases where registrants have violated the securities laws of other jurisdictions appears to involve not an automatic rule but a determination on the facts of each case.[467]

In a disciplinary proceeding, in addition to the sanction of suspension or revocation of a licence, the commission may also condition a registration under OSA, section 7(3).[468]

The securities commissions in Canada do not have any power to impose fines in disciplinary proceedings.[469] Such a power would be desirable because fines can be graded infinitely to fit the exact circumstances of a case, and at present at least the commission in Ontario appears hesitant to impose even a brief suspension upon a firm because of the consequent prejudice to innocent parties in it and to customers.[470]

The enforcement of the licensing requirements involves not only the aspect of controlling the behaviour of licensees but also preventing nonlicensed persons from engaging in activities that require a licence. Proceedings against such persons would be brought under OSA, section 137, which makes contravention of any other section of the act (for example, section 6, trading, advising or underwriting without registration) or of the regula-

466 *In re* Larrimore Securities Ltd., [1956] O.W.N. 501, 4 D.L.R. (2d) 727 (C.A.).

467 As indeed must be the case if the commission is not to be guilty of fettering its discretion in advance; *see* discussion in ch. III.A *supra*. *Compare In re* Alexander & Associates Ltd., [1953] OSC Bull. 3 (June) *with In re* David L. Rotenberg, [1967] OSC Bull. 28, 44 (September); *and In re* Canadian-American Securities Service Ltd., [1968] OSC Bull. 230 (October).

468 *In re* Hevenor Co. Ltd., [1971] OSC Bull. 50 (April). A favoured disciplinary sanction of the SEC in the United States is to prohibit a person from being associated with a broker-dealer "except in a non-supervisory capacity and subject to adequate supervision".

469 The TSE (by-laws, s. 17.10, 3 CCH CAN. SEC. L. REP. ¶89-730) and the IDA (by-law 19, s. 7), on the other hand, do have the power to impose fines as a disciplinary sanction. Like the OSC the SEC has no such power. An argument against a fining power in a regulatory agency might be made on the basis that a fine is a criminal sanction and therefore is not an appropriate sanction to be imposed by an agency, as opposed to a court. If the matter is looked at functionally rather than theoretically, however, it appears that a fine may be a good deal less severe a sanction than a suspension or revocation; therefore a body that can be trusted with the power to impose the latter sanction can be trusted with the former.

470 *See* materials in note 489 and accompanying text *infra*.

tions an offence punishable by fine up to $2,000 or imprisonment up to one year, or both.[471]

As an aid in enforcement, the provincial securities commissions have quite extraordinary powers of investigation. These powers have been considered by the courts on numerous occasions and their validity sustained.[472] Either the commission or the minister may appoint any person to make such investigation as it or he "considers expedient for the due administration of this Act or into any matter relating to trading in securities, and in such order shall determine and prescribe the scope of the investigation".[473] The permissible scope of the investigation may be just about anything conceivably related to trading in securites.[474] The person making the investigation has the same power to summon witnesses, to give evidence and to produce documents as is vested in the Supreme Court for the trial of civil actions.[475] A witness in an investigation may be represented by counsel[476] but there is no provision permitting a party whose affairs are being investigated from having counsel present at any but his own testimony. No person may, without the consent of the commission, disclose to anybody other than his own counsel any evidence or the name of any witness.[477] The person making the investigation may seize and take possession of any documents or records of the person being investigated.[478]

The most far-reaching power of all is that the commission, in connection with an investigation or in connection with a ruling affecting the right of a person or company to trade in securities or in connection with criminal proceedings for a violation of the Securities Act, may order a freeze on all the assets of the subject of

471 For prosecutions brought under analogous provisions of securities acts of other provinces; *see* R. v. W. McKenzie Securities Ltd., 56 D.L.R. (2d) 56 (Man. C.A. 1966); Gregory & Co. Inc. v. Quebec Securities Commission, [1961] S.C.R. 584; R. v. Brown, 16 D.L.R. (3d) 350 (B.C.S.C. 1970).

472 Lymburn v. Mayland, [1932] 2 D.L.R. 6 (P.C.); International Claim Brokers v. Kinsey, 57 D.L.R. (2d) 357 (B.C.C.A. 1966); Re Williams and Williams and Mid-Erie Acceptance Corp. Ltd., [1961] O.R. 657 (C.A.); Torny Financial Corp. Ltd. v. Marcus, [1951] 4 D.L.R. 762 (Ont. H.C.). In the Kinsey case, the B.C. legislation was upheld as *intra vires*, although the provincial Attorney-General was found to have exceeded his powers under the statute in various ways. On investigations *see generally* Baillie *supra* note 220.

473 OSA, ss. 21(2), 23. In the statute at issue in the Kinsey case, *supra* note 472, the investigatory power defined by the statute was "into any matter relating to a trade" and the court concluded that the act did not authorize the Attorney-General to make an investigation into trading generally.

474 OSA, s. 21(3).

475 OSA, s. 21(4).

476 OSA, s. 21(5).

477 OSA, s. 24.

478 OSA, s. 21(6).

the proceeding in the hands of anyone.[479] Finally, in the same circumstances as would enable it to impose a freeze order, the commission may apply to a judge of the Supreme Court for the appointment of a receiver or trustee of the property of the subject person or company.[480]

In looking at the OSC's disciplinary proceedings over a number of years, as reported in the monthly bulletins, one cannot help but note what appears to be a complete lack of standards in fitting the sanction to the violation. It would seem that a registrant going into a hearing at which charges concerning certain specified types of alleged misconduct were to be aired, having read all the OSC monthly bulletins and assuming that the commission would be satisfied of the truth of the charges, would not have the slightest idea what sort of sanction to expect: his registration might be suspended for a couple of days or cancelled. For example, in 1965, the registration of *Harold N. Reynolds*[481] as a salesman was cancelled on the basis that he had made a representation prohibited by OSA, section 69, namely, that an investor's money would double in a certain stock. Ten years later *Rosmar Corporation Limited*,[482] a promoter of speculative mining stocks, and certain of its principals had their registrations suspended for five days upon proof that they had made another representation prohibited by section 69, that they would buy back securities from the persons to whom they were selling them, and had committed what is probably the cardinal sin of securities law: engaging in a distribution of securities for which there had been no prospectus filed. *Michael A. Thomas*[483] had his registration as a salesman cancelled for having lied about a pot-smoking incident in Afghanistan; *Goldmack Securities*[484] received a two month suspension for participating in a market manipulation of over-the-counter mining stocks. *Ross McGroarty*[485] had his registration suspended for a year – and not revoked – after it was proved that he had repeatedly ordered securities for clients' accounts without the permission of the clients, where the securities were highly unsuited for some of the clients and where the securities were being touted by the registrant on the basis of little or no research.

Not infrequently, the issues of proof of offense and sanction have been confused, and the commission has referred to the evi-

479 OSA, s. 26.
480 OSA, s. 27.
481 [1965] OSC Bull. 1 (July-August).
482 [1975] OSC Bull. 30 (January).
483 [1972] OSC Bull. 118 (June).
484 [1966] OSC Bull. 21 (January).
485 [1976] OSC Bull. 239 (September).

dence being uncertain and then proceeded to impose a light sanction, possibly in the expectation that there would be no appeal.[486] James Baillie has made this observation on OSC disciplinary proceedings:

> "The wide range of grounds upon which a denial or suspension of registration may be based, combined with judicial reluctance to review the merits of such a denial or suspension mean that the effective constraints on the exercise by the commissions of this power are very limited. These considerations, combined with the fact that the commissions are not bound by legal or technical rules of evidence, result in considerable temptation to rely on suspension of registration in cases where there is doubt whether a suspected fraud can be successfully proven in court."[487]

On the other hand, the B.C. Corporate and Financial Services Commission appears to take great pains in reviewing the findings of the Superintendent of Brokers of that province and not infrequently it disagrees with the superintendent.[488]

In the case of a large firm, even where the Ontario commission finds a violation on the part of a firm (often failure to supervise), it consistently fails to impose any penalty at all against the firm, on the grounds that a suspension would be unfair to the innocent people in the firm and inconvenient to its customers.[489] The prob-

486 *In re* Lionel Richmond, Henry Collins, Donald F. Greco, [1968] OSC Bull. 222 (September); *In re* MacDougall & Co. Ltd., [1968] OSC Bull. 5 (January); *In re* Nicola Musella, [1967] OSC Bull. 14 (April). However, in one case in which the director had imposed sanctions in the absence of evidence in support of allegations, the commission reversed for that reason; *In re* Murray Kadis, [1969] OSC Bull. 129 (July).

487 Baillie, *supra* note 220, at 500.

488 *E.g. In re* Alan Gould, *supra* note 136; *In re* Fisher Securities Corp., *supra* note 349; *In re* Alan Savage, B.C. Corp. & Fin. Serv. Comm'n Weekly Summary, April 23, 1976, at 11; *In re* Larry Groberman, B.C. Corp. & Fin. Serv. Comm'n Weekly Summary, January 9, 1976, at 7. In disciplinary matters, the structure of adjudication in British Columbia is different from that of Ontario. The power to suspend or to cancel a registration in Ontario is given by the act (s.8) to the commission, rather than to the director, and the commission has not delegated this power. In B.C., on the other hand, disciplinary hearings are conducted first before the Superintendent (or Deputy Superintendent) of Brokers, an office equivalent to that of the director in Ontario, and then an appeal lies to the Corporate and Financial Services Commission, under British Columbia Securities Act, s. 30(1). *See generally* Getz, *supra* note 136.

489 *In re* W.D. Latimer Co. Ltd., [1975] OSC Bull. 102 (March); *In re* United Investment Services Ltd., [1972] OSC Bull. 20 (February); *In re* Davidson & Co., [1972] OSC Bull. 7 (January); *In re* Robertson, Malone & Co. Ltd., [1968] OSC Bull. 254 (November); *In re* Goodwin, Harris & Co. Ltd., [1968] OSC Bull. 266 (November); *In re* J.F. Simard Co. Ltd., [1961] OSC Bull. 1 (November). The reluctance to discipline firms, as opposed to the individuals in them is not peculiar to the OSC. It is shared by the SEC; *see e.g. In re* Shearson, Hamill & Co., Inc., [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶77,306 (1964), detailing one of the more blatant securities frauds in

lem with such an approach is that it seems to sanction one rule for the large firms and another for small ones; in the process of doing so it may give the large firms almost a *carte blanche.* A commission that had the power to impose fines, and not just suspensions and revocations, would be able to discipline firms at least without inconvenience to their customers.

Chapter V
Public and Foreign Ownership of Securities Licensees

The topics of foreign ownership and public ownership of licensees in the securities industry in Canada were first brought together in 1970, in the *Report of the Committee to Study the Requirements and Sources of Capital and the Implications of Non-Resident Capital for the Canadian Securities Industry (Moore Committee Report).*[490] That report concluded generally that for the medium term the traditional sources of capital for the securities industry, that is, partners, officers and directors and their trusts and estates, would be sufficient to meet the projected needs of securities firms.[491] The *Report of the Securities Industry Ownership Committee of the Ontario Securities Commission (OSC Ownership Report)*, published some two years after the *Moore Committee Report*, concluded that additional sources of capital were needed in the industry, taking specific issue in this respect with the conclusions of the earlier report.[492] The more liberal attitude of the *OSC Ownership Report* as compared with the *Moore Committee Report* toward the question of public ownership of licensees (discussed

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modern annals. The registrant underwrote an issue without filing a prospectus, touted the securities to its customers and then, on the basis of highly adverse, undisclosed inside information, bailed out of its own position in the securities - all the while publishing bid and ask quotations for the securities, notwithstanding its refusal to accept sell orders from other brokers or from its own customers. The SEC imposed no sanction against the firm.

One careful study of SEC disciplinary sanctions has revealed a gross disparity in sanctions as between members of the New York Stock Exchange and their associated persons and non-NYSE members and their associated persons, with the sanctions far lighter for the former group. Thomforde, *Patterns of Disparity in SEC Administrative Sanctioning Practice*, 42 TENN. L. REV. 465 (1975). The same author has suggested that the commission should channel its own discretion in choice of sanctions by adopting a rule that would spell out explicitly the factors to be taken into account in determining the sanction; Thomforde, *Controlling Administrative Sanctions* 74 MICH. L. REV. 709, 716-33 (1976).

490 The committee was established by the IDA and the Canadian, Montreal, Toronto and Vancouver stock exchanges. Its chairman was Trevor H. Moore.

491 MOORE COMMITTEE REPORT, *supra* note 200, at 57. The report's projections and conclusions were for the "medium term future" which as defined therein would have expired about 1974-75; *id.* at 54.

492 OSC OWNERSHIP REPORT, *supra* note 53, at 7, 94.

below) no doubt reflected the different appraisals of the two reports of the need for additional sources of capital generally in the industry.

The Moore committee was established largely in reaction to the takeover in 1969 of a substantial Canadian firm, Royal Securities Corporation Ltd., by the largest American securities firm, Merrill Lynch, Pierce, Fenner & Smith Inc.,[493] and so it was inevitable that in considering sources of capital for the Canadian securities industry generally, the Moore committee would give particular attention to the question of foreign ownership.

A. PUBLIC OWNERSHIP

On the issue of public ownership of securities firms, the *Moore Committee Report* declined to adopt the very liberal stance that in the United States had initially been proposed by the Midwest Stock Exchange and ultimately was adopted by the SEC.[494] The chief cause of concern to the Moore committee in liberal public ownership rules was the possible loss of meaningful control over firms by the persons responsible for their day-to-day affairs. It was feared that this loss of control might be reflected in a decline in the standards observed by and services provided by securities firms.[495] Under the Moore proposals, all the world would have been divided into industry investors, being persons active in the day-to-day affairs of securities firms and the trusts and estates of such persons, and nonindustry investors, meaning everyone else. In order to invest in a securities firm, a nonindustry investor would have to be approved by the appropriate self-regulatory organizations. No single approved investor could hold more than 10% of the voting or participating securities of a firm, and approved investors in the aggregate were limited to 25% of such securities.[496] The requirement that any nonindustry investor, no matter how small his investment, would have to be approved would effectively prevent the development of a public market for the securities of securities firms. The *Report of the Joint Industry Committee to Study the Moore Report* (the Joint Industry committee being con-

493 MOORE COMMITTEE REPORT, *supra* note 200, at 1; OSC OWNERSHIP REPORT, *supra* note 53, at 13, 98.

494 MOORE COMMITTEE REPORT, *supra* note 200, at 39-41. The Midwest Stock Exchange proposals were that outside ownership of securities firms be permitted without limitation as to the percentage of a firm's capital that could be owned by outsiders in the aggregate, although any outside investor holding more than 5% of the capital of a securities firm would have to be approved by the exchange.

495 *Id.* at 60-62.

496 *Id.* at 101-04. Up to 40% of a firm's total capital, including subordinated debt and equity, could be held by approved investors.

stituted by the same organizations as had commissioned the *Moore Committee Report*) was released in July 1971 and was in substantial agreement with the Moore recommendations on public ownership.

Finally, there were released in 1972 in Ontario and in Québec reports of government-sponsored committees that dealt with the questions of public and foreign ownership of securities licensees. The *OSC Ownership Report* went much farther in its recommendations on permissible public ownership than had the Moore and Joint Industry committees. The OSC committee noted that there had never been any explicit prohibition against public financing of securities firms but that such a prohibition had been implicit in the registration process in the manner in which the commission examines an applicant firm's sources of capital to guard against the entry of criminal or otherwise undesirable elements.[497] The OSC committee was of the view that there was a fairly pressing need for new sources of capital to become available to the securities industry. On the evidentiary basis of a questionnaire sent to licensees, it concluded that some firms were impeded by insufficient capital from engaging in activities necessary to vigorous capital formation in Canada: notably underwriting.[498] It also saw the turnover problem as a drain on "working capital available for innovation and expansion": that is, the recurring need for juniors to buy out senior officers or partners wishing to retire.[499] The *OSC Ownership Report* recommended that a registrant able to meet the NYSE - NASD requirements, chief of which was $2 million in capital before the public offering, should be allowed to go public by filing a prospectus, much as any other issuer.[500] By virtue of filing a prospectus, such a registrant would become a reporting issuer. Smaller or less well established firms would be able to raise outside capital along the lines proposed in the *Moore Committee Report*.[501] On the public ownership question the *Report of the Québec Ministerial Committee* adopted a stance less restrictive than Moore but more restrictive than the OSC.[502] It proposed to allow securities firms to sell not more than 50% of their voting securities to third parties, with the proviso that any one third party be limited to not more than 10% of the voting securities of a securities firm.[503] In addition, firms would be allowed to issue to

497 OSC OWNERSHIP REPORT, *supra* note 53, at 79.
498 *Id.* at 66-67.
499 *Id.* at 68.
500 *Id.* at 120.
501 *Id.*
502 QUEBEC DEPARTMENT OF FINANCIAL INSTITUTIONS, COMPANIES AND COOPERATIVES, STUDY OF THE SECURITIES INDUSTRY IN QUEBEC, FINAL REPORT (L. Bouchard chairman 1971) [hereinafter cited as BOUCHARD REPORT].
503 *Id.* at 146-47.

third parties various types of nonvoting capital stock and long-term bonds.[504]

The hard times prevailing in the securities industry over the past several years has made public ownership of securities firms much less of a hot topic than it once was.[505] But even bad times hopefully are not permanent and it therefore appears appropriate to make yet one more comment on the matter. In the writer's view, the approach and the reasoning of the *OSC Ownership Report* are the most persuasive that have emerged thus far in Canada on the public ownership debate. Securities firms should be permitted generally to seek capital from such sources as they see fit and it is not against the public interest that there should develop a public market for such securities.[506]

The basic argument against public ownership of securities firms, that control of firms may slip away from persons who are actively engaged in the industry and are amenable to the control of regulatory and self-regulatory agencies and that control could fall into the hands of irresponsible or undesirable elements, is not compelling upon examination. With liberal public ownership rules, such as those prevailing in the United States and proposed for large Ontario firms by the OSC Ownership committee, it is true that voting control could be lost by those who are responsible for a firm's day-to-day management. That is true of any public company. Yet it is widely accepted that managers of public companies, as opposed to their owners, may maintain the effective control.[507] Furthermore, the approval of regulatory and self-regulatory agencies could be required as a precondition to the acquisition of, say, 5% or 10% or more of a firm's voting capital by a nonindustry investor. The regulations might require that where approval, once given, is withdrawn, there must be a forced divestiture to put the

504 *Id.*

505 No public ownership rules were made by the OSC or the QSC. But the TSE has adopted public ownership rules, TSE by-laws, ss. 5.06-5.22, 3 CCH CAN. SEC. L. REP. ¶¶89-276-89-282, following closely the proposals of the MOORE COMMITTEE REPORT, *supra* note 200. Nonindustry investors are limited in the aggregate to 25% of the participating voting securities of a member firm, and individual nonindustry investors are limited to 10%. The total permissible number of such investors in a given firm is 50. Nonindustry investors in a member's equity or subordinated debt must be approved by the exchange. Not more than 40% of the value of all investments in the firm (including equity and subordinated debt) may be owned by nonindustry investors. The Montreal Stock Exchange has adopted an almost identical rule; MSE rule IX, 3 CCH CAN. SEC. L. REP. ¶87-784.

506 Shaw and Archibald, in their final study for the TSE recommend "the elimination of those rules in Canada which prohibit securities firms from issuing their securities to the public"; 8 D. SHAW & R. ARCHIBALD, *supra* note 396, at 110.

507 A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932) (especially 119-25, 233-46).

investor under the threshold percentage requiring approval.[508] Although it would be unusual for a publicly held company, there could be a requirement that the selection of directors and/or officers be subject to regulatory approval.[509] In any event, as the *OSC Ownership Report* cogently observes,[510] other highly regulated financial institutions, such as banks, trust companies and insurance companies, have not become disabled from responsible functioning by virtue of obtaining their capital from the general public.

A securities firm's principal asset is its licence, and regulatory authorities can control the behaviour of licensees no matter who owns them. As for the possibility that regulatory authorities would be hesitant strongly to discipline publicly owned licensees because of the adverse effects upon their public investors, that would represent no change from the present situation, where regulatory authorities are excessively hesitant to discipline substantial securities firms.[511] It may well be, of course, that for investors who are unsophisticated or of modest means securities firms are not suitable investments, not only because their licences to engage in business are subject to the disciplinary power of a regulatory agency, but also because their earnings are notoriously unstable. These are matters best dealt with in terms of prospectus disclosure and the obligations of registrants under the suitability rule.

There is at least one sense, however, in which the question of public ownership of securities firms is more complex than has been indicated here. The matter of public ownership introduces the problems of institutional membership on securities exchanges and, indeed, of fixed rates of commission. For while it is easy enough to suggest that securities commissions and exchanges should be able to restrain "undesirable elements" from gaining control of securities firms by having a power to disapprove the acquisition of more than a given percentage of a securities firm's voting shares by a nonindustry investor, that hardly answers the question whether it is undesirable to allow trust companies or insurance companies or mutual fund management companies to purchase securities firms in order that these institutions can execute their own transactions and avoid fixed rates of commission. The precise question of the appropriateness of institutional investors owning securities firms, as opposed to the general appropriateness of public ownership, may be much influenced by the out-

508 *Compare* OSC OWNERSHIP REPORT, *supra* note 53, at 184-85 (app. I.).
509 *Compare* text accompanying notes 161-164 *supra*.
510 OSC OWNERSHIP REPORT, *supra* note 53, at 85.
511 *See* text accompanying note 489 *supra*; and *see* OSC OWNERSHIP REPORT, *supra* note 53, at 92.

come of the current debate on the future of fixed rates of commission.[512]

B. FOREIGN OWNERSHIP

Foreign ownership of Canadian securities firms is a question closely related to public ownership, since both are in reality subparts of a more general question: what sources of capital should be available to be drawn upon by securities firms licensed to operate in Canada? This paper attempts nothing more than an overview description of the current state of the debate on foreign ownership in the securities industry. No recommendations on foreign ownership are offered here because: first, the writer believes that the matter of foreign investment in the securities industry must be resolved as a political question and does not pertain to the realm of securities regulation; second, the Foreign Investment Review Act established a regime of control of foreign investment that is much broader than but includes the securities industry; and, third, at least for Ontario the issue of what to do about existing foreign control of securities licensees has been effectively settled by regulations adopted on an interim basis in 1971[513] and on a permanent basis in 1974.[514]

The proposals of the *Moore Committee Report* with respect to foreign ownership would have treated the securities industry in the pattern that has been established by "key sector" legislation – that is, subjecting foreign investment in the securities industry to a 25%–10% rule. Foreigners in the aggregate could invest in the voting or participating securities of a Canadian securities firm up to a total of 25% and any individual foreigner would be limited to a 10% interest.[515] Foreign controlled securities *firms*, as opposed to foreigners generally, were to be prohibited from making any investment in a Canadian securities firm.[516] Probably the most contentious issue that had to be dealt with by the Moore committee was what to do about foreign controlled firms already doing business in Canada at the time the Moore recommendations were made. These were about fifteen in number; they included some of

512 Shaw and Archibald, who favour un-fixing commission rates, advocate keeping institutional investors out of the brokerage business; 8 D. SHAW & R. ARCHIBALD, *supra* note 396, at 95, 101. Their recommendations are in accord with the Exchange Act in the U.S., as amended, whereby fixed rates of commission are abolished (s. 6 (e)) and financial institutions are to be prohibited from executing brokerage transactions on their own behalf (s. 11(a)).

513 O. Reg. 296/71, in force July 14, 1971.

514 O. Reg. 600/74, now ss. 6a to 6f of the Ontario Securities Regulations.

515 MOORE COMMITTEE REPORT, *supra* note 200, at 147 (recommendation 2).

516 *Id.* at 148 (recommendations 4, 5).

the largest firms operating in Canada.[517] The committee opted for a "grandfather" exemption for those foreign controlled firms that would have allowed them to do a securities business in Canada with no restrictions not faced by Canadian owned firms, so long as control of the foreign controlled firm did not pass to other foreigners.[518]

The *Report* of the Joint Industry committee opposed the grandfather exemption. The Joint Industry committee recommended that firms already foreign controlled should have their capital frozen and should be able to expand their capital bases by addition thereto of not more than 10% of their earnings each year. Expansion at a greater rate would have been permitted for foreign controlled firms that would embark on a program of Canadianization so as to become 75% Canadian owned over a period of fifteen years. On the other hand, the Joint Industry committee would have permitted investments in Canada securities firms by foreign securities firms to the same extent as by other foreigners.

In July 1971, the Ontario government promulgated a regulation restricting foreign ownership of securities firms.[519] Simultaneously a committee of the OSC was struck to make an investigation of ownership of the securities industry. The OSC committee reported in 1972, and in 1974 a permanent rule was adopted which closely followed the report of the Ownership committee and which also was quite similar to the earlier regulation.[520]

The ownership limitation uses the key sector approach allowing for a maximum foreign investment in a securities firm of 25% aggregate and 10% for any single investor. All capital, and not just voting shares, is included in these percentages. A grandfather clause was included which, while more restrictive than the Moore recommendations, was still quite generous. What the complicated rules in substance provide is that firms more than 25% foreign controlled at the time the regulations were adopted may augment their base capital in either or both of two ways. First, they may sell equity to Canadians. Second, the capital employed in the foreign controlled firm's business may be augmented solely out of its

517 Of these 15 firms, nine were members of the TSE. Today, owing largely to the contraction of the American securities industry, only four TSE members are foreign controlled; *see In re* Baker Weeks of Canada Ltd., [1977] OSC Bull. at 41 (February).

518 Moore Committee Report, *supra* note 200, at 149 (recommendation 9). A foreign controlled firm which, after the date of publication of the *Report*, made a wide public distribution of its securities in its home jurisdiction or that of its parent would have obtained capital in a manner significantly different from that permitted for Canadian securities firms and by so doing would have lost its grandfather exemption.

519 O. Reg. 296/71, in force July 14, 1971.

520 O. Reg. 600/74, now ss. 6a to 6f of the Ontario Securities Regulations.

retained earnings (that is, no new injections of capital from the foreign parent) at a percentage rate not greater than the rate of growth of capital of the largest Canadian owned investment dealers.

On the other hand, quite a restrictive rule was adopted with respect to the transfer of control of a foreign controlled firm to other foreigners. The commission was empowered to approve such a transfer in control if – and only if – the commission found that: the foreign controlled registrant provided "material or unique service to Ontario investors not substantially available...through other registrants"; that this service would be continued under the new foreign control; that either the service was dependent upon continued foreign control or that efforts to find Canadian purchasers had been unavailing; and, in addition to all of the foregoing, that the change in control would not otherwise be prejudicial to the public interest.

The OSC has considered an application for a transfer of control of a registrant among foreigners on four occasions: it approved two of the applications[521] and denied two.[522] One of two recent applications for approval of a new foreign controller of a foreign-controlled registrant provoked a head-on confrontation between the TSE and the OSC. The exchange lost.

Baker Weeks of Canada Ltd., a wholly owned subsidiary of a U.S. parent corporation of similar name, applied to the OSC for approval of a change in control to another U.S. securities firm, Reynolds Securities Inc., which had bought the registrant's American parent firm. The OSC, over the opposition of the TSE and the IDA, approved the application, finding that the capacity for research (presumably into U.S. securities) provided by Baker Weeks was a "unique" service to Ontario investors and dependent for its continuation upon Baker Weeks being part of a strong, foreign controlled securities firm such as Reynolds Securities.[523] For reasons not expressed in its opinion (although probably an effort to draw the teeth from the opposition to the application from the self-regulatory organizations) the commission conditioned its approval upon Baker Weeks not entering the underwriting business in Canada.[524]

521 *In re* Laidlaw Securities Canada Ltd., [1973] OSC Bull. 100 (July) (finding of unique access to the New York Stock Exchange for Ontario investors); *In re* Baker Weeks of Canada Ltd., [1976] OSC Bull. 284 (November) (discussed *infra*).

522 *In re* DuPont Glore Forgan Canada Ltd., [1974] OSC Bull. 133 (June); *In re* Reynolds Securities (Canada) Ltd., [1978] OSC Bull. 101 (March).

523 *In re* Laidlaw Securities Canada Ltd., *supra* note 521.

524 The wisdom of imposition of this restriction is questionable from a public policy viewpoint since in the underwriting field there is probably no meaningful competition in Canada today; *see* text accompanying note 396 *supra*.

The board of governors of the TSE, under its by-laws,[525] was also called upon to consider the proposed change in control and it refused approval. Baker Weeks took an appeal from the board of governors to the commission under OSA, section 140(2).[526] The commission allowed the appeal and compelled the exchange to approve the application for change in control under the exchange by-laws.[527] The commission found, in sum, that its adoption of regulations on the foreign ownership question pretermitted any further consideration of that question by the TSE in the context of an application for approval of a change in control of a member.[528]

The victory of Reynolds Securities (Canada) Ltd., as the Canadian Baker Weeks organization came to be known, may prove to have been short-lived. Scarcely one year after the commission ordered the exchange to accept the transfer of control of Baker Weeks to Reynolds Securities (Canada), Reynold's American parent was taken over by Dean Witter & Co., another very large U.S. brokerage house. And so the whole process started again as Reynolds Securities (Canada) sought approval from the OSC for a change in control of the registrant from the former U.S. Reynolds organization to the newly created entity, Dean Witter Reynolds Organization Inc. (DWRO). The TSE had learned its lessons well in the previous go-around and this time it marshalled its evidence against the foreigners in the OSC approval proceeding rather than relying upon its own power to approve or not a change in the control of its member. The OSC denied the application for approval.[529] The commission was unable to satisfy itself: (1), that the services provided to Ontario investors by Reynolds Securities

525 TSE by-laws, ss. 5.03, 3.18, 3 CCH CAN. SEC. L. REP. ¶¶89-273, 89-219.

526 Section 140(2) provides that "[t]he Commission may, where it appears to be in the public interest, make any direction, order, determination or ruling...with respect to any by-law, ruling, instruction or regulation" of the TSE.

527 [1977] OSC Bull. 32 (February).

528 [1977] OSC Bull. at 47-48. For the commission's reasoning, the reader is referred to the opinion. While one may sympathize with the commission's evident annoyance at the exchange for what appears to have been a naked attempt on the part of the exchange members to eliminate some of their competition, the commission's conclusion that the government's regulation ousts TSE jurisdiction to make its own determinations on foreign ownership is of doubtful validity in the light of the Toronto Stock Exchange Act, R.S.O. 1970, c. 465, s. 4(3) which provides that the exchange may impose "any additional or higher requirement [than is mandated by the OSA] within its jurisdiction". The commission appears to be on stronger ground, however, in an alternative holding that the rule of the board of governors adopting the recommendations of the MOORE COMMITTEE REPORT on foreign ownership was not validly adopted in the absence of a by-law, as appears to be required under s. 10 of the TSE Act. In denying Baker Weeks' application, the board of governors claimed to be following the Moore recommendations, by which the board claimed to be bound.

529 *In re* Reynolds Securities (Canada) Ltd., [1978] OSC Bull. 101 (March), 3 CCH CAN. SEC. L. REP. ¶70,098.

(Canada) continued to be either material or unique and (2), even assuming that they were "material", that they were not substantially available from other registrants. The commission noted that "if the present application is successful, the parent firm whose Canadian subsidiary will benefit is a very different firm from that which controlled the originally grandfathered firm".[530] The massive, publicly-held Dean Witter is not the small, institutionally-specialized, research-oriented Baker Weeks. In the intervening year since the original takeover by Reynolds Securities (Canada) had been approved, the Canadian registrant had lost its entire Canadian research capacity, apparently due to the regulatory quagmire in which the registrant was continually immersed.[531] As far as research into American securities was concerned, the commission could find nothing unique about the services of Reynolds Securities (Canada) as distinguished from those of a variety of other Ontario registrants, both Canadian and foreign controlled.

Those findings settled the issue, insofar as the commission's power to grant the application was concerned.

The commission went on, however, to make a separate finding on the public interest question. It found that the continued registration of Reynolds Securities (Canada) under its new ownership would be in the public interest because it was desirable "to provide the discipline of an additional approach and a fresh perspective" to the securities industry by the presence of a number of foreign-controlled registrants.[532] The public interest element of the foreign ownership regulation is cumulative and not alternative to the other factors, however, and therefore the commission was left with no course but to suggest to the applicant that it might appeal to the provincial cabinet for an *ad hoc* change in the regulation to permit the applicant's continued registration.[533]

Looking at the whole course of Baker Weeks proceedings, one is tempted to the observation that the TSE has won the battle (assuming Reynolds Securities (Canada) does not successfully appeal to Cabinet) but lost the war. It has succeeded in eliminating an unwelcome foreign controlled member, but at the same time it has been put very firmly in a subsidiary place to the commission in determining its own membership.

Back in 1972, shortly before the OSC Ownership committee published its report, the Québec Government's *Study of the Securities Industry* was published.[534] That report declined to recommend

530 *Id.*, 3 CCH Can. Sec. L. Rep. ¶70, 098, at 12,696.
531 The irony was not lost upon the commission; *id.* at 12,697.
532 *Id.* at 12,697-2.
533 *Id.* at 12,697-3.
534 Bouchard Report, *supra* note 502.

any substantial restrictions on non-Canadian control of securities firms. It did recommend, however, that a minimum of 25% of the voting capital stock of all securities firms operating in Québec be held by officers or employees resident in Québec.[535] Just as the *Ontario Ownership Report* concentrated on the danger of a dominance by foreign (read "American") securities firms over Canadian (read "Ontario") firms, so the Québec study concentrated upon the position of dominance of Ontario-based firms doing business in Québec over the Québec-based firms.[536] The concern expressed in the Québec study over the dominance of non-Canadian firms was minimal as compared with concern over the position of Canadian non-Québec firms.

Since publication of the Québec and Ontario reports dealing with ownership of licensees, there has, of course, been a major initiative on the part of the federal government in the form of the Foreign Investment Review Act (FIRA).[537] The screening mechanism of FIRA, operative where non-Canadian interests seek to acquire a Canadian business enterprise or to establish a new business in Canada not related to some business that such foreign interests already are conducting here, will be fully applicable to the securities industry. The act specifies that in determining whether a proposed investment meets the designated test for approval, "significant benefit to Canada", the Foreign Investment Review Agency and the cabinet shall take into account, *inter alia*, "industrial and economic policy objectives of any province likely to be significantly affected by the acquisition or establishment".[538] It therefore incorporates an apt mechanism for taking into account in the securities industry context the quite different views on foreign ownership prevalent in Ontario and in Québec.

On the other hand, FIRA leaves untouched expansion by foreign-controlled securities firms already doing a securities business in Canada on the effective date of Stage II of the act (review of new business establishments) so long as such expansion does not involve acquisition of an existing business enterprise. Furthermore the threshold purchase that will be deemed acquisition of control of a Canadian business enterprise is 20% of the voting shares[539] – a level twice as high as that considered acceptable by

535 *Id.* at 134.

536 *See e.g. id.* at 38, 77, 80, 83-86, 97-100, 116-17, 134-36.

537 S.C. 1973-74, c. 46.

538 *Id.* s. 2(2)(e).

539 "[T]he acquisition by any person or group of persons of shares of a corporation to which are attached ... (ii) 20% or more of the voting rights ordinarily exercisable at meetings of shareholders of the corporation, in the case of a corporation the shares of which are not publicly traded, shall, unless the

the Moore, Joint Industry and OSC committees for ownership by a single foreign interest. If the existing federal controls on foreign investment are more permissive than some of the provinces deem suitable with respect to the securities industry, there appears no reason why such provinces cannot enforce their own more restrictive rules – as is being done presently in Ontario. In fact, the Federal government under FIRA took no action on Dean Witter's application to take over Reynolds Securities (Canada) and, as a result,[540] Dean Witter's application was deemed approved under FIRA.[541]

The vital importance of the securities industry to Canada's economic welfare cannot be gainsaid and thus the securities industry, like other areas of the financial industry,[542] may with particular appropriateness be treated as a key sector for purposes of prohibitions on foreign control, as is urged in the *Moore Committee Report*.[543] At least a certain symmetry would be achieved. However, no such recommendation is made in this paper because the question of the desirability or not of a foreign presence in the securities industry, and how much of a one, pertains to the world of politics and not that of securities regulation. It is a question that is part of a much larger framework: that defining Canada's economic independence or interdependence. It is not a question susceptible of empirical demonstration. Also, it is a question on which there is a very marked difference of opinion between Canada's two most important financial centers, Québec and Ontario, as is demonstrated by the Quebec Securities Commission's recent order to the Montreal Stock Exchange to approve the transfer of control of Reynolds Securities (Canada) to Dean Witter.[544] Finally the question of what to do about foreign-controlled securities firms already registered here has, in the writer's view, in effect been settled for

contrary is established, be deemed to constitute the acquisition of control...".

Foreign Investment Review Act, S.C. 1973-74, c. 46, s. 3(3)(c). The threshold level for publicly traded corporations is 5%, but at present there are no publicly traded securities brokers and dealers in Canada. Acquisition of control of a firm not organized as a corporation may be acquired only by acquiring all or substantially all of the property used to carry on its business; *id.* s. 3(3)(a). There are a few securities firms organized as partnerships rather than corporations. However, all nonresident controlled companies registered to trade in Ontario must be incorporated in Canada; Ontario Securities Regulations, s. 6c(c); OSC OWNERSHIP REPORT, *supra* note 53 at 52.

540 Foreign Investment Review Act, s. 13.

541 Foreign Investment Review Agency, News Release F-20, April 27, 1978.

542 For a comprehensive treatment, *see* Arnold, *Restrictions on Foreign Investment in Canadian Financial Institutions*, 20 U. TORONTO L. J. 196 (1970).

543 MOORE COMMITTEE REPORT, *supra* note 200, at 137.

544 9 QSC Bull. No. 9 (Decision No. 5460, March 7, 1978).

Ontario, the dominant Canadian province in securities matters, by the 1972 regulations.[545] The question was ventilated and reventilated and certain rules were adopted. As a practical matter, it would be exceedingly difficult, if not unfair, to establish more restrictive rules now.[546]

Chapter VI
Recommendations

The following recommendations take account only of changes that the writer would make in the present licensing system for the securities occupations in Canada. Hopefully all of the recommendations flow, at least implicitly, from the foregoing paper. References to the parts of the paper most relevant to each recommendation follows it in parentheses.

(1) A federal licensing initiative in the securities area appears warranted. This conclusion, it must be confessed, is advanced with hesitation. After all, as the foregoing paper indicates, the present provincial licensing system is by no means demonstrably inadequate. The standards of the Canadian securities marketplace at the present moment do not appear to the writer to be shockingly low by any means even though the junior mining and exploration marketplace in the West appears wild and woolly indeed. The writer is not competent to perform an economically accurate cost-benefit analysis concerning introduction of a federal licensing requirement, but we can be sure that there will be substantial costs – both public and private. It might well be possible to have federal securities legislation covering a number of substantive areas and yet to leave licensing as is: exclusively in provincial hands. Even if there is to be federal licensing it will very likely duplicate, not oust, provincial regimes. While a federally granted licence might well be made a necessary condition for the conduct of a given securities market business interprovincially, it probably could not be made a sufficient condition for the conduct of that business within a province which also chose to license it.

545 O. Reg. 600/74, now ss. 6a to 6f of the Ontario Securities Regulations.

546 Recently the OSC has announced an inquiry into the activities of nonresident, nonregistered brokerage houses in Ontario; [1978] OSC Bull. 17 (February). While the announcement states that the commission does not plan to re-examine the issue of foreign control of registrants, in actuality the two issues may prove inseparable. If foreign controlled firms are now carrying on business in Ontario without registration under the umbrella of the very broad exemptions in OSA, s. 19 and if it is proposed to limit these exemptions insofar as foreign-controlled firms are concerned, then either the firms will have to be allowed to register, albeit in a limited way, or else they will have to cease their activities.

Why, then, federal licensing? First and foremost, to the writer the securities markets appear to be a matter eminently of national and not just local concern. It is important to have uniform and uniformly high standards imposed and observed across Canada. Second, while federal licensing will not *ipso facto* oust the provinces, a likely scenario would call for many of the provinces, especially the smaller ones, to drop out of securities regulation altogether over time. Duplication will not, in fact, be complete and those provinces that wished to opt out of the field in reliance upon the federal regulatory regime could do so without sacrificing the interests of their residents. Third, the present provincial statutes appear effectively to reserve to the particular province the right to shut off interprovincial securities trade across its borders, at least so long as the essential powers of federally chartered companies are not sterilized in the process. Such a situation is barely tolerable in a nationally integrated economy (*passim*, especially chapter II.D).

(2) Adoption of the approach of the American federal legislation to defining those persons who must be licensed in order to trade securities as persons "in the business of" trading securities is recommended. Such an approach would cut back drastically on the number of exemptions needed. Those exemptions that would still be deemed desirable, such as exemptions relating to the types of securities traded, should be stated separately from the exemptions from the prospectus requirement. The drafting technique of Ontario's Bill 7 is to be commended in this latter regard (chapter II.A).

(3) In the matter of exemptions to trade certain types of securities, a more discriminating approach than is evidenced in the present acts would be appropriate. There is, for example, no justification for the exemption enjoyed by securities issued by non-Canadian governments. Also suspect in the writer's view are the exemptions for mortgages, and for securities issued by cooperatives and by not-for-profit corporations. It must be added, however, that the foregoing paper does not demonstrate the inappropriateness of these exemptions. A caveat concerning them is perhaps all that is appropriate (chapter II.A.3).

(4) There does not appear to exist any compelling reason to license the business of advising others as to the merits of securities investments when the advising is carried on by a person who is not licensed to trade securities and who does not provide investment management, as opposed to investment advice. There are very few such pure adviser registrants at

present. Subjecting the writer of market letters to licensing while leaving publishers of and writers in newspapers of general circulation outside the pale does not seem rational. Furthermore, even granting that the persons at whom securities advice is aimed may well have a much harder time evaluating its merits than they would have evaluating advice concerning consumer tangibles, it is not apparent that the state either can or should protect its citizens against incompetent advice. This view relates, it is worth emphasizing, only to advice taken alone. When the advising is done by a person in the business of trading in securities or assumes the form of discretionary management, then the opportunities for conflicts of interest or even abuse of trust become sufficient to warrant a state role in their control (chapters II.C and IV.F).

(5) There is not much cause to believe that the extremely broad and legislatively unguided discretion that has been committed to securities administrators in the licensing decision has been abused or that licences have often been denied to people who should have received them. Nonetheless, a seemingly boundless discretion committed to licensing authorities does not appear to the writer to be an attractive legislative technique. It may be neither possible nor desirable to set out disqualifications with precision, but the statute should at least be cast in the form "The [administrator] shall grant the licence unless he finds that...". Then disqualifications could be listed, albeit broadly: fails to meet educational or training prerequisites; fails to meet capital requirements; has been convicted of a crime involving moral turpitude within past [x] time period; has been found to have violated the securities laws of a Canadian jurisdiction or a foreign jurisdiction imposing a similar scheme of regulation within past [x] time period. One might even be prepared to add a catch-all disqualification: not otherwise of good character, although this with hesitancy. In any case, "the public interest" is far too general a standard (chapter III).

(6) With respect to grounds for disciplinary action, some meaningful attempt at specification should be made. Arguably greater precision and greater procedural safeguards should be demanded in the decision to suspend or revoke a licence than in the licensing decision itself since taking away an extant means of livelihood is a more devastating decision than shutting off one of a great number of avenues in a person's future. The record of securities regulators in disciplinary proceedings has not been as free from blemish as in the licensing area. There has been noted in the text a certain

tendency to substitute considerations of poor reputation, and even conjecture, for proof in disciplinary proceedings. The theoretical availability of judicial review has not in practice always kept the agency in line in the exercise of its discretion. This is particularly likely to be the case where courts defer to a supposed agency expertise in determining what is in the public interest and are prepared to hold that grounds for discipline are not limited to statutory violations. The writer would like to see the grounds for discipline spelled out with more precision, in a manner analogous to recommendation (5) above. These would include conviction of a crime involving moral turpitude; violation of the statute and regulations validly enacted under it; violations of the securities laws of other, similar, jurisdictions; and – perhaps – violation of ethical precepts generally accepted in the industry. Finally, it would appear reasonable to give licensees the protection of a statute of limitations, even if the tolling period were rather a long one in recognition of scarcity of investigative resources and the paramount public interest in the integrity of the marketplace. Furthermore, the statute should spell out both the quantum and the burden of proof in disciplinary proceedings (chapters III.D and IV.G).

(7) The writer would like to see a fining power in the regulatory authority. This would seem the most promising solution to the problem of securities regulators' excessive hesitancy to discipline firms, as opposed to individuals, even in cases where violations appear to be truly those of the firm and not just the result of an aberrational failure of supervision (chapter IV.G).

(8) While the topic of self-regulation in the securities industry is not an immediate concern of this paper, the question of whether membership in a self-regulatory organization is to be made compulsory for securities market licensees will have to be considered. On the basis of the present record, the writer would be opposed to obligatory membership. Certainly imposition of such a requirement could not seriously be entertained in the absence of statutory imposition of duties on the self-regulatory organizations to: (a) accept for membership all applicants that meet statutorily defined standards; (b) enforce standards of ethical conduct against their members, and (c) discipline their members in proceedings that will afford the protections of natural justice to the member and the results of which will be public, at least where a finding of misconduct is made. Assuming, however, that membership in a self-regulatory organization is not to be mandatory, nonmembers should be required to pay as fees to the regulatory

authority any incremental regulatory expenditures that must be made from the public purse as a result of the nonmembership (chapter IV.A).

(9) It would be impossible to spell out in legislation all the standards of conduct that registrants may appropriately be compelled to observe. On the other hand, policy statements are not a satisfactory alternative to binding regulations. Nor does one feel confident that appropriate standards can be developed out of some vague notion of the common law of regulation. It would seem, in short, highly desirable that there should be a securities regulatory authority which itself has a rule-making authority in the area of behavioural standards for licensees. At a minimum, it would appear that licensees themselves would be well served by standards that clarified, to the extent possible, what conduct is permissible and what is not (chapters III.A and IV).

(10) Many of the conflict of interest situations confronting securities market licensees are unavoidable – at least by means that would not require a total restructuring of the securities industry in a manner whose outcome it would be hazardous to predict. In particular this is true of conflicts arising from the commission method of compensation, from the fact that by serving as underwriters and in other capacities the personnel of trading firms may become privy to inside information concerning issuers, and from the general mixing of agency and principal trading functions within a single firm. On the other hand, some conflict situations could be avoided without radical surgery on the industry. Serious thought should be given, in particular, to prohibiting licensed traders from managing pooled funds on a discretionary basis. While some Canadian broker-dealer firms do manage mutual funds and other types of pooled accounts, this activity is not believed to be major for many of them. If a prohibition is going to be instituted, the sooner the better. Discretionary management of pooled funds presents conflict situations arising not only out of the commission method of compensation for executing trades but also out of the possibility that the manager's investment decisions for the fund will be coloured by the manager's own position, and those of its associates, in various securities. Current regulations designed to minimize this latter conflict are not particularly strong. If discretionary management of pooled funds were to become an activity banned for broker-dealer firms, strict logic would dictate that the ban be extended to managing the funds of individuals. The writer would not think, however, that a ban going so far would be

warranted. For one thing, discretionary management of individuals' accounts is a much more traditional activity for broker-dealer firms than management of mutual funds and pension funds. More importantly, unlike the case of pooled funds, it does not appear that there are entities other than broker-dealer firms that could suitably manage the securities accounts of individuals on a discretionary basis. Trust companies, in particular, would not be suitable managers for accounts with speculative investment objectives (chapter IV.F).

(11) Present regulation does not, in the writer's view, impose sufficient obligations upon broker-dealers to make full disclosure of their interests in securities concerning which they render advice. Form hedge clauses are not in all cases sufficient disclosure. Present regulations do not require any disclosure to be made concerning a whole variety of interests and relationships that a broker-dealer or its principals or associated persons may have with an issuer of recommended securities. Ontario's Bill 75 would have equated the disclosure obligations of broker-dealers with those of registered advisers. That approach appears desirable to the writer, considering especially that broker-dealers are more likely to have a variety of positions in the securities they are recommending than are persons or firms who are registered only as advisers (chapter IV.F.3).

(12) The law should not prohibit public ownership of securities firms, although it is entirely appropriate that the officers, directors and major owners of capital of publicly owned firms should require regulatory approval (chapter V).

Government Supervision of Self-Regulatory Organizations in the Canadian Securities Industry

Peter Dey and Stanley Makuch

March 1978

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Chapter I
Introduction

This paper does not purport to answer the question of whether self-regulation in the Canadian scheme of securities regulation has operated in the public interest. Nor does it purport to reach a conclusion that self-regulation is generally preferable to direct government regulation. It is accepted that self-regulation has been and will continue to be an integral part of the Canadian scheme of securities regulation. In order to determine whether the self-regulatory organizations (SROs) have acted in the public interest, a more official process than that involved in writing this paper would be necessary.

In the Canadian scheme of regulation, the manner of regulation of market intermediaries is not an "either-or" proposition, that is, direct government regulation or self-regulation, but is a blend of the two. This paper concentrates on the means for blending the two approaches to securities regulation in Canada and the

In addition to examining published materials concerning the government-SRO relationship, the authors had an opportunity to speak to representatives of the Ontario Securities Commission, the Toronto Stock Exchange, the Montreal Stock Exchange, the Investment Dealers Association of Canada, and other members of the securities industry. Their cooperation and thoughts added much to our understanding of the nature of the relationship between government and SROs. Philip Anisman, director of the securities market study, of which this paper is a part, was helpful in reviewing the manuscript and supplying materials on self-regulation issues.

optimum blend for creating incentives for the SROs to operate in the public interest. The paper also considers the means whereby government, from which the SROs derive their regulatory powers, can be assured that the SROs are acting in the public interest.

This is an aspect of securities regulation worthy of inquiry. The Ontario Royal Commission under Mr. Justice Arthur Kelly which inquired into the Windfall Oils and Mines scandal is the only government inquiry into the functioning of an SRO. The recommendations made in the *Windfall Report* provided the basis for the regulatory framework within which the Toronto Stock Exchange now functions. This framework was established over a decade ago. In the interim, the SROs have continued to thrive in Canada, and it is apparent from recent pronouncements of the Canadian securities administrators that government will continue to rely heavily on the SROs for their contribution to securities regulation in Canada.

In the context of law reform, it is interesting to note that the Ontario Securities Act has undergone substantial revision in the course of a reform process which was recently completed and which extended over a period of almost ten years. However, the Securities Act, 1978, of Ontario, does not significantly alter any of the provisions of the 1966 act affecting SROs. Those familiar with the process of reform in Ontario know that the provisions of the 1978 act dealing with self-regulation did not result from any specific study which concluded that the relationship between government and the SROs was without need of reform. On the contrary, self-regulation is an area of the Ontario act which has not concerned the legislature.

The Commodity Futures Act, 1978, which was also recently enacted by the Ontario legislature, does have a slightly more comprehensive scheme for government supervision of commodities SROs. Part VII of this act imposes general registration requirements upon any person or company seeking to carry on business as a commodity futures exchange in Ontario. The act also spells out the various factors which the Ontario Securities Commission (OSC), the administrator of the act, is required to take into account in determining whether or not to grant registration. Once a commodity futures exchange is registered, it is required to file all of its by-laws, rules, regulations and policies with the commission. The commission is empowered to make any decision on the manner in which the exchange carries on business, etc. The scheme of regulation also provides that any person affected by a decision of a commodity futures exchange may appeal the decision to the commission. The Commodity Futures Act, 1978, represents a modest improvement of its provisions dealing with SROs when com-

pared with the equivalent provisions in the Securities Act, 1978, first, in imposing a general registration requirement upon all SROs, and second, in regularizing the relationship between the SRO and the government supervisor with respect to changes in the SRO constitution. This paper recommends that a similar though more comprehensive code should be included in proposals for a federal securities law.

A geographic limitation of this paper is its concentration on the relationship between government and the SROs in Ontario. This limitation reflects practical considerations. However, it is suggested that the discussion does not suffer materially as a result, for two reasons. First, the Toronto Stock Exchange and the Investment Dealers Association of Canada are representative of the two types of SROs which operate in Canada. Second, the relationships between these two SROs and the OSC are representative of the government-SRO relationships in Canada. It should be noted, however, that the British Columbia Corporate and Financial Services Commission has recently heard a number of appeals from individuals affected by decisions of the Vancouver Stock Exchange and the Vancouver Curb Exchange. These decisions, which are referred to briefly in this paper, are necessary reading for an understanding of the relationship between the British Columbia SROs and the commission. Published material on the relationship between the Quebec Securities Commission and the SROs in Québec is very limited, and therefore has not been relied upon in this paper to any great extent.

Another practical limitation is the fact that the paper does not draw heavily on the experiences of participants in other industries who are attempting to establish a scheme of regulation which includes self-regulation. For example, the accounting profession in the United States is currently attempting to establish a scheme of self-regulation which will be satisfactory to the United States Securities and Exchange Commission. The experience of the U.S. accountants would be useful in any further consideration of the subject of self-regulation in the Canadian securities industry.

This paper provides only a condensed discussion of the SROs and their history. The description of the SROs is intended to provide the reader with sufficient information to understand the issues being discussed. More detailed information is readily available from the SROs and other sources. Also the paper does not discuss in any depth the substance of many of the important issues facing the SROs – such as fixed or negotiated commissions, institutional membership and non-resident membership – but rather focuses on the government-SRO machinery for dealing with these issues.

The discontinuance of operations by some SROs in Canada warrants study as case studies in any further examination of self-regulation in Canada. For example, in the mutual fund industry, until 1976 mutual funds were regulated by the Canadian Mutual Funds Association, which was an SRO recognized in the provincial securities regulations as a regulator of certain aspects of the business of mutual funds. In that year, the CMFA ceased to function and was replaced by the Investment Funds Institute of Canada, which did not assume the regulatory role of the CMFA but which functions as a trade association. Another example is the establishment of the Broker-Dealers' Association of Ontario, and its subsequent decline. While the weakening of these organizations has been alluded to in a number of writings, it has not been studied in depth. The experience of the BDA may be useful in the area of commodities regulation because the BDA was formed with the encouragement of government. The commodities industry is also being encouraged by government to establish its own self-regulatory organization. Another example occurred in British Columbia, where the Broker-Dealers' Association has ceased to function and its role in the over-the-counter market has been assumed since 1974 by the Vancouver Curb Exchange, which was formed by the Vancouver Stock Exchange.

What does this paper provide? It is divided into two parts, the first generally describing the existing position of the SROs in the Canadian scheme of securities regulation and the second discussing a number of the important issues in Canadian securities regulation with significance for the SROs.

Part I, chapter II, provides some basic information on the SROs discussed in the paper and chapter III describes the provisions in the Canadian securities laws recognizing the SROs. Chapter IV provides an historical perspective for this aspect of Canadian securities laws, and chapter V considers the advantages and limitations of self-regulation.

Part II discusses the need for government supervision of securities SROs and identifies a number of issues which must be faced by Canadian SROs. These include extension of a registration system to SROs (other than stock exchanges which are already registered – in a manner of speaking), procedures for government approval of SRO rule changes, government review of SRO decisions, SRO powers to regulate admission to membership, resolving the conflict between self-regulation and competition in the securities industry and the problems of supervising SROs created by the fragmented scheme of securities regulation in Canada.

Part I

Chapter II
Self-Regulatory Organizations in Ontario

Reference has already been made to the reasons for the concentration of this paper on the relationship between government and self-regulatory organizations in Ontario. References will be made throughout the paper to the TSE (the Toronto Stock Exchange) and to the IDA (the Investment Dealers Association of Canada) which represent the two basic types of self-regulatory organizations in Canada. These two types will be discussed in chapter III. In addition, some reference will be made to the BDA (the Broker-Dealers' Association of Ontario), more for historical interest than for present impact on securities legislation in Ontario. Following is a general description of these self-regulatory organizations, as background to a discussion of the relationship of these SROs with government.[1]

A. THE TORONTO STOCK EXCHANGE

The Toronto Stock Exchange is incorporated by statute of the Ontario legislature[2] and is the only stock exchange carrying on business in Ontario and therefore the only exchange recognized by the Ontario Securities Commission.[3] The *TSE Annual Report* for the fiscal year ended March 31, 1977, stated that the TSE had seventy-five member firms and corporations. Although most members are based in Ontario there are members with principal offices in most parts of Canada. Indeed, there are a number of firms which do not carry on any business in Toronto or in Ontario, but maintain a TSE membership in order to take advantage of higher commission splits between members and in order to "locate" themselves so that they may receive more favourable treatment than non-TSE members when the Canada-wide trading system being developed by the TSE is implemented.

In terms of value of shares traded on a stock exchange in 1976, the TSE ranked fifth in North America, with shares valued just in

1 A brief but informative history of these SROs is provided in J. WILLIAMSON, SUPP., ch. X.

2 The Toronto Stock Exchange Act, 1968-69, S.O. 1968-69, c. 132, now the Toronto Stock Exchange Act, R.S.O. 1970, c. 465. The original incorporating statute was S.O. 1878, c. 65.

3 OSC Policy No. 3-17, April 5, 1971, 2 CCH CAN. SEC. L. REP. ¶ 54-911.

excess of $5 billion having been traded through its facilities.[4] Subject to the exercise of the supervisory powers of the OSC discussed in part II of this paper, the TSE has plenary power over the activities of its members, including admission to membership, business carried on by members, capital requirements for continued membership, directors and shareholders of members, affiliated companies, trading procedures, rates of commission and relations with customers. In addition, the TSE specifies the terms upon which shares are admitted to trading on the exchange.[5] The TSE performs a trade association function to a limited degree, the bulk of its budget being applied to the operation of the stock exchange facility.

B. THE INVESTMENT DEALERS ASSOCIATION OF CANADA

The Investment Dealers Association, in contrast with the Toronto Stock Exchange, does not offer a facility, access to which is necessary to carry on an investment banking business. The IDA is an unincorporated association of 85 securities firms located in all provinces of Canada who "handle over 90% of all of the investment business in Canada".[6] Members of the IDA are generally the larger well-recognized firms that perform most of the underwriting and trading of non-speculative securities. This is ensured because one of the criteria for IDA membership is that the applicant must be carrying on a business of "investment character".[7] This phrase is defined[8] so that an applicant (and a member on a continuing basis)[9] must derive at least 60% of his gross profits from his dealings with the public, or at least 60% of his total dollar volume of business from trading "investment securities". Investment securities are limited to government, municipal and corporate debt securities not in default, preferred shares not in arrears of dividends and common shares with a demonstrated earning power.[10]

4 The Montreal Stock Exchange ranked eighth with a volume of approximately $1-1/2 billion. *See* TORONTO STOCK EXCHANGE, ANNUAL REPORT 24 (March 31, 1977).

5 For a general discussion of the secondary market in Canada, *see* D. SHAW & R. ARCHIBALD, 8 THE MANAGEMENT OF CHANGE IN THE CANADIAN SECURITIES INDUSTRY 52 (1977) (The Canadian Securities Market, A Framework and a Plan).

6 *Minutes of Proceedings and Evidence of the House of Commons Standing Committee on Finance, Trade and Economic Affairs: Respecting Subject Matter of Bill C-42, An Act to Amend the Combines Investigation Act and to Amend the Bank Act and Other Acts in Relation Thereto or in Consequence Thereof,* No. 52, at 36 (June 7, 1977) (statement by A.G. Kniewasser, president of the IDA).

7 IDA by-law 2.2(e), IDA, BLUE BOOK 406 (1977), 1 CCH CAN. SEC. L. REP. ¶ 821, at 758.

8 IDA by-law 1.1(f), *id.* IDA, BLUE BOOK at 404 B, CCH CAN. SEC. L. REP. at 755-56.

9 IDA by-law 6.1, *id.* IDA, BLUE BOOK at 415, CCH CAN. SEC. L. REP. at 763-10.

10 IDA by-law 1.1(g), *id.* IDA, BLUE BOOK at 404B, CCH CAN. SEC. L. REP. at 756.

The IDA applies a greater portion of its budget to trade association functions than the TSE but also regulates the capital and trading practices of its members.[11] A member's capital position is monitored weekly, monthly and yearly in varying degrees and a surprise audit is conducted at least once every fifteen months.

Membership in the IDA, as non-resident securities firms have discovered, is virtually a prerequisite to participation in national underwriting. However, membership in the IDA is not a legal prerequisite to carrying on an underwriting business. The choice of the underwriter is up to the issuer and theoretically the issuer can choose a firm other than an IDA member.[12] The underwriter assembles the banking group and the selling group, subject occasionally to suggestions by the issuer. In fact, if an issuer is anxious for broad distribution of securities, the issuer will choose an IDA member as underwriter and the underwriter will put together banking and selling groups composed of only IDA members. In some respects, the IDA does operate a marketplace like the TSE in that to effect a broad distribution of securities it is essential for members of the IDA to be involved in the distribution.

The IDA is also directly involved in regulation of the market practices associated with the underwriting and distribution of securities,[13] that is, the primary market, and in regulation of the secondary market in corporate and government bonds.[14]

C. THE BROKER-DEALERS' ASSOCIATION OF ONTARIO

The Broker-Dealers' Association of Ontario is also incorporated by statute.[15] Any regulations made by the BDA are subject to the approval of the OSC.[16] The circumstances surrounding the establishment and the decline of the BDA are described[17] in chapter IV.

There have been no applications for membership in the past five years. The twelve continuing members are subject to capital restrictions (which are the same as those imposed by the Ontario Securities Act)[18] established by the association and enforced by

11 IDA by-law 17, *id.* IDA, BLUE BOOK at 439, CCH CAN. SEC. L. REP. at 763-32.
12 The Government of Canada chooses only IDA members to underwrite its issues of debt securities.
13 8 D. SHAW & R. ARCHIBALD, *supra* note 5, at 48.
14 *Id.* at 50.
15 The Broker-Dealers' Act, 1947, S.O. 1947, c. 8.
16 *Id.* s. 5.
17 Text accompanying note 79 *infra.*
18 Ontario Securities Regulations, s. 6(1).

regular and surprise audits.[19] The BDA does not offer a trading facility like the TSE or an implicit stamp of approval like the IDA. The only apparent advantage of BDA membership is in the event of a complaint about a member. The OSC normally refers the complaint to the BDA which would conduct the initial investigation. In this respect, the BDA acts as somewhat of a buffer against OSC investigation.

Chapter III
Delegation of Powers to Self-Regulatory Organizations

A. THE MEANING OF "SELF-REGULATORY ORGANIZATION" (SRO)

It is possible for any group of persons or companies with a role in the securities industry – for example, securities salesmen or financial analysts – to establish an association which could have a number of purposes. The association may simply provide a forum for the exchange of information by members. Or, the association may assume the more conventional trade association role, and keep members informed of, and lobby for, changes in the laws affecting the members. The association may apply standards for membership and regulate the conduct of members, using cancellation of membership in the association as the ultimate sanction. If the association is carrying out regulatory functions which are the responsibility of government and government is prepared to recognize this form of regulation, and, indeed, to delegate governmental authority to the association to carry out the regulatory functions, then the association is considered for purposes of this paper a self-regulatory organization – an "SRO".

Recognition of the association by government can come about in two ways. First, the association may operate a facility which is integral to the functioning of the securities markets, such as a stock exchange. A stock exchange assumes the nature of a public utility, which by definition, requires regulation. In the case of a stock exchange, the regulation is normally carried out by its members. Government, however, will want to be satisfied as to the efficacy of the regulation by exchange members to ensure that the utility provided by the exchange is operated in the public interest. Second, the association may not operate a facility, but may feel that it is in a position to effectively regulate certain phases of the activities of its members and therefore will seek government

19 BDA members who are not also TSE members must submit to the secretary of the association all sales literature prior to circulation which acts as a check only against

recognition of its regulatory activities, usually because the association members prefer regulation by their peers. Again, government will be aware that, in the absence of regulation by the association, government will be responsible for regulating the activities of the members, and that to recognize the regulatory activities of the association will amount to a delegation of government power to the association. Delegation of regulatory power can only be made if government is satisfied that the association will exercise its regulatory powers in the public interest.

How are the TSE, IDA and BDA vested with their regulatory powers?

B. LICENSING OF SECURITIES FIRMS

To the extent that trading in securities is to be regulated, the responsibility for such regulation is vested under the present scheme of regulation in Canada, in the government of the province in which the trading takes place. In Ontario, which is a typical province in terms of its scheme of regulation, the government discharges this responsibility through a statutory scheme which, among other things, requires any person wishing to trade in securities to be registered with the Ontario Securities Commission. The registration is granted if the applicant is "suitable" for registration and the proposed registration is not "objectionable".[20]

The commission also has the power to suspend the registration where in the opinion of the commission suspension is in the public interest.[21]

By implementing the registration system government attempts to assure the public of the suitability of all persons and companies carrying on a securities business in each province.

Issuers of securities constitute another major group of participants in the securities industry. The issuers are subject to extensive regulation under the Ontario Securities Act through the requirement for a prospectus on a new issue of securities, through the rules relating to takeover bids and through the provisions of the act requiring financial information on a regular and timely basis – regulatory requirements which are familiar to all Canadian public companies. Issuers of securities differ from registrants in

flamboyance; the BDA check is not a defence in a fitness for registration hearing by the OSC. *See In re* Cumco Corporation Ltd., [1966] OSC Bull. 9 (March).

20 Ontario Securities Act, R.S.O. 1970, c.426, s. 7(1).

21 *Id.* s. 8(1).

that issuers are not generally subject to regulation by SROs whose regulatory powers are exercisable only over their members.[22]

C. DELEGATION OF POWER TO REGULATE NET FREE CAPITAL POSITION OF SRO MEMBERS

Three SROs have been conferred with regulatory power by the act:[23] The Toronto Stock Exchange,[24] the Ontario District of the Investment Dealers Association of Canada and the Broker-Dealers' Association of Ontario. The statutory recognition is provided for in part V of the Ontario Securities Act relating to audits.[25] The act imposes upon every registrant the obligation to keep the books and records necessary for the proper recording of his business transactions and financial affairs and the obligation to file with the OSC annually, and at such other times as the commission may require, a financial statement satisfactory to the commission, and such other information as the commission may require in such form as it may prescribe.[26] There is a broad exception to this requirement for registrants who are subject to audit by the three SROs referred to above. The three SROs are required to cause each member to appoint an auditor from a panel selected by the SRO and the auditor is required to make the examination of the financial affairs of the member prescribed by the SRO and is further required to report to the SRO auditor. The SRO auditor is appointed by the SRO with the approval of the commission.[27] The

22 The exception is the issuer whose securities are listed and posted for trading on a stock exchange. Such an issuer is required to comply with certain provisions in the by-laws of the TSE, for example, the obligation to make a filing statement in the event of a material change in the business of certain issuers. If an issuer does not comply with these by-laws, the TSE has the power to delist the issuer's shares. Issuers are not directly represented on the board of governors of the exchange or on its other regulatory committees. This is also the case for issuers whose securities are listed and posted for trading on the Montreal Stock Exchange and the Vancouver Stock Exchange.

23 The "act" is the Ontario Securities Act, *supra* note 20.

24 The act refers to "every stock exchange in Ontario recognized by the Commission...." As previously stated, the Toronto Stock Exchange is the only stock exchange in Ontario and it is recognized by the commission; Ontario Securities Commission, Policy Statement No. 3-17, *supra* note 3.

25 Ontario Securities Act, ss. 30-33. Ontario Securities Regulations, pt. X, empowers the commission to require reporting of information concerning trading in the over-the-counter market to an agency recognized by the commission. The commission relies on the IDA for supervising the assembling of information on trading in this market and has published a manual for registrants on over-the-counter trading reports.

26 Ontario Securities Act, s. 32.

27 *Id.* s. 30(b). The commission recently gave notice of its approval of a new exchange auditor on certain conditions; *see* OSC Weekly Summary, January 20, 1978; text accompanying note 212 *infra*.

by-laws, rules and/or regulations of the SROs in respect of the practice and procedure of the examination and the actual conduct of the examination must be satisfactory to the commission.[28]

The statutory provisions relating to SRO audits are at first glance merely procedural. However, in practice, they have the effect of conferring upon the SROs the authority for monitoring the conventional index for measuring a registrant's health, that is, its capital position. The stock exchanges and the IDA have made arrangements for dividing this audit jurisdiction in the case of firms that are members of more than one SRO.[29] The requirement that the regulation of the SROs be satisfactory to the commission does give the commission the power to retrieve its delegated responsibility for ensuring the suitability for continued registration of persons and companies carrying on a securities business. (This "threat" to the SROs' regulatory powers is one way - although perhaps not so intended - in which the government assures itself of effective SRO regulation.) In fact, the OSC has drawn upon the expertise of the SROs with respect to audits and has adopted, in substantially the same form, the auditing requirements of the SROs and published them as conditions of registration for every registrant whose financial affairs are not subject to examination by an SRO under section 31 of the act.[30] The SROs therefore have assumed full responsibility for assuring themselves that members maintain adequate capital. There is considerable incentive for each SRO to take a tough position on the maintenance of adequate net free capital because the greater portion of the cost of the failure of a member firm within the audit jurisdiction of the SRO is assumed by members of that SRO. The cost is borne by all registrants by way of their contributions to a national contingency fund. Participation in such a fund is a condition of registration found in subsection 6(3) of the Ontario Securities Regulations. As additional assurance against failure, the SROs

28 Ontario Securities Act, s. 31(2).

29 *See* discussion in ch. XII.B *infra*.

30 Ontario Securities Regulations, s. 6(6). In paragraph 6 of these Conditions of Registration the OSC recognized the Canadian Mutual Funds Association and noted its approval of the procedure for audit surveillance and rules relating to the examination of the financial affairs of its members and exempted mutual fund dealers from the requirements of the conditions so long as they complied with the requirements of the association. However, starting in 1976, the Canadian Mutual Fund Association began to phase out its self-regulatory function and, in particular, it discontinued its responsibility for the auditing of its members. This function is now performed by the securities commission of the relevant province. As part of the process, the association changed its name to the Investment Funds Institute of Canada on June 2, 1976. (A recently published revision of the Conditions of Registration makes no reference to the Canadian Mutual Funds Association or to the Investment Funds Institute.)

have adopted higher requirements for minimum net free capital than those prescribed by the regulations made pursuant to the Ontario Securities Act.

D. REGULATION OF NON-SRO MEMBERS

None of the provinces require as a prerequisite to carrying on a securities business that a person or company be a member of an SRO. In Ontario there are seven categories of dealers,[31] only three of which require membership in an SRO:

(1) a broker, which is a person or company registered exclusively to trade securities as an agent and is a member of the Toronto Stock Exchange;
(2) a broker-dealer, which is a person or company that trades as agent or as principal and is a member of the Broker-Dealers' Association of Ontario;
(3) an investment dealer, which is a person or company that trades as an agent or principal and is a member of the Ontario District of the IDA.

If a firm does not wish to become a member of one of the three SROs, the firm can nevertheless carry on a securities business in the capacity of either an agent or principal by being registered as a securities dealer.[32] As of April 30, 1978, there were seven firms registered only as brokers, ten firms registered only as investment dealers, and twelve firms registered as broker-dealers. The largest category is that of broker-investment dealer, reflecting membership in both the TSE and the IDA. There were forty-six firms registered as broker-investment dealers. There were ten firms registered as securities dealers, and eleven firms registered as both brokers and securities dealers.[33] The latter are members of

31 Ontario Securities Regulations, s. 2(1).

32 *Id.* The other categories of dealers set out in s. 2(1) are: mutual fund dealer, scholarship plan dealer and security issuer. Subsection 2(2) provides that anyone who is an adviser is to be registered as one of investment counsel, portfolio manager, or securities adviser. Anyone registered as a broker-dealer, investment dealer or securities dealer is also deemed to be registered as an underwriter; *id.* s. 2(3).

33 These represent some significant changes. As of June 30, 1976, the numbers were as follows:

Brokers	8
Investment dealers	11
Broker-dealers	12
Broker-investment dealers	52
Securities dealers	9
Broker-securities dealers	13

Information taken from [1976] OSC Bull. 192 (July).

The other registrants as of April 30, 1978 were as follows:

Broker-broker-dealers	1
Scholarship plan dealers	1

the TSE but carry on an underwriting business without membership in the IDA.

Ontario then recognizes that not every registrant will qualify or will want to quality for membership in an SRO. The government of Ontario has therefore had to retain those regulatory powers for non-SRO members which have been delegated or assumed by the SROs. Ontario could, if it felt that self-regulation provided a greater degree of investor protection, require the SROs to regulate non-SRO members, although it has not chosen to do so.

Chapter IV
Evolution of the Scheme of Statutory Recognition of SROs

A. SELF-REGULATION WITHOUT GOVERNMENT SUPERVISION

Ontario SROs enjoyed an era of self-regulation free of government supervision until the enactment of the Security Frauds Prevention Act, 1930.[34] The era began at least as early as 1852 when the Toronto Stock Exchange started business[35] and continued through the introduction of the first Ontario legislation enacted to protect investors. The reason for the lack of government regulation was that early Ontario securities legislation concentrated on the regulation of the primary or "new issue" securities market. For example, the earliest investor legislation in Ontario[36] provided for the statutory liability of a director for untrue statements contained in a prospectus of his company. In the late 1800s and into the 1900s protection of the public was not apparently perceived to require any government regulation of the secondary markets.

The Security Frauds Prevention Act, 1928,[37] provided for some regulation of the secondary market by requiring registra-

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Securities issuers	12
Underwriters	6
Investment counsel	9
Mutual fund dealers	18
Securities advisers	1
Portfolio managers	46

Information provided by C.E. Goad, deputy director of registration, Ontario Securities Commission.

34 S.O. 1930, c. 39.

35 The Toronto Stock Exchange (TSE) was incorporated by statute in 1878; S.O. 1878, c. 65.

36 Director's Liability Act, 1891, S.O. 1891, c. 34, s. 4. The earliest legislation in Canada directed specifically at investor protection was the Manitoba Sale of Shares Act of 1912 which was later replaced by the Municipal and Public Utility Board Act; S.M. 1926, c. 33.

37 S.O. 1928, c. 34.

tion of brokers and salesmen.[38] At the same time, the disclosure requirements found in the Companies Act[39] were transferred to the Companies Information Act, 1928.[40] The latter act provided for the filing of a prospectus by an issuer, which would also have to be registered as a broker under the Security Frauds Prevention Act, 1928. Although by today's standards these statutes established a relatively primitive approach to government protection of investors, they had a significant impact on the primary market of the day. If the absence of provisions dealing specifically with the regulation of the secondary market suggests that this was not an area of great concern to the legislature in 1928, the degree of regulation was to change within a short time.

In the province of Québec, legislative concern for investors did not materialize until 1924, even though the Montreal Stock Exchange had been incorporated back in 1874.[41] In 1924, "An Act respecting the issue and sale of shares, bonds and other securities"[42] was proclaimed. This was a basic disclosure statute and did not provide for government regulation of the secondary markets.

Meanwhile, British Columbia was following the example of Ontario. In addition to requiring prospectus disclosure, the Companies Act, 1897[43] created statutory liability for statements made by directors in a prospectus. A decade later, the Vancouver Stock Exchange was incorporated by statute.[44]

British Columbia securities legislation did not develop further until the province enacted the uniform Security Frauds Prevention Act, along with Alberta, Manitoba, Nova Scotia, Ontario, Prince Edward Island, Québec and Saskatchewan. It is apparent that until the introduction of the uniform acts, the SROs were not subject to government supervision and therefore enjoyed a period of pure self-regulation.

38 The 1928 act prohibited trading in any security without registration; the terms "trade" or "trading", "security" and "fraud" are defined in s. 2 of the 1928 act.

39 R.S.O. 1927, c. 218.

40 S.O. 1928, c. 32.

41 S.Q. 1874, c. 54.

42 S.Q. 1924, c. 64.

43 S.B.C. 1897, c. 2.

44 Vancouver Stock Exchange Act, R.S.B.C. 1907, c. 62.

B. SECURITY FRAUDS PREVENTION ACT, 1930 – DELEGATION OF THE AUDIT FUNCTION

In Ontario, the Security Frauds Prevention Act, 1930,[45] replaced the 1928 statute and is important in a discussion of self-regulation because it was the first statute completely revising Ontario's securities legislation and establishing[46] what continues today to be the basic scheme for SROs assuming responsibility for the manner in which their members' financial affairs are audited.[47] The 1930 legislation required the executive committee of every stock exchange to appoint an auditor for each stock exchange member. The auditor was vested with broad powers and was required to audit the financial statements of stock exchange members allocated to him as of specified dates (brokers not subject to exchange audit were required to file audited financial statements with the Registrar[48]).[49] The auditor could also be authorized by the executive committee to conduct a special audit or, "report upon the whole or any aspect of the business or affairs of any person or company who is or has been a member or in any way represented upon the exchange".[50] The 1930 statute had teeth – the executive committee of the stock exchange could impose any requirements on members relating to any system of bookkeeping or record-keeping,[51] and failure by a member to comply with an exchange requirement constituted an offence and entitled the stock exchange executive committee to suspend the member from the exchange.[52]

The absence of any published Ontario government reports or studies indicates that there was no coherent philosophy of self-

45 S.O. 1930, c. 39. As stated above, most of the provinces adopted the uniform Act in 1930. Alberta enacted the Security Frauds Prevention Act, 1930, S.A. 1930, c. 8; British Columbia, SecurityFrauds Prevention Act, S.B.C. 1930, c. 64; Manitoba, An Act to Amend the Security Frauds Prevention Act, 1929, S.M. 1930, c. 26; Nova Scotia, the Security Frauds Prevention Act, S.N.S. 1930, c. 3; Prince Edward Island, the Security Frauds Prevention Act, 1930, S.P.E.I. 1930, c. 2; Québec, Security Frauds Prevention Act, 1930, S.Q. 1930, c. 88; Saskatchewan, the Security Frauds Prevention Act, 1930, S.S. 1930, c. 74. While the statutes were substantially uniform, there were some notable differences due to the absence of stock exchanges in several of the above-mentioned provinces. Provisions relating to stock exchanges were deleted and alternative means of regulation inserted in their place.

46 The provisions for the audit of brokers were first enacted by the Security Frauds Prevention Act, 1929, S.O. 1929, c. 51, which amended the Security Frauds Prevention Act, 1928. These provisions were reenacted in the 1930 act. *See* ch. III.C *infra*.

47 *See* Ontario Securities Act, ss. 30-33; Ontario Bill 7, ss. 18, 19-21.

48 The registrar was appointed by the Lieutenant Governor in Council.

49 S.O. 1930, c. 39, ss. 17-28.

50 *Id.* s. 21.

51 *Id.* s. 25.

52 *Id.* s. 26.

regulation but rather a pragmatic response to one aspect of the provision of investor protection – assuring some organized control over the manner of reporting and the timing of reports of the financial position of stock exchange members. From this, one may infer that the government considered public confidence in the securities market to be dependent on the financial stability of members and that the best way to monitor members' financial positions was through audits of their financial statements. This approach to regulation probably made good political sense, because the public would be much more sensitive to the failure of a stock exchange member than to a stock market manipulation.

The Security Frauds Prevention Act, 1930, contained further evidence of an increasing awareness by legislators to the importance of the secondary markets. The statute gave to the Lieutenant Governor in Council broad powers to make regulations "for the regulation of listing and trading in securities upon any stock exchange, of the records relating thereto and of the clearing of transactions thereon...".[53] No regulations were ever enacted under this provision. The 1930 act also required that every stock exchange in Ontario keep a record of the trading conducted on the exchange,[54] and further required that it make this information available to the parties involved in a particular trade.

C. CREATION OF THE ONTARIO SECURITIES COMMISSION

A securities commission was unheard of up to 1930 because the regulation of trading in securities was the responsibility of the Attorney-General. It was not until the following year that a government board was set up to regulate the securities industry.[55] The board was to be appointed by the Lieutenant Governor in Council to administer the Security Frauds Prevention Act, 1931, but was not referred to as the Ontario Securities Commission in the legislation until 1933.[56] The power of the Lieutenant Governor in Council to make regulations concerning the listing and trading of securities on any stock exchange created by the 1930 legislation was transferred to this board, subject, however, to the approval of the Lieutenant Governor in Council.[57] This transfer of the power

53 *Id.* s. 31(a).

54 *Id.* s. 16.

55 Security Frauds Prevention Act, 1931, S.O. 1931, c. 48, s. 3. Manitoba was ahead of Ontario, having established a board in 1926 under the Municipal and Public Utility Board Act, S.M. 1926, c. 33.

56 *See* the Statute Law Amendment Act, 1933, S.O. 1933, c. 59, s. 34; Ontario Order-in-Council (65 Ont. Gazette, pt. II, 883) (June 23, 1932); Securities Amendment Act, 1937, S.O. 1937, c. 69, s. 3.

57 Security Frauds Prevention Act, 1931, S.O. 1931, c. 48, s. 3.

to make regulations, although temporary,[58] is probably the closest the Ontario Securities Commission has come to having something equivalent to the rule-making power of the United States Securities and Exchange Commission.[59]

The lack of concern during this period with some of the issues to be discussed in part II of this paper, such as the impact of the stock exchanges on competition and whether the procedures used by the SROs are fair, is apparent. The major impact of securities legislation in this period was to create both civil and criminal liability for false statements in prospectuses. By the 1930 act, however, broad powers were vested in the executive committee of a stock exchange, including suspending a stock exchange member for failing to comply with a stock exchange requirement relating to a member's financial position, but no provision was made for review by a government body of the exercise of these powers by the executive committee. Indeed, the 1930 act gave protection to a stock exchange from actions against any stock exchange, or against any broker or exchange auditor in respect of any act dealing with audits.[60] Certainly the appearance of integrity in the securities markets could be created by the imposition of tough sanctions in the event of false statements. However, as discussed later in this paper, self-regulation has a number of limitations which can result in abuse of the regulatory role. Concern about such abuse was not apparent in the legislation.

D. THE SECURITIES ACT, 1945 – INCREASED SUPERVISION OF THE TORONTO STOCK EXCHANGE

The Ontario scheme of securities legislation was not entirely successful in protecting the investor from fraud and manipulation in the securities markets. By 1945, Ontario had achieved an international reputation as a haven for fraudulent stock promoters[61] and in 1945 the Royal Ontario Mining Commission (the Urquhart Commission) was able to write:

> "The stated purpose of the Ontario Securities Act and its predecessor the Security Frauds Prevention Act of 1928, 1929 and 1930, was to prevent fraud and misrepresentation in the sale of securities to the public. The Acts, with

58 The board did not have this power under the Securities Act, 1945, S.O. 1945, c. 22 (1st Sess.).

59 *See* Securities Exchange Act of 1934, s. 23(a).

60 S.O. 1930, c. 39, s. 27.

61 Bray, *Ontario's Proposed Securities Act: An Overview, Its Purpose and Policy Premises,* [1975] OSC Bull. 235 (October).

their many amendments and regulations, do not appear to have attained the objective set."[62]

The Urquhart Commission did not concern itself with the operation of the stock exchanges, but was more concerned with the powers of the Ontario Securities Commission and the impact that such powers had on prospecting activity in Ontario. Many of the Urquhart Commission recommendations were accepted in the Securities Act, 1945,[63] which was, by today's standards, Ontario's first comprehensive securities legislation. The legislation is also important in the context of this paper in that it marked the first statutory requirement for government supervision of stock exchanges.

The 1945 act required any person wishing to carry on business as a stock exchange to obtain the consent of the Ontario Securities Commission.[64] In addition, every stock exchange member was required to furnish to the exchange auditor a completed statement, presumably relating to the members' financial condition, in the form approved by the commission.[65] In anticipation of the establishment of an association of non-stock exchange brokers, the 1945 legislation provided for the assumption of the audit function by the association from the OSC.[66]

Although regulation of certain aspects of the affairs of their respective members by the stock exchange and a brokers' association was provided for, this provision was not enacted in response to a comprehensive rationale for self-regulation in the securities industry. Rather, it was enacted as one way of limiting government control of the securities industry, a form of control which the Urquhart Commission considered had an adverse effect on mining financing. The OSC did however retain its broad powers to cancel or suspend the registration of any broker or dealer[67] and to approve a prospectus which was required when there was a primary distribution to the public.[68] If the reason for this intended shift of

62 2 REPORT OF THE ROYAL ONTARIO MINING COMMISSION 18 (1944) [1945] (Regulations Governing the Financing of Mining Developments).

63 S.O. 1945, c. 22 (1st Sess.).

64 *Id.* s. 31. In Canada this requirement first appeared in Manitoba in An Act to Amend the Security Frauds Prevention Act, 1929, S.M. 1930, c. 36, and was introduced in Ontario in the form of an Order-in-Council under the Securities Act, 1930; *see* Ontario Order-in-Council (66 Ont. Gazette, pt. II, 1951) (September 21, 1933).

65 S.O. 1945, c. 22 (1st Sess.), s. 35(2).

66 *Id.* s. 42(2).

67 *Id.* s. 10.

68 *Id.* s. 49. The term "prospectus" was not used in the legislation but instead s. 49(1)(a) provides for "a clear and concise statement in the form prescribed by the regulations dated and signed by every person who is, at the time of filing, a director or promoter of the person or company issuing the security or an underwriter or

regulatory power from government to the private sector was to create a looser regulatory environment in order to stimulate mining financing, the shift of power could be interpreted as an unfortunate statement about self-regulation and the perception of self-regulation by the government of the day. It suggests that self-regulation is not as strict as government regulation or, is regulation motivated by self-interest or, at best, is regulation which is more sensitive to the needs of the regulated. There does not appear to have been any public discussion of this shift of power to the SROs other than a not very informative statement by the Attorney-General upon introducing the Broker-Dealers' Association Act.[69]

The Securities Act, 1947,[70] was a consolidation of the various pieces of securities legislation[71] then in force. The power given to the OSC to consent and, by implication, withdraw its consent, to a person or company wishing to carry on business as a stock exchange did not mean increased supervision of the TSE by the OSC.[72] The termination of the business of the TSE for even minor reasons was too severe a sanction and unlikely to be exercised. Confronted with the choice of using the "big stick" or doing nothing, the OSC would generally do nothing.[73] In order for the

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optionee of the security, containing a full, true and plain disclosure of all material facts...".

69 The Attorney-General, the Hon. Leslie E. Blackwell, on the first reading of the act stated:

> "I might now refer to the other Bill. At the present time there exist two organizations with which the Commission can deal, the first of which is the Stock Exchange which is incorporated under an Act of this Province of long standing. The other is the Investment Dealers Association of Canada, which has an Ontario division. But the greater number of brokers and dealers in mining promotions, by and large, are not members of either of these organizations, although a limited number are, but in the main, they have been a number of individuals. The Commission has been completely without a representative body with which matters could be discussed, and where a certain amount of sound regulation of the members could be procured to the advantage of the public interest. It is not contemplated that any of these organizations should have the control of registration. Under the Act, the road is still clear to any one who wishes to engage in the business, and anyone is eligible for registration without membership in an organization being a condition precedent to so engaging in that business."

LEG. ONT. DEB. 22d leg., 3d Sess. No. 1, at 884 (1947).

70 Securities Act, 1947, S.O. 1947, c. 98.

71 Securities Act, 1945, S.O. 1945, c. 22; Securities Amendment Act, 1946, S.O. 1946, c. 86; Prospecting Syndicate Agreements Act, 1945, S.O. 1945, c. 16.

72 The Toronto Stock Exchange has been the only stock exchange operating in Ontario since the 1934 merger of the old Toronto Stock Exchange with the Standard Stock and Mining Exchange.

73 The SEC faced a similar limitation on its supervision of the U.S. SROs prior to the Securities Reform Act of 1975; *see* REPORT OF THE SUBCOMM. ON SECURITIES OF THE SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, S. REP. No. 13, 93d Cong., 1st Sess. 188 (1973) [hereinafter SENATE SECURITIES INDUSTRY STUDY].

OSC to effectively supervise the TSE, other sanctions and procedures would have to be spelled out in the legislation.

The commission did have some other powers over the TSE. The prospectus requirements of the Ontario Securities Act did not apply to the securities of mining, industrial and investment companies, which were listed and posted for trading on any recognized stock exchange if such securities were sold through such stock exchange.[74] The OSC assumed that recognition of a stock exchange could only be by the commission. It has been pointed out, however,[75] that it is possible to interpret the recognition requirement so that recognition had nothing to do with the OSC, and that it was a matter of fact in each case whether or not a particular stock exchange was "recognized". If the OSC's interpretation was correct, to terminate recognition of the TSE would have denied to companies listed on the exchange an important advantage of listing and an important means of raising capital from the public. However, the power to recognize a stock exchange did not give the commission any direct supervisory powers over the other activities of the exchange[76] and, like the power to consent to a person or company carrying on business as a stock exchange, really only gave the commission a lever that could be used in negotiations with an exchange seeking recognition.

Other powers of the commission which could be exercised to control the activities of stock exchange members were the power to suspend or cancel the registration of a TSE member as a broker under the Securities Act, the power to investigate the affairs of a TSE member and the power to order a surprise audit.[77] Had the commission wanted to carefully supervise the activities of the exchange, these powers plus the consent and recognition powers would clearly have given the commission a very strong hand in any negotiations with the exchange.[78]

74 Securities Act, 1947, S.O. 1947, c. 98, s. 46(b). The exemption also existed in the Securities Act, 1945, S.O. 1945, c. 22, s. 49(7)(b), but detailed prospectus requirements were not introduced until the 1947 act.

75 Baillie, *The Protection of the Investor in Ontario* (pts. 1-2), 8 CAN. PUB. ADMIN. 172 and 325, 334 n. 369 (1965).

76 *Id.*

77 S.O. 1947, c. 98, ss. 8, 26 and 41 respectively.

78 In addition to these powers vested in the OSC, the cabinet had power to pass regulations concerning the listing and trading of securities, but this power was never exercised; *see* Baillie, *supra* note 75, at 334 n. 369.

E. THE BROKER-DEALERS' ASSOCIATION OF ONTARIO

From 1945 to 1963, few changes were made to Ontario's scheme of securities regulation. From the point of view of self-regulation, perhaps the most interesting event was the formation and legislative authorization in 1948 of the Broker-Dealers' Association of Ontario.[79] The Broker-Dealers' Act, 1947, conferred on the board of governors of the association power to make regulations necessary for the association to function. But the regulations were made expressly subject to the approval of the OSC, which indicated that the legislature was not prepared to permit an SRO to be totally free of government supervision.[80]

At the time of the BDA's creation, there were more than 200 non-stock exchange members "who specialized in the sale of highly speculative mining securities across the continent through the use of direct mailings and the long distance telephone".[81] The BDA was established to regulate registrants who were not members of the stock exchange or the Investment Dealers Association. Its establishment followed completion of a review by the OSC of the fitness for continued registration of every registrant,[82] a review which resulted in the elimination of a substantial number of registrants. Incorporation resulted from warnings of the chairman of the OSC who suggested that the alternative to self-regulation by the broker-dealers was strict bureaucratic control.[83]

By 1948, the OSC had passed on some regulatory authority to the BDA. However, control over the association was reassumed by the commission in 1949 as a result of dissatisfaction with the workings of the association. "Although the association had done some housecleaning, it appeared to be as much interested in promoting legislation to relax controls on securities dealings as in limiting the undesirable activities of its members."[84]

The creation of the BDA should not be construed as an attempt by the government of Ontario to strengthen self-regulation in the securities industry in Ontario, in the same manner as was

79 The Broker-Dealers' Act, 1947, S.O. 1947, c. 8. For a detailed analysis of the sanctioning practices of the association, *see* P. Anisman, Sanctioning Practices of the Broker-Dealers' Association of Ontario: Self-Regulation in Action (1967) (unpublished paper prepared for the Federal Securities Task Force, on file in Corporate Research Branch, Consumer and Corporate Affairs Canada, Ottawa).

80 Broker-Dealers' Act, s. 5.

81 Bray, *supra* note 61, at 238.

82 *Id.*

83 *See* J. WILLIAMSON, SUPP. at 293.

84 J. WILLIAMSON at 277; J. WILLIAMSON, SUPP. at 294 n. 83. *See* P. Anisman, *supra* note 79.

the United States Maloney Act of 1937[85] which provided for the registration of national securities associations with the SEC. The creation of the BDA was a pragmatic attempt by the government to provide protection to the investors of the province by means of private regulation, thereby sparing the government direct responsibility for regulation of a sector of the securities community.

F. RECOGNITION OF THE INVESTMENT DEALERS ASSOCIATION

From a self-regulatory point of view, the other interesting event during this era was recognition in Ontario securities legislation of the existence of the Investment Dealers Association of Canada.[86]

The provision for audits of stock exchange members supervised by a stock exchange auditor was extended to the IDA (as well as to the BDA) which was required to appoint a district association auditor responsible for supervising the audit of the affairs of members of the IDA Central District.

The Securities Act, 1947, added to the supervisory powers of the OSC over the SROs.[87] It provided that the by-laws, rules and regulations of every stock exchange, the rules and regulations of the IDA Central District, and the regulations of the BDA in respect of the practice and procedure of the examinations of the financial affairs of members by auditors and the actual conduct of such examinations be satisfactory to the OSC.

There is no publicly recorded evidence of OSC intervention to change the practice and procedure in the supervision of auditing members' affairs by the TSE and IDA. Indeed, it was not until the OSC and the TSE were jolted by the Windfall affair that the OSC made some adjustments to its laissez-faire relationship with the TSE.

G. THE WINDFALL REPORT

Government responsibility for permitting SROs to carry on business and for supervising their operations became an issue of public concern with the appointment under Mr. Justice Arthur Kelly of the Ontario Royal Commission to inquire into trading of shares of Windfall Oils and Mines Limited.[88]

The Royal Commission was appointed as a result of public concern over dramatic fluctuations in the price and volume of

85 The Maloney Act added s. 15A to the Securities Exchange Act of 1934.
86 Securities Act, 1947, S.O. 1947, c. 98, s. 38.
87 *Id.* s. 39(2).
88 The commission published the WINDFALL REPORT (1965).

trading in Windfall shares, a speculative mining and exploration company listed on the TSE. George and Viola MacMillan had purchased large blocks of Windfall shares which permitted them to take control of the company, the shares of which were listed on the TSE. Public interest in the company followed the April 16, 1964, announcement of the huge mineral discovery by Texasgulf in the Timmins area which was followed two days later by the sale to Windfall by Mrs. MacMillan of claims in the vicinity of the Texasgulf discovery. By the middle of June, Windfall had arranged for distribution of its shares on the exchange.

Interest in the Windfall shares intensified when a drilling rig was moved onto the Windfall property. The price of shares rose rapidly because of Windfall's failure to release to the public preliminary findings indicating negative results. The only public statement was a press release stating that Windfall was drilling in the vicinity of the Texasgulf discovery. With the price of the Windfall shares climbing, the MacMillans began selling. The TSE then made a formal demand for more information. After a meeting attended by representatives of the TSE, OSC and Windfall, another press release was issued, but this release merely served to fan buyer interest. Before release of a laboratory analysis of the core samples the stock reached a high of $5.50 per share. The day after the release of the negative report, the opening price plummeted to $0.80 per share.

As disturbing as the above events were for the investing public in Ontario, the conclusion was worse. The MacMillans ended up with profits in excess of $1 million which they did not have to disgorge, apparently due to lack of adequate civil liability remedies. Members of the TSE realized net profits of about $0.5 million in addition to estimated brokerage commissions of $1.2 million. Losses of approximately $1.1 million and $1.3 million were suffered by miscellaneous large traders and small traders respectively. Criminal charges were laid, which resulted in acquittals or minor sentences.

The Windfall affair underlined the inadequacy of the OSC supervision of the TSE, the need for an effective, timely disclosure policy and the inability of the TSE to force disclosure by listed companies. In addition it highlighted the problems of primary distributions through the facilities of the TSE (which were exempt from regulation by the OSC).

The inadequacy of the powers of the Ontario Securities Commission over the TSE was particularly reflected by the OSC, TSE, Windfall meeting referred to above. The OSC called the meeting to determine the reasons for the heavy trading of Windfall shares. At the end of the meeting, a timely disclosure statement was

published which, as noted, did little to still the rumours about Windfall drilling results but served simply to prolong market activity. The exchange apparently felt that once the commission had been drawn into the affair the exchange was absolved from further responsibility. Mr. Justice Kelly disagreed, concluding that the full responsibility for the trading was that of the exchange because of the lack of commission authority to take corrective action.[89] The commission apparently did not construe its power to withdraw its consent to the exchange's carrying on business as a mandate from the legislature to regulate day-to-day trading on the exchange.

Another example of the commission's lack of power over the exchange was demonstrated by the misuse of the exemption from the prospectus requirements of the Ontario act for distributions of shares of listed companies through the facilities of the exchange. Mr. Justice Kelly explained that the exemption from the prospectus requirements amounted to a statutory delegation to the stock exchange of commission responsibility for prospectus disclosure, but that such delegation should only be made on the condition that "the Commission should have the right and responsibility to oversee the performance of the delegated duties".[90]

H. THE KIMBER REPORT

The *Windfall Report* was published in September 1965. Earlier in the same year, the *Kimber Report*[91] had been published, and although the latter report did not study the relationship between the OSC and the TSE in depth, the Kimber Committee did consider the question of primary distributions through the facilities of the TSE, recommending that such distributions be discontinued because of the manipulation of the exchange market which occurred in the course of such distributions.[92]

Probably assuming that Mr. Justice Kelly would study the relationship between the OSC and TSE in depth, the Kimber Committee commented on only one occasion about the OSC-TSE relationship stating: "In our opinion, the policy-making functions of the Commission, especially in the significant areas of primary

89 WINDFALL REPORT at 67. The power to issue a cease trading order, now found in Ontario Securities Act, s. 144, was introduced by s. 40 of the Securities Amendment Act, S.O. 1968, c. 123.

90 WINDFALL REPORT at 99.

91 Published in March 1965.

92 KIMBER REPORT ¶ 7.19.

distribution and jurisdiction over stock exchanges, should be embodied in published regulations".[93]

I. THE SECURITIES ACT, 1966 – SPECIFIC PROVISIONS FOR OSC SUPERVISION OF THE TSE

The publication of the *Kimber Report* and the *Windfall Report* was quickly followed by the introduction of the Ontario Securities Act, 1966.[94] Although that statute has been identified more for its introduction of requirements on insider trading, financial reporting, proxy solicitation and takeover bids, it also prescribed more carefully the relationship which should exist between the Toronto Stock Exchange and the government of Ontario, through the Ontario Securities Commission. This relationship was given definition by the act in three ways:

1. *OSC Consent to the Exchange Carrying on Business*

The question of whether or not a stock exchange had to be recognized by the OSC to qualify under the Ontario act as a "recognized stock exchange" was answered with the introduction of the prohibition against any person or company carrying on business as a stock exchange in Ontario unless the stock exchange was recognized in writing as such by the commission.[95] The Toronto Stock Exchange is the only stock exchange recognized by the commission.[96]

2. *Distributions through the TSE*

The prospectus exemption for primary distribution of listed securities through the TSE, which had concerned both Mr. Justice Kelly and the Kimber Committee, was continued, though with a significant qualification. A listed company taking advantage of

93 *Id.* ¶ 8.06.

94 S.O. 1966, c. 142. The 1966 act was proclaimed in force on May 1, 1967.

95 *Id.* ss. 139(1), 58(2)(b). The Securities Act, 1947, S.O. 1947, c. 98, had distinguished between "consent" to carry on business and "recognition" for the purpose of exemption from prospectus requirements. The new provision appears to have lumped "recognition" and "consent" together.

96 OSC, Policy No. 3-17, *supra* note 3. In the discussion of the Estimates of the Ontario Ministry of Consumer and Commercial Relations by the Standing Committee on Administration of Justice, James Renwick asked the the OSC chairman Arthur Pattillo, "is the Commission considering revoking the license of the Toronto Stock Exchange to conduct the exchange?" Patillo responded glibly, "No, not at the moment". The minister echoed Pattillo's sentiments, "Hadn't entered our minds". Ont. Leg. Committee on Supply, Proceedings, No. S-26, 5th Sess., 29th Leg. at S848-49 (June 5, 1975).

this means for distributing shares was required to prepare a statement of material facts which had to be acceptable to the stock exchange and the commission. The prospectus exemption was effectively nullified because the standard of disclosure required for a statement of material facts is identical to that required of a prospectus.[97] Distributions of shares through the stock exchange are now rare because of the high standard of care and disclosure, the stricter policies of the commission dealing with financing of mining and oil companies[98] and the general decline in public equity financings.

3. *Government Supervision of the Exchange*

The regulation of distributions through the exchange and the requirement for OSC consent to carry on the business of a stock exchange did not deal directly with the issue of exchange supervision by the Ontario government. Mr. Justice Kelly, however, wished to deal with this issue, stating there must be "a decision of far-reaching consequence as to whether or not security trading on an exchange should be subject to regulation by an external agency and, if so, the extent of that control".[99] To understand the supervisory powers conferred on the OSC by the 1966 act it is useful to review the reasons why Mr. Justice Kelly considered that self-regulation on the Toronto Stock Exchange displayed weakness. He listed these reasons as follows:

> "First, rule-making has not kept pace with the ingenuity of those who wish to take advantage of the deficiencies in the rules. Secondly, there is widespread aberration from strict observance of the spirit of the rules. Thirdly, there is woeful lack of any effective surveillance to ensure the adherence to rule; an explanation frequently offered in justification for departure from the rules is that 'it is customarily done that way'."[100]

Not surprisingly, His Lordship concluded strongly in favour of external supervision of the exchange:

> "Even if the Exchange merits the continuance of its self-governing character by adopting satisfactory rules and showing a disposition to enforce them strictly but

97 *See* Ontario Securities Regulations, s. 53(1) *as amended*, which requires that a statement of material facts provide full, true and plain disclosure of all material facts relating to the security proposed to be issued.

98 *See e.g.* OSC, Policy No. 3-02, April 1, 1976, revised October 1, 1977, 2 CCH CAN. SEC. L. REP. ¶ 54-866 (Financing of Mining and Oil Companies), which, *inter alia*, sets maximum offering prices or price spreads.

99 WINDFALL REPORT at 99.

100 *Id.* at 100.

equitably, it is essential that some supervision be provided over the manner in which the Exchange performs its self-regulatory function. The supervisory body should not be empowered to examine the operations of an exchange member directly, but should in the first instance confine its attention to examining the effectiveness of the Exchange's supervision of the conduct of business by its members. Any direct control over an individual member should be exercised only when, through the examination of the general performance of the Exchange there appears to be good cause to suspect misconduct on the part of the member."[101]

The 1966 act gave the commission statutory power to regulate virtually every aspect of the operations of the TSE, in the following terms:

"The Commission may, where it appears to be in the public interest, make any direction, order, determination or ruling,

"(a) with respect to the manner in which any stock exchange in Ontario carries on business;

"(b) with respect to any by-law, ruling, instruction or regulation of any such stock exchange;

"(c) with respect to trading on or through the facilities of any such stock exchange or with respect to any security listed and posted for trading on any such stock exchange; or

"(d) to ensure that companies whose securities are listed and posted for trading on any such stock exchange comply with this Act and the regulations."[102]

In addition to the 1966 act there are two other statutes which give the OSC supervisory power over the TSE. The Toronto Stock Exchange Act, 1968–69,[103] which replaced the original statute[104] incorporating the exchange, "represented a restatement of the exchange's authority as a self-regulatory body"[105] and reinforced the commission's powers under the Ontario Securities Act by providing in subsection 4(3):

"The Corporation shall operate the exchange in a manner that does not contravene the requirements of The Securities Act, 1966, and the regulations, directions, orders,

101 *Id.* at 101.

102 Securities Act, 1966, S.O. 1966, c. 142, s. 139(2).

103 S.O. 1968-69, c. 132.

104 S.O. 1878, c. 65.

105 *In re* Baker Weeks of Canada Ltd. and the Toronto Stock Exchange, [1977] OSC Bull. 32, 37 (February).

determinations or rulings made thereunder, and the Corporation may impose any additional or higher requirement within its jurisdiction."

and in section 112:

"Nothing in this Act shall be construed to derogate from the powers of the Ontario Securities Commission under The Securities Act, 1966, or any other Act."

In considering whether or not the Vancouver Stock Exchange was an SRO or just an operator of a stock exchange, the B.C. Corporate and Financial Services Commission referred[106] to the Toronto Stock Exchange Act to compare it with the Vancouver Stock Exchange Act, noting that the regulatory powers conferred on the TSE by the Ontario statute were much broader than those conferred on the VSE. The deficiencies in the B.C. statute were remedied shortly thereafter.[107]

The other statute is the Securities Amendment Act, 1968–69, which added to the 1966 act a right of appeal to the commission from a decision of the TSE in the following terms:

"Any person or company who feels aggrieved by any direction, order or decision made under any by-law, rule or regulation of a stock exchange in Ontario may apply to the Commission for a hearing and review in the same manner as to the hearing and review of a direction, decision, order or ruling of the Director."[108]

Ontario Bill 7 which introduced the Securities Act, 1978, is the most recent attempt to improve the statutory regulation of the secondary market with the creation of a statutory obligation on "reporting issuers" to make timely disclosure of material facts supported by sanctions for failure to comply. The Securities Act, 1978, is the first major revision of the Securities Act since 1966.[109] It continues, without significant amendment, the major provisions relating to SROs.

106 *In re* Canarim Investment Corporation Ltd. and Robert Joseph Ginnetti and the Vancouver Stock Exchange, B.C. Corporate and Financial Services Division Weekly Summary, January 9, 1976, at 5, 6.

107 S.B.C. 1977, c. 86.

108 S.O. 1968-69, c. 116, s. 9; now Ontario Securities Act, s. 140(3).

109 Ontario Bills 154, 75, 98, 20 and 30 respectively.

J. STATUTORY REVISIONS IN QUÉBEC AND BRITISH COLUMBIA ON GOVERNMENT SUPERVISION OF SROS

The legislative experience in Ontario was generally duplicated in Québec and British Columbia. As discussed above, Québec adopted the uniform Security Frauds Prevention Act, 1930.[110] This act provided for registration of brokers and salesmen, investigation and action by the Attorney-General, audit of brokers by an auditor from a panel selected by a stock exchange, preparation of audited financial statements by brokers who were not members of a stock exchange, regulation of trading by brokers, and the requirement that stock exchanges keep records of stock transactions. From 1930 to 1955, when Québec adopted more modern legislation based on the 1945 Ontario Securities Act, there were six amending statutes which revised and expanded on the topics listed below.

However, unlike the Ontario statute, the Securities Act[111] of 1955 did not give the QSC power over SROs. In fact, it was not until a 1971 amendment[112] to the Securities Act that the legislation provided that "No person or company may operate a stock exchange in the Province of Québec unless such stock exchange is recognized as such in writing by the Québec Securities Commission".[113] The same amending statute gave the commission broad powers to intervene in the affairs of an exchange when it is of the opinion that the public interest so requires. This provision permits the commission to take any decision, make any order, or give any instruction or direction,

> "(a) respecting the manner of operating a stock exchange in the Province of Québec;
> "(b) respecting any regulation, direction, instruction or order of such stock exchange;
> "(c) respecting dealing on the floor or by means of other devices of such stock exchange or respecting any security quoted or agreed to be quoted on such stock exchange;
> "(d) to ascertain that the companies the securities of which are quoted or agreed to be quoted on such stock exchange comply with the Securities Act and the regulations made under such act;
> "(e) respecting reports and information from any stock

110 S.Q. 1930, c. 88.
111 S.Q. 1954-55, c. 11.
112 S.Q. 1971, c. 77.
113 *Id.* s. 21; now Québec Securities Act, s. 92(1).

> exchange, its members or the firms or companies represented at such stock exchange."[114]

With the exception of clause 92(2)(e), the above provisions are essentially those included in Ontario's Securities Act of 1966.

While the QSC's powers over SROs are still limited to the Montreal Stock Exchange[115] it does have extensive powers over securities firms, similar to those possessed by the OSC. The act prohibits trading in securities without registration,[116] provides that the granting or renewal of registration is to be at the discretion of the director[117] and provides that the commission may at any time, after giving the registrant an opportunity to be heard, suspend, cancel or revoke the registration.[118] In addition, the commission has powers to launch investigations to determine, *inter alia,* if there has been a breach of the securities legislation.[119]

Supervision of SROs in the province of British Columbia began with the requirements for audits of its members by the Vancouver Stock Exchange in the 1930 uniform act.[120] This supervision was extended in 1937[121] with the introduction of several new provisions with respect to stock exchanges. There was a prohibition against carrying on the business of a stock exchange without the consent in writing of the Attorney-General;[122] the Attorney-General and the Superintendent of Brokers were given the power to inspect stock exchanges;[123] and stock exchanges were required to file with the superintendent copies of all by-laws and amendments within seven days of their adoption.[124] However, the superintendent was not given any power to review, reject or approve the by-laws.[125] In sections 20 and 21 the executive committee of the stock exchange was explicitly given self-regulatory duties. It was directed not to allow members to trade in violation of the act, regulations or of its own by-laws. To enforce this directive, stock

114 S.Q. 1971, c. 77, s. 21.

115 The only reference in the Securities Act to an SRO other than a stock exchange appears in Quebec Securities Act s. 92(4) which provides that "any stock exchange and any association of brokers established in the Province of Québec..." shall deliver a list of members to the commission and inform it of any changes.

116 Quebec Securities Act, s. 16.

117 *Id.* s. 24.

118 *Id.* s. 25a.

119 *Id.* s. 36.

120 S.B.C. 1930, c. 64.

121 S.B.C. 1937, c. 69.

122 *Id.* s. 16.

123 *Id.* s. 18.

124 *Id.* s. 19.

125 An amendment to s. 137 of the British Columbia Securities Act (S.B.C. 1975, c. 70, s. 9) provides that "No stock exchange shall enforce any by-law, rule, instruction or regulation unless it has been filed with the Superintendent and approved by him in writing". This provision had not been proclaimed as of June 20, 1978.

exchanges were given the power to suspend or expel any member of the stock exchange "notwithstanding anything contained in the by-laws of a stock exchange".[126]

In 1967, British Columbia adopted a new Securities Act[127] similar to the Ontario Securities Act of 1966.[128] Sections 32 to 35 provided for the assumption of the audit function by three self-regulatory organizations: "Every stock exchange in the Province recognized by the commission, the Pacific District of the Investment Dealers Association and the British Columbia Bond Dealers Association...".[129] The Vancouver Stock Exchange was the only stock exchange recognized by the British Columbia Securities Commission under this section and section 137(1)[130] until the Vancouver Curb Exchange came into existence in 1974[131] to provide a market in over-the-counter issues after the Broker-Dealers' Association of British Columbia ceased to function as of June 1, 1974.[132] In the same year, an amendment to the act established a new commission, the British Columbia Corporate and Financial Services Commission, to replace the B.C. Securities Commission and to function as an independent appellate body for administrative decisions in the entire corporate and financial area. At the same time, the administrative powers of the Superintendent of Brokers were extended to include many of those formerly vested in the B.C. Securities Commission.[133]

Chapter V
A Rationale for Self-Regulation

The evolution of the legislation establishing Ontario's scheme of self-regulation reflects a lack of any purposeful government philosophy about self-regulation. As in the United States,[134] initial attention was focused on the stock exchanges, although this attention really constituted recognition of an existing situation. The rationale for establishment of the Broker-Dealers' Association appears to have been based on a mixture of concerns, for example, that direct government regulation would be too strict, and that

126 *Id.* s. 21.
127 British Columbia Securities Act.
128 S.O. 1966, c. 142.
129 British Columbia Securities Act, s. 32.
130 This section continues the provision introduced in 1937 which provides that no person or company shall carry on the business of a stock exchange unless recognized in writing by the commission.
131 British Columbia Securities Commission Weekly Summary, July 12, 1974.
132 British Columbia Securities Commission Weekly Summary, June 28, 1974.
133 S.B.C. 1974, c. 82.
134 SEC, 4 REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS, H.R. Doc. No. 95, 88th Cong., 1st Sess. 501 (1963) [hereinafter the SPECIAL STUDY].

government would be reluctant to incur the expense of expanding its bureaucratic machinery to regulate the 200-odd non-stock exchange, non-IDA brokers. With one exception referred to below, there was no policy foundation for Ontario's scheme. Practicality dictated the scheme, rather than an assessment of the advantages and disadvantages of self-regulation.

Practicality was the primary ground for resorting to self-regulation as a control technique in the enactment of the United States Securities Exchange Act in 1934. The practicality of self-regulation was referred to in hearings before the House of Representatives on the 1934 act, in the following terms:

> "In framing a regulatory measure, the practical problem of administration has always to be faced and when regulation gets beyond a certain point and sheer ineffectiveness of attempting to exercise it directly through government on a wide scale counterbalances the fact that possibly the exchanges might not be as diligent as we would wish them to be about regulating themselves or as diligent as the Government would be if the task were compact enough to fall within the limits of effective governmental performance."[135]

The one exception to the lack of governmental analysis of the theory of self-regulation is the statement made by the Ontario Attorney-General on introducing the Broker-Dealers' Association Act, 1947,[136] when he suggested that the establishment of such a body would raise the standard of transacting business in a way that is difficult to accomplish through the "policing" of the industry by government.[137] The BDA did not prove to be a very convincing example of the objective outlined for the association by the Attorney-General for a number of reasons. Perhaps the most important of these was that the scheme of regulation was imposed upon a group of securities firms which were, at best, mildly enthusiastic about regulation. Another reason would be the lack of careful government supervision in the initial stages of the operation of the association.

Whether or not there exists a conscious government policy on self-regulation, the fact is that our scheme of securities regulation does exist, and to the degree that this scheme includes self-regula-

135 *Hearings on H.R. 7852 and H.R. 8720 before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 514 (1934) (Statement by John Dickinson, Assistant Secretary of Commerce and Chairman of the Roper Committee), *quoted in* SPECIAL STUDY, *supra* note 134, at 501. The Roper Committee (named after Secretary of Commerce Daniel Roper) was appointed by President Roosevelt as a Federal Interdepartmental Committee on Stock Exchanges.

136 S.O. 1947, c. 8.

137 *See* materials in note 69 *supra*.

tion, state powers have been conferred on private organizations. The exercise of such powers clearly can have anti-competitive consequences and can be used to seriously impinge on the rights of individuals. The potential for abuse of these powers makes more important the development of a strong rationale for self-regulation. Following is a summary of some of the advantages and limitations[138] of self-regulation in the securities industry:

A. ADVANTAGES OF SELF-REGULATION

In addition to the practicality of self-regulation referred to above, regulation by one's peers should mean that those persons engaged in developing and enforcing regulations are more expert than a government regulator would be. Government is more remote from the business of the members of the SROs. The SEC *Special Study* comments that

> "persons on the scene and familiar with the intricacies of securities and markets from daily and full-time pursuit of the business can more readily perceive and comprehend some types of problems, and more promptly devise solutions than a governmental agency which, however great its collective knowledge and skill, may be able to concern itself only intermittently with specific problems, may become aware of them only after the event, and often must defer decision and action until thorough investigation or study has been completed.[139]

In addition to the expertise of members and the informality and flexibility of self-regulatory procedures, another suggested advantage is that self-regulation is less costly than direct regulation. Direct regulation would involve an increase in the government bureaucracy and increased expenditure of funds. However, it has been submitted by some that there are in fact no savings flowing from self-regulation. Studies have suggested that the efficient functioning of bureaucracies is determined not by whether they are public or private, but rather by a number of other factors such as size, relationship to the organizations around them, and the definition of their goals or functions.[140] On the question of cost, self-regulation itself requires the expenditure of very sub-

138 There are some limitations of self-regulation in Canada that stem not from self-regulation per se but from the general structure of the government supervisory scheme which has different provinces supervising a single SRO or one province supervising an SRO which impacts on the securities markets in all parts of Canada. These limitations are discussed in ch. XII *infra*.

139 SPECIAL STUDY, *supra* note 134, at 694.

140 *See* P. BLAU AND W. SCOTT, FORMAL ORGANIZATIONS 198 (1962); M. BERNSTEIN, REGULATING BUSINESS BY INDEPENDENT COMMISSION, ch. 3 (1955).

stantial funds which must be borne by the industry, and ultimately by the investing public. Because pay scales may be higher in the private sector than in government, there is an increase in the cost of regulation. In any event, the cost of regulation – private or public – could be allocated by an excise tax.[141]

In the United States, the *Report of the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs*[142] states that the most important advantage of self-regulation is its potential for establishing and enforcing what Mr. Justice Douglas referred to as "ethical standards beyond those any law can establish".[143] He stated:

> "Self-regulation...can be pervasive and subtle in its conditioning influence over business practices and business morality. By and large, government can operate satisfactorily only by proscription. That leaves untouched large areas of conduct and activity; some of it susceptible of government regulation but in fact too minute for satisfactory control; some of it lying beyond the periphery of the law in the realm of ethics and morality. Into these larger areas self-government and self-government alone can effectively reach. For these reasons, such regulation is by far the preferable course from all viewpoints."[144]

In Britain, the City Panel on Take-Overs and Mergers is an example of self-regulation without government supervision. Its chairman, Lord Shawcross, has expressed the same thought:

> "What is regarded as good ethical practice has in this field gone far ahead of what Parliament has or indeed ever could lay down. It may indeed be said that as a general proposition that where the aim is to establish high standards of conduct in technical or professional matters, the only way in which the maximum standards, can be obtained is by self-regulation and discipline."[145]

It is not that the Ontario Securities Commission lacks the power to create and impose high standards. Indeed, the commission has used its authority on section 8 fitness for registration

141 Jennings, *Self-Regulation in the Securities Industry: The Role of the Securities and Exchange Commission*, 29 LAW & CONTEMP. PROBS. 663, 667 (1964).

142 SENATE SECURITIES INDUSTRY STUDY, *supra* note 73, at 149.

143 *Id.* The Senate report quotes address by SEC chairman William O. Douglas before the Bond Club of Hartford, Conn. (January 7, 1938).

144 Address by SEC chairman Douglas, *supra* note 143; *also quoted in* Jennings, *supra* note 141, at 678.

145 CITY PANEL ON TAKE-OVERS AND MERGERS, REPORT ON THE YEAR ENDED MARCH 31, 1974 (1974) (Foreword by Lord Shawcross, chairman). The establishment of the Council for the Securities Industry, of which the City Panel will constitute an arm, is discussed in text accompanying note 159 *infra*.

hearings to enforce obligations on registrants beyond those required by any statute or regulation, and which are more in the realm of ethics. In a recent section 8 hearing, the commission stated:

> "[The registrant] and his counsel both sought to impress on us the scrupulous attention that (he) paid to the legal requirements of The Securities Act, the staff of the commission, and the requirements imposed on his registration. In our opinion, it is not good enough merely to try by means of corporate distinction and geographical walls to urge compliance with the letter of the restrictions and not in the spirit of them....However, we want you to understand, and we want all the Broker-Dealers' Association to understand, that we expect you to operate in the future so that the public has a fair shake for its money."[146]

There are, however, numerous examples of standards for behaviour established by the SROs which are tougher than those imposed by the commission and subsequently adopted by it. For example, the commission recently acknowledged the TSE's know-your-client rules and procedures, which the commission has attached as a condition of registration to all classes of dealer.[147] (The Conditions of Registration generally apply to non-SRO members.) Indeed, the provisions in the OSC Conditions of Registration for Calculation of Minimum Free Capital have been based on the equivalent TSE provisions. Another example of policy development in the private sector, later to be adopted by the public sector, is the evolution of the TSE's timely disclosure policies which preceded the equivalent OSC policies.

An equally if not more important advantage of self-regulation relates to the psychological acceptability to the industry of regulation by one's peers. As Jennings states, no one likes external controls, least of all businessmen. The opportunity to participate in the regulatory process makes it much more palatable.[148] As Mr. Justice Douglas put it, "self-dicipline is always more welcome than discipline imposed from above".[149]

Mr. Justice Kelly in the *Windfall Report*[150] stressed another advantage of regulation by one's peers, namely, the more favourable position of one's peers to detect breaches of SRO regulations. His Lordship stated:

146 *In re* Herbert & Co. Securities Ltd., [1975] OSC Bull. 35, 39-40 (January).
147 *In re* Gordon Robert Fischel, [1978] OSC Bull. 9, 13 (January).
148 Jennings, *supra* note 141, at 678.
149 Address by SEC chairman Douglas, *supra* note 143; also *cited in* Jennings, *supra* note 141.
150 WINDFALL REPORT, *supra* note 88, at 100.

"It is to be expected that the combined wisdom of the members of the exchange would enable them to appreciate the objectives to be sought and the means by which these could be attained. The Exchange is favourably situated to assess the performance if its constituency and to determine the areas which call for the greatest vigilance in its supervision."

The B.C. Superintendent of Brokers has made a point of underlining the "duty incumbent upon members of self-regulatory bodies at all levels within the securities industry to assist in policing the marketplace in the best interest of the public and clients dealing in the marketplace".[151]

B.C. registrants were warned that concealment of knowledge of manipulative schemes is a factor that will be taken into account in determining fitness for continued registration.

With the increasing complexity of securities trading techniques and systems, surveillance by those close to the markets can be more effective.

The intense competition in the brokerage industry creates a considerable incentive for every broker to ensure that his competitors are abiding by the rules. The SRO rules generally restrict action by market intermediaries. In many cases the rules are designed to remove the conflicts of interest that exist between a broker and his client. A simple example is a broker trading against his client. Such trading might be profitable to the broker; the stock exchanges, however, have enacted rules to prevent it. Another example is the employee of an underwriter purchasing securities in a "hot issue" in preference to the wishes of his client. Such purchases are contrary to the IDA rules. Brokers and underwriters who comply with the rules should be quick to ensure that their competitors also comply so that their competitors do not realize an unfair advantage through departures from the rules.

Another incentive for SROs to vigilantly police their members stems from the wishes of the SROs to preserve their existing regulatory powers and, where possible, expand such powers before they are assumed by government. In general, businessmen are not enthusiastic about regulation. However, if there must be some form of regulation in the securities industry, businessmen are very enthusiastic about self-regulation compared with direct government regulation.

The enthusiasm of the industry for self-regulation raises queries about state powers being used for private ends. Nevertheless,

151 Notice published in B.C. Corporate and Financial Services Division Weekly Summary, April 23, 1976, at 2.

industry enthusiasm underlines the belief prevalent in the industry that those who don't play according to the rules can be more readily detected and removed by the industry. Industry members know that unless conduct contrary to SRO rules is effectively policed, sooner or later it will become apparent to outsiders who will incur losses and complain to government about inadequate regulation. Regulatory responsibility is shared between the SRO, as regulator, and the government, as supervisor. Inadequacy of the regulation will generally be the fault of both the SRO and the government and will result in less SRO regulatory power and more government supervision – the situation which the industry continually seeks to avoid. An example of such a series of developments is the Windfall affair, the *Windfall Report* and the government's response to the report.[152]

The SROs are very protective of their status in the securities regulatory system. To preserve this status, the SROs are exceedingly conscious not only of imposing effective regulation, but also of being seen to impose effective regulation. On some occasions one suspects that the SROs are more severe in disciplining particular conduct than the OSC would have been in similar circumstances. Consider some of the limitations of self-regulation.

B. LIMITATIONS OF SELF-REGULATION

The following limitations should be read bearing in mind the effect increased government supervision would have in eliminating or reducing the impact of these limitations on securities regulation.

First, there is a concern that self-regulatory agencies might approach their regulatory duties with something less than enthusiasm.[153] The SEC *Special Study* referred to this concern in the following terms:

> "No business is eager for regulation, for self-evident reasons, and it is only natural to expect less zeal for almost any aspect of the job on the part of a self-regulator than may be true of an outsider whose own business is not involved. The former may be complacent about a matter of public concern where the latter is disturbed; may not see any need for an organizational change or a rule change where the latter does; may interpret a rule more narrowly; may be satisfied with a lesser program of surveillance and detection; may be more lenient in imposing

152 *See* WINDFALL REPORT, pt. I, ch. III.6.
153 SPECIAL STUDY, *supra* note 134, at 501.

> sanctions; may have greater concern with avoiding adverse publicity for a specific violation or an industry group, and so on. To the extent that these are matters of degree the self-regulator, absent governmental oversight, is generally and understandably motivated by self-interest to lean toward the lesser degree."[154]

There is an equal danger of the regulation imposed by self-regulators being overzealous. SROs in their efforts to retain and even increase the scope of their regulatory powers may be inclined, when disciplining a member, to impose a sanction which is not consistent with the seriousness of the offence. The SRO then hopes that its expeditious manner of dealing with the offence will impress government and the public generally and will allay government fears that the SRO is falling down in its regulatory efforts. Whether the danger is one of unenthusiastic regulation, or overzealous regulation, it does underline the need for government supervision to monitor the intensity of the SROs' regulatory efforts.

Second, there is the tendency of an SRO to carry on its business in an anti-competitive or monopolistic manner. The temptation exists for businessmen to use their self-regulatory powers to impair competition in order to advance private economic interest rather than to satisfy regulatory needs.[155] This is a concern reflected in the Stage II amendments to Canada's competition legislation, although this concern does not stem specifically from the operation of the SROs in the securities markets.[156] Related to the competition question is the possibility that if membership in the SRO is not available to all participants in the industry, those who are members may realize a competitive advantage over those who are not.[157]

One has to be impressed with the sense of responsibility with which the officers of the TSE and the IDA approach their SRO regulatory powers. There is little doubt that the SROs are very anxious to preserve their regulatory responsibilities. They know that with government supervisors who are increasingly qualified the preservation of their regulatory responsibilities requires a higher degree of care. The SROs are also very anxious about the effect the Stage II amendments to Canada's competition legislation will have on their self-regulatory powers. They know that the only effective way of avoiding the intervention by administrators of the competition policy is to enact regulations and administer

154 *Id.* at 695.
155 Senate Securities Industry Study, *supra* note 73, at 149.
156 *See* discussion in ch. XI.C *infra.*
157 Canadian Mutual Fund Report at 724-25.

them in a manner consistent with the objectives of achieving an efficiently functioning capital market and with the objectives of Canada's competition laws. Perhaps the best rationale, then, for preserving the Canadian self-regulatory scheme of regulation is that the various incentives which now exist for the SROs to effectively discharge their responsibilities will assure the Canadian investing public of regulation consistent with capital markets operated fairly and efficiently.

Although this paper does not purport to make any systematic assessment of whether or not self-regulation operates in the public interest the conclusion is inevitable that self-regulation is an established and integral part of the Canadian scheme of securities regulation. Indeed, James Baillie, chairman of the OSC, has since his appointment on January 1, 1978, stated the commission's belief in self-regulation and in expanding the role of self-regulation.[158] This paper is concerned with a number of aspects of the relationship between government and the SROs and in part II makes some proposals for improvement.

Part II

Chapter VI
Government Supervision of SROs

The North American style of self-regulation is self-regulation with government supervision. In Britain, self-regulation of the securities markets is "pure" in the sense that there is not even the statutorily created possibility of the U.K. government's intervening in the regulation of the U.K. securities industry by the newly created Council for the Securities Industry. Regulation in the U.K. is voluntary, as is compliance. Indeed, the U.K. government in establishing the Council for the Securities Industry has opted

158 The occasion for Baillie's statement was a letter from the chairman addressed to the subscribers of the Weekly Summary; *see* OSC Weekly Summary, March 23, 1978, at 2A. The expanded role for self-regulation involved a regulation suggested by the commission exempting dealers which concurrently carry on portfolio management activities from obtaining concurrent registration as portfolio managers on the condition that the IDA and the TSE adopt rules governing the conduct by their members of these activities; *see* OSC Weekly Summary, March 16, 1978. Another recent endorsement of self-regulation, not just by the Ontario Securities Commission, but by all the Canadian securities administrators is evidenced in the amendment to National Policy No. 17. The policy now provides that not only violations of securities laws of other jurisdictions are prejudicial to the public interest and may affect the fitness for continued registration of registrants, but also violations of the rules of a recognized self-regulatory organization that are adopted for the protection of investors; National Policy No. 17, May 1978, 2 CCH CAN. SEC. L REP. ¶ 54-854.

against setting up a securities commission to oversee regulation of the securities markets in favour of creating the council which, among other things, will assume the role of the City Take-Over Panel and apply the panel's standards to a wider range of activities in the securities markets.[159]

As will be apparent from the discussion that follows, the U.S. has reinforced the supervisory powers of the SEC over the United States SROs in the Securities Reform Act of 1975. The scheme of regulation in the U.S. has been referred to as "cooperative regulation",[160] rather than self-regulation, in order to denote regulation both by the government and the SROs.

The SEC's *Special Study*[161] describes three reasons why government supervision of SROs is necessary:

A. GOVERNMENT MUST BE ASSURED THAT THE SROS ACTUALLY PERFORM THEIR REGULATORY FUNCTIONS

Because government is ultimately responsible for regulation of the securities markets, government must be assured that the SROs actually assume responsibility for, and effectively discharge, their regulatory functions. If the regulatory functions are not performed by the SROs they will have to be performed by government. If government does not undertake the regulatory functions and the SROs do not perform the functions faithfully and effectively, the result will be an appearance, a mere facade, of protection for the public which will be more dangerous than no protection at all.

B. REGULATION MUST REPLACE IMPAIRMENT OF COMPETITION

Some degree of impairment of competition and public control will result from self-regulation. Supervision is necessary, not only to ensure that such impairment is compensated for by effective regulation, but also to ensure that the kinds and extent of impairment are no greater than required by the exigencies of regulation.

A concern expressed about self-regulation is the lack of enthusiasm of businessmen for regulation. An equally important concern should be for overzealous regulation – regulation not necessary and inconsistent with the objectives of securities legislation. Supervision is necessary to maintain the balance between

159 Bank of England, Press Notice, The Council for the Securities Industry (March 30, 1978).

160 SPECIAL STUDY, *supra* note 134, at 723.

161 *Id.* at 501 ff.

the objectives of securities markets to function both fairly and efficiently.

C. SUPERVISION OF A QUASI-PUBLIC UTILITY IS NECESSARY

The facility operated by a stock exchange is in the nature of a quasi-public utility, and in this capacity requires public oversight for much the same reason that other utilities such as telephone companies do. Supervision by government is necessary to assure that the market is operated in the public interest.

The OSC has three bases for its power to supervise the TSE:

(1) the TSE requires recognition by the OSC before it can carry on business as a stock exchange in Ontario;
(2) the OSC can make any direction, order, determination or ruling on the activities of the TSE;
(3) the OSC hears appeals from decisions of the TSE by any person or company that feels aggrieved by such decision.

These three supervisory powers,[162] the power to register, to make rules for SROs and to review SRO decisions, are now considered in turn – first, how they apply to the TSE, and second, how they can be refined and applied to other SROs.

Chapter VII
A Registration System for SROs

A registration system for SROs should be designed to assure government that an SRO is qualified to exercise regulatory powers that would otherwise have to be exercised by the government. Such a system would apply to SROs in two different ways, depending on the nature of the SRO. If the SRO is an association of securities firms, such as the IDA, which does not operate a facility like a stock exchange, registration would be optional and would be sought by the association if it wanted to assume and apply regulatory powers which would otherwise be applied by government. If the SRO is a stock exchange, registration would be mandatory. The public would be invited to trade securities only on an exchange which the government was satisfied had the resources to operate in the public interest.

Ontario now has, in effect, a system of registration as it applies to stock exchanges in that no person or company can carry on business as a stock exchange in Ontario unless the stock ex-

162 The provisions of the Ontario Securities Act relating to the supervision of the TSE would be carried forward unchanged by Ontario Bill 7.

change is recognized by the commission.[163] The OSC will presumably not recognize a stock exchange unless the OSC is satisfied that the exchange will be operated in the public interest. The *ALI Federal Securities Code* (American Law Institute) would make it unlawful for an exchange or clearing agency to do business unless it was registered, and further provides that an association of brokers and dealers may become a registered securities association.[164] Ontario does not impose any general registration requirement on a securities association, although, as has been described, the Ontario District of the IDA and the BDA, along with the TSE, have been vested with limited regulatory powers under the Ontario Securities Act in respect of the control of the auditing of members' financial affairs. In fact, to the extent of the exercise of these powers, there is a limited system of registration, in that the rules of the Ontario District of the IDA and the BDA (and the TSE) on practices and procedures in examining the financial affairs of their members must be satisfactory to the commission.[165] As has also been previously noted, the TSE and the IDA exercise regulatory powers, beyond those delegated by statute, relating to members' capital position, insurance, and trading practices, with the concurrence of the OSC.

A. APPLICATION FOR "RECOGNITION" UNDER THE ONTARIO SECURITIES ACT

Under the Ontario Securities Act, no procedure has been developed which a stock exchange would have to follow to obtain recognition by the OSC. This is not particularly surprising in view of the fact that the TSE is the only exchange carrying on business in Ontario, and its existence preceded the first requirement in Ontario securities legislation for recognition of a stock exchange.[166] Similarly, there is no formal procedure whereby the TSE, the Ontario District of the IDA or the BDA can satisfy the OSC that their rules and regulations on the practice and procedure in audits of members' financial affairs are satisfactory to the commission.

163 Ontario Securities Act, s. 140(1).
164 ALI FEDERAL SECURITIES CODE, Tent. Draft No. 5, ss. 802(a), (b) respectively.
165 *See* discussion in ch. III.C *supra*.
166 *See* discussion in note 64 *supra*.

B. APPLICATION FOR REGISTRATION UNDER THE ALI FEDERAL SECURITIES CODE

The *ALI Federal Securities Code*[167] prescribes a procedure to be followed by an exchange, securities association or clearing agency seeking registration. The application must contain the rules of the SRO and be accompanied by whatever other information, financial statements or documents the commission specifies by rule.[168] Publication of a notice by the commission that an application has been made is required. Time limits within which the commission must either grant registration or institute a proceeding to determine whether registration should be denied are prescribed. The criteria which must be satisfied in order for an application for registration to be granted are also spelled out, and include the requirement that the applicant have the capacity to comply with and carry out the purposes of the code and to enforce compliance by its members with the rules of the applicant and with the applicable code provisions. In addition, the code spells out a number of substantive requirements relating to the terms of the rules of the applicant. These requirements relate to who can be a member of the SRO (open membership),[169] composition of the SRO board of directors,[170] (for example, issuers and investors must be represented), allocation of fees and charges by the SRO,[171] the substance of the SRO rules[172] (for example, the rules must be designed, *inter alia* to remove impediments to a free and open market and in general to protect investors), discipline,[173] fair procedure with respect to discipline and denial of membership[174] and competition.[175] The rules may not impose any burden on competition not necessary in furtherance of the purposes of the applicant as an SRO under the code.

The requirements in the code substantially repeat the requirements of the 1934 Securities Exchange Act after the 1975 amendments.[176]

Once registered, the code provides for careful supervision by the appropriate government regulator of the SRO. The means for

167 ALI FEDERAL SECURITIES CODE, Tent. Draft No. 5, ss. 802(a), (b).
168 *Id.* s. 803(a).
169 *Id.* s. 803(f).
170 *Id.* s. 803(g).
171 *Id.* s. 803(h).
172 *Id.* s. 803(i).
173 *Id.* s. 803(j).
174 *Id.* s. 803(k).
175 *Id.* s. 803(l).
176 Securities Exchange Act of 1934, s. 6(b). Indeed, Rule 6a-1 under this act prescribes

supervising the SROs are explored later in the paper[177] but include provisions requiring government approval before any SRO rule change takes effect, specifying the procedure to be followed in the event of a disciplinary action and providing for government review of disciplinary proceedings.

Although the Securities Act of Ontario leaves a great deal to inference, the supervisory scheme spelled out in the code is essentially that to which the TSE is now subject. The apparent reason for the government not imposing this scheme on the IDA is that the IDA does not operate a marketplace as does a stock exchange.[178] How valid is this distinction between the IDA and the TSE and how important is it in this context?

C. CRITERION FOR REQUIRING SRO REGISTRATION – IDA REGISTRATION

The simple test for determining whether or not a securities association should be registered with a government-appointed supervisor such as the OSC is whether the association is exercising regulatory powers which would otherwise be exercised by the government.

Reference has already been made[179] to the rather extensive regulations of the IDA and to the fact that IDA membership is virtually a prerequisite to carrying on an underwriting business in Canada. In the latter respect, the IDA is like a stock exchange in that IDA membership opens the doors to participation in particular markets. Discipline by the IDA can therefore have a material effect on a member's earnings. Penalties include a reprimand, a fine not exceeding $15,000, suspension of membership rights and privileges and expulsion from the association.[180] In addition, provision is made for the IDA to publish the penalty – the IDA has a complete by-law on "Publication of Notice of Penalties".[181] There

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a form to be completed by a stock exchange applying to become registered as a national securities exchange.

177 *See* discussion in ch. VIII *infra*.

178 *See* comment to ALI FEDERAL SECURITIES CODE, Tent. Draft No. 5, s 802(b), which provides that an association of brokers and dealers may become a registered securities association. In the comment, it is explained that s. 802(b) does not parallel s. 802(a)(1) requiring an exchange to be registered, because associations do not operate a marketplace as exchanges do and, therefore, it is not unlawful for an association of brokers and dealers to function without registration. Some do.

179 *See* discussion in ch. II.B *supra*.

180 IDA by-law 19.7, IDA, BLUE BOOK 445 (1977), 1 CCH CAN. SEC. L. REP. ¶ 821, at 763-39.

181 IDA by-law 20, IDA, BLUE BOOK 449 (1976), 1 CCH CAN. SEC. L. REP. at 763-43.

are four degrees of notice provided, depending on the offence, which range from notice to all members[182] to notice to the press.[183]

Fines of this severity are doubtless necessary to ensure compliance with minimum net free capital requirements, but one is also driven to the conclusion that the IDA must offer something that its members consider valuable. It is difficult to believe that the IDA simply offers its members a forum to discuss issues of common interest and the opportunity to participate in the submission of briefs to government. Because of the regulatory role which has been conferred upon and assumed by the IDA, and because of the significance in the underwriting community of IDA membership, the association should be subject to the same standard of supervision as the Toronto Stock Exchange.

The first step to providing for such supervision is to require the IDA to be "recognized" by the appropriate government agency - which means to be registered with such agency. The statute should not simply empower the OSC to register the SRO when the SRO is "suitable" and is "not objectionable" or when registration would be in the public interest. Actual standards to be satisfied by the SRO should be spelled out, as in the *ALI Federal Securities Code*, to guide the SRO and to require the government to publish what it thinks are the appropriate standards for an organization or exchange seeking to exercise government regulatory powers. The Securities Act when amended by Ontario Bill 7 will be more specific in some areas on the grounds for exercise of commission discretion.[184] The precedent has been set.

There are a couple of problems with this proposal. The TSE is located in one place geographically. It is therefore relatively easy under the existing scheme of securities regulation in Canada for securities regulators to agree on the government regulator with jurisdiction to supervise the TSE.[185] (Presumably when fully automated trading is implemented the location of the computer will be determinative of this question.) The IDA carries on its operations in all provinces, and may assume a different degree of responsibility for regulation in each province. The rules of the IDA are uniform, although it functions according to district. If the supervision of the IDA is to be on a provincial basis, then it will be necessary for the association, if it wishes to maintain uniform rules

182 IDA by-law 20.1(a), (b), *id.*

183 IDA by-law 20.4, *id.*

184 *See* the basis for the exercise of the so-called "blue sky" discretion in Ontario Bill 7, s. 60; *compare* Ontario Securities Act, s. 61.

185 This is not of course to be interpreted as saying that supervision by the province is the best supervision. As discussed *infra*, the activities of the TSE obviously have

and regulations, to adopt rules and regulations acceptable to each province. This is now the case for IDA rules and regulations on the practices and procedures in auditing members' financial affairs.

Appeals from decisions of IDA regulatory committees can be heard on a provincial basis. If a member is affected by a disciplinary proceeding taken by the Ontario District Conduct Committee, then that appeal would be heard by the Ontario Securities Commission because the OSC will be responsible for supervising the Ontario district.

It should be added in this context that the IDA would apparently welcome government supervision. The IDA takes the position that it has nothing to hide from the securities commissions and formal supervision by the commissions might assist the IDA in its attempt to obtain an exemption from Canada's competition laws.

Bill C-13 which would amend the Combines Investigation Act,[186] if enacted, could impose severe restrictions on the IDA's ability to regulate its members, because the IDA rules might be construed to be anti-competitive. An exemption from these provisions is made for "regulated conduct"[187] which is conduct subject to regulation by a "regulating agency".[188] If the IDA was required to be registered under the Securities Act and as a result of such registration was subject to supervision of the requisite degree, then the regulation of members' conduct by the IDA would be exempt from the Combines Investigation Act.

On the same theory for requiring registration of the IDA, the BDA should also be registered, although it is now in effect registered with the OSC because all its rules must be approved by the OSC. Registration would also require the OSC to be satisfied that the BDA has the capacity to enforce its rules.

Registration of other securities associations would be optional to the associations and would only be sought if the association sought to exercise regulatory powers which would otherwise be the responsibility of government.

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implications beyond the borders of Ontario, and perhaps the best supervision would be at the federal level; *see* discussion in ch. XII *infra*.

186 An Act to Amend the Combines Investigation Act and to Amend the Bank Act and Other Acts in Relation Thereto or in Consequence Thereof, Bill C-13, 30th Parl., 3d Sess. (first reading November 18, 1977).

187 Subsection 4.5(2) of the Combines Investigation Act, R.S.C. 1970, c. C-23, as it would be amended by Bill C-13, *id. See* discussion in ch. XI.C *infra*.

188 Subsection 4.5(2) of the Combines Investigation Act, as it would be amended by Bill C-13.

Chapter VIII
Government Power to Make Rulings Concerning SROs

The power of the Ontario Securities Commission to make any ruling under subsection 140(2) of the Ontario Securities Act on the business of a stock exchange is exercised in two ways.

The TSE submits all by-laws and revisions to by-laws to the OSC for review prior to the by-law or revision becoming effective.[189] The effective date is ordinarily set by the exchange board of governors after the OSC has completed its review and is satisfied with its terms.

On receipt of a by-law, the OSC conducts its review and makes a judgment on whether or not there is sufficient public interest in the by-law to warrant a public hearing. The OSC rarely convenes public hearings into TSE by-laws, but instead may summarily advise the exchange that the commission has no objection or may "negotiate" changes to the by-law to assure itself that the by-law does conform to the commission's view of the public interest.[190]

A. PRIVATE NEGOTIATION OF TSE BY-LAW CHANGES

An example of OSC-TSE negotiation of a by-law may be gleaned from the commission's reasons in the *Bralorne Resources Limited* case.[191] Cornat Industries Limited proposed to acquire 50.5% of the Bralorne shares, all of which were listed on the TSE, MSE and VSE. The proposal involved avoiding the takeover bid requirements in provincial securities legislation by relying on the "exempt offer" exception[192] to the takeover bid rules for offers to purchase shares to be effected through the facilities of a stock exchange (whether or not recognized by the commission). The proposed acquisition was to be made at a time when the OSC and the TSE were attempting to agree on a code of rules for "stock exchange takeover bids". (The VSE and MSE had already settled rules with their respective securities commissions.)[193]

Before the bid was actually made, Bralorne was advised by the OSC that it would not permit the proposed offer to proceed

189 The by-law will generally have been enacted by the TSE board of governors and approved by the exchange members before it is submitted to the commission.

190 For a description of the private consultation which transpired between the NYSE and the SEC to settle NYSE rule changes before the Securities Reform Act of 1975, *see* note, *Informal Bargaining Process: An Analysis of the SEC's Regulation of the New York Stock Exchange*, 80 YALE L.J.. 811 (1970-71).

191 *In re* Bralorne Resources Limited, [1976] OSC Bull. 258 (September).

192 Ontario Securities Act, s. 81(b).

193 Montreal Stock Exchange Rule VIII, 3 CCH CAN. SEC. L. REP. ¶¶ 87-700-87-777 (November 18, 1975) (Stock Exchange Takeover Bids).

through the facilities of the TSE, apparently on the basis that such bids would not be permitted until the code for stock exchange takeover bids was settled. Accordingly, Cornat and Bralorne decided to proceed through the VSE only. Shareholders, including those resident in Ontario, could deposit their shares in response to the bid through the VSE. The OSC issued a cease-trading order against the Bralorne shares. The order was subsequently terminated and in its reasons for lifting the order, the OSC made it clear[194] that such bids would not be permitted in the future, unless the proposal was submitted to the OSC in advance and unless the proposal at least satisfied the TSE draft requirements for stock exchange takeover bids. The commission then explained the status of its discussions with the exchange in the following words, "in the meantime, it is hoped that the uncertainties referred to at the hearing will be removed by an early agreement between the Toronto Stock Exchange and the Ontario Securities Commission".[195]

Because rules had already been adopted by the VSE and MSE, there was considerable pressure at the time of the Cornat bid for the TSE to prescribe rules governing takeover bids effected through its facilities. The uncertainty created by the inability of the OSC and the TSE to agree on a set of rules meant that a number of large transactions were effected through the other exchanges depriving members of the TSE who were not members of the other exchanges of commission revenue. The problem that arose was that any person who owned 20% of the equity shares of a company could not increase his holdings through the TSE without complying with the takeover bid requirements of the Ontario Securities Act. Without the stock exchange exemption, such shareholders could not increase their holdings through stock exchange purchases.

This gave rise to great pressure on the TSE from firms that were not members of the other stock exchanges for the TSE to adopt a code which would make provision for "normal course purchases".[196] The TSE was, of course, at the mercy of the OSC in these circumstances.

This series of events illustrates the sometimes informal nature of the process for OSC approval of a TSE by-law. If a formalized approval process had existed, including requirements for the

194 *In re* Bralorne Resources Limited, *supra* note 191, at 264.

195 *Id.*

196 TSE by-law 23.01(16), 3 CCH CAN. SEC. L. REP. ¶ 90-126 (December 7, 1976). In the period during which these rules were being settled, disciplinary proceedings were taken by the TSE against a firm of which the then chairman of the TSE was a director.

OSC to publish notice of the by-law to afford interested persons an opportunity to comment on the by-law, approve the by-law or convene a public hearing on it – all within specified time limits – it would have meant that any delay experienced by the TSE in implementing its takeover bid rules would have been quantifiable in advance.

B. PUBLIC HEARINGS ON TSE BY-LAW CHANGES

The alternative to private negotiations between the TSE and the OSC to settle a TSE by-law is to convene a public hearing as part of the process for settling the by-law terms. The decision on whether or not there will be a public hearing is made solely by the OSC. A public hearing requires the TSE in a public submission to the OSC to defend the terms of its by-law, and provides members of the public an opportunity to make submissions on the proposed by-law. As noted above, there is no prescribed code of procedure for publication of notice of the hearing and time limits within which the hearing must be held and within which the commission decision must be made. Once the OSC decides to convene a hearing, the Statutory Powers Procedure Act[197] of Ontario applies and it provides that reasonable notice of hearings is to be given to all parties and that the notice is to set out the "time, place and purpose of the hearing".[198] This act also permits notice to be given by public advertisement, or by some other method in the discretion of the tribunal where it is impracticable to give individual notice.[199]

On the first occasion when the OSC decided to convene a public hearing under subsection 140(2)[200] the TSE suggested that "the Commission should act under this section by means of private consultation with the exchange when the exchange was considering important matters of policy rather than by public hearings".[201] It is worthwhile quoting at length the commission's reasons for rejecting this suggestion, because it is the first statement of the OSC's understanding of its responsibilities under subsection 140(2):

> "In the first place, the language of the Act referred to above does not provide that the Commission should consult with and advise the Exchange. Secondly, it is the opinion of the Commission that the course suggested by

197 S.O. 1971, c. 47.

198 *Id.* ss. 6(1), (2).

199 *Id.* s. 24(1).

200 Then s. 139(2) of the Securities Act, S.O. 1966, c. 142.

201 *In re* the Toronto Stock Exchange and the Proposed Schedule of Commission Rates, [1967] OSC Bull. 15, 16 (June).

the Exchange could involve the Commission in many of the day-to-day details of the administration of the Exchange which the Commission does not consider is its proper function. It is the Commission's view that the Toronto Stock Exchange should continue to administer its affairs in the future as in the past. If, however, any of the actions of the Exchange appear to the Commission to be contrary to the public interest the Commission will ask the Exchange to explain the matter. This action might be taken by the Commission either on its own volition or as a result of representations received by it from members of the public. Such a hearing being ipso facto a matter concerning the public interest should be in public. It seems to the Commission that this procedure is preferable to any exercise by the Commission of its statutory authority in any informal or private manner.

"By the foregoing the Commission does not in any way suggest that there should be any interruption or diminution in the continuous exchange of information and discussion which has taken place in the past between the staffs of the Commission and the Exchange and such close co-operation between these staffs has and will continue to serve a very useful purpose in achieving strong administrative practices and policies."[202]

The occasion for this pronouncement was an amendment to a TSE by-law to increase minimum commission rates. The OSC in effect determined that the question of stock exchange commission rates involved a matter of public policy which should be considered in a public hearing. On the basis of this decision, all proposed amendments to the TSE commission rate by-laws have been the subject of a public hearing before the OSC.[203] In the course of these hearings, the commission has considered not only the reasonableness of proposed commission rate increases and temporary surcharges, but also the general question of whether or not the TSE

202 *Id.* at 16-17.

203 The commission decisions on the TSE commission rate by-laws are reported as follows:
[1973] OSC Bull. 107 (August);
[1974] OSC Bull. 199 (November);
[1975] OSC Bull. 193 (August);
[1975] OSC Bull. 278 (December);
[1976] OSC Bull. 289 (November);
[1976] OSC Bull. 157 (July); *see also the commission decision on the TSE by-law relating to the Conduct of Principal Transactions, in In re* the Toronto Stock Exchange, [1977] OSC Bull. 171 (July).

minimum rate by-law should be repealed and be replaced by fully negotiated rates.[204]

Whereas the commission rate hearings are convened in response to a TSE proposal to amend the relevant by-laws, the OSC can and has used its powers to convene a hearing under subsection 140(2) on its own initiative when broad questions of principle are raised by a TSE by-law. This was explained in the commission's consideration of by-law 24 and ruling 49 of the TSE:[205]

> "These questions involved, we felt, matters of principle that deserved more exhaustive consideration than we should be able to give them if we left them to be decided incidentally as they came up in particular cases. We therefore decided to exercise the power granted to us by subsection 2 of Section 139 and institute, of our motion, a legislative type hearing to consider them."[206]

By-law 24 and ruling 49 were replaced by by-laws 19.01 and 19.09, respectively, when the Toronto Stock Exchange Act[207] became effective on June 18, 1969. By-law 19.09 applies to "non-exempt"[208] listed companies. A non-exempt company must file with the exchange a filing statement of any proposed material change in its business or affairs. If the filing statement is not accepted by the exchange and the material change is proceeded with, the shares of the company will be delisted. This by-law was intended to enable the exchange to control companies whose "assets had been dissipated and stolen through improvident or fraudulent transactions"[209] and remove companies which failed to maintain minimum listing requirements from the exchange list.[210]

A further refinement of the OSC-TSE relationship for approving TSE by-laws was evidenced in the first month of the tenure of the new chairman of the OSC. In its *Weekly Summary*[211] the commission announced it had no objection to TSE By-law No. 169

204 For a commentary on the commission's decision specifically related to this question, *see* Connelly, *Fixed Versus Negotiated Commission Rates on the Toronto Stock Exchange*, 2 CAN BUS. L.J. 244 (1977).

205 *In re* by-law 24 and ruling 49 of the Toronto Stock Exchange, [1970] OSC Bull. 9 (February).

206 *Id.* at 10.

207 S.O. 1968-69, c. 132.

208 TSE by-law 19.09(3), 3 CCH CAN. SEC. L. REP. ¶ 89-798, gives the exchange power to exempt listed companies from by-law 19.09, thus the exempt and non-exempt lists.

209 *In re* by-law 24 and ruling 49 of the Toronto Stock Exchange, *supra* note 205, at 15.

210 In a hearing which preceded the *By-law 24 and Ruling 49* hearing by three months, the OSC had an opportunity to consider by-law 24 on an appeal from a decision of the TSE board of governors in *In re* Win-Eldrich Mines Limited, [1969] OSC Bull. 110 (July). In this case, the commission was also critical of the TSE's methods of proceeding in deciding to suspend trading of listed shares.

211 OSC Weekly Summary, January 20, 1978.

relating to the trading of listed securities in, by, or through a Computer-Assisted Trading System(CATS). This announcement is significant because the OSC does not ordinarily publish in its *Weekly Summary* a notice of a new exchange by-law or that the OSC approves of such a by-law. Giving public notice of OSC approval of an exchange by-law is a possible first step toward more public participation in SRO rule-making and the passage of SRO rules that better reflect the public interest. The publication of the notice in this case, however, did not go quite far enough in that no notice of the by-law was given when it was received by the OSC.

This apparently more public approach to the OSC-TSE relationship is further evidenced by the recent publication by the OSC of a notice[212] of its approval of a new exchange auditor. Approval of the exchange auditor is required by section 30 of the Ontario Securities Act. The commission explained in the notice that the new auditor (as was the case with his predecessor) is an employee of the exchange. The other SROs retain an independent firm of chartered accountants to perform the equivalent functions. The exchange auditor is required to act in accordance with a list of instructions prepared by the exchange. The OSC has required that the instructions not be amended without its consent.

C. APPROVAL OF SRO RULE CHANGES UNDER THE ALI FEDERAL SECURITIES CODE

Under the *ALI Federal Securities Code*, a rule change of an SRO does not take effect unless approved by the commission.[213] A procedure is described in the code which must be followed by the commission before a rule change is approved. The procedure requires the SRO to file copies of the rule change with the commission, the commission to publish a notice of the rule change and to afford interested persons an opportunity to comment on the rule change.[214] Upon expiration of a specified period of time, the commission must either approve the rule change or institute a proceeding to determine whether or not the rule change should be disapproved.[215] The order instituting the proceeding must give notice of the grounds for disapproval, and at the conclusion of the proceeding, the commission must decide whether or not to approve

212 OSC Weekly Summary, February 24, 1978.

213 ALI FEDERAL SECURITIES CODE, Tent. Draft No. 5, s. 805(b)(1). The commission is defined in the code to mean the Securities and Exchange Commission; ALI FEDERAL SECURITIES CODE, Reporter's Revision of Tent. Drafts Nos. 1-3, s. 218.

214 ALI FEDERAL SECURITIES CODE, Tent. Draft No. 5, ss. 805(b)(2), (3).

215 *Id.* s. 805(b)(4).

the rule change.[216] Provision is also made for a summary procedure[217] for approval of certain types of rule changes, such as changing a fee relating to administration of the SRO. Provision is also made for the commission to make a change in the rules of an SRO on stipulated grounds.[218]

Although the Ontario Securities Commission has never actually made a change in the rules of the TSE, its powers under subsection 140(2) of the Ontario Securities Act are certainly broad enough to enable it to do so. Perhaps the closest situation to the government (not the OSC) enacting a TSE by-law change occurred in connection with the review of the TSE decision rejecting the Baker Weeks of Canada Ltd. application for continued membership after a change of control. The OSC held that the regulations enacted by the Lieutenant Governor in Council on this subject would in effect govern the TSE's policy on the issue.[219]

D. CODIFYING PRACTICE FOR GOVERNMENT APPROVAL OF SRO RULE CHANGES

To impose a similar code of procedure on the TSE, other registered SROs and the government regulator would have the effect of regularizing the undefined relationship which exists between the government regulator and the SROs. As indicated above, the TSE practice[220] since 1967 has been to place all by-laws before the commission so that the commission may, should it so desire, exercise its powers of review pursuant to paragraph 140(2)(b) of the Ontario Securities Act. The IDA similarily keeps the provincial securities commissions constantly aware of its activities and "would not implement any decision or by-law that was opposed by them. Further, we are in constant touch with federal authorities, particularly the Bank of Canada and the Department of Finance....These federal authorities, like the provincial securities commissions, are constantly aware of our activities and we would not implement any decision or by-law that was opposed by them".[221]

216 *Id.* ss. 805(b)(5), (7).
217 *Id.* s. 805(c).
218 *Id.* s. 805(e)(l).
219 *See* discussion in text accompanying note 242 *infra.*
220 Specific reference is made to this practice in Toronto Stock Exchange, Submission to the Minister of Consumer and Corporate Affairs with respect to Bill C-42, an Act to Amend the Combines Investigation Act, at 7 (September 19, 1977).
221 IDA, Impact on the Securities Industry and Capital Markets of Proposed Stage Two, Bill C-42, Amendments to the Combines Investigation Act, at 3 (May 17, 1977) (Submission to the Hon. Anthony C. Abbott, Minister of Consumer and Corporate Affairs).

The only issue, then, is whether or not the government regulator should be required to publish a notice of a proposed rule change. In fact a proposed rule change receives very broad circulation among the membership of the SRO and, accordingly, it is difficult to imagine the SRO being prejudiced by having the government regulator publish the rule change prior to government approval. After publication, the government regulator would receive comments on the proposed rule change and would have a more accurate idea of the public interest in it. On this basis, the government regulator would be in a position to make a more informed judgment on whether or not the proposed rule change should be the subject of a public hearing.

By regularizing this procedure, the rule changes of the SROs will have increased credibility with members of the investing community, because they will have had an opportunity to make their views known on any issues raised by proposed rule changes.

Chapter IX
Review of SROs' Actions

The Ontario Securities Act now provides that any person or company that feels aggrieved by any decision made under any by-law, rule or regulation of a stock exchange in Ontario may apply to the Ontario Securities Commission for a hearing and review thereof.[222] A hearing and review by the commission of a stock exchange decision is governed by the same procedural requirements as a review by the commission of a decision of the OSC director.[223] Accordingly, in order for the person or company that feels aggrieved to initiate the review proceedings, notice must be given in writing to the commission within thirty days after the mailing of the notice of the stock exchange decision.[224] Upon the hearing of the review, the commission may by order confirm the decision under review, or make such other order as the commission considers proper.[225] The commission is also empowered to grant a stay of the decision under review until disposition of the hearing and review.[226]

222 Ontario Securities Act, s. 140(2).
223 *Id.*
224 *Id.* s. 28(1).
225 *Id.* s. 28(2).
226 *Id.* s. 28(3).

A. PRINCIPLES GOVERNING OSC REVIEW OF SRO ACTION

Although the first review of a stock exchange decision occurred shortly after the review power became effective,[227] the commission did not enunciate the principles which it would follow upon review of stock exchange decisions until 1972 in the *Williams* case.[228] Williams appealed a decision of the board of governors of the TSE declaring that he was unfit to be granted the status of an "approved" person under the by-laws of the exchange.[229] Thus Williams raised the issue of the power of the exchange to set standards for the admission of exchange members and employees of exchange members.

At the outset, the commission made it clear that the standards by which it measures applicants for registration may differ from those applied by the exchange and that registration under the Ontario Securities Act would not guarantee that the registrant would be approved as a registered representative employee of an exchange member. The commission then proceeded to state its views on the circumstances in which it would interfere with the exchange's exercise of discretion:

> "Since the Exchange has the power to impose additional or higher requirements in the ordinary case it would not be our intention to substitute our standards for those of the Exchange nor to substitute our discretion for that of the Governors. If their standards were not consistent with our view of the public interest or their discretion were not exercised fairly, such as an absence of evidence upon which their conclusions could be supported, we would not hesitate to intervene."[230]

The views expressed in the *Williams* case were developed further on the occasion of the first appeal by Lafferty, Harwood & Partners Ltd. from a decision by the Toronto Stock Exchange rejecting the Lafferty application for exchange membership.[231] In affirming the exchange's decision, the commission stated:

> "We reaffirm our position in the Williams case again in this case. We do not consider it a proper exercise of our

227 The power was granted in S.O. 1968-69, c. 116, s. 9 and the first decision was the review in *In re* Win-Eldrich Mines Limited, [1969] OSC Bull. 110 (July).

228 *In re* Edward Arthur Paul Williams v. the Toronto Stock Exchange, [1972] OSC Bull. 87 (May). For a pre-1966 example of how the commission dealt with an exchange member which did not meet exchange membership requirements, *see In re* Barrett, Goodfellow & Company Limited [1966] OSC Bull. 9 (July-August).

229 Such status is necessary for an individual to be employed as a "registered representative" or "account executive" by a TSE member.

230 *In re* Edward Arthur Paul Williams v. TSE, *supra* note 228, at 88-89.

231 *In re* Lafferty, Harwood & Partners Ltd., [1973] OSC Bull. 26 (February).

> jurisdiction under subsection 3 of section 140 and under subsection 2 of section 28 to which section 140(3) directs us, to substitute our judgment for that of the Exchange merely because we may disagree with the decision they have come to or because we may have given a different decision. If the Exchange has proceeded on some incorrect principle, or has erred in law, or has overlooked some material evidence, or new and compelling evidence was presented to us that was not presented to the Exchange, then we would deem it proper to interfere with a decision of the Exchange. In the absence of such factors we do not believe it to be a proper exercise of our jurisdiction to so interfere."[232]

The courts had an opportunity to consider the principle enunciated by the commission when, undaunted, Lafferty reapplied to the TSE for membership, was rejected, and applied to the OSC for a review of the exchange decision.[233] The commission again affirmed the exchange decision and Lafferty appealed the commission's decision under subsection 29(1) of the act to the Divisional Court of the Ontario High Court of Justice.[234] Counsel for Lafferty argued that the OSC ought to have held a trial de novo and should not have limited itself in the manner described in the quotation from the commission's reasons above. This contention was rejected by the Divisional Court.[235]

B. REVIEW OF SRO ACTION NOT INITIATED BY SRO MEMBERS

Not all of the reviews by the commission of stock exchange decisions have resulted from a stock exchange ruling applicable to one individual. On one occasion a company (which was not a member of the exchange) feeling it was "aggrieved" by an amendment to the exchange by-laws on commission rates applied to the commission for a review of the by-law in question.[236] The applicant, Fiscal Consultants Limited, could no longer "bunch" orders of its clients over five-day periods in order to obtain lower commission rates. The commission refused to grant the relief requested and the exchange by-law remained intact.

232 *Id.* at 45.

233 *In re* Lafferty, Harwood & Partners Ltd., [1974] OSC Bull. 125 (June).

234 8 O.R. (2d) 604, 607–08 (1975).

235 The Divisional Court's confirmation of the OSC statement of the general principles governing an appeal in cases of this kind was adopted by the B.C. Corporate and Financial Services Commission in *In re* Bali Exploration Ltd., B.C. Corporate and Financial Services Division Weekly Summary, July 30, 1976, at 1.

236 *In re* the Toronto Stock Exchange and Fiscal Consultants Limited, [1974] OSC Bull. 139 (June).

The B.C. Corporate and Financial Services Commission had an opportunity to consider who had status to seek review of an SRO decision in a case where a member of the public sought review of a decision by the VSE not to investigate her complaint against an exchange member.[237] In rejecting the application, the reasons of the commission include a useful discussion of the meaning of "person aggrieved". The B.C. commission has also had an opportunity to hear an appeal by a company whose shares were listed on the Vancouver Curb Exchange from an order by the exchange suspending trading of the shares[238] and an appeal by some shareholders of a company whose shares were listed on the Vancouver Stock Exchange from a decision of the exchange accepting a notice for filing by the company.[239]

C. OSC INTERFERENCE WITH SRO DISCRETION

In only one case has the OSC interfered with the exercise of the exchange's discretion because the exchange standards were not consistent with the commission's view of the public interest – as enunciated by the commission in its reasons in the *Williams* case.[240] The circumstances for this action by the commission arose in connection with the application for continued membership on the exchange of Baker Weeks of Canada Ltd. (hereinafter "Baker Canada"). Prior to the application, Baker Canada was a wholly-owned subsidiary of Baker, Weeks & Co. Inc. of the United States. With the introduction of fully negotiated commission rates in the United States, Baker U.S. became less and less profitable and ultimately its assets, including the shares of Baker Canada, were sold to Reynolds Securities Inc. The sale of assets resulted in a change of control of Baker Canada, which triggered a number of regulatory requirements to be satisfied by the new owners, (1) the consent of the OSC to the material change of control of an Ontario registrant;[241] (2) the approval of each of the TSE, MSE and IDA of the new controlling shareholder; and (3) approval by the Foreign Investment Review Agency.

Baker Canada first sought and obtained the consent of the OSC notwithstanding the opposition of both the TSE and the

237 *In re* Hill and the Vancouver Stock Exchange, B.C. Corporate and Financial Services Division Weekly Summary, April 18, 1975, at 1.

238 *In re* Avalanche Industries Ltd. and the Vancouver Curb Exchange, B.C. Corporate and Financial Services Division Weekly Summary, March 18, 1977, at 3.

239 *In re* Herman Janzen, B.C. Corporate and Financial Services Division Weekly Summary, December 17, 1976, at 2.

240 *In re* Edward Arthur Paul Williams v. TSE, *supra* note 228.

241 Ontario Securities Regulations, s. 6d(3).

IDA.[242] The OSC's consent was conditional upon Baker Canada not engaging in any underwriting activity in Canada.

The next step for Baker Canada was to seek the approval of the TSE to the change in shareholders.[243] This involved a two-stage process; first the applicant had to obtain the approval of the TSE board of governors, and second, the approval of the exchange membership as a whole. The board did not approve the change and therefore the application was not submitted to the exchange membership as a whole. Accordingly, Baker Canada sought a review of the board's decision by the commission.[244]

The question of public policy raised by the Baker Canada application for review was the question of whether the exchange could accept or reject membership applications on the basis of the residence of the owners. The commission in effect determined that if the Securities Act or regulations thereunder already dealt with a question of public policy, an SRO no longer has any power to enact regulations dealing with the same issue. In order to reach this conclusion, the commission first had to painstakingly trace the evolution of the regulations under the act dealing with non-resident securities firms. The commission then stated:

> "But as the custodians of a public monopoly granted by the Government of Ontario any power the Exchange might have had to bar non-resident owners disappeared on July 14th, 1971, when the regulations, made by Lieutenant Governor in Council pursuant to the Securities Act were filed. These regulations were exhaustive of the rules to be applied to non-residents in Ontario with respect to non-resident ownership."[245]

Not only was the commission prepared to intervene when it felt that a question of public policy on which the government had already acted was at issue, but the commission also gave definition to the TSE's jurisdiction. It has already been noted that under the Toronto Stock Exchange Act, 1968–69[246] the exchange could impose "any additional or higher requirement within its jurisdiction".[247]

242 *See In re* Baker Weeks of Canada Ltd. and regulation 6d(3), [1976] OSC Bull. 284 (November).

243 Required by TSE by-law 5.03(b), 3 CCH CAN. SEC. L. REP. ¶ 89-273. Baker Canada had already obtained the approval of the MSE and the Quebec Securities Commission.

244 Decision reported in *In re* Baker Weeks of Canada Ltd. and the Toronto Stock Exchange, [1977] OSC Bull. 32 (February).

245 *Id.* at 48.

246 S.O. 1968-69, c. 132.

247 *Id.* s. 4(3).

D. REVIEW OF ACTIONS OF SROS OTHER THAN STOCK EXCHANGES

If Baker Canada had been heavily engaged in the underwriting business, no doubt the IDA would have, on the same grounds as the TSE, rejected Baker Canada's application to continue its IDA membership. Baker Canada could not have sought review of this decision by the OSC. Furthermore, the OSC would have lacked the power to make an order requiring the IDA to delete from its by-laws the provisions dealing with non-resident members. If the OSC's decision in the Baker Canada case requiring SROs to refrain from passing regulations dealing with matters of public policy already subject to regulation by the government is to be effective, then the OSC should have the right to order the deletion from the IDA by-laws of a provision in an "occupied field". In this respect, section 805(e) of the *ALI Federal Securities Code*[248] which enables the SEC to make a rule change in the rules of an SRO is a precedent. If the government enacts rules in an area of public policy, an SRO should not have the power to emasculate these rules through its own rules. Control of Baker Canada, now Reynolds Securities (Canada) Ltd., has again changed with the merger in the United States of Reynolds Securities International and Dean Witter Organization Inc., thereby necessitating another set of approvals.[249]

Registration of the IDA with the appropriate government regulator would mean that any person or company that feels aggrieved by a decision made under a rule of the IDA could apply

248 ALI FEDERAL SECURITIES CODE, Tent. Draft No. 5, s. 805(e).

249 The OSC has denied the application for an order permitting the change in ownership of Reynolds Securities (Canada) Ltd.; *In re* Reynolds Securities (Canada) Ltd., [1978] OSC Bull. 101 (March). The commission decided that certain conditions set out in s. 6d(3) were not satisfied; specifically, there was no "material or unique service to Ontario investors" which was "not substantially available to those investors through other registrants". However, the commission felt that it was in the best interests of the public to continue the registration. For this reason, it decided to postpone the procedure for termination of the registration of Reynolds Securities (Canada) Ltd. for a reasonable period of time to allow the registrant time to approach the Ontario cabinet through the Minister for a change in the regulations. The original theory underlying the requirement for approval of changes in control was to prohibit non-residents from obtaining "backdoor" registrations. This theory is not applicable when the change in control results, not from the intention of an acquirer to obtain a Canadian registration, but simply from the continuing rationalization of the U.S. securities industry.

The MSE rejected the application by Reynolds Canada for approval of the change of shareholders from Reynolds Securities Inc. to Dean Witter Reynolds Inc. However, the QSC ordered the MSE to approve the change of control on the basis that the application satisfied all exchange requirements for membership in the absence of specific regulations with respect to non-resident members; 9 QSC Bull. No. 9 (Decision No. 5460, March 7, 1978). In its reasons on this appeal the QSC also rejected the rather novel argument of the exchange that a decision of its members was not

to the regulator for review of the decision. The right of appeal from the IDA makes sense for many of the reasons that registration of the IDA as an SRO makes sense. A person or company that is denied membership in the IDA should have the right to have the IDA decision reviewed, if, for example, the person or company feels that the IDA proceeded on an incorrect principle or has overlooked material evidence. Similarly, because the IDA is involved in market regulation, if a person or company feels aggrieved by a rule change of the IDA that does affect the market, then again, it is not difficult to justify such a person or company having a right to seek a review of the rule change. With respect to the BDA, it is interesting that the OSC has veto power over any by-laws or regulations of the BDA, but has no jurisdiction to review any ruling by the BDA board of governors.[250]

E. REVIEW PROVISIONS IN ALI FEDERAL SECURITIES CODE

The provisions for review of SRO actions in the *ALI Federal Securities Code* are spelled out in much greater detail than the equivalent provisions in the Ontario Securities Act. First, the SRO is required to file a notice of its action in certain circumstances: if the SRO makes an adverse determination on the application for membership, imposes a disciplinary sanction on a member, or prohibits or limits any person in respect of access to services offered by the SRO or a member.[251] The SRO action is subject to review by the appropriate regulatory agency, either on its own motion or on an application by an aggrieved person. The code then spells out the principles to guide the regulatory agency in reviewing the decision. If the decision under review is a denial of membership, the agency must find that specific grounds for the SRO action exist, that the SRO action accords with the rules of the SRO and that those rules are and were applied in a manner consistent with the purposes of the code. If this is the finding, then the proceeding is dismissed. If the agency does not make this finding, or if it finds that the action taken imposes a burden on competition not necessary or appropriate in furtherance of the purposes of the code, the agency must set aside the order and require the SRO to admit the applicant to membership.[252] In respect of disciplinary

a decision of the exchange and therefore was not subject to review by the commission; *id.*

250 The OSC had assumed it had this power over the BDA until 1956 when the Ontario Court of Appeal held otherwise; *Re* Larrimore Securities, [1956] O.W.N. 501 (C.A.).

251 ALI FEDERAL SECURITIES CODE, Tent. Draft No. 5, s. 810(a); based on Securities Exchange Act, s. 19(d)(1).

252 ALI FEDERAL SECURITIES CODE , Tent. Draft No. 5, ss. 810(d)(1)(A), (B).

proceedings the code provides that if the appropriate regulatory agency finds that a sanction imposes a burden on competition not necessary or appropriate in furtherance of the purposes of those provisions, then the agency may cancel, reduce or require the remission of the sanction.[253]

The bases for the review spelled out in the code are in some respects similar to the principles enunciated by the OSC.[254] However, with the increasing emphasis which will have to be placed on the implications for competition of SRO actions, the reviewing agency should be specifically required to direct itself to this question on every review of an SRO's action. It should state specifically that such action does not exceed the requirements of a competitive securities market and what is necessary for the protection of the investor.

Chapter X
Membership in SROs

> "Inherent in self-regulation is the 'private' formulation of restrictive standards of business conduct and their enforcement by exclusionary and other 'anti-competitive' practices."[255]

A. APPLICATION FOR MEMBERSHIP ON THE TSE

The grounds for describing a stock exchange as a "private club" have all but disappeared with increased government supervision and increased publicity of stock exchange affairs. However, it is still possible for the membership of the TSE to "blackball" an applicant from membership. An application for membership on the TSE is first referred to the board of governors and "the candidate will be admitted only if approved first by the board and then by the members on a ballot...".[256] The TSE by-laws provide for a minimum number of votes to be cast on the question, a minimum number of such votes to be in favour of the admission and a limitation on the number of votes against admission.[257]

253 *Id.*, s. 810(d)(3).

254 *See* discussion in text accompanying notes 230, 232 *supra*.

255 SPECIAL STUDY, *supra* note 134, at 149.

256 TSE by-law 3.14, 3 CCH CAN. SEC. L. REP. ¶ 89-215.

257 *Id.* subsection (3) of by-law 3.14 provides:

> "The candidate shall be admitted if: (a) the number of votes cast on the question is at least 50% of the total number of votes that could be cast thereon by all members then entitled to vote thereon, and (b) at least 2/3 of the votes cast thereon are in favour of admission of the candidate, and (c) the number of votes against admission of the candidate is less than 20%

There is little doubt about the statutory power of the TSE to regulate admission to membership. The TSE's act of incorporation provides[258] that the by-laws of the TSE may provide for and regulate the admission of members, including the requiring of approval by the directors or members or both, at meetings or individually, and the manner in which such approval is to be given. The OSC has affirmed that the TSE has the power to refuse membership to an applicant for membership on the exchange.[259]

B. THE LAFFERTY AND BAKER CANADA TSE MEMBERSHIP APPLICATIONS

Neither the Lafferty Harwood nor the Baker Canada TSE membership application was referred to the membership for a vote. Both were denied by the TSE board of governors. However, the denial of the Lafferty Harwood and Baker Canada applications were based on two different policies. In *Lafferty, Harwood & Partners Ltd.* the board of governors determined that the Lafferty firm was not fit for membership based on evidence of past conduct of *Lafferty.* The OSC confirmed the judgment of the TSE board that the conduct indicated a lack of judgment and responsibility on the part of the applicant.[260] On the second *Lafferty* application, the decision of the TSE board of governors was again confirmed on the basis of the applicant's present attitude toward his past conduct (and not for the conduct itself).[261] The *Baker Weeks of Canada Ltd.* case[262] did not involve an application for membership but approval of a change of control,[263] which is treated like a membership application under the TSE by-laws. As was noted in the commission decision, there was no suggestion that Reynolds Securities Inc., the new owner of Baker Canada,

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of the total number of votes that could be cast on the question by all members then entitled to vote thereon."

The by-laws of the Montreal Stock Exchange also provide for consideration of an application for membership by the Governing Committee of the exchange. If a majority of the Governing Committee approves the membership application it is submitted to the members and "the applicant shall be declared elected if at least the majority of the members have voted and at least two-thirds of the ballots have been cast in favour of the admission of the applicant"; MSE by-law No. III, art. 3108, 3110, 3111, 3 CCH CAN. SEC. L. REP. ¶¶ 85-208, 85-210, 85-211.

258 S.O. 1968-69, c. 132, s. 11(c).

259 *In re* Lafferty, Harwood & Partners Ltd., [1973] OSC Bull. 26, 37-38 (February).

260 *Id.* at 44. The conduct related to an accommodation in connection with the preparation of Lafferty Harwood financial statements and a suggestion of political influence on the part of the Chief Justice of the High Court of Ontario in an action relating to important mineral claims.

261 *In re* Lafferty, Harwood & Partners Ltd., [1974] OSC Bull. 125, 132 (June).

262 *In re* Baker Weeks of Canada Ltd. and the Toronto Stock Exchange, [1977] OSC Bull. 32 (February).

263 Required by TSE by-law 5.03(b), 3 CCH CAN. SEC. L. REP. ¶ 89-273.

failed to meet any of the tests relating to honesty, reputation in the business community, ability, experience, competence and financial resources[264] as was the case with the Lafferty application. The board of governors of the TSE based its decision on the public policy question already referred to,[265] that is, that non-resident controlled firms which were members of the SROs at the date of the *Moore Committee Report*[266] would be granted "grandfather status" provided that upon a change of control the grandfather status could be withdrawn. It was on this basis that the TSE board of governors denied continued membership to Baker Canada. As was discussed in chapter IX, the OSC determined that if the government has enacted regulations on important questions of public policy, including restrictions on non-resident ownership, then the power of the exchange to enact regulations dealing with such questions is removed. The commission did concede that in the absence of government action an SRO such as the exchange might have the power to deal with questions of public policy such as non-resident ownership.

C. PRIVATE BALLOTS ON MEMBERSHIP APPLICATIONS

The Baker Canada decision afforded the OSC an opportunity to comment on the private ballot procedure used by the exchange membership in determining the admissibility of an applicant for membership or for approval of new shareholders of an applicant which has undergone a change of control. The TSE argued that even if the board of governors did not have the power to deny the Baker Canada application for membership, the board of governors should be permitted to refer the question to the TSE members for a vote. The commission replied:

> "Moreover, as we have concluded, there is no jurisdiction in the Exchange to deal with any question involving non-resident ownership, it would clearly be an abuse to permit a vote when the only matter in issue must be that of non-resident ownership. A negative vote of the member might be perceived as a vote designed on the one hand to support the decision of the Board, and on the other to further reduce non-resident competition. No matter how erroneous this perception might be there is no effective

264 *In re* Baker Weeks of Canada Ltd. and the TSE, *supra* note 262, at 47-48.

265 *See* discussion beginning in text accompanying note 230 *supra*.

266 REPORT OF THE COMMITTEE TO STUDY THE REQUIREMENTS AND SOURCES OF CAPITAL AND THE IMPLICATION OF NON-RESIDENT CAPITAL FOR THE CANADIAN SECURITIES INDUSTRY (May 1970). This committee was established jointly by the IDA, TSE, VSE and Canadian Stock Exchange with Trevor F. Moore as chairman.

> way of examining the reasons of the individual member for its vote and, therefore, lodging an effective appeal from such a decision."[267]

The commission effectively points up the problems with the secret ballot. A vote against an application for membership could be based on any number of motivations, for example, a question of public policy upon which the SRO has no power, or a concern about competition from the applicant for membership. In addition, there is the problem that if the vote is unfavourable the applicant has no reasons that can be examined to determine whether OSC review of the decision is worthwhile. The applicant is effectively denied the statutory right of review.

The IDA by-laws on membership do not provide for a secret ballot by members on an application for membership.[268] An application must first be approved by the applicable District Council, then the National Committee of the IDA, which, in its discretion, decides on all applications. All members are given notice of an application for membership and have the opportunity to object to the admission of the applicant. However, whether it is the District Council or the National Committee which ultimately refuses an application, there will be reasons available to the applicant and he can decide whether or not a government review of the SRO decision would be worthwhile.

D. REMOVAL OF THE "BLACKBALL" VOTE

Recommending the removal of the "blackball" vote from SROs on applications for membership is not a very radical suggestion. As noted above, recent applications for membership on the TSE were not denied as a result of a secret ballot vote, but for reasons spelled out in writing by the board of governors of the exchange. The secret ballot is not consistent with the public utility nature of the stock exchanges and with the increasing concern, evidenced in the proposed amendments to the Combines Investigation Act, that private powers may be used to limit competition.

SROs should not be permitted to include in the criteria for membership "questions of public policy" - which have already been taken into account in the registration requirements - as outlined in the OSC's decision on the review of the TSE decision on Baker Canada. What constitutes a "question of public policy" would be determined by the appropriate government regulator. This determination would be made upon an application by an SRO

267 *In re* Baker Weeks of Canada Ltd. and the TSE, *supra* note 262, at 51-52.
268 IDA by-law No. 2, IDA BLUE BOOK 406 (1976), 1 CCH CAN SEC. L. REP. ¶ 821.

for registration as an SRO or upon the submission for government approval of an SRO rule change.

The *ALI Federal Securities Code* requires that the rules of an applicant for registration as an SRO, in the case of an exchange or association of securities firms, provide that any registered broker-dealer may become a member of the SRO.[269] The code further provides that a national securities exchange or registered securities association may deny membership to a person who does not meet the standards of financial responsibility or operational capability prescribed by the SRO rules, or deny membership to a natural person from becoming an associate[270] of an SRO member if the person does not meet the standards of training, experience and competence prescribed by the SRO rules or has engaged, and there is a reasonable likelihood that he will again engage, in acts or practices inconsistent with just and equitable principles of trade.[271]

It is submitted that similar restrictions upon SRO bases for admitting and denying membership should be included in the securities laws of Canada.

Chapter XI
Self-Regulation and Competition Policy

In a submission to the United States Secretary of the Treasury, J. Lorie states:

> "The general objective of public policy is to have markets that operate fairly and efficiently. Fairness and efficiency lead to confidence on the part of the investing public that returns will be reasonably related to risks, that the institutions through which they deal have financial integrity, and that the individual investor is not at a serious disadvantage compared with the institutional investor. The principal and best method of ensuring this result is well known: competition."[272]

Historically, Canadian legislators and administrators of securities regulations have concentrated on the fairness of the operation of our securities markets. Legislation and administration directly intended to enhance the level of competition in the markets have taken a secondary position to investor protection. However, sensitivity to competitive conditions is increasing. Concern

269 ALI Federal Securities Code, Tent. Draft No. 5, s. 803(f).

270 An associate of an SRO member is equivalent to a salesman employed by a Canadian dealer.

271 ALI Federal Securities Code, Tent. Draft No. 5, s. 807(c).

272 J. Lorie, Public Policy for American Capital Markets 3 (1974).

about the level of competition in the Canadian securities markets has been stimulated by the 1975 amendments to the Securities Exchange Act in the U.S. which, for example, required negotiated commission rates.[273] In addition, Canada's own competition legislation has been revised and further revisions are proposed. This reform process has been directed toward the extension of competition laws to service industries.

A. STAGE I AMENDMENTS TO THE COMBINES INVESTIGATION ACT

The Stage I amendments to the Combines Investigation Act[274] include an exemption from certain offences in relation to competition, for agreements or arrangements between or among persons where such an agreement or arrangement has a reasonable relationship to the underwriting of a specific security.[275] The IDA had argued in favour of such an exemption on the basis that it would be coextensive with the regulatory and supervisory authority of the provincial securities commissions.[276] The securities industry is using essentially the same argument in its attempt to limit the application of the Stage II amendments to the Combines Investigation Act in Bill C-13.[277]

B. U.S. EXPERIENCE

The issue of the applicability of the antitrust laws to self-regulatory action in the securities industry was faced, not by a legislative body, but by a court in the United States in 1963 in *Silver v. New York Stock Exchange.*[278] Silver's securities firms were not members of the exchange, but instead had wire connections with some firms which were members. The members applied for approval as required by the rules of the exchange. "Temporary approval" was granted, but several months later the exchange ordered its members to discontinue the wire connections with Silver's firm without giving Silver a hearing or reasons for its decision. Silver commenced an action against the exchange and its members alleging, *inter alia,* breach of the Sherman Act. The

273 Securities Exchange Act of 1934, s. 6 *as amended by* Securities Reform Act of 1975, s. 4.

274 S.C. 1974-75-76, c. 76.

275 *Id.* s. 2.

276 Competition Act Committee of the Investment Dealers Association of Canada, Submission to the Department of Consumer and Corporate Affairs, as to the effect of the proposed federal Competition Act on the Canadian capital markets and securities industry 15 (May 1972).

277 Bill C-13, 30th Parl., 3d Sess. (1977).

278 373 U.S. 341 (1963).

exchange pleaded that the Securities Exchange Act of 1934 required it to regulate its members and therefore provided it with immunity from antitrust suit and effectively repealed the antitrust laws. The court held that the concerted action of the exchange and its members was a group boycott and therefore a per se violation of the Sherman Act absent justification derived from the policy of another statute. The problem that arose was one of reconciling "pursuit of the antitrust aim of eliminating restraints on competition with the effective operation of a public policy contemplating that securities exchanges will engage in self-regulation which may well have anti-competitive effects in general and in specific applications".[279] After reviewing the history of self-regulation the court held that since the Securities Exchange Act contains no express exemption from antitrust law, "[r]epeal is to be regarded as implied only if necessary to make the Securities Exchange Act work, and even then only to the minimum extent necessary. This is the guiding principle to reconciliation of the two statutory schemes".[280] The court then went on to conclude that the act did not afford justification for anti-competitive collective action taken without according fair procedure. In other words, there could be no justification where the exchange exceeded the scope of its authority under the act.

This case left open several of the key questions in the application of antitrust law to self-regulatory action because, first, the Securities and Exchange Commission did not have the power to review the action of the exchange in the *Silver* situation,[281] and second, this was a procedural attack on exchange rules as opposed to one questioning the merits or substance of the rule. The court made it clear that "Should review of exchange self-regulation be provided through a vehicle other than antitrust laws, a different case as to antitrust exemption would be presented".[282]

The cases which followed *Silver* failed to provide a satisfactory answer to the unresolved questions. *Kaplan v. Lehman Brothers*[283] was a derivative action on behalf of mutual funds claiming that fixed commission rates constituted a violation of antitrust law. The U.S. District Court of Illinois gave summary judgment for the defendants holding that it was clearly implied in the Securities Exchange Act that stock exchanges had the power to fix minimum

279 *Id.* at 349.
280 *Id.* at 357.
281 *Id.* The SEC had power to request exchanges to make changes in their rules, but the act did not give the SEC jurisdiction to review particular instances of enforcement of exchange rules.
282 373 U.S. 341, 360 (1963).
283 250 F. Supp. 562 (1966).

commission rates. It pointed out that the Securities and Exchange Commission had the power to review the rate structure and that any appeal as to the unreasonableness of the rates should be made to the commission.

In *Thill Securities Corporation v. New York Stock Exchange*,[284] non-members of the exchange brought a suit complaining that a rule prohibiting members from sharing commissions with non-members violated antitrust laws. A divided U.S. Court of Appeals remanded the case to the District Court after deciding that the rule was not exempt from attack under antitrust law merely because the rule was subject to SEC review. The exchange had the onus of proving that the rule was necessary for it to discharge its responsibilities under the Securities Exchange Act. The majority was split on the question of whether the SEC had primary jurisdiction to consider anti-competitive aspects of exchange rules or whether the matter should go directly to the courts. This issue appeared to have been decided in favour of granting primary jurisdiction to the regulatory agency in *Ricci v. Chicago Mercantile Exchange*.[285] However, in 1976, the United States Supreme Court clarified its decision in *Ricci* as well as the general question of immunity.

In *Gordon v. New York Stock Exchange*[286] the plaintiff sued on behalf of himself and other small investors claiming that fixed commission rates for transactions under $500,000 violated antitrust law. After a lengthy review of the history of commission rates, and a description of the supervision provided by the SEC and the Congress, the court reaffirmed its decision in *Silver*. It then went on to hold "that these requirements for implied repeal are clearly satisfied here. To permit operation of the antitrust laws with respect to commission rates, as urged by petitioner Gordon and the United States as *amicus curiae*, would unduly interfere, in our view, with the operation of the Securities Exchange Act".[287] The factors which influenced this result were (1) the statutory authorization for regulation by the SEC; (2) the long history of oversight by the SEC and, in particular, the recent moves toward more competitive rates; and (3) continued congressional approval of the SEC's authority over the commission rate system. Finally, the court decided that the question of whether there is repeal of antitrust law is one for the courts, but that the courts may defer to the regulatory agency where the issue is whether the activities violate the Securities Exchange Act or rules. There would be no

284 433 F.2d 264 (1970).
285 447 F.2d 713 (1971).
286 422 U.S. 659 (1975).
287 *Id.* at 686.

deference where the "conduct charged was clearly encompassed by the legislation or rules and where there was no factual dispute".[288]

In proposing the Stage II amendments[288a] the Government of Canada is asking Parliament, in effect, to spell out the criteria which must be satisfied before there is an exemption, whether or not "implicit", under the competition legislation.

C. STAGE II AMENDMENTS TO THE COMBINES INVESTIGATION ACT

Bill C-13 provides an exemption for "regulated conduct" from certain offences in relation to competition, including conspiracy to unduly restrain competition, bid-rigging, monopolization, price discrimination, unfair allowances and price maintenance.[289] "Regulated conduct" is defined in the bill,[290] and it is interesting to review this definition, not only because of its significance in the application of the bill to the securities industry, but also because of the response of the securities industry to the definition. The response is revealing of the industry's relationship to the provincial securities commissions.

> " 'Regulated conduct' means conduct in respect of which the following conditions are met:
> "(a)the conduct has been expressly required or authorized by a regulating agency[291] that...is not appointed or elected by the persons, or by classes or representatives of the persons, whose conduct is subject to be regulated by such agency...and
> "(b)the regulating agency is expressly empowered, by or pursuant to an Act of Parliament or of the legislature of a province, to regulate the conduct in the manner in which it is being regulated and has expressly directed its attention to the regulation of the conduct...."[292]

288 *Id.* at 688.

288a Bill C-42, 30th Parl. 2d Sess. (first reading March 16, 1977), An Act to Amend the Combines Investigation Act and to Amend the Bank Act and Other Acts in Relation to or in Consequence Thereof, and its subsequent replacement, Bill C-13, 30th Parl., 3d Sess. (1977), have proposed numerous amendments to the Combines Investigation Act. One amendment would have changed the name of the act to the Competition Act.

289 Bill C-13, 30th Parl., 3d Sess., s. 4.5 (1977).

290 *Id.* s. 4.5(2).

291 *Id.* The term is defined in s. 4.5(2).

292 Section 4.5 of the proposed Competition Act as it would have been amended by Bill C-13, 30th Parl., 3d Sess. (1977). The TSE noted in its submission on Bill C-42, 30th Parl., 2d Sess. (1977), that the standards in s. 4.5 are substantially more onerous than those imposed under the present law which is summarized by Chief Justice McRuer in R. v. Canadian Breweries Limited, [1960] O.R. 601, 629 (H.C.). Bill C-42, which preceded Bill C-13, contained a third condition for "regulated conduct", that

A provincial securities commission would be considered a "regulating agency" as defined in the bill.

The TSE in its submission on Bill C-42,[293] the predecessor of Bill C-13, applied the "regulated conduct" criteria to the process of fixing commission rates and to other exchange-regulated activities to point out the stringency of the "regulated conduct" exemption. The conduct of the TSE in respect of commission rates involves the exchange applying to the OSC for approval of a specified schedule of rates. On this basis, the TSE concluded that its conduct in this respect is "expressly authorized".

However, on the second part of the "regulated conduct" definition, the TSE did not believe "that it could accurately be said that the commission is expressly empowered to regulate the setting of commission rates",[294] notwithstanding the broad supervisory powers of the commission over the exchange contained in subsection 140(2) of the Ontario Securities Act. In addition, the commission's consideration of the TSE's application for approval of its schedules of commission rates means that the OSC "has expressly directed its attention to the regulation of the conduct".

As stated above,[295] Bill C-42 contained a requirement that the proposed Competition Act seriously interfere with the attainment of the primary regulatory objectives of the relevant act before the conduct was considered "regulated conduct". This requirement was dropped when Bill C-13 was introduced. The TSE had complained that this criterion was imprecise and it was not certain how a court would conclude in these circumstances. The TSE's concerns did not fall on deaf ears.

Consider the application of the "regulated conduct" criteria to other aspects of stock exchange conduct. As noted earlier, the OSC does not normally conduct a public hearing into a proposed stock exchange by-law, and therefore, there may not be any express authorization by the OSC of the by-law. In the absence of this express authorization, such a by-law may not be considered "regulated conduct". As noted above, although the OSC has broad supervisory powers over the exchange, it is not expressly empowered to regulate the various aspects of the conduct of the exchange members which are the subject of exchange by-laws. In the ab-

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in the application of which under the proposed Competition Act to the conduct, in the specific circumstances of the case, would seriously interfere with the attainment of the primary regulatory objectives of the act empowering the regulatory agency; see Bill C-42, clause 5.

293 The Toronto Stock Exchange, Submission with Respect to Bill C-42, An Act to Amend the Combines Investigation Act 12 (September 19, 1977).

294 *Id.* at 13.

295 *See* note 292 *supra.*

sence of the publication by the OSC of a statement indicating its approval of an exchange by-law, such as the statement approving the exchange by-law implementing the Computer-Assisted Trading System,[296] there will not be any evidence available to the TSE that the commission has expressly directed its attention to the exchange by-law.[297]

The TSE concluded in its brief:

"With regard to the operation of the Exchange, we submit that the results arrived at by the application of section 4.5 of the Bill to the self-regulatory function performed by it and its members under the supervision of the Ontario Securities Commission, the Securities Act and the Government of Ontario are not in the public interest".[298]

The exchange supported a recommendation by the IDA which would involve an amendment to the Combines Investigation Act giving "specific recognition of the distinctive position of the securities industry through an exemption similar to the underwriting exemption in section 4.1".[299]

The conduct of IDA members as regulated by the IDA would not be "regulated conduct" under the bill because of the absence of any requirement in the Ontario Securities Act for recognition of the IDA and for approval by the provincial securities commissions of IDA conduct.[300] The IDA recognizes that its rules could be considered to have an "undue" impact on competition within the meaning of section 32 of the Combines Investigation Act as it would be amended by Bill C-13 and the association is concerned that it is open to attack, "an attack that might be launched despite the fact that the activities are conducted openly and with the approval of both provincial and federal regulatory authori-

296 *See* text accompanying note 211 *supra*.

297 The exchange in its submission on Bill C-42 provided an example of how the third criterion contained in that bill (and not carried forward in Bill C-13) for "regulated conduct" could effectively nullify the exchange's self-regulatory functions. If an applicant for membership in the exchange is rejected because he fails to meet the capital requirements imposed by the exchange, the applicant may argue that the requirements are anti-competitive in nature and are not so necessary that rendering them ineffective would interfere with the primary regulatory objectives of the Securities Act. The exchange considers that requirements such as the capital requirements are "necessary and appropriate to the administration of its self-regulatory function". However, it pointed out that under Bill C-42 it is open to a court to determine that such is not the case.

298 TSE submission, *supra* note 293, at 22.

299 IDA brief, *supra* note 221, at 6.

300 One exception relates to audit standards discussed in text accompanying note 24 *supra*.

ties".[301] The IDA concludes: "While it seems unlikely that a criminal prosecution would succeed, it is unfair to this Association for us to face any exposure as a consequence of open adherence to rules that are designed for investor protection and that enchance the effective operations of our capital markets."[302]

D. INCREASED AWARENESS BY GOVERNMENT SUPERVISORS OF COMPETITION POLICY

Parliament will have to decide whether (1) the standards of self-regulation imposed by the stock exchanges and the IDA on their respective memberships and (2) the supervision of the stock exchanges and the IDA by the provincial securities commissions are sufficiently sensitive to competitive conditions in the securities markets.[303] A scheme of securities legislation in place in Ontario has developed because of the emphasis on investor protection. Investor protection has been sought through the imposition of disclosure requirements and licensing requirements, and by legislating against insider trading. Investor protection therefore has meant, historically, protection against a lack of information, unscrupulous and undercapitalized securities firms and inequality of information – not protection against the costs of anti-competitive conduct.[304]

The only examples of the OSC expressly directing itself to the state of competition in the marketplace appear in its consideration of stock exchange commission rates and particularly in its 1976 decision on whether or not commission rates should be unfixed. Indeed, the majority opinion concluded:

> "After considering all of the facts relating to competitive forces now in effect and appreciating that hard evidence in support of either fixed or negotiated commissions is limited, the majority of us have concluded that it would not be in the public interest at this time to direct the

301 IDA brief, *supra* note 221, at 5.

302 *Id.*

303 8 D. Shaw & R. Archibald, *supra* note 5, at 107-08, describes the concern expressed in some quarters that the major underwriters act in a non-competitive manner in their banking group relationships, choosing syndicate members based on historical relationships rather than capability.

304 *See* Saari, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 Stan. L. Rev. 1031, 1069 (1977). Saari states:

> "The SEC has typically reacted to assertions that it is failing to achieve its goals by recommending more and better disclosure, or by calling for stricter enforcement of insider trading laws. Belief in the virtues of disclosure and in the evils of insider trading has become so strong that the SEC has not considered seriously the true effects of its regulation on the investors who it is charged with protecting;" *id.*

immediate introduction of negotiated rates in whole or in part."[305]

The two commissioners who dissented and favoured negotiated rates concluded:

> "Real competition through the price mechanism will encourage the responsiveness to new conditions, the healthy rationalization and the spirit of innovation that should characterize the Canadian securities industry if it is to meet the needs of the capital market in the years ahead."[306]

Competition and regulation are not antithetical: both are an attempt to maximize efficiency by eliminating monopoly profit through inducing competitors to provide services at a minimum cost, through preventing undue discrimination in pricing and, in general, encouraging business to be responsive to consumer preferences. Indeed, both antitrust enforcement and regulation from this point of view have the same goals.[307]

The securities industry is thus faced with the dilemma of all regulated industries: regulation can be constructive in developing the credibility of the marketplace, thereby enhancing efficiency, while regulation can, at the same time, be destructive because compliance with rules can inhibit efficiency. The analysis of the implications on the marketplace of revisions to our securities laws has been limited and usually only carried out in response to a reaction from the private sector. The consequences of a fraud are relatively easy to identify in economic terms and to explain in legal terms and therefore provide an easy basis for preventive legislation. The consequences of new legislation for the marketplace are prospective and difficult to measure, and are therefore not often analyzed in depth prior to enactment.

The provincial securities commissions have not dealt forcefully with the issue of competition and indeed have received little encouragement from the legislatures to do so. Competition and the resultant increase in efficiency must become a major consideration in reviewing the activities of the various SROs. It has been noted that such a concern does not run contrary to desires to protect the investor and that regulation generally has the same goal in that it attempts to reinforce competition. Full competition in the securities industry is not possible.[308] The difficulty is that

305 *In re* the Securities Act and part XV of the by-laws of the Toronto Stock Exchange, [1976] OSC Bull. 289, 302 (November).

306 *Id.* at 319.

307 Seltzer, *Antitrust and Regulatory Policies: An Introduction and Overview*, 16 ANTITRUST BULL. 669 (1971).

308 *Id.*

competition and efficiency have so often been neglected in favour of the goal of investor protection. Perhaps this has not been such an unfortunate situation. In order for our securities markets to efficiently allocate resources, integrity must be a primary and competition a secondary concern. Considerations of competition generally have been sacrificed when the two values conflicted. The integrity of our markets has not been seriously questioned in the last ten years, and thus it is timely for our regulators to be more sensitive to the establishment of a highly competitive open environment for trading securities.

The U.S. Securities Reform Act of 1975 was primarily motivated by the desire to increase the level of competition in the securities markets. The *ALI Federal Securities Code* would require the appropriate government regulator to consider the implications of the conduct of SROs for the level of competition. In order for an SRO to become registered under the code, its rules must satisfy a number of requirements including that they do "not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes that the applicant is intended to further as a self-regulatory organization under this Code".[309] One of the criteria which must be applied by the appropriate government regulator in reviewing the action of an SRO is whether or not the disciplinary action "imposes a burden on competition not necessary or appropriate in furtherance of" the purposes of the code,[310] and if the government regulator finds inappropriate or unnecessary actions, it is required to nullify the action. Under the *ALI Federal Securities Code,* the commission has the power to make rules and orders to implement specific provisions of the code.

> "In exercising its rule-making authority, the Commission shall consider, among other matters, the impact that the rule change would have on competition. It may not adopt a rule change that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of this Code and it shall include in the statement of basis and purpose incorporated in every rule change the reasons for its determination that any burden on competition imposed by the rule change is necessary or appropriate in furtherance of those purposes."[311]

If the Canadian securities industry is to achieve the exemption it has requested from the federal competition legislation[312] then it must be in a position to demonstrate to Parliament that its

309 ALI FEDERAL SECURITIES CODE, Tent. Draft No. 5, s. 803(L).
310 *Id.* s. 810(d)(B).
311 *Id.* s. 1502(c).
312 IDA brief, *supra* note 221.

regulators are sensitive to the considerations of competition and that their rules will not be enacted if they restrain competition in a manner not necessary for the purposes of the scheme of securities regulation. The regulators in the best position to make this determination are the self-regulators and the government supervisors rather than a commission or body appointed under the proposed Competition Act. The self-regulators and government supervisors have the proximity to the securities markets which is necessary to make the delicate judgment of whether regulations unduly restrain competition. Upon review of the rules of an SRO, registration of an SRO, application for approval of a rule change of an SRO and review of an action taken by an SRO, the government regulator should be specifically required by statute to consider whether or not the SRO action restrains competition in a manner inconsistent with the purposes of the scheme of securities regulation. The government regulator's decision must also be made in the course of a procedure which provides for public notice of the SRO rule and the opportunity for public comment on the rule.

Chapter XII
Division of Regulatory Powers in Canada's Scheme of Securities Regulation

Operation of the SROs in a manner that is responsive to the public interest depends in some measure on adequate government supervision. Under the existing scheme of securities regulation, government supervision is carried out largely by the provinces. Therefore, the Toronto Stock Exchange is supervised by the Ontario Securities Commission, the Montreal Stock Exchange by the Quebec Securities Commission, the Vancouver Stock Exchange and Vancouver Curb Exchange by the British Columbia Corporate and Financial Services Commission, and so on. The IDA is not formally supervised by the provincial securities commissions, except to the extent that each IDA district has been vested with powers to regulate the auditing practices and procedures of members' financial affairs. Rules relating to such powers must be satisfactory to the provincial securities commission for the province in which members of a particular IDA district are registered. The IDA, to some degree, is supervised by the federal government in the sense previously discussed, in that the IDA submits to the Department of Finance rule changes which may interest the department. An example would be a rule change relating to mar-

gin requirements.[313] There are some problems and some advantages built into this fragmented regulatory structure.

A. DIVISION OF REGULATORY POWERS AMONG THE PROVINCES

Operations of an SRO may have implications which transcend the boundaries of the province which is responsible for supervising the SRO. The best example of such a circumstance is the process for establishing commission rates in Canada. The supervisory power in respect of commission rates has been exercised only by the province of Ontario. The process has been relatively simple, involving an application by the TSE to the OSC for approval of a minimum rate structure. Recognizing in the absence of adoption of a materially lower rate schedule or of negotiated rates that the TSE really determines the commission rates for Canada, the QSC and the B.C. commission have not second-guessed the Ontario process.[314] The TSE has afforded the other stock exchanges an opportunity to participate in the preparation of the rate structure submitted to the OSC. For example, the rate structure proposed by the TSE in 1973 was a "new national commission scale" because it was approved by each of the Toronto, Montreal, Canadian (as it then was) and Vancouver stock exchanges before it was proposed to the OSC. Amendments to this national commission scale have since been made, but always with the participation of the other exchanges.

Because the OSC is the government supervisory body for the TSE, it performs the responsibilities, in many ways, of a national securities commission. Because of the concentration on the TSE of share trading in Canada the TSE is in a position to dictate commission rates, and, accordingly, the rate structure proposed to the OSC sets the standards for the industry. The OSC has assumed this role reasonably comfortably, noting that "We have been as sensitive to the national interest as our duty to the Ontario public permits. The evidence before us suggests that the changes which

313 In BANK OF CANADA, ANNUAL REPORT FOR THE 1956 FISCAL YEAR 34 (1957), reference was made to an example of federal supervision of the SROs. The report states that "the general margin requirement according to the Rules of Stock Exchanges in Canada is 50%. The Bank of Canada has no power to impose or alter margin requirements. The Bank did, however, have a discussion with members of the governing bodies of the Montreal, Canadian and Toronto Stock Exchanges, in the course of which general agreement was expressed that it would be undesirable for the volume of credit used in stock market trading to increase any further under present conditions. A circular to this effect was issued by these three Exchanges to their members." *Id.* at 34.

314 The QSC and the BCSC could not directly question the TSE commission rates but could only do so when adopted by the Montreal Stock Exchange or the Vancouver Stock Exchange, as the case may be.

were made in the original proposals were not the result of regional differences peculiar to any province".[315] This passage does, however, point up the conundrum for the OSC establishing a national commission structure. Is the Ontario public interest consistent with the national interest?

The amendments to the MSE by-laws on commission rates are submitted to the QSC for approval and the QSC has, to date, agreed with the Ontario determination.[316]

The impact of the OSC's determinations on TSE commission rates was again noted in the OSC decision on whether or not the TSE should be required to discontinue minimum rates.[317] The OSC received submissions from the MSE[318] and VSE and from the Director of Investigation and Research under the Combines Investigation Act, Consumer and Corporate Affairs Canada.[319]

The problem in having one province consider the reasonableness of a national rate structure is apparent. Will a provincial commission be able to elicit submissions representing regional interests, and indeed is a provincial commission equipped to make determinations with respect to such interests? Interest in the Canadian rate structure is not confined to the regions of Canada, but also exists internationally, and the question must be asked whether or not a provincial commission is the appropriate body for assessing the international implications of such a decision.

An illustration of what is possible can be based on the unfinished debate over whether or not commission rates should be fixed or negotiated. The OSC, for the time being, has determined that fixed rates of commission are in the public interest. Coincidentally,

315 *In re* Proposed Amendments to Part 15 of the By-laws of the Toronto Stock Exchange, [1973] OSC Bull. 107, 126 (August).

316 The Quebec Securities Commission first considered Montreal Stock Exchange commission rates in 1973; *see* 4 QSC Bull. No. 31 (Decision No. 3635, July 25, 1973). At that time the QSC noted that s. 32 of the Quebec Securities Act gave it the power to review commission rates but stated that the public interest did not then require its intervention. Rather than making a decision on the rates it preferred to comment on the data presented and to point out the need for more thorough studies. It also raised the possibility of negotiated rates. *See also* 5 QSC Bull. No. 32 (Decision No. 4338, August 13, 1974); 8 QSC Bull. No. 13 (April 26, 1977). In the most recent consideration the QSC announced that it intends to recommend to the Québec government the adoption of legislation establishing the principle of competition in the determination of commission rates, *i.e.* negotiated rates. *See* text accompanying note 320 *infra*.

317 *In re* Part 15 of the By-laws of the Toronto Stock Exchange, [1976] OSC Bull. 289 (November).

318 *Id.* at 295. The MSE Director of Development had prepared a study; *see* P. Lortie, The Case for Fixed Commission Rates in Canada (1975).

319 Director of Investigation and Research, Combines Investigation Act, Consumer and Corporate Affairs Canada, Ottawa, Submission to the Ontario Securities Commission Regarding Fixed Commission Rates on the Toronto Stock Exchange (July 19, 1976).

by letter dated April 18, 1977, the chairman of the Quebec Securities Commission wrote to the Montreal Stock Exchange and "announced that the Commission intends to recommend to the Québec Government the adoption of legislation establishing the principle of competition in the determination of commission rates on the Montreal Stock Exchange. Such legislation will be based on the principle that competition is the best determinant of prices".[320]

The Canadian securities industry has been the beneficiary of cooperation among stock exchanges. However, if the provincial supervisory bodies for the stock exchanges require exchanges to assume conflicting positions on matters such as commission rates, the fragmentation of the securities industry may be heightened.

Another example of division of policy at the supervisory level is on the policy question of non-resident investment in the securities industry. The province of Ontario is the only Canadian jurisdiction which has enacted regulations specifically on non-resident securities firms.[321] Because of Ontario's policy, non-resident firms have been denied access to Canada's major financial centre. The implications of Ontario's actions are clear in that Ontario is defining a national policy for non-resident securities firms. A non-resident firm considering expanding into Canada thinks first of the Ontario prohibition which it would consider as characterizing Canada's national policy and only as a second alternative looks at the more open policies of some of the other provinces.

The Shaw-Archibald recommendation on regulation of foreign market intermediaries is that they be permitted to operate in Canada to the extent of transacting in foreign securities with Canadians.[322] In order for such a recommendation to be adopted, cooperation by Canadian stock exchanges is necessary. Such cooperation may be forthcoming, but uniformity is unlikely in the absence of government intervention. Government intervention

320 8 QSC Bull. No. 13 (April 26, 1976). The translation of chairman Lacoste's letter continues:

> "This recommendation is a result of several studies on the question. The Commission followed closely the adoption of such a policy by the Securities and Exchange Commission in the United States, as well as its effect, and undertook quantitative studies on the impact of such a measure on member-brokers of the Montreal Stock Exchange. The Commission also considered the impact of such a change on the efficiency of our market. The decision of the Ontario Securities Commission was also considered as well as representations made before the Ontario Securities Commission during last summer's hearing on this question." *Id.*

321 The OSC is currently studying the policy underlying the Ontario regulations and may recommend the enactment of regulations which would permit non-registered, non-resident securities firms to trade foreign securities with Ontario residents and to underwrite securities of Canadian companies for foreign sales; *see* OSC Weekly Summary, February 10, 1978.

322 8 D. SHAW & R. ARCHIBALD, *supra* note 5, at 96.

may similarly not be coordinated from province to province. Again, as is the case with commission rates, if one exchange "breaks rank" the market system is faced with an unresolved issue. Possibly different rules on different exchanges could be in the national interest, but there is no supervisory body in place now that has the scope to deal with national interests. Certainly the federal government would be somewhat limited in its dealings with foreign governments on the issue of non-resident participation in the Canadian securities markets when these rules are set by provincial securities commissions, or by SROs over which the federal government has no supervisory authority.

B. COOPERATION AMONG SROS

There are a number of examples of cooperation among the SROs, particularly the stock exchanges, and a number of examples of competition among the stock exchanges which, in the end, have probably benefitted the Canadian investing public. Cooperation is evidenced, for example, in the sharing of the audit responsibility among the stock exchanges and the IDA. There is a considerable incentive for the SRO with audit responsibility to discharge this responsibility carefully, because any failure of a member for which it has audit responsibility may cost members of the SRO a greater amount than if the SRO did not have audit responsibility. As noted above, the SROs have also cooperated in the preparation of a national commission rate structure which they have considered to be in the public interest. Other matters of broad public policy have also been the subject of study on a cooperative basis by the SROs, for example, diversification of business by securities firms.

Competition among the stock exchanges has sometimes resulted in benefits to the investing public. For example, there was the joint effort of the TSE and the MSE to establish one clearing operation for options on Canadian stock. However, the joint effort broke down over the incompatibility of computer operations at the two exchanges and the splitting of the options list. When both the Toronto and Montreal exchanges applied to the OSC for approval to establish separate options corporations, the OSC granted such approval on the condition that a joint facility be created within a year. The competition between the exchanges may have resulted in an options clearing unit available to the investing public at an earlier date than would otherwise have been possible, but it doubtless also represented unnecessary costs as a result of the duplication. Another example of both competition and cooperation relates to the imposition and recently proposed removal by both the MSE and the TSE of the restrictions on arbitrage and "freighting"

between exchanges. The TSE anti-freighting rule was adopted in the 1960s in retaliation against a somewhat laxer requirement by the QSC that trades ordered by Québec residents must be shown on the floor of the MSE before being attempted elsewhere.[323] This regulation of the QSC was abolished in September 1977.[324] On this basis, the TSE has proposed dropping its "anti-freighting" rule, which formally prohibited brokers buying or selling stocks for their own account and liquidating the position on another Canadian exchange.

A law requiring SROs to share regulatory responsibility is not feasible on a provincial basis. The *ALI Federal Securities Code*, on the other hand, proposes that the Securities and Exchange Commission have the power by rule to allocate among the SROs the authority to adopt rules with respect to matters over which the SROs share authority, and with respect to a person who is a member of more than one SRO, in order to relieve any SRO of certain regulatory responsibilities and, similarly, relieve such person of the duty to comply with the rules of the SRO to the extent that the SRO is relieved of responsibility.

The SROs as a group are not enthusiastic about further government regulation of any sort. Accordingly, they have an incentive to cooperate in the public interest in sharing responsibilities and adopting policies in order not to encourage the creation of a federal supervisory power which would be able to require and enforce cooperation among the SROs. However, this incentive may not always be adequate to ensure SRO cooperation in the national interest.

Chapter XIII
Conclusion

Self-regulation in the Canadian securities industry is vital to the overall scheme of securities regulation. Most market intermediaries seldom deal directly with government on regulatory matters. The business they can conduct and the manner in which it is conducted is regulated by the SROs of which they are members. The SROs are conscious of and anxious to protect their regulatory role. The alternative to self-regulation is increased government regulation. Without doubt, SRO members prefer regulation by their peers.

Notwithstanding this vital role, the public does not know a great deal about the internal operations of the SROs and the

323 The Globe and Mail (Toronto), February 3, 1978, at B2.
324 8 QSC Bull. No. 35 (Decision No. 5316 September 6, 1977).

functioning of the SRO-government relationship. What regulatory functions does government assume the SROs are performing? The securities statutes certainly disguise the extent of the regulatory responsibilities of the SROs. Where does the standard of SRO regulation fit in relation to the standard of government regulation of non-SRO members? Are the SRO standards for monitoring the conduct of their members adequate? Does government perform "surprise audits" of SRO operations? Or should it be the other way around? Is there duplication of government regulation and SRO regulation? What really happens when the TSE proposes a by-law change to the OSC? Would the IDA really welcome a requirement for registration of its various districts in all of the provinces in which it functions? How do the stock exchanges agree to a uniform commission rate schedule? Do we have adequate regulatory machinery if the MSE opts for negotiated commission rates or admits non-resident members?

This paper suggests a number of additions to the securities laws in Canada which provide for the supervision of SROs in order to define more carefully the responsibilities of government in conferring regulatory powers on the SROs and the responsibilities of the SROs in exercising these regulatory powers, and also to provide the public with more information about the functioning of the SROs. With more information, we will be able to better examine the issue of whether the SROs do operate in the public interest.

This of course is the question which is basic to the continuation of the SROs in the Canadian scheme of regulation. There is an obvious assumption underlying our scheme of regulation that self-regulation is in the public interest. No government in Canada has ever articulated the rationale for this assumption. Self-regulation has "just happened". The recent pronouncements by Canadian securities administrators in favour of self-regulation are rather stark. It is incumbent on the administrators to articulate this rationale and tell the Canadian public how the SROs function within this rationale. The suggestions in this paper may to some limited degree assist the administrators in this task. However, only the administrators have the daily and direct contact with the SROs to assess their performance.

There are other issues facing the Canadian securities industry that will test the SRO-government relationship and, in particular, government supervision of SROs. More and more the secondary markets will operate across provincial boundaries. Our scheme of securities regulation is however based on provincial securities statutes and administration. The administrators in the past have been innovative in providing for regulation of issues of securities with implications which go beyond provincial boundaries, and

their ability to innovate will be necessary to continue to effectively supervise the SROs. The alternative is, of course, one national administrator responsible for supervising the SROs. The allocation of regulatory responsibility, and therefore the efficacy of the supervision, will be important to the quality of self-regulation in the future.

Failures of Securities Dealers and Protective Devices

John Honsberger

April 1978

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Chapter I
An Overview of the Securities Industry in Canada and the United States

A. THE SECURITIES INDUSTRY

"The pursuit of the economic development of a society tends to be gravely impeded by a scarcity of resources. It thus becomes imperative to create an active financial market which eases the investors' access to the pool of available capital in their society. One of the important elements of this financial market is the securities industry.

"The financial market comprises, besides the mass of individual investors, two main types of well defined economic organisms: the financial institutions properly so called on the one hand and the securities firms on the other. The financial institutions (banks, trust companies, pension funds, insurance companies, etc.) act mainly as financial middlemen between borrowers and lenders. Their main function consists in raising funds from the public through the issue of debt securities and making these funds available to third parties in the form of investments (personal, collateral, mortgage and industrial loans, bonds, etc....).

> "On the other hand, the securities firms' role is to ensure the marketing, distribution and trading of the various securities being traded on the financial market. In order to do so, they must bring together those who seek and those who have funds. The liquidity of a security is thus directly linked to the dealer's ability to dispose of such securities in the primary market and maintain their marketability in the secondary market where trading by institutional and individual investors takes place."[1]

The securities industry has been broadly defined as meaning "those financial intermediaries required to obtain registration in some principal capacity under the Securities Act".[2]

Under the Ontario Securities Act there are three main classes of activity which require registration. These are "advisers", "dealers" and "underwriters".[3] "Advisers" and "dealers" are further classified in the regulations to the act according to differences in function and membership in recognized self-regulatory bodies. These definitions indicate both the various classes of persons that constitute the securities industry and the difficulty of using one title to describe all classes.

An "adviser" is defined as one who engages in or holds himself out as in the business of advising others on the desirability of investing in or buying or selling securities.[4] An "adviser" may be either an "investment counsel" or "securities adviser". An "investment counsel" is defined as advising others on the advisability of investing in specific securities or giving continuous advice on the investment of funds on the basis of individual client needs.[5] A "securities adviser" is defined as one who advises either directly or

1 DEPT. OF FINANCIAL INSTITUTIONS, COMPANIES AND CO-OPERATIVES, STUDY ON THE SECURITIES INDUSTRY IN QUEBEC: FINAL REPORT 27, 28 (1972) [hereinafter cited as BOUCHARD REPORT]; W. MARTIN JR., THE SECURITIES MARKETS: A REPORT WITH RECOMMENDATIONS 4 (Bd. of Governors of NYSE 1971) states:

> "The public interest dictates that the primary purpose of a securities market is to raise capital to finance the economy. Without continuous capital formation, our economy could not grow or prosper. It could not provide job opportunities for our growing labour force. It could not sustain a rising standard of living. It could not generate economic opportunities so vital to the health of our free economic system. It could not assist government in its programs to lessen social problems such as poverty, pollution and crime..."

2 ONTARIO MINISTRY OF CONSUMER AND COMMERCIAL RELATIONS, REPORT OF THE SECURITIES INDUSTRY OWNERSHIP COMMITTEE OF THE ONTARIO SECURITIES COMMISSION 35 (1972) [hereinafter cited as ONTARIO OWNERSHIP REPORT].

3 *See* Ontario Securities Act, s. 1(1) (definitions of "adviser", "dealer" and "underwriters").

4 *Id.* s. 1(1).

5 Ontario Securities Regulations, s. 2(2) (1).

through publication or writings on the advisability of investing in specific securities.[6]

A "dealer" is described in the Ontario Securities Act as one who trades in securities in the capacity of principal or agent.[7] This is a very wide term which is further classified in the regulations to the act into one or more of the following groups:

"(a) 'broker', a member of the Toronto Stock Exchange who trades exclusively as an agent;

"(b) 'broker-dealer', a member of the Broker-Dealers' Association of Ontario who may trade as an agent or principal and who automatically receives registration as an underwriter;

"(c) 'investment dealer', a member of the Investment Dealers Association of Canada, who may also trade as an agent or principal and who automatically receives registration as an underwriter;

"(d) 'mutual fund dealer', registered exclusively to trade in securities of mutual funds; members of the Canadian Mutual Fund Association have modified conditions attached to their registration;

"(e) 'scholarship plan dealer', registered to trade exclusively in the securities of a scholarship or educational plan or trust;

"(f) 'securities dealer', trades either as principal or agent and is automatically registered as an underwriter but is not a member of one of the recognized self-regulatory bodies; and

"(g) 'securities issuer', registered to trade exclusively in securities of his or its own issue."[8]

An "underwriter" under the Ontario act is one who, if he is not registered under any other capacity, may only distribute to the public through other classes of registrant.[9] Broker-dealers, investment dealers and securities dealers, each of whom is registered to trade as principal or agent, are deemed to be granted registration as underwriters. This permits them, and the issuer with whom they are dealing, to enjoy the exemption contained in section 19(1)6 and section 58(1)(c) of the Securities Act.

In this paper, unless the contrary is indicated, "securities dealer" is used to describe all persons in the securities industry that deal in securities as principal, agent or adviser.

It is, however, important at the outset to distinguish the

6 *Id.* s. 2(2) (2).
7 Ontario Securities Act, s. 1(5).
8 Ontario Securities Regulations, s. 2(1).
9 *Id.* s. 2.

function and operation of brokerage firms and investment dealers. The stockbroker, or as he is more often known, a broker, and the investment dealer or dealer play very different roles.

> "Stockbrokers act essentially as agents or mandataries in their transactions and must comply with their clients' wishes. The clients place their orders for securities (buy or sell) with their stockbroker who executes them on the floor of the exchanges. It might be noted that the investor's decision may be influenced by the stockbroker's recommendations due to the latter's great experience and knowledge; however, in the final analysis, the decision is the investor's."[10]

Meyer describes the role of a broker as follows:

> "The broker, in executing his customer's order for the purchase or sale of securities or commodities, acts as the customer's agent. The broker does not himself sell to or buy from the customer, but represents the customer in making a contract of purchase or sale with a third party."[11]

and

> "In the execution of an order for the purchase or sale of securities or commodities, the relationship between the broker and the customer is that of agent and principal. The contract of purchase or sale is between the customer and a third party, the broker acting as the customer's agent in making the contract. The broker does not himself sell to or buy from his customer, and therefore in making the purchase or sale is not himself the seller or buyer.[12]
>
> "There are two ways for one to purchase stocks or bonds through a broker. The customer may give the broker the full amount of the requisite purchase price or he may make a margin arrangement with the broker: the usual margin required being 10%[13] of the purchase price. In such a transaction the customer pays the broker this margin; and it is then the duty of the broker to buy the stock himself advancing the remainder of the necessary amount. In either case the broker assumes a fiduciary relation towards his customer. In actual practice the bro-

10 BOUCHARD REPORT, *supra* note 1, at 28.

11 C. MEYER, THE LAW OF STOCKBROKERS AND STOCK EXCHANGES AND OF COMMODITY BROKERS AND COMMODITY EXCHANGES 148 (1931).

12 *Id.* at 249.

13 In the 65 years since the article from which this quotation is taken was written, the usual margin has increased from 10% to 50%.

> ker does not advance out of his own pocket the money necessary to buy the stock. On the contrary, he hypothecates the purchased stock to a bank for the necessary amount. Hence, in every margin transaction there are three parties, the customer, the broker and the broker's bank."[14]

The broker, being an agent, is paid a commission for his services.

The investment dealer, on the other hand, acts on his own behalf in market transactions. He builds up an inventory of securities for resale to interested purchasers.[15] The true investment dealer buys as a principal, often through underwriting, and sells for his own account.[16].

Generally, the larger securities firms combine the functions of stockbrokers and investment dealers. There are only a few securities firms in Canada which act exclusively as investment dealers. As an agent, a securities firm may purchase or sell for the customer's account. As a principal it may purchase for its own account from and sell to a member of the public or another dealer. The former function is often regarded as the "broker" function and the latter as its "dealer" function.[17]

While the brokerage function constitutes the major function of a broker-dealer or securities firm such firms provide many other services related to a traditional role of corporate financial advisers. A securities firm, for example, may offer a market service to its clients and information on request. It may offer investment advice to clients on a regular basis, issue market commentaries and recommendations. Some firms provide portfolio management services as investment counsel. Other firms manage pooled accounts known as "in house" mutual funds which through a prospectus are qualified for sale to the public. Other so-called convenience accounts such as margin accounts, custody for clients' securities and collection of interest and dividends may be provided. In addition, corporate clients may be advised, on a fee basis, on a wide range of business problems including mergers, acquisitions, corporate reorganizations and even economic forecasting and future expansion.[18]

> "The key factors which distinguish the securities industry from other industries are its custodial responsibility for customers' funds and securities and the unique role

14 Glenn, *The Rights of Defrauded Customers of an Insolvent Broker*, 12 COLUM. L. REV. 422, 423-24 (1912).

15 BOUCHARD REPORT, *supra* note 1, at 28.

16 ONTARIO OWNERSHIP REPORT, *supra* note 2, at 39.

17 *Id.*

18 *Id.* at 45.

the industry must play in the formation and maintenance of the capital needs of governments and corporations."[19]

B. THE OPERATION OF A BROKERAGE FIRM

"The present securities markets require that the broker be able to locate and deliver free credits and free securities immediately upon the direction of his customer. To do this the broker must identify the specific transaction which was performed on behalf of those customers and which resulted in the credits and securities due the customer. This will permit the broker to determine that he has an obligation to perform the customers' instruction. The broker must then locate the cash or securities necessary to comply with the instruction and dispose of them as the customer directs."[20]

If a broker's business is confined to institutional clients or only to a few clients who are members of the public, all of these acts can be performed by him. A separate depository could be used for each client's securities. This, however, would be all but impossible for a large firm.

In practice, brokers use a system of bulk segregation. Individual transactions that result in a securities or cash position for a customer can always be identified, thereby permitting the broker to ascertain his obligations to his customers. However the actual proceeds of a transaction or the securities involved in respect of a customer cannot be specifically identified after completion of the transaction and its recording in the books of the firm. Both the cash and securities involved are regarded as fungible. The broker uses the cash and securities to meet the obligations incurred for all his customers. The cash becomes a part of the firm's "float" and the securities go into the bulk segregation provided by the "one box system".[21]

The customers' free credit balances held by a broker have traditionally been used in the conduct of a broker's business.

"A free credit balance is an amount of cash owed by a broker-dealer to a customer which is not subject to any unfulfilled commitments of the customer to the broker-

19 Notice of Revisions to Proposed Rule 15c3-1 and Notice of Proposal to Adopt an Alternative Net Capital Requirement for Certain Broker-Dealers, SEC, Securities Exchange Act of 1934 Release No. 11094, November 11, 1974, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶80,006.

20 Shields & Co., Re: Protection of Customers' Securities and Free Credit Balances in the Possession of Brokers, June 21, 1971, at 11 (memorandum by NYSE member).

21 *Id.* at 12.

> dealer, and which the customer has an unrestricted and immediate right to withdraw on demand. A free credit balance is usually created in one of three ways: (a) by the deposit of cash by the customer with the broker-dealer in anticipation of placing an order to buy securities; (b) by the broker-dealer selling securities for the customer and holding the proceeds of the sale pending reinvestment or other instructions; or (c) by the broker-dealer receiving and holding for the customer interest or dividends received on securities owned by him."[22]

A study made by one brokerage firm indicated that about 70% of the individual balances were for less than $100 and in that group the average balance was $16. Sixteen percent did not exceed $500 with the average balance in that group being $230. The study indicated that credit balances for the most part are transitory and represent a "float". One-third of all balances had a life of only one day to a maximum of three weeks. An additional 25% had been on the books for less than sixty days. [23]

Free credit balances, while in a constant state of change are, in aggregate, important to the securities industry. They are, in fact, the source of millions of dollars of interest-free capital used by the industry to finance loans to other customers. The report of member firms of the Toronto Stock Exchange as at the close of business on December 31, 1974, indicated that customers' free credit balances totalled $85,672,000. For the industry in Canada at any one time, free credit balances would be in excess of $120 million to $150 million.[24]

Historically, the securities industry, particularly that segment doing a major share of retail business and directly serving the public, has been financed by the unrestricted use of such customers' funds.[25]

A broker, by custom of the industry, is permitted to use free credit balances if:

22 SECURITIES INDUSTRY STUDY, REPORT OF THE SUBCOMMITTEE ON COMMERCE AND FINANCE OF THE HOUSE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE 38 (Subcomm. Print 1972) [hereinafter cited as SECURITIES INDUSTRY STUDY REPORT].

23 Letter from Merrill Lynch, Pierce, Fenner & Smith to J.R. Kimber, president, Toronto Stock Exchange (September 20, 1968).

24 For member organizations of the New York Stock Exchange carrying public customers' accounts, free credit balances at 1970 year-end amounted to $2.0 billion compared to total capital (including subordinated liabilities) of $3.1 billion. During the first nine months of 1971, free credit balances of these member firms ranged at month-ends between $2.1 and $2.8 billion; SECURITIES INDUSTRY STUDY REPORT, *supra* note 22, at 38. On November 1, 1968, Shearson, Hamill & Co., Inc., held $41,419,965 in free credit balances, representing 18% of the firm's total liabilities; The New York Times, December 14, 1968, at 59.

25 SECURITIES INDUSTRY STUDY REPORT, *supra* note 22, at 38.

(1) the contractual arrangement between the customer and broker expressly authorizes such use;
(2) the course of dealing between the customer and the broker is such that a court would imply a term in the contract authorizing such use; or
(3) the custom established in the trading of securities in a particular community authorizes such a use and is one which the courts will deem to govern the contractual relationship between the broker and his customer.[26]

"Representatives of the securities industry have stated frequently that, if customers' funds were no longer available as working capital, replacing these funds would result in loss of income to the broker-dealer and this probably would result in higher costs to individual customers."[27]

Brokers contend that they do not have the same fiduciary relationship with their customers as do, for example, solicitors, insurance and real estate agents, trustees and others with their customers, clients or *cestui que trust*. This, they say, is the reason for the custom of the trade permitting the non-segregation of free credit balances and therefore their use as a source of working capital.[28]

Brokers as a rule act as agents for undisclosed principals. As a result, when a broker completes a trade on the floor of an exchange he assumes a liability of his own. The broker must settle the transaction with the broker with whom he trades whether or not his customer defaults.

The liability of a broker can extend over some considerable time. Rules of exchange trading provide for settlement three or four days later. In many cases, the liability remains for much longer by reason of delays in effecting the delivery of securities through registrations, transfer and other requirements.

The clearing of business each day, which is done by offsetting or netting out securities and money, results in materially reducing the total dollars and securities needed for settlement. However, as a result of this process, settlement is usually made with a broker other than the broker with whom the trade was made. The major consequences of this is that all members of an exchange become collectively responsible for every member meeting his clearing commitments each day.

A different system of trading developed in Europe. Member-

26 Letter from A.J. MacIntosh, Q.C., to J.R. Kimber, president, Toronto Stock Exchange (September 18, 1968).
27 SECURITIES INDUSTRY STUDY REPORT, *supra* note 22, at 39.
28 Toronto Stock Exchange, The Reason for the Custom of the Trade (1968) (memorandum).

ship in European exchanges is exclusively in the hands of banks and trading approaches a basis of immediate cash or unquestioned ability to pay and immediate delivery. The European exchanges do not, however, have the same high volume of trading, members of the public are not large participants and the exchanges do not have the same high degree of liquidity as do the exchanges in the United States and Canada.[29]

C. CLEARANCE AND SETTLEMENT: PROCESSING OF CERTIFICATES

Clearance and settlement are the processes involved in the completion of either a purchase or sale of securities between broker-dealers. Clearance is the process of comparing the details of the transaction to ensure that there is agreement. This involves, for example, the details of the number of shares traded and the price. Settlement is the completion of the transaction in which the securities are delivered from one broker-dealer to the other in exchange for payment.[30]

The clearance and settlement process involves the processing of stock certificates whereby the certificiates of a vendor are converted into certificates in the name of the purchaser or several purchasers in exchange for the agreed consideration. Traditionally this has been a manual process that was both lengthy and complex. The United States *Securities Industry Study Report* in 1972 by the House Subcommittee on Commerce and Finance listed the major steps involved in the manual process of clearance used as late as the 1960s, in a typical transaction executed through a broker-dealer that was a member of an exchange, as follows:

> "1. The customer placed his buy order with a registered representative, usually at the branch office of a brokerage firm.
>
> "2. The registered representative wrote up the order which was then telephoned or teletyped to the brokerage firm's central office for relay to a broker on the floor of the exchange for execution.
>
> "3. The floor broker took the order to the post – a designated location on the exchange floor where the stock is traded. He checked the market with the specialist handling the particular stock and made a bid to buy the securities either from the specialist or from another broker at the post who was attempting to sell the stock.
>
> "4. He and the seller then quickly negotiated a price. (In

29 *Id.*

30 *Id.* at 59.

some cases, the specialist may have offered his own stock to assure an orderly market.) ([*Note:*] If the buyer limited his order to a price below the current market, the floor broker then would give the order to the specialist to enter in his book for execution, should the market decline to the specified price.)

"5. Each broker marked the price and the other broker's symbol on his ticket and returned the ticket to his booth on the floor. The price was then telephoned or teletyped back to the brokerage house for customer notification.

"6. A reporter on the exchange floor recorded the trade and relayed the price to an exchange clerk who keyed it into the tickertape system.

"7. The executed order, as annotated by the floor broker, was hand carried to the brokerage house where cards were punched to be used to prepare customers' billings.

"8. These cards (the counterparts of which were prepared by the selling broker) were submitted to the clearing-house daily for comparison and netting of the day's trades in each security. Also, allocations were made which showed to whom the selling brokers must deliver and, conversely, from whom the buying brokers would receive securities. This is called the daily balance order system.

"9. The seller's brokerage firm obtained the securities from the seller and delivered them to the clearinghouse. The securities were designated for specific brokers (under the netting process, not necessarily the brokers on the other side of the trade) and were accompanied by a list showing the money due for each delivery.

"10. The clearinghouse sorted each firm's securities receipts for the day and placed them in messenger boxes for delivery to the appropriate brokerage firm. The money value of deliveries was credited to the delivering broker and debited against the receiving broker. The dollar difference between credits and debits was settled daily between the brokerage firms through the clearinghouse.

"11. Upon receipt of these securities by the buying brokerage firm, they were generally sent to the transfer agent who canceled them and issued new certificates in the broker's name (commonly known as 'street name') if they were to be held by the brokerage firm or in the customer's name if they were to be delivered to him. The transfer agent then forwarded the new certificates to the registrar for registration.

"12. The registrar checked the new certificates for validity (*i.e.*, to make certain that the stock was not restricted and that the total number of shares outstanding did not exceed the amount authorized) and registered the certificates on the corporate records. The registrar then returned the certificates to the transfer agent who in turn delivered them to the brokerage house. Ownership was now properly recorded so that dividends, proxy statements, quarterly reports and other such materials would be sent to the registered owner. Where securities were registered in street name, dividends and share-holder information were sent to the brokerage firm, which credited the owner's account with the dividends and forwarded information to the beneficial owner.

"13. Upon receipt of the new certificates from the transfer agent, the brokerage firm verified them against the transfer instructions. They were then either sent out to the customer (if in the customer's name) or were held by the brokerage firm.

"In executing and processing a single transaction, a typical brokerage firm used approximately 33 different documents, 18 for each trade and 15 for summary records of the transaction. One error may have doubled the number of documents required when corrections were made. In the case of one large brokerage firm, 210 pieces of paper were prepared and moved in consummating a transaction from the time an order was entered until the final disposition of the stock certification. ([*Note:*] See Hearings [Senate Securities Industry Study Hearings], p. 1597, testimony of Robert R. Maller.)

"Indeed, as has been pointed out by one study:

"A middle-aged investor who dealt with the same brokerage firm during the past 25 years might have observed that, as volume mounted, striking transformations occurred in the physical appearance of the office, the character of the personnel, and the speed with which he was able to obtain information. The board room that he visited to check the current status of the market was more comfortable and the visual displays more complete and easier to see....The investor now could obtain a wide range of current statistics on price, volume, dividends, and earnings, by simply pressing the appropriate keys of an electronic machine. All in all, he would be very pleased, not only with the conveniences afforded him, but because these very same innovations indicated the firm's ability

to keep pace with the changing times....But had he asked for a description of the path his order took, from the time he submitted it until he finally received a stock certificate, his registered representative might have presented a flow diagram yellowed with age. In other words, from a systems viewpoint, there was little change. ([*Note*:] Hearings, Appendix BB, p. 2187, from the report of Lybrand, Ross Bros. & Montgomery, at p. 22.)

"Until very recently, relatively little attention in the industry was given to standardizing the documents which accompany stock certificates during their processing. Noncertificate paper represents a significant part of the total paperwork load in processing a single transaction. According to testimony before the Senate Securities Subcommittee in September, 1971:

"[T]he stock certificate is just one of many kinds of paper that contribute to the total log jam. There is a multitude of other documents, and each of them, under current systems, varies in data content and format. These documents are produced, transmitted and processed by a myriad of diverse procedures by and for a variety of loosely coordinated entities. ([*Note*:] 2 Securities Industry Study, Hearings before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, 92d Cong., 1st Sess. ["Senate Securities Industry Study Hearings"], p. 65, 1971. See also Hearings, p. 1359, for a discussion of the problems associated with the lack of standardization of documents.)

"Reference was made above to the daily balance order method of clearing and settling transactions. This system has traditionally been used by the Stock Clearing Corporation of the New York Stock Exchange. Another method currently gaining wide acceptance is that of 'continuous net settlement' (CNS), used by the clearing corporations operated by the Pacific Coast Stock Exchange and the Midwest Stock Exchange and being increasingly used by the National Clearing Corporation in connection with over-the-counter transactions. ([*Note*:] As of June 5, 1972, all of National Clearing Corporation, 250 New York clearing members had been converted to CNS for over-the-counter transactions. Clearing had been extended on a pilot basis to Boston and Philadelphia and, by year-end, according to the NASD, over 40% of its members' OTC activity should be on CNS.) The following is a brief description of how each system operates:

"Under the 'daily balance order' method, the clearing corporation nets out on settlement date each day's purchases and sales submitted by firms which are clearing members. This process produces a daily net balance of shares to be delivered or received, depending upon whether a firm on that day was a net seller or a net buyer of a particular security. As the brokerage firms deliver or receive their designated balances of securities through the clearing corporation, the money balances, which have been similarly netted, are also settled. When a firm cannot deliver its stock, this creates a 'fail'.

"Under the 'continuous net settlement' system, the clearing corporation acts as an intermediary rather than a keeper of accounts between different firms. The brokerage firm settles with the clearing corporation which, in effect, stands on one side or the other of every transaction. Thus, the firm becomes either a debtor or creditor of the clearing corporation. This system provides for more effective control over 'fails' because the clearing corporation is on the opposite side of every transaction. In the event of a firm's failure to deliver stock on the settlement date, an appropriate entry is made in the firm's account with the clearing corporation which reflects the market value of the stock on the day the firm failed to deliver. As long as the 'fail' is outstanding, it is marked to the market daily. Thus, when the contract is ultimately settled, the moneys receivable by the broker reflect the current market, not the original contract price. No other system for fails control eliminates market risk as does the CNS system. ([*Note*:] See Hearings, p. 1367, statement of David H. Morgan.)"

In order to cut down on the paper work involved in the clearance and settlement process there has been a growing use of depositories. Typical of these is the depository operated by the Stock Clearing Corporation of the New York Stock Exchange in conjunction with its daily balance order clearance and settlement system. Studies are under way to expand the use of depositories into a Comprehensive Securities Depository System (CSDS) which will serve all brokers, banks and institutions in the United States as the Central Certificate Service (CCS), the depository operated by the NYSE serves its member firms. It is expected that a central depository system will soon be introduced into Canada.

Under the CCS system firms transmit most of their proprietory securities to the central depository. This would include all fully paid and excess margin securities as well as margined but

unhypothecated securities. The securities are then registered in the name of the depository. These certificates are then converted into certificates of larger denominations and except for a small working supply are deposited in the banks of the depository.[31]

Margin accounts are affected by a bookkeeping entry which transfers the securities to the account of the pledgee bank.

Subsequent transactions are cleared through the depository's computer and appropriate adjustments are made in the accounts of members. Unless there is a specific request there is no physical delivery of securities.

Under a depository system there is only bulk segregation of securities. Segregation is by record only as the securities are held by the depository. Free credit balances are unaffected as they are not included in the system.

D. SOME DIFFERENCES IN THE CANADIAN SYSTEM OF PROCESSING CERTIFICATES

The preceding description of the processing of certificates applies to the U.S. system and, while substantially the same, the Canadian system does differ in a number of respects. Although a number of U.S. firms failed during the 1960s through loss of control of their operations it does not appear that any Canadian firm failed for this reason.

Canadian stock exchanges, brokers and transfer agents appear to have better operation systems for the settlement of transactions. Good delivery, for example, in the United States has been by way of one hundred share certificates while in Canada it has always been by way of so-called "jumbo" certificates.[32] This, by itself, has resulted in much less paper to control. Canadian exchanges also use a three-part trade ticket which results in "locked in" settlement information with no D.K.s.[33] In the United States, D.K. rates range from 3% to 10% of transactions.[34]

Another major difference between the U.S. and Canadian systems is that in Canada almost all public securities business is done through exchange members. In the United States there is a substantial volume of business done through over-the-counter

31 STOCK CLEARING CORPORATION, OUTLINE OF MAJOR OPERATIONAL FUNCTIONS OF CENTRAL METHOD FOR HANDLING SECURITIES (1967).

32 A "jumbo" certificate is a certificate for a large denomination.

33 A "D.K." is the abbreviation for "Don't Know". It is an expression used in the brokerage business to indicate that a certain transaction which another brokerage concern is attempting to confirm or compare is unknown to them. When mutual understanding is reached, the transaction is properly compared or cancelled.

34 H. Cleland & D. Gardner, memorandum to R. Tassé, Assistant Deputy Minister, Consumer and Corporate Affairs Canada, April 14, 1972, at 2.

firms that are not regulated to the same extent as firms which are members of an exchange. In Canada some 90% to 95% of equity trading is in listed issues. In the United States over-the-counter trading is equal to or greater than exchange trading.[35]

A major difference between the U.S. and Canadian systems is size. It is important to take this into consideration when comparing procedures. Many procedural problems in the processing of certificates directly relate to the size of the systems. The Canadian system is very much weaker than the U.S. system. In the United States there are six to ten times as many transactions per day as in Canada with a dollar value thirty or forty times greater. While the population of the United States is about ten times that of Canada, the U.S. securities market in terms of size and volume of activity is approximately twenty to thirty times larger than the Canadian market. Merrill Lynch has a capital of some $500 million, which is more than double that of the entire Canadian industry. Merrill Lynch processes as many transactions per day as all Canadian broker-dealers put together.[36]

It is also significant that the capital of Canadian brokerage firms is almost all "cash" capital. This is very different to the securities positions pledged as capital in the United States. The effect is that in Canada, brokerage house principals have a greater personal responsibility for a firm's capital than do their U.S. counterparts. Moreover, Canadian margin requirements are, as a rule, more conservative on debt instruments and the same or more liberal on equities.[37]

E. THE LEGAL RELATIONSHIP BETWEEN A BROKER AND HIS CUSTOMERS

The Canadian securities industry is very closely patterned on that of the United States but is much smaller. As a result there have been comparatively few failures of Canadian broker-dealers, particularly in recent years. The Canadian courts have accordingly not had a great number of cases relating to the insolvency of broker-dealers. As a result, U.S. authorities are frequently referred to in Canadian cases and in this paper.

Mr. Justice Anglin, later Chief Justice of Canada, made reference many years ago to the need to look to and rely upon U.S. authorities:

"It is common knowledge that the business of stockbro-

35 *See, Cleland.*

36 H. Cleland & D. Gardner, *supra* note 34, at 2; *Cleland;* MERRILL LYNCH, PIERCE, FENNER & SMITH, ANNUAL REPORT 1 (1974); Black, *Stockbrokerage Bankruptcies: Implementing CCS,* 54 CORNELL L. REV. 750, 752, n. 13 (1969).

37 H. Cleland & D. Gardner, *supra* note 34, at 2, 3.

kers in this country is conducted in a manner more closely resembling that which prevails in the United States, and particularly in the State of New York, than that which obtains in England. Many customs and usages of English brokers are unknown in Canada; and many practices prevalent in our markets, which have come to us from the United States, would not be recognized on the London Stock Exchange. For this reason, and also because of the dearth of English Authority (*see* R. 70 of the London Stock Exchange, Stutfield 3rd ed., p. 45). I have drawn for authorities, perhaps more freely than is usual in our courts, upon American Sources."[38]

In *In re Stobie-Forlong-Mathews, Ltd.*, Dysart, J., observed that:

"In general there is a sharp line of cleavage – the British cases on stock transactions follow the general principles of the law of trust; the United States decisions follow new principles, based on fictions designed to work out rateable treatment for all creditors."[39]

In the Manitoba Court of Appeal, Fullerton, J.A., referred to the fact that it was impossible to find English authority for the reason that the customs and usages of stockbrokers there are very different from most in vogue in this country. In coming to his decision he discussed at length and followed a line of cases of the Supreme Court of the United States saying:

"I can see no reason why the above principles (as referred to in the Supreme Court of the United States cases) should not be applicable here."[40]

As it is desirable that there should be as much uniformity in the law as possible and, with the great similarity between our two systems, it would be natural to expect Canadian courts to continue to rely on U.S. cases.

The legal relationship between a broker and his customer is in part based on custom.[41] In *Solloway v. Blumberger* Mr. Justice Rinfret said:

"This was an agreement for dealing in stocks on the Vancouver Stock Exchange. In the absence of evidence to the contrary, the respondent, who gave authority to the appellants to do business for him on the Exchange, should be deemed to have contracted subject to the rules and

38 Clarke v. Baillie, 45 S.C.R. 50 (1910).

39 *In re* Stobie-Forlong-Mathews Ltd., 12 C.B.R. 228, 232 (Man. K.B. 1931).

40 *In re* Stobie-Forlong-Mathews Ltd., 12 C.B.R. 311, 319 (Man. C.A. 1931); *In re* R.P. Clark & Co. (Vancouver) Ltd., 13 C.B.R. 118 (B.C.S.C. 1931); Re Ord Wallington & Co. Ltd., 15 C.B.R. (N.S.) 66, 70 (Ont. S.C. 1971).

41 Richardson v. Shaw, 209 U.S. 365 (1908); Solloway v. Blumberger, [1933] S.C.R. 163.

> customs of the Exchange; and the nature of the powers and duties of the brokers would be determined by the usage and course of dealing in transactions of this character between broker and customer in Vancouver."[42]

A custom or rule of an exchange can alter a duty which the law would ordinarily impose. In general, any contractual relationship between a broker and a customer is ordinarily governed by well established usages in effect in the brokerage community or on the exchange where the transaction is completed. Thus, in *Forget v. Baxter*,[43] the customer took the position that a broker had no right to sell shares acquired for the customer when the customer failed to pay the balance of his account because the broker was a pledgee who could only sell by following the procedure prescribed by the Civil Code. Sir Henry Strong, who wrote the opinion of the Judicial Committee of the Privy Council, held that:

> "[W]hen one employs a broker to do business on a Stock Exchange he should, in the absence of anything to show the contrary, be taken to employ the broker on the terms of the stock exchange."[43a]

However, a custom of a stock exchange, even though well understood, cannot prevail against the express terms of the actual contract between broker and customer.[44] As a rule, brokers who are members of regular exchanges and who purchase securities for margin, collateral or partial payment require their customers to sign agreements which permit the broker to rehypothecate the securities for any purpose in miscellaneous loans for any amount.

Depending, however, on the circumstances of a customer's dealing with a broker,

> "In any given situation there may be customers who have deposited securities with the broker for safekeeping or on an order to sell; others who have given the broker cash with which to buy certain securities, paying for them in full, which order may or may not have been executed. Then too there are always margin customers who have deposited their own stocks as security for their trading accounts, and some for whom the broker has bought securities on margin, which he is carrying for them subject to their indebtedness to him on account of the purchase. Between these different groups who have claims

42 Solloway v. Blumberger, [1933] S.C.R. 163, 166.

43 [1900] A.C. 467 (P.C.).

43a *Id.* at 478.

44 Cartwright & Creckmore Ltd. v. MacInnes, [1931] S.C.R. 425, [1931] 3 D.L.R. 693, *aff'g*, [1931] 1 W.W.R. 81, [1931] 1 D.L.R. 572 (B.C.C.A.); N. Elevator Co. v. Lake Huron Mfg. & Milling Co., 13 D.L.R. 349 (C.A. 1907).

on bankruptcy the legal relationship of the broker varies; so that he is at once a creditor, bailee, agent, trustee and pledgee. As to the safekeeping securities he is bailee, trustee; in executing orders for purchase or sale he acts as agent, while in advancing the credit with which to buy on margin he becomes a creditor who holds on pledge the securities bought. When money is put up by a customer to buy particular stocks, the broker has been held a trustee under the duty of carrying out his instructions.

"On the occurrence of [a] bankruptcy the state of the bankrupt's accounts theoretically may include any one or more of the following situations:

"1. The broker has in his possession the particular certificates deposited or bought in execution of the customer's order.

"2. The broker has specifically earmarked certificates for all customers; though not those originally deposited or bought for them.

"3. There are in the box stocks and bonds of the kind claimed, not earmarked, but sufficient to satisfy all demands.

"4. The broker has pledged to his bankers or correspondents (a) the securities of margin customers, which may or may not be enough alone to satisfy the pledgee's lien, or (b) fully paid for securities. The property pledged may have been rightfully pledged either by consent expressed or implied from the custom of the trade; wrongfully pledged or wrongfully pledged in part, as in the case of margin stocks pledged for more than the debt of the customer.

"5. There are bank accounts which in addition to the broker's own general funds include (a) purchase money for unexecuted orders, traceable into the particular fund, or (b) proceeds of converted securities traced therein."[45]

In an Ontario case, Ferguson, J.A., quoted *inter alia* from Jones on pledges and Dos Passos on stockbrokers:

"Jones on *Pledges*, 2nd ed., para 496: The broker acts in a threefold relation: first in purchasing the stock he is an agent; then, in advancing money for the purchase, he becomes a creditor; and, finally, in holding the stock to secure the advances made, he becomes a pledgee of it. It does not matter that the actual possession of the stock

45 Note, *The Bankrupt Stockbroker: Section 60(e) of the Chandler Act*, 39 COLUM. L. REV. 485 (1939).

> was never in the customer. The form of a delivery of the stock to the customer, and a redelivery by him to the broker, would have constituted a strict, formal pledge. But this delivery and redelivery would leave the parties in precisely the same situation they are in when, waiving this formality, the broker retains the certificates as security for the advance. The contract is in spirit and effect, if not technically and in form, a contract of pledge, and is governed by the law of pledges.
>
> "Dos Passos on *Stockbrokers*, 2nd ed., p. 205 and 804: We have already seen what the relation is where a stockbroker contracts to buy stocks for a client on a margin for speculation, and advances all or the greater portion of the purchase-money, and that, after such purchase, the broker immediately acquires a lien upon the stocks, for the balance of the purchase-money in excess of the margins received, which he has advanced to pay for the stocks, and becomes in relation thereto, a pledgee, with the full powers and responsibilities of that position...where the broker advances the money to pay for the stock which he is employed to purchase, he stands in the position of pledgee of the stock so purchased, and may hold the same until his advances are paid, as we have seen in another connection."

Ferguson, J.A., went on to say that:

> "A careful perusal and consideration of the reasons for judgment in *Ames v. Conmee*, 10 O.L.R. 159, affirmed 12 O.L.R. 435.which was reversed (*subnom. Conmee v. Securities Holding Co.*), 38 S.C.R. 601, and in *Clarke v. Baillie*, 19 O.L.R. 545, affirmed 20 O.L.R. 611, which was affirmed 45 S.C.R. 50, leads me to the conclusion that the law of this Province in respect of the relationships arising out of a transaction in stocks on margin, such as is stated by the learned Judge appealed from, is accurately and concisely stated in the quotations I have made from...Jones on *Pledges*, and Dos Passos on *Stockbrokers*...."[46]

The general rule is that if a broker is given money to buy a particular stock, he becomes a trustee as to both stock and money. If he sells a particular stock belonging to a client, he becomes a fiduciary as to such stock and its proceeds. But as to money deposited on "margin" to cover the fluctuation of the market, and

46 Re Stout and City of Toronto, 60 O.L.R. 313, [1927] 2 D.L.R. 1100 (C.A.). The quotation from L. JONES, LAW OF PLEDGES (2d ed. 1901) was also approved in Richardson v. Shaw, *supra* note 41; and *see* Re Bryant Isard & Co., 3 C.B.R. 49, 22 O.W.N. 537 (S.C. 1922), *aff'd*, 4 C.B.R. 537, 23 O.W.N. 113 (C.A. 1922).

where settlements are had by the balances struck, he is merely a debtor to his client.[47]

The general nature of margin transactions in stocks is well understood. The typical contract between a broker and margin customers has been described as follows:

"The broker undertakes and agrees:

"1. at once to buy for the customer the stocks indicated;

"2. to advance all the money required for the purchase beyond the ten percent furnished by the customer;

"3. to carry or hold such stocks for the benefit of the customer so long as the margin of ten percent[48] is kept good, or until notice is given by either party that the transaction must be closed. An appreciation in the value of the stocks is the gain of the customer and not of the broker;

"4. at all times to have in his name and under his control ready for delivery the shares purchased, or an equal amount of other shares of the same stock;

"5. to deliver such shares to the customer when required by him, upon the receipt of the advances and commissions accruing to the broker; or,

"6. to sell such shares, upon the order of the customer, upon payment of the like sums to him, and account to the customer for the proceeds of such sale.

"Under this contract the customer undertakes:

"1. to pay a margin of ten percent [49] on the current market value of the shares;

"2. to keep good such margin according to the fluctuations of the market;

"3. to take the shares so purchased on his order whenever required by the broker, and to pay the difference between the percentage advanced by him and the amount paid therefor by the broker.

"The position of the broker is twofold. Upon the order of the customer he purchases shares of stocks desired by him. This is a clear act of agency. To complete the purchase he advances from his own funds, for the benefit of the purchaser, ninety percent of the purchase money. Quite as clearly he does not in this act as an agcnt, but assumes a new position. He also holds or carries the stock for the benefit of the purchaser until a sale is made by the

47 J. Dos Passos, Law of Stockbrokers and Stock Exchanges 199, 200 (2d ed. 1905); McBurney v. Martin, 29 N.Y. Super. Ct. Rep. (6 Robt.) 502 (1866).

48 The usual margin today is 50%.

49 McBurney v. Martin, *supra* note 47.

order of the purchaser or upon his own action. In thus holding or carrying he stands also upon a different ground from that of a broker or agent whose office is simply to buy and sell. To advance money for the purchase and to hold and carry stocks is not the act of the broker as such. In so doing he enters upon a new duty, obtains other rights, and is subject to additional responsibilities....In my judgment the contract between the parties to this action was in spirit and effect, if not technically and in form, a contract of pledge."[50]

Chapter II
Failures of Broker-Dealer Firms

"[A]ny reasonable man ought to know that a broker's office is no place to leave money or securities for safekeeping."[51]

By reason of the similarity of the securities industry of Canada and the United States there is frequent reference in this chapter to the U.S. experience. Where a distinction can be made between the experience or the organization of the industry in the two countries this has been done. As the law discussed in this chapter is confined to common law and equitable principles unaltered by statute, there are many references to U.S. authorities. There are only a very few instances in which Canadian courts have not followed the general principles in this field of law as developed in the U.S. courts.

A. SOME CAUSES FOR FAILURES

The peculiar nature of the securities industry creates unusual hazards that can very quickly put a broker-dealer in a position where he is unable to meet his obligations as they become due. Large amounts of negotiable property are entrusted to broker-dealers. In addition, there are usually large cash accounts carried arising out of the proceeds of sales, dividends paid on shares held in street name and deposits for future purchases. Fraud and misappropriation by employees and officers are constant dangers to the investing public. There is also the danger of incompetent broker-dealers or the overly risky business practices of other

50 Markham v. Jaudon, 41 N.Y. 235, 239 (1869), *applied in* Richardson v. Shaw, 209 U.S. 365, 375 (1907).

51 McLaughlin, *Aspects of the Chandler Bill to Amend the Bankruptcy Act*, 4 U. CHI. L. REV. 369, 398 (1937) (*quoting* Garrard Glenn).

broker-dealers either in the selection of customers or by speculative ventures.[52]

If public confidence is to be maintained in the securities market it is important to prevent, or at least minimize, the number of failures of broker-dealer firms and to protect the *bona fide* investor from loss. A necessary first step is to analyze previous failures and to ascertain their causes. As the number of Canadian failures has not been great, exclusively Canadian statistics are not sufficiently representative to permit a meaningful analysis. The U.S. experience has been much greater. But while the analysis of the failures of broker-dealers in the United States is helpful for Canadian purposes, it must be recognized that the U.S. and Canadian securities markets are not always comparable. A major and significant difference, for example, is their size.

The failures of securities dealers during the 1960s in the United States resulted to a considerable extent from the inability of brokers to meet their obligations during periods when the market was suffering unusual increases in volume accompanied by wide price fluctuations.

> "The large increases in volume impaired the operational fitness of many firms while radical price fluctuations impaired their ability to meet financial obligations. As a result they became unable to satisfy their daily commitments to customers and to other brokers for both cash and securities. Changes in market condition will specifically affect the ability of a broker to function, as follows:
>
> "(a) Volume fluctuations – a change in volume will require the broker to handle a larger number of orders, record larger bookkeeping and physical handling burdens. As the bookkeeping burdens increase, the time consumed in directing the movement of securities increases; and as the volume of deliveries increases the physical movement is slowed even more.
>
> "(b) Price fluctuations – a failure of the broker to satisfy his operational commitments places each uncompleted transaction at the risk of the market. In a stable market this is inconsequential, but in a fluctuating market this impairs the financial stability of the broker. As the operational capacity of the firm declines and the market level moves away from the unfulfilled commitments, the bro-

52 Note, *Protection of the Accounts of Stockbrokerage Customers*, 77 HARV. L. REV. 1290 (1964).

> ker is exposed to increasing financial losses on transactions which it is physically unable to consummate."[53]

The very nature of a securities firm and the changing conditions to which it is subject cause it to have many risk factors. In the United States, where securities firms are permitted to issue securities generally to the public, the most recent registration statements by securities firms have described these risk factors in detail. The registration statement, for example, filed by Bache & Co. Inc. contains the following statement:

> "As indicated in this prospectus, the company and the securities industry are subject to a number of inherent risks. Factors affecting the securities industry as a whole include such uncertainties as the state of world affairs and the national economy, governmental and other regulatory policies and trading volume and price levels in securities and commodities markets.
>
> "Volume of trading and price levels in the securities and commodities markets fluctuate widely. Any significant reduction in trading volume on the exchanges of which the company is a member or in the over-the-counter market could result in lower brokerage commission revenues. Significantly increased volume, on the other hand, could result in increased operational problems such as increased failures to deliver and receive, errors in servicing customer accounts and in processing transactions and increased clerical and supervisory salaries and related costs. Price fluctuations could result in losses in the company's securities inventories and investment accounts.
>
> "The securities industry is governed by regulatory bodies which are charged with protecting the interests of the company's customers in many instances rather than its shareholders. Bache's business is subject to immediate curtailment and even termination of its memberships on securities and commodities exchanges or its broker-dealer registration should be revoked or lesser sanctions imposed.
>
> "Recent and proposed changes in regulations governing the securities industry may have an adverse effect on the Company."

The United States *Study of Unsafe and Unsound Practices of*

53 Shields & Company, Re: Protection of Customers' Securities and Free Credit Balances in the Possession of Brokers, June 21, 1971, at 13, 14 (memorandum).

Brokers and Dealers criticized the following practices which it found to be unsound:

> "1. Inadequacy and impermanence of capital; in some cases the injudicious employment of capital that did not exist.
>
> "2. Over-emphasis on sales and trading activities at the expense of operational resources.
>
> "3. There was an absence of control of securities traffic to provide assurance of prompt delivery of securities and remittance of payments. The result was a virtual breakdown in the control over the possession, custody, location and delivery of securities, and in the payment of money obligations to customers, exposing customers to risk of loss. The industry, and to an extent the self-regulatory bodies themselves, had not implemented or planned broad-based solutions to the settlement process and the related flow of paper.
>
> "4. Inability of self-regulatory organizations to respond to the crisis with meaningful corrective measures. The absence of an effective early warning system caused belated action when the full impact of the crisis was finally ascertained.
>
> "5. Lack of experience of principal members of many, principally small, concerns, pointing up problems in entrance requirements to the industries."[54]

The paper handling breakdown which resulted in a breakdown of the operations systems and procedures for handling the paper work in some U.S. brokerage firms was a principal cause of several bankruptcies in the 1960s. The volume of securities transactions in the United States from 1965 to 1968 had multiplied dramatically. In 1964 the average daily volume of the New York Stock Exchange was 4.9 million shares. This had increased to 7.5 million shares by 1966 and to 10.1 million in 1967. On twenty-nine days in 1971 the number of shares traded on the New York Stock Exchange exceeded 20 million. In 1972 the average daily volume reached 16.5 million shares.[55]

This dramatic increase in the volume of shares traded made it almost impossible for most brokerage houses to keep up with the paperwork demands of their business. As a result of the paperwork deluge or back office crisis, papers including share certificates, confirmations and ledger accounts became misplaced or misfiled. In such circumstances, instructions could be more easily misread

54 *See* SEC, 38TH ANNUAL REPORT 4 (1972).

55 NYSE, 1973 FACT BOOK, 6, 72 (1974).

and wrong stock or wrong size deliveries made. Very great costs were incurred by firms as the result of large amounts of securities being delivered in, while deliveries out against payment were slowed down by the paperwork crisis.

In such situations, employees in a brokerage house that was having difficulties could also more easily misappropriate large amounts of monies and securities through alterations of records that could not be reconstructed or sufficiently documented to permit the firm to make a claim on its insurance. This happened to several firms in the United States and was the direct cause of their subsequent failure.[56]

There appears to have been no Canadian failures directly attributable to the paper handling breakdown. This may be because the volume of trading by Canadian houses did not compare with comparable U.S. houses and in some respects Canadian stock exchanges, brokers and transfer agents had better operation systems for the settlement of transactions.[57]

A substantial change in the prices of securities can seriously hurt a broker and in extreme cases cause bankruptcy when the securities

(1) are held in inventory;
(2) are ordered by a customer who cannot or refuses to pay for them on delivery; or
(3) are held by a customer on margin.[58]

The bankruptcy of a broker-dealer through the bad investment of the broker's own funds, while possible, is not common:

> "Generally, brokers have internal rules for their traders regarding concentration of firm positions. They are looking for profitable trades – any decline in value of inventory is like a loss of earnings. Brokers are very sensitive to such losses. Another significant feature of inventory accounts is that open purchases and sales for inventory accounts become clear liabilities of the firm as soon as the position is taken. They are obvious both to internal financial control personnel and to regulatory body examiners. In Canada, exchange and IDA margin requirements are applied to house positions without relief. These requirements form a more than adequate cushion against possi-

56 SEC, Study of Unsafe and Unsound Practices of Brokers and Dealers, H.R. Doc. No. 92-231, 92d Cong., 1st Sess. 13-14, app. A (1971).

57 H. Cleland & D. Gardner, *supra* note 34, at 7, 8.

58 I am obliged to Messrs. Cleland and Gardner for this analysis of the changes in security prices as a cause of bankruptcy; *see id.* at 4.

> ble losses – except perhaps in investments in short-term debt instruments where margin rates are very low."[59]

The margin customer has traditionally been considered as posing a greater danger to a broker than a cash customer. This usually is not the case, however, as the broker has more control over the margin account than he has over the cash account customer.

A "cash account" is settled, as a rule, in full on the value date, which is three business days after the trade. Exchange rules require it to be settled in ten days, very often "delivering against payment" (DAP), frequently to a bank where settlement will be made as required. While in theory the broker has control over a cash account, in that credit managers will sell out suspicious accounts and stocks on the third day after trade where payment is not made, it is difficult, particularly if the broker is not in a position to make delivery.[60]

There are two kinds of "no-pay" cash accounts that may hurt a broker. The first is the account of the usually honest customer who has overreached his resources and is not able to pay for a stock that did not perform as expected.[61] The second is the account of the dishonest customer who has set up the broker for a no-pay situation.

In the usual case of the no-pay account where the customer is unable to pay by reason of having overreached his resources, the losses of the broker who must take over the account are not so large as to cause the broker to fail. As a rule the losses can be absorbed out of the capital of the firm which in the case of delinquent accounts is continually being put aside to meet margin and capital requirements.

> "Probably, the most dangerous position for a broker's solvency is created by a deceptively arranged cash account – DAP to a bank. Accounts which are engineered to go bad usually start by the completion of several legitimate trades in legitimate stocks. Gradually, the account gets involved in a 'speculative' stock, several deliveries are completed to the bank and paid for. Then one day

59 *Id.* at 5.

60 H. Cleland & D. Gardner, *id.* point out that:
"It should be made clear that an under-margined margin account and a cash account are very similar so far as the broker is concerned for capital requirement purposes - the obligations rest with the customer but the broker is *responsible* for securing any shortages. In effect, exchange rules require brokers to set aside sufficient capital to take over under-margined and upaid-for cash accounts as if they were inventory accounts after they have been negligent for an unreasonable time (value date for under-margined accounts; 3, 8 or 21 days in the case of cash accounts depending on circumstances)."

61 *Id.* at 6.

> when there is a big delivery to be made the bank has no instructions, the client cannot be found and suddenly there is no bid: the broker is 'hung'. This is something like what happened in the *Malone Lynch* case."[62]

A broker may suffer a loss that will affect his capital position arising out of a holding in a customer's margin account. But for this to occur three things must happen.

(1) In the first place, the value of the security must fall by an amount which will entirely wipe out the customer's equity. In practice, having regard to the rules of the exchange, this means a fall of more than 50% for an equity.
(2) In addition, the fall in price must be such as to wipe out the equity value of all the other securities held by that customer in his account.
(3) The customer must also have refused to honour his obligation to the broker to repay the loan.[63]

Above all else, before a broker can suffer a loss from a holding in a customer's margin account there must be a degree of negligence on the part of the broker in not selling out the account before, or as the stock fell, to have permitted a substantial part of a loan against a single security, and to have done business or continued to do business with a person who does not or is not able to honour his obligation.

> "In view of the fact that brokers are required to have substantial net liquid assets in addition to exchange seats and other fixed assets which are not counted in capital requirements and that no broker is obligated to take an order for a customer, the confluence of circumstances necessary to bring about a bankruptcy through margin account trading is rare indeed."[64]

Any bad account whether arising out of a cash or margin account ends up the same as inventory positions – that is, to be supported by the broker's capital. In both cases the loss for the broker is created by the very large change in the price of the security. The broker is, however, most vulnerable not in a margin account but in a cash account that provides for delivery upon payment.

As a rule, failures result not so much from trading losses as from manipulation of assets.

Whatever a dishonest customer can do with a cash account can be done by the principals of the firm. Indeed, they are in a better

62 *Id.* at 6, 7, *citing* Re Malone Lynch Securities Ltd., 17 C.B.R. (N.S.) 105 (S.C. Ont. 1972).

63 H. Cleland & D. Gardner, *supra* note 34, at 4.

64 *Id.*

position to defraud a firm, as the internal control decisions are often the responsibility of the owners.

The 1972 *Securities Industry Study Report* said:

> "[U]ntil such time as the stock certificate is eliminated as evidence of ownership, theft will continue to present a serious operational and financial problem to the securities industry. Testimony has indicated that at least one brokerage firm ultimately failed principally as a result of financial losses sustained from a theft of $1.8 million worth of securities. One witness testified that an estimated $1.2 billion in negotiable stolen securities are a source of extreme concern to the securities industry. A more recent estimate places the value of stolen and missing securities at a figure of as high as $10 billion."[65]

One final cause of brokerage bankruptcies that might be mentioned is the domino effect caused by the sudden failure of a broker who has been acting as an agent for other broker-dealers. It could also happen where customers or inventory accounts were trading commercial paper or bonds and the issuer failed to honour the obligation on maturity.[66]

In the United States, The Securities Investor Protection Corporation, which will be discussed in detail later in this paper, attempted to ascertain the causes of failures of sixty-four securities firms liquidated by it and found that:

> "Inadequate, inaccurate or non-existent books and records must be mentioned as one of the most significant conditions encountered in almost all of these cases. In a number of instances records have been falsified and customers' accounts manipulated by the principals. This failure of record keeping has led in some cases to a loss of control of the business....
>
> "In many cases, the operating management did not have the qualifications or experience needed to operate a general securities business. Principals did not possess the

65 Securities Industry Study Report, *supra* note 22, at 75. The figure of $10 billion for stolen or missing securities must be higher. The National Crime Information Center computer operated by the FBI already lists $11 billion of stolen, counterfeit or missing securities. Since it is certain that some lost or stolen securities are not listed on the computer, it is clear that the true figure must be higher. A witness before the U.S. Senate Permanent Subcommittee on Investigations testifed that the dollar value of lost or stolen government and corporate securities could be as high as $50 billion but other witnesses doubted whether the figure would be anywhere near that high.

66 H. Cleland & D. Gardner, *supra* note 34, at 7. Section 16.15 of the Toronto Stock Exchange By-Laws, 3 CCH Can. Sec. L. Rep. ¶¶89-635-89-645c, provides that the margin may be as little as 1/4% on prime commercial paper of less than 16 days maturity.

knowledge of complicated trading procedures or basic concepts of good management and control over securities operations. Many were ignorant of brokerage accounting and regulatory rules and regulations.

"Lack of adequate capital has been mentioned by the trustees as a major factor in firm failures....This condition may result from a number of reasons ranging from too small a capital base to such matters as temporary illiquidity, over-commitment in a particular security or venture, inability to absorb an adverse market movement, too rapid expansion or improper controls. There was over reliance on subordinated capital in a number of instances. In others, the subordination was improperly executed or fraudulently induced....

"Of the firms in liquidation, 49 had been in business five years or less and 19 under two years. Expressed on a percentage basis 77% of the firms in liquidation were in business five years or less and 30% two years or less.

"Mismanagement likewise has been stated frequently as a major factor. This may stem from a lack of knowledge and experience in the business, emphasis on sales to the exclusion of other aspects of the business, ineptitude, failure of records or controls or other matters such as, for example, conduct reflecting on the integrity of the principals or their key employees.

"The matter of fraud and manipulation which has surfaced in a number of cases must be recognized as a major factor in these failures. Customer securities and funds were fraudulently used in the business including improper use of discretionary accounts. There were several market makers and underwriters of low grade, highly speculative issues where prices were inflated and customer accounts manipulated to maintain these prices. Heavy concentrations in a few speculative issues and imprudent trading activities contributed to other failures....

"Reasons for failures of sixty-four firms are:

Reasons	*Number of firms*
Poor books and records	44
Misconduct	26
High operating costs – poor controls	21
Mismanagement	28
Lack of knowledge of the securities business	18
Adverse market conditions	10
Dealing in highly speculative issues	29"[67]

Any review or examination of the failure of broker-dealer firms should not be concluded without observing that there are certain events or conditions which, contrary to wide belief, do not cause the bankruptcies of securities dealers in Canada.

In the first place, while a principal of a securities firm may defraud the firm, the theft, forgery or defalcation by an employee of a firm will not usually result in bankruptcy because brokers are required to carry insurance against this risk. This, of course, assumes that the alterations of records can be sufficiently reconstructed and losses documented to permit the firm to make a claim, which is not always the case.

Secondly, contrary to the experience of securities firms in the United States and the bankruptcy experience of Canadian marketing or manufacturing businesses, no Canadian securities firm has failed by reason of non-expansion or from loss of control of operating expenses.

Finally, no Canadian firm has collapsed only because of a demand for payment by a trade creditor or bank which has been "going along with management" in trying to get the firm back on a profitable basis. This is almost impossible by reason of the margin and capital requirements.[68]

B. WHAT CAN HAPPEN ON THE VERGE OF THE FAILURE OF A BROKER-DEALER FIRM

It is not unusual in a bankruptcy for very large losses to be incurred during the last few weeks prior to the bankruptcy. As credit is cut off from the debtor or greatly reduced, the assets that might otherwise be available to the creditors are consumed by the debtor in a last desperate effort to stave off bankruptcy. As bankruptcy appears to be all but inevitable, very often there is a strong temptation on the part of debtors to hide assets. This activity could take the form of fraudulent and surreptitious transfer of assets to persons not at arm's length. It could also amount to out-and-out theft. The temptation to convert assets to one's own use is often felt by the employees of the debtor who see the business failing before their eyes, accompanied by the fact that during the last few weeks there is often not the same supervision and control by management over the operations of the business.

The securities industry is a complex operation that is in deli-

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67 SECURITIES INVESTOR PROTECTION CORPORATION (SIPC), 2ND ANNUAL REPORT 24, 25 (1972).

68 H. Cleland & D. Gardner, *supra* note 34, at 3.

cate balance. When adversity strikes, whether it affects the entire industry or any individual unit of it, extremely difficult legal problems are encountered. The complexity of these problems is such that normal legal remedies are difficult and expensive to enforce. Losses can be very great and safeguards designed to protect customers are often ineffective or insufficient.

The nature of the securities industry, which places large amounts of negotiable securities in the hands of securities dealers, makes fraud and manipulation easier. The complexity of the records resulting from the normal volume of individual transactions often makes it difficult to detect fraud or to identify the persons responsible for it.

Both employees and principals of firms in a shaky position can be expected to make a special effort to register and deliver out securities to customers. Families and friends may come first. In addition, employees and principals may move their accounts to other firms to escape the expected collapse.

As the collapse becomes imminent and there is no longer sufficient time to deliver securities to customers, there is a temptation to "straighten out" the records of the firm in favour of principals, employees and favoured customers so that their positions are assured and it is easier for them to trace securities. Securities can be segregated and other securities identified as belonging to particular customers. This can be done quickly and without witnesses in the last few hours before a receiver or bankruptcy trustee takes possession of the firm. In theory, such registrations and deliveries might be attacked as preferential or as fraudulent conveyances, but it is unlikely that they would be discovered as it would be all but impossible to reconstruct the books and records and identify what in fact had been done.

> "It is well to remember that large and highly portable values are involved. These values are controlled by easily alterable records. A bankruptcy is a situation of desperation for those who see their hard-earned assets in jeopardy. It would be naïve to expect associates of a brokerage house to fold their hands when they are the people in a position to have a substantial impact on their own personal outcome. The point we are stressing is that a brokerage bankruptcy arising from a back office paper-processing breakdown is not like bankruptcies in other types of business and the protections given to creditors in other bankruptcies through tracing and preference control are not likely to be effective in brokerage practice."[69]

69 *Id.* at 8.

C. THE OBLIGATIONS OF A BROKER TO HIS CUSTOMERS UPON THE FAILURE OF THE BROKER

Before considering the remedies available to a customer of a defaulting broker-dealer it is useful to first consider the obligations of the broker-dealer to his customers at the point of time of his failure.

> "He should have on hand, or in pledge with the banks, enough securities of the kind ordered by his margin customers to meet their contracts with him. He should likewise have on hand, set apart from his own assets and free from lien, all monies furnished him with which to buy securities outright, all securities so acquired for customers who have paid in full and all securities which his customers have left with him, for safekeeping or otherwise, upon which he has made no advances."[70]

The problem is that for many reasons the broker-dealer very often will have neither the cash nor the securities on hand that he should have. In this event, the customer will usually have a cause of action against the broker-dealer.

Where a customer has paid the broker-dealer in full for the purchase of securities and the securities are not on hand the customer may maintain an action for money had and received to his use.[71] The customer, in addition, may file a proof of claim in the bankruptcy of the broker-dealer for the money paid to him and where the customer is already indebted to the broker-dealer he may offset his indebtedness to the estate of the broker-dealer against the conversion of his money.[72]

Where a broker-dealer, who in fact has purchased securities ordered and paid for, subsequently sells the securities without the authority of the customer, the customer has a valid claim for the conversion of the securities against the estate of the broker-

70 Glenn, *supra* note 14, at 425.

71 8 HALSBURY'S LAWS OF ENGLAND (3d) ¶409 states:

"The precise nature of the action of money had and received has long been a matter of discussion. One approach is to regard the defendant as liable because he has been unjustly benefited. Another is to regard him as liable on an implied promise to pay. A third school of thought considers that the matter is still open and that the true nature of the action has yet to be established. Finally, it has been suggested that although the basis of the action is an implied promise to repay, such a promise will be implied only where an element of unjust enrichment exists."

See also Royal Securities Corp. Ltd. v. Montreal Trust Co., [1967] 1 O.R. 137 (H.C.) (*per* Gale C.J.H.C.).

72 Glenn, *supra* note 14, at 427.

dealer. The customer may also file a proof of claim for the value of the converted securities.[73]

In the cases above mentioned, all that the customer is required to prove to make a *prima facie* case of nonapplication of his money is to show that, at the time of the failure of the broker-dealer, the securities he should have purchased on the order of the customer were not on hand either in the office of the broker-dealer or in any of the banks with which he did business. In the case of the margin customer, a proof of claim may be filed for the difference between the value of the securities the broker should have on hand as of the date of the failure less the amount that would as of that date be due to the broker-dealer by the customer.[74]

In a bad insolvency, a customer would receive only a few cents on the dollar in respect of any claim proved in the bankruptcy. Consequently, customers are always more interested in attempting to trace their money or securities. If, however, they cannot trace their securities they would be relegated to their rights as general creditors;[75] only then would they file a claim.

D. TRACING

Prior to the case of *Re Hallett's Estate*,[76] where a trustee failed to observe the terms of the trust in respect to specific property, a court of equity would either appoint a new trustee or give the property to the *cestui*. If, however, the trust property consisted of money or the trustee by his own wrongdoing had converted it into money, then the court took the position that money had no earmark and was incapable of identification. Accordingly, if a trustee, before his bankruptcy, had converted trust property into money and mingled the proceeds with his own or with the money of others it was difficult for an *cestui* to successfully assert a claim against the fund.[77] At common law, tracing was treated in a strictly materialistic way.

> "It (the Common Law) could only appreciate what might almost be called the 'physical' identity of one thing with another. It could treat a person's money as identifiable so long as it had not become mixed with other money. It could treat as identifiable with the money other kinds of property acquired by means of it, provided that there was

73 *Id.*

74 *Id.* at 428.

75 *In re* J.T. Richards & Co. Ltd., 20 C.B.R. 140, 144 (Ont. S.C. 1938); Re Ord, Wallington & Co. Ltd., 15 C.B.R. (N.S.) 66, 71 (Ont. S.C. 1971).

76 Re Hallett's Estate, 13 ch. D. 696 (C.A. 1880).

77 Glenn, *supra* note 14, at 429.

> no admixture of other money. It is noticeable that in this latter case the common law did not base itself on any known theory of tracing such as that adopted in equity. It proceeded on the basis that the unauthorized act of purchasing was one capable of ratification by the owner of the money."[78]

In the case of *Re Hallett's Estate* Sir George Jessel, M.R., reviewed all the authorities in respect of tracing trust property mixed with other property. His Lordship said:

> "Supposing the trust money was 1,000 sovereigns, and the trustee put them into a bag, and by mistake, or accident, or otherwise, dropped a sovereign of his own into the bag[79].... I do not like to call it a charge of 1,000 sovereigns on the 1,001 sovereigns, but that is the effect of it. I have no doubt of it. It would make no difference if, instead of one sovereign, it was another 1,000 sovereigns; but if instead of putting it into his bag, or after putting it into his bag, he carried the bag to his bankers, what then? According to law, the bankers are his debtors for the total amount; but if you lend the trust money to a third person, you can follow it. If in the case supposed the trustee had lent the £1,000 to a man without security, you could follow the debt, and take it from the debtor.... If, instead of lending the whole amount in one sum simply, he had added a sovereign, or had added £500 of his own to the £1,000, the only difference is this, that instead of taking the bond...the *cestuis que trust* would have a charge for the amount of the trust money on the bond."[79a]

Since *In Re Hallett's Estate* the law has been:

> "If a trustee mixes trust property with his own private property, whether in his banking account or elsewhere, then, if there is ultimately specific property whether in the shape of a credit balance in that banking account or otherwise, to which the trust money can be traced, the *cestui qui trust* has, as against the trustee and his un-

78 Diplock v. Wintle, [1948] Ch. D. 465, 518, [1948] 2 All E.R. 318, 345 (C.A.), *aff'd sub nom.* Ministry of Health v. Simpson, [1951] A.C. 251, [1950] 2 All E.R. 1137 (H.L.).

79 In Diplock v. Wintle, [1948] Ch. at 521, [1948] 2 All E.R. at 347, Lord Greene, M.R., said it was "tempting to use the illustration of sovereigns in a bag" but pointed out that "such an illustration has little or no likeness to possible facts in present-day conditions".

79a Re Hallett's Estate, *supra* note 76, at 711.

> secured creditors or trustee in bankruptcy, a charge on that specific property for the trust money."[80]

Or, as the Supreme Court of the United States explained *In Re Hallett's Estate*:

> "If money held by a person in a fiduciary character though not as trustee has been paid by him to his account at his bankers, the person for whom he held the money can follow it and has a charge on the balance in the bankers' hands, although it was mixed with his own monies...."[81]

In Re Hallett's Estate also held, overruling the existing law, that where a trustee wrongfully or otherwise comingles his own money with monies of his *cestui qui trust* in one account and then makes withdrawals from the mass so constituted, the trustee is presumed to make payments for his own purposes out of his own money and not out of the trust money.

In *Sinclair v. Brougham*[82] Lord Chancellor Haldane called attention to the fact that at common law the right to follow money was not confined to cases where there was a fiduciary relationship, although the existence of that relationship was the ground upon which the right to follow was often based. The question at common law was, had the property passed, and if it had not and no relation of debtor and creditor had intervened, the money could be followed and recovered notwithstanding its normal character as currency, provided it could be earmarked or traced into assets acquired with it. The Lord Chancellor also pointed out that equity exercising a concurrent jurisdiction based upon trust gave a further remedy where the money could not be specifically identified. The Lord Chancellor said:

> "But while the common law gave the remedy I have stated, it gave no remedy when the money had been paid by the wrongdoer into his account with his banker, who simply owed him a debt, so that no money was or could be, in the contemplation of a court of law, earmarked. Here equity, which had so far exercised a concurrent jurisdiction based upon trust, gave a further remedy. The Court of Chancery could and would declare, even as against the general creditors of the wrongdoer, that there was what it called a charge on the banker's debt to the person whose money had been paid into the latter's bank account in favour of the person whose money it really was. And, as

80 33 HALSBURY'S LAWS OF ENGLAND (3d), at 330, 331.

81 National Bank v. Insurance Co., 104 U.S. 54, 68 (1881).

82 [1914] A.C. 398 (H.L.).

Jessel, M.R., pointed out in *Hallett's Case*, 13 Ch. D 696, 49 L.J. Ch. 415, this equity was not confined to cases of trust in the strict sense, but applied at all events to every case where there was a fiduciary relationship. It was, as I think, merely an additional right, which could be enforced by the Court of Chancery in the exercise of its auxiliary jurisdiction, wherever money was held to belong in equity to the plaintiff. If so, subject to certain qualifications which I shall presently make, I see no reason why the remedy explained by Jessel, M.R., in *Hallett's Case, supra*, of declaring a charge on the investment in a debt due from bankers on balance, or on any mass of money or securities with which the plaintiff's money had been mixed, should not apply in the case of a transaction that is *ultra vires*. The property was never converted into a debt, in equity at all events, and there has been throughout a resulting trust, not of an active character, but sufficient, in my opinion, to bring the transaction within the general principle."[83]

It is a basic concept in the law of bankruptcy that, in general, a trustee has no better title to property coming into his hands or disposed of by the bankrupt before his bankruptcy than the bankrupt. This concept is particularly important in the bankruptcy of broker-dealers.[84] Accordingly, while

"A broker may not be strictly a pledgee, as understood at common law, he is essentially a pledgee and not the owner of the stock, and turning it over upon demand to the customer does not create the relation of a preferred creditor within the meaning of the bankrupt law."[85]

So also where money is handed to a broker for the purpose of purchasing securities and he invests it in unauthorized securities and then becomes bankrupt, the securities purchased belong to the principal and not to the broker's trustee in bankruptcy, for a broker is a constructive trustee for his principal. Lord Ellenborough said:

"The property of a principal entrusted by him to his factor for any special purpose belongs to the principal, notwithstanding any change which that property may

83 *Id.* at 420.

84 Hewitt v. Berlin Machine Works, 194 U.S. 296 (1904); Thompson v. Fairbanks, 196 U.S. 516 (1905); Humphrey v. Tatman, 198 U.S. 91 (1900); *In re* Nakashidze, [1948] O.R. 254, 29 C.B.R. 35, [1948] 2 D.L.R. 522 (S.C.); the trustee takes the property of the bankrupt merely as a successor in interest of the bankrupt not as an innocent purchaser for value without notice but as the debtor had it at the time of the bankruptcy subject to all valid claims, liens and equities.

85 Richardson v. Shaw, 209 U.S. 365, 380 (1907).

> have undergone in point of form, so long as such property is capable of being identified, and distinguished from all other property."[86]

Tracing is further discussed in chapter II. G, "Priorities in Securities".

E. SECURITIES ARE FUNGIBLE

Securities are treated as fungible goods. This is the "grain in the bin" concept. James A. McLaughlin in testifying before the House Committee on the Judiciary in respect to section 60(e) of the Bankruptcy Act of the United States said:

> "Under the prevailing rule, stocks are treated as fungible goods, having no earmark which distinguishes one share from another, but is [sic] like a grain of uniform quality in an elevator, one bushel being of the same kind and value as another."[87]

In *Caswell v. Putnam*[88] which was quoted with approval in *Richardson v. Shaw*[89] the court said:

> "One share of stock is not different in kind or value from every other share of the same issue and company. They are unlike distinct articles of personal property which differ in kind and value, such as a horse, wagon or harness. The stock has no earmark which distinguishes one share from another, so as to give it any additional value or importance; like grain of a uniform quality, one bushel is of the same kind and value as another."[90]

The court in *Richardson v. Shaw* in respect of the same matter went on to say that:

> "A certificate of the same number of shares, although printed upon different paper and bearing a different number, represents precisely the same kind and value of property as does another certificate for a like number of shares of stock in the same corporation. It is a misconception of the nature of the certificate to say that a return of a different certificate or the right to substitute one cer-

86 Taylor v. Plumer, 3 M. & S. 562, 573, 105 E.R. 721, 725 (K.B.); *see also Ex parte* Cooke, 4 ch. D. 123 (C.A. 1876) which held that apart from the question of trust, the position of a broker is not that of a banker, but of an agent into whose hands money is put to be applied in a particular way and that money paid can therefore be followed by the customer.

87 *Hearings on H.R. 6439 before the House Committee on the Judiciary*, 75th Cong., 1st Sess. (1937).

88 120 N.Y. 153 (1890).

89 209 U.S. 365, 379 (1907).

90 120 N.Y. 153, 157 (1890).

> tificate for another is a material change in the property right held by the broker for the customer."[91]

Mr. Justice Holmes in *Richardson v. Shaw* stated:

> "[I]t is possible to say that after a purchase of stock is announced to a customer he becomes an equitable tenant in common of all the stock of that kind in the broker's hands, that the broker's powers of disposition, extensive as they are, are subject to the duty to keep stock enough on hand to satisfy his customer's claims and that the nature of the stock identifies the fund as fully as a grain elevator identifies the grain for which receipts are out."[92]

Thus, as in other cases of tenancy in common of fungible goods, or goods treated as fungible where the mass is not sufficient to satisfy all who are entitled to share in it, each owner can only have a proportionate interest in the mass.[93]

An alternative theory for the proposition that securities are fungible is the so-called "presumption" theory. This was described by the Supreme Court of the United States in *Gorman v. Littlefield*:

> "The ground upon which the Circuit Court of Appeals decided the case seems to have been that the certificates were not sufficiently identified, but, as we have said, they were on hand to an amount claimed by the appellant and more, and were not claimed by any other customer. We think that there should be no presumption that the stock was stolen or embezzled with intent to deprive the rightful owner of it, and when the unclaimed shares are found in the possession of the bankrupt it is only fair to accept the general presumption in favor of fair dealing and to decide, in the absence of countervailing proof, that the broker out of his funds has supplied the deficiency for the benefit of his customer, which he had a perfect right to do."[94]

The presumption theory has been criticized in that it is generally not supported by the facts. Mr. Justice Pitney of the Supreme Court of the United States said in a dissenting opinion:

> "It is one thing to infer an intent to make restitution to a customer when the acts have been done that are necessary to effect restitution; it is an entirely different mat-

91 209 U.S. 365, 379 (1907).

92 *Id.* at 385.

93 Oppenheimer, *Rights and Obligations of Customers in Stockbrokerage Bankruptcies*, 37 HARV. L. REV. 860, 866 (1924), *citing* Richardson v. Shaw, 209 U.S. 365 (1907); Thomas v. Taggart, 209 U.S. 385 (1908); Sexton v. Kessler, 225 U.S. 90 (1912); Gorman v. Littlefield, 299 U.S. 19 (1913). *See also In re* Stobie-Forlong-Mathews Ltd., 12 C.B.R. 313, 319 (Man. C.A. 1931).

94 Gorman v. Littlefield, 299 U.S. 19, 25 (1913).

ter to infer an intent to make restitution when no restitution has in fact been made. The presumption of an intent to restore fractional interests in this case must rest on the merest fiction; and such a fiction ought not to be indulged in cases of this character, where it will inevitably result in creating a series of arbitrary preferences, contrary to the equity of the Bankruptcy Act."[95]

F. THE NEW YORK AND MASSACHUSETTS RULES

The 1938 amendments to the Bankruptcy Act of the United States introduced provisions specifically dealing with proceedings involving stockbrokers and the rights of customers of a bankrupt broker. The amendments were designed to bring uniformity to the confusing system of administration of bankrupt estates under different and often conflicting state rules. Under the prior law customers were ranked into a number of classes depending on the circumstances of their dealings with the bankrupt. Two rules evolved. The majority view was the so-called "New York" rule while the minority view was known as the "Massachusetts" rule.[96]

The New York rule, which is the rule recognized by Canadian courts, treated the broker-dealer as the agent for his customers in purchasing and selling securities. The customer was regarded as the owner of the shares if he could identify them irrespective of whether the shares had been delivered for safekeeping and segregated, or delivered to the broker-dealer as margin or purchased by the broker-dealer for the customer's account and held in pledge.[97]

A broker under the New York rule was permitted to pledge in a common loan the stock purchased by him on margin in order to raise the money for the purchase of them. Thus the stock purchased for customer A and the securities purchased for customers B, C and D could be pledged in the common loan. The broker thereby was given the fullest use of all such securities in order to raise the purchase money on them, subject, however, to the final rule that the broker would be liable for conversion if he was unable to tender to his customer, when required, not necessarily the identical securities originally purchased, but similar shares of the same stock.[98]

The customer had to trace his securities to reclaim them. That is, he had to find them among those in the possession of the

95 Duel v. Hollins, 241 U.S. 523, 530 (1916).

96 3 W. Collier, on Bankruptcy 1157-58, s. 60.72 (J. Moore ed. 14th ed. 1973) [hereinafter referred to as W. Collier]; Black, *supra* note 36, at 753.

97 3 W. Collier, *supra* note 96, at 1160-61, s. 60.72; Glenn, *supra* note 14, at 424.

98 3 W. Collier, *supra* note 96, at 1160-61, s. 60.72; Glenn, *supra* note 14, at 424.

broker-dealer or of the person to whom the broker-dealer had rehypothecated them. It was not necessary, however, to specifically identify particular share certificates or specific securities if share certificates or securities of the same kind were found in the possession of the broker-dealer or his pledgee. A margin customer could claim his securities which were subject to a pledge for the unpaid balance by doing no more than showing that he was entitled to shares of the same issue as those found in the bankrupt's custody. Securities were treated as fungible.[99] If, however, the broker-dealer did not have the same or similar securities, the customer's claim failed and he too became a general creditor.

The minority Massachusetts rule following the English law held that the relation between the broker-dealer and his customer as to the security purchased is that of creditor and debtor. It regarded the broker-dealer in margin transactions as the owner of the security purchased on margin and his title to the security in general passed to the trustee. The broker was regarded as an independent middleman and the view of a margin transaction was a partially performed contract, under which upon payment of the balance of the price the broker-dealer would deliver the shares. In essence it was regarded as a conditional sale. In bankruptcy the margin customer was treated as a creditor with a contract claim.[100].

The Massachusetts rule in part is based on the law relating to "contango" transactions which are common on the London Stock Exchange. In its more usual sense "contango" means continuation or carrying-over, which is in form and in law a sale and repurchase, or a purchase and resale, as the case may be. It is a new contract and not merely getting further time for the performance of the old contract. [101]

> "When a client directs a broker to buy stock for which the client is not himself finding the money to pay at the time, the money is provided by the broker, and he borrows the money for the purpose. This is done sometimes, no doubt, by a pure and simple loan; but in a very large majority of cases...the thing is done by the broker finding the money on 'contango', and then what happens is this: he is treated, not as the mortgagee or pledgee of the shares for the money which he advances, but he becomes by contract the purchaser of the shares, out-and-out, and they

99 3 W. COLLIER, *supra* note 96, at 1161, s. 60.72.

100 *Id.* at 1159, s. 60.72; Note, *supra* note 52, at 1299; Glenn, *supra* note 14, at 424, Oppenheimer, *supra* note 93 at 864; Smith, *Margin Stocks*, 35 HARV. L. REV. 485 (1910).

101 36 HALSBURY'S LAWS OF ENGLAND (3d), at 548-49 ¶¶843-45.

> become his own property. The shares are not yet transferred to him – he does not acquire any legal interest in them; but, as between the client on whose account he has bought them on the one hand, and himself on the other when he finds the money on 'contango' he becomes the absolute owner of the property, subject, however, to a contract made at the same time, or part of the same contract, that he is to resell to the client a like amount, not the same identical shares, but a like amount of similar shares, usually on the next account day, although a later day may be fixed by arrangement, at a price larger than that for which he gave his client credit on the first occasion; because the enhanced price is to cover interest upon the money in the meantime."[102]

The results under both the New York and Massachusetts rules, but particularly the New York rule, were widely criticized. The rules were regarded as "complicated, impracticable and usually inequitable"[102a] and turned upon "refinements utterly unintelligible to the businessman" and involved "elements of chance more appropriate to a beano party than to the administration of justice".[103]

G. PRIORITIES IN SECURITIES

In 1938, the Chandler Act[104] added section 60(e) to the United States Bankruptcy Act which provided for a statutory scheme of distribution of the estate of a bankrupt stockbroker. Prior to that time distribution was governed by federal equity jurisprudence. Priorities depended upon the status of the customers' property under state law. Four classes of claimants to property in the possession of stockbrokers were recognized prior to the Chandler Act. These were:

> "1. Those who could reclaim specific assets in the possession of the stockbroker;
>
> "2. Claimants who were customers and who had claims to securities that survived a wrongful hypothecation and liquidation of the broker's pledge. These claimants were known as class A claimants;
>
> "3. Claimants who were customers and who had claims to securities that survived an authorized hypothecation and

102 Bentink v. London Joint Stock Bank, [1893] 2 Ch. D. 120, 140 (*per* North, J.) *quoted with approval* in Clarke v. Baillie, 45 S.C.R. 50, 64-65 (1910) (*per* Duff, J.).

102a 3 W. COLLIER, *supra* note 96, at 1158, *citing* HOUSE JUDICIARY COMMITTEE, 74TH CONG., 2D SESS., AN ANALYSIS OF H.R. 1289 at 192 (Comm. Print 1936).

103 McLaughlin, *supra* note 51, at 398.

104 Pub. L. No. 696, 54 Stat. 840-940 (1938).

liquidation of the broker's pledge. These were known as class B claimants;
"4. General creditors."[105]

1. *Canadian Position*

The pre-Chandler Act order of priority in the United States is the order of priority which currently prevails in Canada. The Canadian courts, however, have hesitated in making a distinction between cases of wrongful and lawful pledging. With this exception the pre-Chandler Act and the present Canadian order of priority on distribution is as follows:

a. *First Priority*

The first priority in distribution is the class of claimants who can trace and identify specific assets owned by them in the possession of the broker-dealer, as for example certificates that were "in the box" at the time of his failure and which can be identified by their number. However, effect is given to this class of claims only if they are paid up or on the payment of the balance due.[106] "If the owner can identify his security and pay up his indebtedness to the broker, he is entitled to the return of his security; it is his property."[107]

In certain cases, cash may be reclaimed - as, for example, where it has been deposited for purchase or where it arises from sales and the funds can be traced into a specific account.[108]

Where securities cannot be traced by certificate number but are found in quantities sufficient to satisfy the demands of all claimants, each claimant is entitled to recover in full if the securities are found "in the box".[109]

When no claims are made to the specific securities held by the trustee and the quantities are insufficient to satisfy the demands of all the claimants in full, all of the claimants long of that particu-

105 Note, *supra* note 52, at 1298.

106 Re Bryant Isard & Co., 22 O.W.N. 537 (H.C. 1922), *aff'd*, 23 O.W.N. 113 (C.A. 1922); Re J.T. Richards & Co. Ltd., *ex parte* Byrne, 25 C.B.R. 317 (Ont. S.C. 1944); *In re* Nakashidze [1948] O.R. 254, 29 C.B.R. 35, [1948] 2 D.L.R. 522 (S.C.); *In re* J.T. Richards & Co. Ltd. 20 C.B.R. 140, 144 (Ont. S.C. 1938); and *see* ch. II.D *supra*.

107 *In re* J.T. Richards & Co. Ltd. 20 C.B.R. 140, 144 (Ont. S.C. 1938).

108 Lavien v. Norman, 55 F.2d 91 (1st Cir. 1932); *but see* Schuyler v. Littlefield, 232 U.S. 707 (1914).

109 3 W. Collier, *supra* note 96, at 1162-63, *citing, inter alia*, Duel v. Hollins, 241 U.S. 523 (1916); Lavien v. Norman, *supra* note 94; Gorman v. Littlefield, *supra* note 108. In Ontario *see In re* Heron [1933] O.R. 693, 15 C.B.R. 39 (S.C.) (trustee handed over the returned securities identified by customers and there was enough left to satisfy the claims of one who could not identify any).

lar security hold as tenants in common in respect of the mass of certificates of that security.[110]

If a customer finds securities which he can identify in the possession of the pledgee of the broker, they can be reclaimed in full, subject to the "burden of the loan" and also to rights of a superior class, if such class existed.[111]

The doctrine of "sharing the burden of the loan" or the doctrine of "contribution" has been stated thus: "where securities belonging to different customers are pledged by the broker, and some are sold by the pledgee in order to satisfy his claim, whereas others which are not needed for that purpose are not sold, the owners of the securities which are not sold must contribute *pro rata* to the loss of those whose securities have been sold."[112] The rule does not rest on contract, or on any principle of joint action or original relationship between the parties whose securities will be pledged but on principles of fundamental justice and equity and the maxim that "equality is equity".

"Sharing the burden of the loan" only applies as a rule when the pledgee sells the securities after bankruptcy. If the liquidation is before bankruptcy and the proceeds of the securities have in any way been applied to the use of the insolvent broker, the customer is not entitled to contribution from others whose securities remain.

> "The reason for this is that he has been unable to trace his securities and therefore no matter how great a wrong has been committed against him, cannot reclaim. That is one of the hazards assumed by a customer in entrusting securities to his broker."[113]

However, the fact that securities are liquidated prior to bankruptcy does not affect the operation of the doctrine if the customer can identify the proceeds of his securities as part of the fund held by the pledgee.

Where a broker has pledged securities belonging both to him and to customers, the securities belonging to the broker must be

110 Richardson v. Shaw, 209 U.S. 365 (1908); *In re* J.T. Richards & Co. Ltd., 20 C.B.R. 140, 144 (Ont. S.C. 1938); Oppenheimer, *supra* note 93, at 872 ("If several persons prove that they had pledged stock and a less amount of the stock is on hand, then they are entitled to share among them *pro rata* that which has been returned.").

111 3 W. Collier, *supra* note 96, at 1163, s. 60.72.

112 C. Meyer, *supra* note 11, at 262; Oppenheimer, *supra* note 93, at 877-78; Sexton v. American Trust Co., 45 F.2d 372 (8th Cir. 1930); Re C.A. MacDonald & Co., 2 C.B.R. (N.S.) 258, 262 (Alta. C.A. 1961); *In re* Nakashidze, [1948] O.R. 254, 29 C.B.R. 35 (S.C.); *In re* J.T. Richards & Co. Ltd., 20 C.B.R. 140 (Ont. S.C. 1938); Re Bryant, Isard & Co., *ex parte* Turner, 31 O.W.N. 29, 7 C.B.R. 44 (C.A. 1929); Re Waite, Reid & Co. Ltd., 12 C.B.R. (N.S.) 199, 208 (Ont. S.C. 1969).

113 C. Meyer, *supra* note 11, at 634.

applied to the pledge before the securities of the customer can be called upon to contribute.[114]

b. *Second Priority*

The second order of priority which was recognized by the U.S. courts prior to the Chandler Act in 1938 is the class of claimants whose securities were wrongfully hypothecated by the broker. Such customers take before and, if necessary, to the exclusion of those customers whose shares were used lawfully. The underlying principle for this priority is that when a customer gives a broker authority to do what he has done, he stands in an inferior position to a customer who did not voluntarily subject himself to the same risk.[115] This priority has been explained on the basis that:

> "[S]uperior rights should be granted to claimants whose securities have been wrongfully hypothecated by the bankrupts over those whose securities have been rightfully pledged....
>
> "When a broker pledges as collateral to his loan at a bank securities left with him for safe-keeping or for sale, he is a wrongdoer from the outset, and while the bank may have the right to hold the securities, the claim of the owner, upon the satisfaction of the bank's demand, is of the highest equity. On the other hand, when a broker, acting under the authority conferred upon him by a customer, hypothecates his securities, the latter may, upon the adjustment of his account with the broker and the termination of the bank's demand, reclaim his securities; but, as he has no ground for complaining that his securities were pledged, his rights are clearly inferior to the owner whose securities were wrongfully hypothecated."[116]

The courts in Canada have not distinguished between different degrees of wrongdoing in the wrongful pledge of securities of several customers. This, no doubt, arises from the fact that equities cannot always be measured by a hard and fast rule.[117]

c. *Third Priority*

The third priority in distribution is the class of claimants who

114 Re Clark Martin & Co., 15 C.B.R. 89, 96 (Man. C.A. 1933); Re Wiggins, 12 C.B.R. 386 (Ont. C.A. 1931); Re C.A. MacDonald & Co. Ltd., *supra* note 112; *In re* Heron, *supra* note 109.

115 Gilchrist, *Stockbrokers' Bankruptcies: Problems Created by the Chandler Act*, 24 Minn. L. Rev. 52, 56 (1939); Oppenheimer, *supra* note 93, at 872.

116 *In re* Ennis, 187 F. 720, 722 (2d Cir. 1911).

117 *In re* Bryant, Isard & Co., 7 C.B.R. 44, 49 (Ont. C.A. 1925).

expressly or impliedly gave the broker authority to rehypothecate their securities but for the amount of their indebtedness only, and whose securities were rehypothecated by the broker for a greater amount. They participate only after the claims of creditors with a superior position, such as those who did not voluntarily subject themselves to the same risk, have been satisfied in full. Their rights are those of owners whatever may be their obligations to the trustee or to other owners.[118]

d. *Fourth Priority*

The fourth and last priority in distribution are the general creditors who in the failure of a broker-dealer are usually customers whose securities do not happen to survive the wreck. It can be argued that the fund available to distribute among the general creditors may be increased by unclaimed customers' securities.

> "If customers who have certain rights of ownership in securities which survive or can be traced do not assert their rights, their shares it is submitted should fall into the general pot, rather than go to other customers whom luck has already favoured."[119]

An Ontario case supported this suggestion. Armour, J., in an *obiter dictum* said:

> "the fund may be sufficient or more than sufficient to meet all such equitable claims. In that happy event, the claims are all satisfied in full and the remainder of the fund, if any, goes to swell the general assets of the estate."[120]

This doctrine is based on the position that traders on margin reclaiming their securities can obtain no greater benefit than they would receive if *all* such traders had filed similar reclamation claims.[121] The United States Second Circuit Court of Appeals said:

> "But their shares must be ascertained by including in the calculation the shares of all long customers in the same position, whether they made claim for their shares in the stocks on hand or not. That the shares of those who claim should be increased by the circumstance that other long customers made no claim would be inequitable. What would otherwise have gone to those customers should go to the general creditors."[122]

118 Oppenheimer, *supra* note 93, at 872-73.
119 *Id.* at 872.
120 *In re* Heron, *supra* note 109, at 51.
121 Tillinghast, *Problems of Distribution in Bankruptcies of Stockbrokers*, 44 HARV. L. REV. 65, 82 (1930).
122 *In re* Pierson, 238 F. 142 (2d Cir. 1916).

One commentator observed that the court did not explain why it is that any other course would be "inequitable". He points out that the generally accepted theory of the legal relation between a stockbroker and margin trader is that the securities are regarded to be the property of the trader with a right in the broker to pledge them as security for the advance he has made for their purchase. Accordingly, it would seem that the trustee in bankruptcy could have no interest in the pledged property since it is not property of the broker.[123]

2. *Criticism of the System*

The system of priorities and the protection afforded to customers prior to the Chandler Act amendments to the Bankruptcy Act of 1938 were widely criticized.

Judge Learned Hand in referring to the system once said:

> "Nobody recognizes more acutely than I do the artificiality of all this reasoning...."[124]

In another case decided the same year, Judge Rose was moved to express his scepticism over the value of the complicated equities traced in stockbrokerage bankruptcies.

> "The practical importance of having a fixed and uniform rule in these cases is great.... But is there not more of theory than substance in the assumption that the unclaimed property must be treated as if it had been the bankrupt's at bankruptcy merely because another customer in like class with petitioner does not, after bankruptcy, claim what such other was entitled to? There would seem nothing to recommend except a certain formal logic which it has or seems to have.... *In the long run, would not as high a degree of equity be worked out, if all the customers of the bankrupt brokers shared equally in their assets, and that, too, with infinitely less of trouble, delay and expense?*"[125]

Perhaps the frustration over the existing system was best summed up by James A. McLaughlin, whose remarks were quoted in part previously:

> "The existing law turns upon refinements utterly unintelligible to the businessman and involves elements of

123 Tillinghast, *supra* note 121, at 82.

124 *In re* Walter J. Schmidt & Co., 298 F. 314, 319 (S.D.N.Y. 1923).

125 *In re* Archer, Harvey & Co., 289 F. 267, 272 (D.C. Md. 1923) (italics added); *In re* Wiggins Ltd., [1931] O.R. 573 (C.A.) ("The law is simple in its principles but difficult in its application." *per* Middleton, J.A.).

chance more appropriate to a beano party than to the administration of justice."[126]

Chapter III
Protection of Customers' Funds and Securities in the United States

Prior to the Chandler Act, the legal remedies available to customers of a broker-dealer that had failed were at best cumbersome and expensive and at worst inequitable and capricious.

The law in respect to bankrupt stockholders was formulated primarily in cases involving the rights of margin customers. In the United States where most of this law developed, the rights of customers varied from state to state with the federal bankruptcy court applying the law of the jurisdiction in which the transaction at issue took place. As has been seen, a number of inequities developed. To a great extent the system provided for both lucky and unlucky claimants and it was often difficult to decide whether any particular claimant was a member of one class or another.[127]

This chapter will describe the changes to the legal system and the devices developed in the United States over the past forty years for the protection of customers and the integrity of U.S. capital markets.

A. SECTION 60(e) OF THE UNITED STATES BANKRUPTCY ACT

Section 60(e) which deals exclusively with broker bankruptcies was added to the Bankruptcy Act by the Chandler Act of 1938[128] as a result of the general dissatisfaction with the treatment of the customers of bankrupt brokerage houses.

According to J. MacLachlan:

"Section 60(e) adopts the theory that all the customers of a broker who permit him to have wide powers over their securities are subjecting themselves to the common risk of his failure. He should not be permitted to favor some over others when he and they contemplate the imminence of his failure. Furthermore, upon bankruptcy the available assets should be distributed by applying equitable principles upon a broader base than that recognized under the pre-existing bankruptcy law."[128a]

126 McLaughlin, *supra* note 51, at 397.

127 NATIONAL BANKRUPTCY CONFERENCE, REPORT OF THE COMMITTEE ON STOCKBROKER BANKRUPTCIES (1971).

128 Pub. L. No. 696, 52 Stat. 840-940 (1938).

128a J. MACLACHLAN, BANKRUPTCY 323 (1956).

The primary objective of the draftsmen of section 60(e) was to eliminate, as far as possible, the old classifications of stockbrokerage customers with the artificial distinctions that had arisen and to bring bankruptcy practice in respect to stockbrokers more in line with other fields such as voidable preferences.[129]

The general policy of section 60(e) is that customers who are the owners of specifically identified property (the "cash customers") are entitled to preferred treatment while the margin customers who permit the broker to have wide powers over their securities should be subject to the risk of the broker's failure but with some priority over general creditors.[130] Accordingly, three classes of claims were established: (1) "cash *customers*" who are able to identify "specifically" their securities; (2) all other *customers*, and (3) general *creditors*.

As the primary purpose of section 60(e) was to eliminate as far as possible the old classifications of margin customers the draftsmen concentrated mainly upon the rights of such customers and apparently gave no deep consideration to the rights of customers who did not enter into margin transactions.[131]

The first level of priority established by section 60(e) is "cash customers" who have paid in full for securities that are specifically identifiable. These customers are permitted to reclaim such identifiable securities and thereby gain priority over other customers, presumably on the theory that they are believed to be still owners of the specific property. Securities are regarded to be not specifically identified unless they remained in their identifiable form in the broker's possession until the date of the bankruptcy, or unless such securities or any substitutes therefor or the proceeds thereof were more than four months before bankruptcy or at a time while the stockbroker was solvent, allocated to or physically set aside for such customer, and remained so allocated or set aside at the date of bankruptcy.[132]

Thus, in order that securities be specifically identified, one of three alternatives must be met:

(1) the securities must have remained in their identical form in the broker's possession until the date of bankruptcy; or
(2) the securities or any substitutes therefor or the proceeds thereof must have been allocated to and physically set aside for the customer more than four months before bankruptcy and remained so allocated or set aside at the date of bankruptcy; or

129 Note, *supra* note 52, at 1300.
130 National Bankruptcy Conference, *supra* note 127, at 1.
131 Gilchrist, *supra* note 115.
132 Chandler Act of 1938, Pub. L. No. 696, s. 60(e)(4).

(3) the securities or any substitutes therefor or the proceeds thereof must have been allocated to or physically set aside for the customer while the broker was solvent and remained so allocated or set aside at the date of bankruptcy.[133]

The express intent of the draftsmen was that unless the certificate was "specifically allocated or physically set aside, it must be thrown into the fund for distribution to all customers of the single class".[134]

The second level of priority for claimants to the assets of a bankrupt broker as established by section 60(e) consists of all other customers as a group, except those cash customers who are able to specifically identify their property in the manner specified by subsection 4 of section 60(e). Such creditors as a group have priority over other creditors of the bankrupt broker in a "single and separate fund" created by pooling all property acquired or held from or for customers except property that can be specifically identified as belonging to "cash customers".[135]

With respect to margin customers the old New York rule based upon ownership was rejected by the draftsmen of section 60(e) and the Massachusetts rule which treated the relationship between a stockbroker and his customer as that of debtor and creditor was adopted instead.

The third level of priority consists of general creditors who share in the assets of the bankrupt broker after the customers have been satisfied.

In practice, unforeseen inequities developed as the industry introduced new methods of allocating and segregating customers' securities.

The Securities and Exchange Commission's *Report of Special Study of Securities Markets*[136] in 1963 expressed doubt as to the ability of a cash customer to obtain preferential treatment under section 60(e) by reclaiming securities which have been put in bulk segregation where the brokers' records are the only means of identifying a customer's interest in the mass.[137] It also discussed various difficulties which arise under section 60(e) and made the following recommendations for changes in section 60(e):

"6. Problems arising from broker-dealer insolvency:

"It seems evident that section 60(e) is a significant im-

133 NATIONAL BANKRUPTCY CONFERENCE, *supra* note 127, at 2.

134 HOUSE JUDICIARY COMMITTEE, 74TH CONG., 2D SESS., ANALYSIS OF H.R. 1289, at 193 (Comm. Print 1936).

135 NATIONAL BANKRUPTCY CONFERENCE, *supra* note 127.

136 SECURITIES AND EXCHANGE COMMISSION, 1 REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 95, 88th Cong., 1st Sess. 412–16 (1963).

137 *See also* Black, *supra* note 36, at 757.

provement over the law as it formerly existed. Even so, it presents problems both of interpretation and of correlation with the financial responsibility rules.

"*Two main problems of interpretation exist. The first is the question whether the term 'stockbroker', which is not defined in the Bankruptcy Act, means only those who buy and sell securities for their customers on an agency basis or also includes 'dealers'. In Gordon v. Spaldin,* 268 F.2d 327, 330–331 (5th Cir. 1959), the court said: 'The history as well as the text of said S60, sub. e(1) indicates clearly that it was intended to apply only to those who hold securities on margin and otherwise, not as owners, but as agents for their customers.'

"Thus, the test which the court established is the capacity in which the 'stockbroker' has come into possession of a customer's assets; *i.e.*, whether as a principal (dealer) or as agent (broker). It is apparent that this narrow definition could lead to strange results: If a 'stockbroker' purchased securities for a customer as agent, was paid, and held the securities in safekeeping, the customer might be able to reclaim them. If, however, the same securities were sold to the customer in a principal transaction, Section 60(e) might not apply and the customer, even though he had paid for securities, would either have to find his identical certificates in order to reclaim them or become a general creditor. Clarification would obviously be desirable.

"The second involves the ambiguous definition of the term 'customer'. A person who deposits cash with a broker-dealer against a purchase of securities that does not occur before bankruptcy might not qualify as a 'customer' so as to qualify for the second level of priority.

"Even assuming that the foregoing problems are resolved, questions of correlation with the financial responsibility rules would still exist. Segregation of securities, implementing the 'reasonable relationship' rules, may permit many customers specifically to identify their securities and thus to reclaim them in the first level of priority. There may be considerable problems, however, where securities are held in bulk segregation. For securities to be 'identified specifically' one of two tests must be met: The securities must remain in their 'identical form' in the 'stockbroker's' possession until the date of bankruptcy; or the securities or substitutes therefor or proceeds thereof must have been allocated to or set aside for the customer, more than 4 months prior to bankruptcy or

while the 'stockbroker' was solvent, and must have remained so allocated or set aside until bankruptcy. Sec. 60(e)(4).

"The normal manner of operating the bulk segregation system unfortunately makes it impossible for securities to remain in their 'identical form'. Securities are removed from, or placed in, segregation as the day's transactions require, and securities certificates in segregation are regarded as fungible. It may be impossible for any one customer to say that certificates set aside for him remained in their identical form to the date of bankruptcy. Thus, a customer would not be entitled, as a cash customer, to reclaim securities held in bulk segregation, unless those securities were allocated to him more than 4 months prior to bankruptcy or while the broker-dealer was solvent. If the customer could not meet his requirement he would be entitled to share only in the 'single and separate' fund, at the second level of priority.

"A similar problem exists with respect to customers' free credit balances. Even if segregation of such balances were required, it seems clear that the ordinary practices of the securities industry would render it virtually impossible for a given customer to 'identify specifically' a deposit of cash as his own. If a customer delivers a check to a 'stockbroker' it could be said to be in its 'identical form' if it remained uncashed at bankruptcy. Once it is deposited, however, it loses its 'specific identity' and the customer is at best only a 'customer' within the meaning of Section 60(e). Thus, the only means by which a customer having free credit balances could receive protection as a 'cash customer' in accordance with Section 60(e) would be for the free credit balances to be allocated to, or physically set aside for, the customer in a special account, more than 4 months prior to bankruptcy or while the broker-dealer was solvent.

"Finally, Section 60(e) does not apply to receiverships. An insolvent broker-dealer can be placed in the hands of a receiver and be liquidated without ever going into bankruptcy at all. When liquidation is accomplished in this manner it appears that the old Massachusetts and New York doctrines may still have vitality and the capriciousness of result which Section 60(e) was designed to eliminate may prevail.

"A recent application of the New York doctrine occurred in *East v. Crowdus*, 302 F.2d 645 (8th Cir. 1962), in which

the petitioners argued that they had the right to reclaim certain shares of stock held in street name by a broker-dealer who was in receivership. The evidence showed that the claimants had ordered and paid for certain shares, that like shares had been purchased for the account of the broker-dealer, and that they were never specifically allocated to or set aside for the claimants. The claimants, relying upon the New York pledgor-pledgee doctrine, argued that they had traced the securities sufficiently to reclaim them by establishing that like securities to those they had purchased were on hand in an amount sufficient to meet their claim; in short, that securities of like kind are fungible when not specifically identified. The court supported their contention and permitted reclamation.

"Although it would appear from the facts of this particular case that the claimants would have been entitled to the shares even if Section 60(e) applied, slight variations in the facts could have caused the claimants to be reduced to 'customers' at the second level of priority. This indicates the difficulty of developing a system which assures a fair result to all claimants against the assets of a broker-dealer. Nonetheless, if a broker-dealer properly segregated the securities of his customers, it is believed that there would be far less danger under Section 60(e) that results of allocation of the broker-dealer's assets upon bankruptcy would be unfair, than if the Massachusetts and New York doctrines continued to have force.

"*Thus, there are broker-dealer bankruptcy problems still to be resolved.* Amendment of Section 60(e) to assure that 'stockbrokers' include dealers having public customers, and to assure that those who transmit cash to broker-dealers for stock purchases are included in the definition of 'customers' is indicated. The difficulty caused by bulk segregation could be resolved either by requiring specific identification, *i.e.*, abandoning the bulk segregation system or by amending Section 60(e) to include the bulk system among the types of 'specific identification'. As between the two possibilities, the latter would seem preferable. Bulk segregation is the only practicable system for many firms with large holdings of customers' securities and, in the event that a centralized handling system is instituted, all securities of customers in the system probably would be held in that manner or a similar one.

"5. SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

"Many broker-dealers perform banking and custodial functions in the course of which they have custody of, and use, customers' assets of enormous value. The degree of dominion and control over customers' cash and securities may vary considerably depending upon the type of account which the customer has with the broker-dealer and with the amount, if any, owed by the customer to the broker-dealer. While many firms give regular notice to customers as to the status of their accounts, it would appear that there are many others which do not do so.

"Customers' free credit balances are among the foregoing assets and may form a substantial part of the working capital of many broker-dealers. They are rarely segregated from broker-dealers' own funds. On the basis of prior loss experience, there does not appear to be a need to require complete segregation at this time. It would seem, however, that broker-dealers may reasonably be required to maintain an adequate liquid reserve against free credit balances, much as banks are required to maintain such a reserve against deposits. Furthermore, broker-dealers should be required to inform customers at regular intervals as to the status of their accounts.

"Customers' margin and fully paid securities likewise are held in large volume by broker-dealers. Under the rules of the Commission, in some States and certain exchanges, broker-dealers are restricted both in the use which may be made of those securities and in the manner in which they may be held. The rules presently existing are salutary to the extent of their coverage; the rules of the Commission and of some of the self-regulatory organizations should be extended, however, so that they provide the fuller protection now existing under the rules of certain exchanges with respect to segregation and hypothecation and lending of customers' securities.

"The net capital ratio rules of the Commission and certain exchanges have been a valuable protection for investors in preventing insolvency of broker-dealers. The current rigid 'haircut' provisions of these rules, however, do not distinguish among broker-dealers performing different functions in the securities markets (except that exchange specialists and other members having no public business are not subject to such provisions), nor do they take account of changing circumstances in the markets. One result is that broker-dealers, including those making

> primary markets, may not be adequately restricted in accumulating inventories of over-the-counter securities during periods of price rises, but may be compelled to reduce inventories rapidly during periods of falling prices, contrary to market needs.
>
> "Section 60(e) of the Bankruptcy Act is a notable advance in the administration of broker-dealer bankruptcies. Nevertheless, there are within it certain ambiguities which should be resolved; furthermore, it is believed that customers whose securities or free credit balances are appropriately segregated should be entitled to greater protection than they are now accorded by Section 60(e)."[137a]

The *Special Study* concludes and recommends:

> "5. Section 60(e) of the Bankruptcy Act should be amended to provide (a) that customers' securities that have been appropriately segregated within 4 days after receipt so that their ownership can be ascertained, whether or not specifically identified (*e.g.*, the bulk segregation system), and customers' free credit balances if similarly segregated, will be considered to be 'identified specifically' within the meaning of Section 60(e)(4) notwithstanding that such segregation may have occurred less than 4 months prior to bankruptcy or during insolvency; (b) that the term 'stockbroker' clearly include 'dealers' as well as 'brokers'; and (c) that the term 'customers' include persons depositing cash for the purchase of securities. In addition, the Bankruptcy Act should be amended to empower the Commission to petition that an insolvent broker-dealer be adjudicated a bankrupt, so as to assure equitable treatment of claimants under Section 60(e)."[138]

After almost a decade of studies, both in and out of Congress, a new Bankruptcy Bill, H.R. 8200, was approved by the House on February 1, 1978. Senate action is expected later in the year.[139]

Many of the technical deficiencies of, and the problems which arose under, section 60(e) have been remedied by the new bill.

"Stockbroker" is defined by the bill to mean a "person with respect to which there is a customer (as defined by the bill) engaged in the business of effecting transactions in securities: (a) for the account of others; or (b) with members of the general public

137a SECURITIES AND EXCHANGE COMMISSION, *supra* note 136, at 412-16.

138 *Id.*

139 The bill was signed by the President on November 16, 1978.

from or for such person's own account". This definition makes it clear that "stockbroker" includes both a broker and a dealer.

The scheme for the administration of stockbroker liquidations under H.R. 8200 is to create two classes of customers' property found in the possession of the bankrupt stockbroker.

The one class of property is "customer name security". These are securities held for the account of a customer on the date of the filing of the bankruptcy petition of the stockbroker which are registered in the customer's name on such date or in the process of being so registered under instructions from the debtor and are not in a form transferable by delivery on such date.[139a] The trustee is required to deliver such securities to the customer upon payment of any amount owed by the customer to the stockbroker.[140]

The other class of property is "customer property", being cash, securities or other property, and proceeds of such cash, securities or property held by or for the account of the debtor from or for the securities account of a customer, but not including a customer name security delivered to or reclaimed by a customer or property to the extent that a customer does not have a claim against the debtor based on such property (for example, office furniture, computer, etc.).[141] The trustee is required to distribute "customer property" rateably to customers on the basis and to the extent of such customer's allowed net equity claims.[142] To the extent that there is a surplus, it is distributed to the general creditors.[143] To the extent that there is a deficiency, the unpaid customers may claim as unsecured creditors against the general estate of the stockbroker.[144]

Any cash or securities remaining after the liquidation of a security interest created under a security agreement made by the debtor is required to be apportioned between the general estate of the stockbroker and "customer property" in the proportion that the general property of the stockbroker and the cash or securities of customers were subject to such security interest.[145]

139a H.R. 8200, 95th Cong., 2d Sess., s. 741(3) (1978).
140 *Id.* s. 751.
141 *Id.* s. 741(4).
142 *Id.* s. 752(a).
143 *Id.* s. 752(b)(1).
144 *Id.* s. 752(b)(2).
145 *Id.* s. 752(c).

B. VOLUNTARY TRUST FUNDS OF UNITED STATES EXCHANGES

While many broker-dealer firms had failed in the aftermath of the 1929 crash, in the years following the enactment of the Securities Exchange Act of 1934 broker-dealer insolvencies were almost unknown in the United States. Before 1960 there had been only three insolvencies involving members and these had all occurred in 1938. There was a public confidence in the major exchanges. The New York Stock Exchange actively encouraged the widely held view that membership in the NYSE is synonymous with solid financial status.

DuPont, Homsey & Co. was the first member of the NYSE to fail after 1960. The NYSE contributed $797,000 to its receiver. The payment was made to create the belief that the NYSE would stand by an insolvent member's customers and secure them from losses caused by the insolvency.[146] It was argued that by indemnifying stockbrokerage customers the NYSE "sought to preserve the image of financial integrity its members had commanded in the eyes of the public".[147] It was said "no customer of a member organization of the New York Stock Exchange in more than 30 years has sustained a loss of securities or funds as the result of the failure of a NYSE member firm".[148]

The failure of DuPont, Homsey & Co. was caused in part by one of the partners absconding with assets of the firm. The NYSE in order to prevent similar failures demanded that fidelity bond requirements be raised to prevent losses due to defalcations by brokerage firm partners.[149] The NYSE took out a fidelity bond to protect customers against fraud by member firms.[150] After all that it did to protect the customers of DuPont, Homsey & Co. the NYSE went out of the way to say that its actions were not to be taken as a "precedent binding the exchange to a similar course of action in the future".[151]

The spectacular failure in 1963 of Ira Haupt & Co. was triggered when one of its customers was unable to meet margin calls on commodities contracts. It was in fact one of the principal

146 Guttman, *Broker-Dealer Bankruptcies*, 48 N.Y.U.L. Rev. 887, 906 (1974).

147 Lasdon, *Stock Exchange Liability in Member Firm Insolvencies*, 81 Banking L.J. 38 (1964).

148 *Hearings on S. 2348, S. 3988 & S. 3989 before the Subcommittee on Securities of the Senate Committee on Banking and Currency*, 91st Cong., 2d Sess. 176 (1970) (remarks of Robert W. Haack).

149 NYSE Rule 319, 2 CCH NYSE Guide ¶2319.

150 The New York Times, March 23, 1961, at 50.

151 The Wall Street Journal, November 21, 1960, at 26, cols. 1 & 2 (*quoting* Keith Funston, President of NYSE).

casualties which arose out of The Great Salad Oil Swindle. The NYSE again moved to protect the customers from losses.[152] When disaster struck the Haupt firm, almost all of the firm's cash had been wiped out by losses in the futures markets and it was left with enormous debts. It owed in all to United States and British banks more than $37 million that it could not pay.[153]

Stock exchange officials on learning the extent of the probable losses feared with good reason that if the exchange did not help Haupt there would be widespread loss of confidence in the integrity of brokerage firms. Some 20,700 customers of Haupt had left securities worth more than $450 million in the safekeeping of the firm. Almost $90 million of these securities had been purchased on margin and these had been pledged to banks for loans. Customers, in addition, had left $5.5 million in cash on deposit with the firm. The Haupt firm had been suspended from the exchange. It was only the second time in the NYSE's 171-year history that a member firm had been suspended, and as a result customers were not able to withdraw their securities or money while the firm was under suspension.[154]

The NYSE feared that if the Haupt firm was to be made bankrupt it could be years before the customers recovered their securities and money. Undoubtedly, the customers would suffer losses too if the firm was liquidated through bankruptcy. It was considered that such a situation could not be permitted as it would be the most damaging blow to Wall Street since the crash of the stock market in 1929.

The exchange and the major banks that were creditors of Haupt were convinced that the public interest demanded that Haupt not be forced into bankruptcy. The board of directors of the NYSE devised a liquidation plan for Haupt in which the exchange would provide up to $12 million to pay Haupt's debts to customers which was to be repaid by increasing member firms' dues by 50% for the next three years and the banks would defer up to $24 million of the loans owed to them. The chief examiner of the exchange acted as "liquidator" of Haupt and supervised payments to customers. The partners of Haupt accepted the plan and the claims of customers were quickly settled. The plan was also well received by the other members of the exchange. In devising the plan to protect the Haupt customers from losses which in fact were beyond the control of the exchange, arising as they did from the commodities business of the firm, the exchange was concerned not

152 Guttman, *supra* note 146, at 907.
153 N. Miller, The Great Salad Oil Swindle (1965).
154 *Id.*

only about the customers but about the image of the exchange and the brokerage business in general.[155]

In 1964 the NYSE moved to put its rescue operations on a permanent basis by establishing a Special Trust Fund. It consisted of $10 million in cash backed up by a $15 million line of bank credit.[156] The Special Trust Fund was created notwithstanding the earlier disclaimer of the NYSE that its bailing-out operation in respect of DuPont, Homsey & Co. was not to be taken as "a precedent binding the exchange to a similar course of action in the future".[157]

The purpose of the Special Trust Fund as stated in its constitution is for "providing direct or indirect assistance to customers of a member...threatened with loss of their money or securities because such member...is insolvent or is in such financial condition that he or it may be unable without assistance to meet his or its obligations to such customers". It went on to disclaim any responsibility to the public by stating "no customer of any such member...and no other person shall in any event have any claim or right of action at law or in equity...against the Exchange, the Trustees of the Special Trust Fund, or any other person, or against the Fund, as a result of any action taken or the failure to act by the Trustees in the exercise of their discretion".[158]

By 1968 all of the major stock exchanges in the United States had established voluntary trust funds by making assessments upon their members. The various funds were small, however, when compared with the volume of trading done by members of the individual exchanges, the value of customers' assets held by members, the size of the net losses arising out of the increasing number of failures of member firms and the amounts earned by member firms from the free credit balances of customers left in their brokers' hands.[159]

155 *Id.*

156 H. Baruch, Wall Street: Security Risk (1971).

157 *See* note 151 *supra*.

158 H. Baruch, *supra* note 156, at 214.

159 The American Stock Exchange fund was $2.6 million with standby credit of $7.4 million. The Midwest Stock Exchange fund was $515,000. The Philadelphia & Baltimore-Washington Exchange fund was $325,000. *See Hearings on H.R. 13308 before the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce,* 91st Cong., 2d Sess., 152 (1970). Robert W. Haack, a former president of the NYSE, once said: "the self-regulators who have been so frequently decried and deplored have, by using their own hard-earned money, kept probably 600,000 to 700,000 accounts out of a bankruptcy court"; H. Baruch, *supra* note 136, at 32-33, retorted by saying that:

> "[i]ncluding the $30 million commitments made to Merrill Lynch in connection with its takeover of Goodbody, all monies ever expended do not exceed $150 million while member firms of the NYSE alone can be fairly charged with earning a net profit of over $230 million on customers' free credit balances in the year 1969."

After the creation of the NYSE Special Trust Fund, no NYSE firm had to be liquidated in the next few years. The first failure thereafter was that of Pickard & Co. The exchange voluntarily responded in coming to its assistance, and to the assistance of some nine other firms which failed shortly afterwards. In 1970, however, the NYSE initially failed to come to the rescue of three member firms and was severely criticized in financial and business circles.[160] It was apparent towards the end of 1970 that the Special Trust Fund of the NYSE was depleted to the point of veritable exhaustion.[161] To shore up the fund, an extra $30 million from the Building Fund of the NYSE was added to the "Special Trust Account".[162]

By April 1970 just over one-half of the NYSE Special Trust Fund had been committed to assist the liquidation of five firms. A special committee of the NYSE was established to "determine the appropriate size of the fund and ways to enlarge it".[163] By July 22, 1971, the NYSE Special Trust Fund had advanced or committed $30 million to assist Merrill Lynch in its absorption of Goodbody & Co.

By 1970 in the United States it was evident that the voluntary trust funds were a "stop-gap" creation at the most. There was increasing public apprehension that the member firms of the various exchanges did not have the ability to meet new losses. A part of this general uneasiness was directly attributable to the exchanges. The exchanges took the position that notwithstanding that they created the funds and publicized the fact to promote investor confidence they had no legal obligation to member firms to pay anything.[164]

The precarious position of customers was underlined by the fact that apart from the voluntary trust funds there was noprotection available to customers of brokers who became bankrupt such as was available to depositors of banks and other groups. Moreover, there was no protection available for customers of broker-dealers who were not members of the exchanges or for customers of commodity brokers.

160 Barron's, November 23, 1970, at 1; Barron's, December 21, 1970, at 3; The Wall Street Journal, November 19, 1970, at 2; BUSINESS WEEK, November 28, 1970, at 70.

161 The NYSE conceded on November 12, 1970, that it might have to "take steps to expand the hard pressed emergency reserve"; The Wall Street Journal, November 13, 1970, at 4.

162 SEC, STUDY OF UNSAFE AND UNSOUND PRACTICES OF BROKERS AND DEALERS, *supra* note 56, at 13-14, app. A at 204.

163 The Wall Street Journal, March 26, 1970, at 6, col. 3.

164 *NYSE, Crisis in the Securities Industry, A Chronology 1967-70: Hearings before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 92d Cong., 1st Sess. 14, 28 (1971) (Serial No. 92-37); and *see* Guttman, *supra* note 146, at 907.

C. THE SECURITIES INVESTOR PROTECTION ACT OF 1970

Congressional action was demanded when the number of failures of both large and small brokers and the dollar losses increased with the apparent vacillation of the NYSE to come to the rescue of member or former member firms. It was not, however, a new demand, for as early as 1957 Congresswoman Edna F. Kelly of New York had introduced a bill that would have required all brokers to carry insurance on customers' funds entrusted to them.

In June 1969 Senator Edmund Muskie of Maine introduced a bill modeled after the legislation that produced the Federal Deposit Insurance Corporation (FDIC) which provided protection for brokerage customers through the creation of a Federal broker-dealer insurance corporation. In the hearings on the bill there was little disagreement over the fact that the most satisfactory solution to protect the investor was a comprehensive insurance scheme. Disagreement for the most part centred on whether the administration of such a scheme should be in the hands of the industry or of the government.

Senator Muskie in his bill had proposed that the board of directors of the corporation consist of the commissioners of the Securities and Exchange Commission and thus be free of industry control. The exchanges at first had simply opposed the bill. This resulted in a strong public criticism. In April 1970 the chairman of the SEC said he was concerned with "the financial problems of the industry and the losses sustained in 1969 and the first quarter of 1970". The exchanges in a joint industry task force drafted an alternative proposal for an insurance scheme by way of self-regulation. The scheme provided for a corporation that would have twelve directors with only two public seats and with no offer of any regulatory authority to the SEC. Spokesmen for the industry argued that "such an administrative mechanism would be preferable to the creation of another layer of governmental regulation which would be unwieldy as well as unnecessary".[165]

Congress had however become impatient with the industry in its failure to show a sense of urgency in responding to the demonstrable need for some better system to protect investors. In the hearings of the Senate Subcommittee on Securities Senator Muskie indicated this impatience when he replied to a witness from the industry: "The industry had ten months last year to meet those ifs that you just posed in your answer. It was only two days before the

165 *Hearings on S. 2348 before the Subcommittee on Securities of the Senate Committee on Banking and Currency, supra* note 148, at 29 (statement of Donald T. Regan).

hearing today that the industry finally organized itself to put together a program. Is that a confidence-instilling reaction?"[166] Shortly afterwards the Securities Investor Protection Act (SIPA) was enacted and effectively brought to an end self-regulation in this area.

The exchanges, particularly the NYSE, had urged when it was apparent that SIPA would be enacted that the new legislation be made retroactive. In the case of the NYSE this would have relieved it from coming to the aid of the customers of three former member firms that had recently failed. It was the vacillation of the NYSE, and the citing by it of the voluntary nature of its "special trust" fund as one of the reasons for its reluctance to act, that had largely convinced Congress of the necessity of the legislation. Congress, however, lacked precise information on the condition of the industry and was concerned with the impact that the new legislation would have on the Treasury. It accordingly refused to make it retroactive. Congress regarded the losses that had already been experienced as the responsibility of the industry and, in effect, demanded from the industry, as the price for the legislation, that the industry accept responsibility for the losses of customers suffered before the act's enactment.[167]

Indicative of its concern with the industry, Congress added a provision to SIPA that did not appear in either the House or Senate bills. It required the SEC to make a study of unsafe and unsound practices of broker-dealers, to report within twelve months the steps being taken to eliminate them and to recommend any additional legislation needed to do so.[168]

> The legislative history of the SIPA describes its purpose: "The serious and persistent financial problems besetting the securities industry in recent months have led to the voluntary liquidations, mergers, receiverships or, less frequently, bankruptcies of a substantial number of brokerage houses. Such failures may lead to loss of customers' funds and securities with an inevitable weakening of confidence in the U.S. Securities Markets. Such lessened confidence has an effect on the entire economy – whatever other steps must be taken to improve these conditions, one objective of the bill, as reported, is to provide investors protection against losses caused by the

166 *Id.* at 33.

167 S. Rep. No. 1218, 91st Cong., 2d Sess. 6 (1970); H.R. Rep. No. 1613, 91st Cong., 2d Sess. 14; SEC v. Guaranty Bond and Sec. Corp., 496 F.2d 145 (6th Cir. 1974); Lohf v. Casey, 466 F.2d 618 (10th Cir. 1972).

168 Securities Investor Protection Act, 1970, s. 11(h), 15 U.S.C. s. 78 aacc., Pub. L. No. 91-598, 84 Stat. 1636-1757 (1970) [hereinafter cited as SIPA].

> insolvency of their broker-dealer. The need is similar, in many respects, to that which prompted the establishment of the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation."[169]

On December 30, 1970, The Securities Investor Protection Act, 1970,[170] became law when President Richard Nixon signed the bill. He said it was "a vitally important advance in the consumer protection field".[171]

The most important feature of SIPA was to establish the Securities Investor Protection Corporation (SIPC):

> "to protect individual investors from financial hardship; to insulate the economy from the disruption which can follow the failure of major financial institutions; and to achieve a general upgrading of financial responsibility requirements of brokers and dealers to eliminate, to the maximum extent possible, the risks that lead to customer loss."[172]

The SIPC is a private "nonprofit corporation". It is not designed to be an agency or establishment of the United States government but rather to be a membership corporation consistent with the self-regulatory nature of the securities industry. While in theory SIPC is an independent corporate entity, in practice the corporation is completely subordinated to the discretionary power of the Securities and Exchange Commission.[173]

> "The SIPC's role is primarily one of consultation and cooperation with the self-regulatory organizations which remain subject to the federal security terms and the rules of the SEC. By mandating membership in the SIPC for certain members of the securities industry and by granting the SIPC general assessment authority over the members in order to establish a SIPC fund, Congress accomplished its intentions that the cost of providing protection to customers under SIPC was to be borne by the securities industry itself."[174]

The members of SIPC are all persons registered as brokers or

169 [1970] 4 U.S. CODE CONG. & AD. NEWS 5255, *quoted in* SEC v. Guaranty Bond and Sec. Corp., *supra* note 167; and *see* SEC v. Alan F. Hughes Inc., 461 F.2d 970, 977 (2d Cir. 1972) ("The primary purpose is to afford protection to public customers in the event broker-dealers with whom they transact business encounter financial difficulties and are unable to satisfy their obligations to their public customer.").

170 15 U.S.C. s. 78 aacc., Pub. L. No. 91-598, 84 Stat. 1636-1757 (1970).

171 The New York Times, January 3, 1971, at 1.

172 S. REP. No. 1218, *supra* note 167, at 4.

173 Gates, *The Securities Investor Protection Act of 1970: A New Federal Role in Investor Protection*, 24 VAND. L. REV. 586, 606, 607 (1971).

174 SEC v. Guaranty Bond and Sec. Corp., *supra* note 167.

dealers under section 15(b) of the Securities Exchange Act of 1934 and all persons who are members of a national securities exchange other than persons whose business as a broker or dealer consists exclusively of (i) the distribution of shares of registered open-end investment companies or unit investment trusts, (ii) the sale of variable annuities, (iii) the business of insurance or (iv) the business of rendering investment advisory services to one or more registered investment companies or insurance company separate accounts.[175]

In order to finance the insurance program contemplated by the act, SIPC is required to establish a fund consisting of cash, amounts invested in United States government or agency securities and confirmed lines of credit.[176] Assessments in favour of the fund are required to be made against all members based upon the members' gross revenues derived from their securities business.[177] The fund was required to total at least $75 million within 120 days after the enactment of SIPA.[178] It is to eventually reach $150 million "or such other amount as the Commission (SEC) may determine in the public interest".[178a] If there should be heavy claims made against the fund, the SEC, on behalf of SIPC, may borrow up to one billion dollars from the United States Treasury and arrange for a repayment plan subject to SEC approval.[179]

The scheme of the act provides for a liquidation procedure which is closely modeled on section 60(e) of the United States Bankruptcy Act. Indeed, the liquidation procedures of the two acts are very similar except in respect of the rehabilitation of a debtor. SIPA specifically prohibits the formulation of a plan of reorganization[180] and by inference prohibits an assisted "wind down period" so that the liquidation of the broker-dealer could be more manageable.[181] The liquidating trustee, however, does have the power to operate the business of the debtor in order to complete its open contractual commitments.[182]

SIPA stands alone. It neither amends the Securities Exchange Act of 1934 nor does it amend the Bankruptcy Act. The SEC in commenting upon the proposed SIPA said:

"In summary, the bill does not in any way amend the

175 SIPA, s. 3(a)(2).
176 SIPA, s. 4(a)(2).
177 SIPA, s. 4(c)(1).
178 SIPA, s. 4(a)(3)(b).
178a SIPA, s. 4(d)(1)(a). It is expected that the fund will exceed $160 million by mid-1978 at which time assessments will be suspended; SIPC, 7TH ANNUAL REPORT 10 (1977).
179 SIPA, s. 4(h).
180 SIPA, s. 6(c)(1).
181 Duff, *Reforming SIPC*, 7 REV. SEC. REG. 988 (January 31, 1974).
182 SIPA, s. 6(b)(1)(B).

Bankruptcy Act, as such, but rather provides a specialized liquidation procedure for securities firms in financial difficulties which is designed to accomplish the purposes of the bill in a prompt and fair way, including utilization of any funds advanced by the corporation. In so doing, the bill draws heavily upon the provisions of the bankruptcy laws, many of which are incorporated by reference, but modifies the procedures to the extent determined necessary to accomplish the special purpose of the bill."[183]

The Senate report on SIPA made reference to the existing shortcomings in the Bankruptcy Act:

"Certain shortcomings in Section 60e of the Bankruptcy Act which relate to stockbrokers' bankruptcies have become apparent and SIPA is intended to remedy these shortcomings."[184]

While it is strictly correct to say that SIPA does not, in fact, repeal section 60(e) of the Bankruptcy Act, it has the effect of largely repealing it, as an application for a liquidation under SIPA may be filed notwithstanding the pendency in the same or in any other court of any bankruptcy proceeding[185] and the court is required to stay any pending bankruptcy proceeding.[186]

SIPA makes no provision for the general creditors of the broker-dealer, as opposed to its customers, other than to provide that customers who do not have their claims satisfied in full from the single and separate fund (the concept of which is found in section 60(e)(2) of the Bankruptcy Act and which is continued in SIPA) may share in the general estate of the broker-dealer with the general creditors.[187] The general creditors and customers whose claims are not satisfied in the SIPA proceedings (SIPA does not provide for a discharge of claims not satisfied) who look to the general estate of the broker-dealer to satisfy their claims can, however, only commence or continue proceedings after the SIPC trustee has completed his liquidation proceedings.

Proceedings under SIPA are triggered by the SEC. The SEC, if it is aware of facts which lead it to believe that any member broker or dealer is in or is approaching financial difficulty, is required to immediately so notify SIPC. Similarly, when any of the

183 *Hearings on S. 2348, S. 3988 & S. 3989 before the Subcommittee on Securities of the Senate Committee on Banking and Currency, supra* note 148, at 260-62 (memorandum of the SEC regarding possible amendment of the Bankruptcy Act); SEC v. Wick, 360 F. Supp. 312 (N.D. Ill. 1972).

184 S. Report No. 218, 91st Cong., 2d Sess. (1970).

185 SIPA, s. 5(a)(3)(B).

186 SIPA, s. 5(b)(2).

187 SIPA, s. 6(c)(2)(B).

self-regulatory organizations become aware that a SIPC member is "in or is approaching financial difficulty" it must so notify the SEC.[188]

If the SIPC determines that any member has failed or is in danger of failing to meet its obligations to customers and that any one or more prescribed "danger signals" exist, the SIPC may apply to the court for a decree adjudicating that customers of such member are in need of the protection provided by SIPA. The danger signals are that the member:

"(i) is insolvent within the meaning of section 1(19) of the Bankruptcy Act, or is unable to meet its obligations as they mature, or

"(ii) has committed an act of bankruptcy within the meaning of section 3 of the Bankruptcy Act, or

"(iii) is the subject of any proceeding pending in any court or before any agency of the United States or any State in which a receiver, trustee or liquidator for such member has been appointed, or

"(iv) is not in compliance with applicable requirements under the 1934 (The SEC) Act or rules or regulations of the Commission (SEC) or any self-regulatory organization with respect to financial responsibility or hypothecation of customers' securities, or

"(v) is unable to make such computations as may be necessary to establish compliance with such financial responsibility or hypothecation rules or regulations."[189]

If the court makes an adjudication that customers of a member are in need of the protection provided by SIPA, the court is required to appoint a trustee for the liquidation of the business of that member and an attorney for such trustee as SIPC shall specify.[190]

Once a SIPC trustee is appointed in a SIPC action the procedure that follows is described by the act as a "liquidation proceeding".[191] The purposes of the proceeding are (1) to operate the business of the debtor in order to complete open contractual commitments, (2) to return specifically identifiable property (both cash and securities), distributing the "single and separate fund" to be constituted similar to that required by section 60(e) of the Bankruptcy Act and paying to customers monies advanced by

188 SIPA, s. 5(a)(1).
189 SIPA, s. 5(b)(1)(A).
190 SIPA, s. 5(b)(3).
191 SIPA, s. 6(a).

SIPC, (3) to enforce SIPC's rights of subrogation, and (4) to liquidate the business of the debtor.[192]

In order to accomplish these purposes, a SIPC trustee is given the same power and title over the SIPC member and its property, including the right to set aside preferences as a trustee in bankruptcy. The trustee is also subject to the same duties as a trustee in bankruptcy. He need not, however, reduce into money securities held by a member but not identified as belonging to specific customers.[193] The trustee with the approval of the SIPC may hire and pay all administrative personnel he deems necessary for the purposes of the proceedings.[194]

It is not completely clear what property comes under the jurisdiction of a SIPA trustee. It has been suggested, for example, that as one of the stated purposes of SIPA is "to liquidate the business of the debtor" the personal assets of a debtor who operates a brokerage house as a sole proprietor do not pass to the SIPA trustee and are not included in the liquidation process. It would seem, however, in such a situation that as solvency is predicated upon a debtor's total estate the total estate should be used to meet business debts. It would follow as a corollary that the debtor's personal creditors would be entitled to participate in the distribution of the debtor's general estate subject to the rules of marshalling assets.

A major innovation of SIPA to which reference has already been made is the provision for the completion of open contractual commitments. Section 6(d) provides:

> "The trustee shall complete those contractual commitments of the debtor relating to transactions in securities which were made in the ordinary course of the debtor's business and which were outstanding on the filing date,
> "(1) in which a customer had an interest, except those commitments the completion of which the Commission (SEC) shall have determined by rule or regulation not to be in the public interest, or
> "(2) in which a customer did not have an interest, to the extent that the Commission (SEC) shall by rule or regulation have determined the completion of such commitments to be in the public interest."

The rule established by the commission respecting the completion of open contractual commitments establishes detailed procedures for their completion.

192 *Id.*
193 SIPA, s. 6(b)(2).
194 SIPA, s. 6(b)(3)(A).

"Generally, it permits the completion of fails to receive and fails to deliver between the debtor and another broker-dealer which were made in the ordinary course of the debtor's business and which were outstanding on the filing date. Such open contractual commitments must have arisen from a 'current' transaction, as defined in the rule, in which the other dealer was acting as agent for a customer (or in certain defined principal transactions), and must be bought in, sold out, or closed by delivery of funds and securities promptly in accordance with the provisions of the rule."[195]

The completion of open contractual commitments essentially involves a question of the adequacy of working capital. If and to the extent the debtor's funds are insufficient to complete transactions SIPC may advance to the trustee such monies as may be required to complete them.[196] When the "single and separate fund" is distributed, SIPC is entitled to be repaid in priority to all other claims payable from such fund, the amount of all advances made to permit the completion of open contractual commitments.[197]

While the duty imposed upon the trustee to complete open contractual commitments has the effect of winding down an estate in an orderly manner, it also "means that the brokers with which the bankrupt firm has dealt will probably get paid in full for all cash and securities due them, except where both firms were acting for their own account and not as brokers for their customers".[198]

In order to provide for the prompt payment and satisfaction of net equities of customers of a broker-dealer who has failed, SIPC is also required to advance necessary monies to the liquidating trustee of the broker-dealer from the SIPC fund. There is an overall limit of $50,000 per customer account for a claim for securities and cash left on deposit with a firm. However, where any part of a customer's claim is for cash, as distinct from securities, the amount advanced for the cash part of the claim may not exceed $20,000. Customers who hold accounts in separate capacities are deemed to be a different customer in each capacity. There are certain other limitations on the amounts that may be advanced which primarily prevent advances to be made to a claimant who has an interest in the business of the broker-dealer firm.

SIPC in addition to its right to make advances to complete open contractual commitments and to provide for the prompt

195 SIPA, s. 6(d); SIPC, 3D ANNUAL REPORT 22 (1973).

196 SIPA, s. 6(f)(2); H.R. REP. No. 1613, 91st Cong., 2d Sess. 9 (1970).

197 SIPA, s. 6(c)(2)(B).

198 H. BARUCH, *supra* note 156.

payment and satisfaction of net equities of customers also may make advances to pay administrative expenses of the trustee and may make funds available to pay customer claims within the limits imposed by SIPA. This is designed to ensure the prompt payment and satisfaction of the net equities of customers.

No advance may be made by SIPC to the trustee to satisfy any claims of any customer who is a general partner, officer, or director of the debtor, the beneficial owner of 5% or more of any class of stock, or limited partner with a participation of 5% or more in net assets or net profits of the debtor. No advance may be made by SIPC to the trustee to satisfy the claims of any broker or dealer or bank unless the claims arise out of transactions for customers of the broker or dealer or bank, in which event each customer is deemed a separate customer of the debtor.[199]

The actual liquidation of a debtor's business is not dissimilar to a liquidation under section 60(e) of the Bankruptcy Act. In general the provisions of the Bankruptcy Act apply except where they are inconsistent with SIPA and except also that, in no event, may a plan of reorganization be formulated.

The SIPA, for example, as does section 60(e) of the Bankruptcy Act, divides claimants against the broker-dealer into three classes: (1) cash customers, (2) all other customers and (3) general creditors. The definition of a "customer" is expanded by SIPA. It recognizes that a debtor is not necessarily only a stockbroker but may have been a dealer, *i.e.*, he acted as a principal and that the term "customer" includes a person who had deposited cash with the debtor for the purchase of securities. However, it expressly excludes any person to the extent that such person has a claim for property which by contract, agreement or understanding, or by operation of law is part of the capital of the debtor or is subordinated to the claims of creditors of the debtor.[200]

SIPA also expands the definition of "cash customer" in section 60(e) of the Bankruptcy Act (a customer who is entitled to immediate possession of securities without the payment of any sum to the debtor) to include one who is entitled to the immediate possession of "cash" as well as of securities. The same person may be a "cash customer" as to certain securities or cash and not a "cash customer" with reference to other securities or cash.[201] Guidelines set by SIPA to determine whether property was allocated to or specifically set aside for customers recognize that brokers or dealers keep property in street name and utilize bookkeeping segregation and

199 SIPC, 3D ANNUAL REPORT 22 (1973); SIPA, s. 6(f)(1)(C)(D).

200 SIPA, s 6(c)(2)(A)(ii).

201 SIPA, s. 6(c)(2)(C).

that securities may be held in a central or similar depository in bulk segregation.[202]

SIPA, like section 60(e) of the Bankruptcy Act, provides that all customers other than cash customers constitute a single and separate class of creditors entitled to share rateably in the single and separate fund on the basis of their net equities and subject to certain priorities. If the "single and separate fund" is insufficient to pay the cash customers in full, they are entitled to share in the debtor's general estate with his general creditors.

While SIPA contemplated that trustees could make payments to customers in the interests of speedy settlements whether or not they have filed a formal proof, the:

> "SIPC has taken the position that advances should not be made until the trustee and the SIPC are satisfied that claims are *bona fide* and accurate. Experience to date has warned of the need to be watchful for fraudulent claims or at least erroneous ones. The state of the books and records frequently is such that it is possible for claims to be misstated under circumstances making difficult detection and prevention of overpayments or improper payments."[203]

This cautious approach has lead to some criticism of SIPC. The delay in payments has not helped to increase the confidence of investors in the industry which was one of the principal reasons for the enactment of SIPA. The SIPC liquidation that has been completed in the shortest period of time involved a firm where a total of six claims were received. It took twenty-two months to complete the liquidation.[204]

The SIPC has however accomplished a good deal. At the end of 1977, which was the seventh anniversary of the enactment of SIPA, 128 firms had been placed in liquidation under the act.[205] Of this number the liquidation of all but five have been completed or substantially completed – that is, all claims except problem claims have been satisfied. The value of cash and securities distributed for accounts of customers to December 31, 1977, is approximately $279 million. In 1977 seven firms were placed in SIPC liquidation. This compares with four in 1976, eight in 1975, fifteen in 1974 and forty in the high year, 1972.[206]

202 *Id.*
203 SIPC, 1ST ANNUAL REPORT 26 n. 44 (1971).
204 Duff, *supra* note 181, at 990. The firm referred to was that of Lang-Lasser & Co. of Beverly Hills, California. The trustee was appointed on September 14, 1971. The liquidation was closed on July 16, 1973.
205 SIPC, 7TH ANNUAL REPORT 4 (1977).
206 *Id.* at 5.

There has been some general criticism of the drafting of SIPA. Difficulties often arise in its practical application. The court, for example, in *SEC v. Aberdeen Securities Inc.*, observed:

> "The intent of Congress to protect customers of financially distressed security dealers is clear, but the specifics of precise resolution of individual situations are clouded by the provisions of a statute which range far from the clarity of the blue sky one might expect in this area of the law."[207]

As a result of general criticism of the legislation and a desire to remedy the shortcomings of the act, a special task force was created by SIPC in 1973 to consider ways and means, including legislative proposals, to improve the program of customer protection under SIPA. In announcing the composition of the task force the chairman of SIPC said:

> "The Securities Investor Protection Act of 1970 was an innovative and exemplary piece of remedial legislation, evolved principally through the cooperative efforts of the Congress, the Securities and Exchange Commission, and the securities industry itself. In general it has worked well, and thousands upon thousands of securities investors have been greatly benefitted. However, as with any new legislation, only experience can demonstrate its precise efficacy and suggest areas of possible improvement. Now that SIPC has had experience in the liquidation of 94 firms over a three-year period it is appropriate for it to join with other interested and knowledgeable parties in a common effort to improve this program of customer protection."[208]

SIPC was not unaware of the practical problems involved. The first large broker-dealer liquidated by SIPC was Weiss Securities, Inc., a member of the NYSE with some 32,000 active customers. As Weiss had maintained an apparently accurate system of computerized customer account records, the trustee was able to begin settling customer claims immediately upon his appointment. Within three months the trustee had processed and approved for payment some 92% of the customer claims filed. Notwithstanding, some 5% of the customers filed objections with the court to the trustees' proposed distribution. Approximately 10% of the customers corresponded with the trustee concerning settlement of their claims. The principal complaints were the sale by banks of the

207 SEC v. Aberdeen Securities, Inc., 480 F.2d 1121 (3d Cir. 1973); on the confusion that exists in the jurisdiction of a SIPA Court, *see* Karmel & Weissman, *Taking Stock of the Court's Jurisdiction in a SIPA Liquidation*, 41 BROOKLYN L. REV. 1 (1974).

208 SIPC, 3D ANNUAL REPORT 5 (1973).

hypothecated margin securities of customers and the disruption which the customer experienced in the normal flow of dividends and other distributions. From the Weiss experience it became even more apparent that the liquidation procedures prescribed by SIPA are in some respects inefficient, expensive, inflexible and not necessarily the speediest methods possible.[209]

The task force made its report in July of 1974. Broadly, the report recommended that SIPC's role should remain that of a liquidator and not a regulator, that broker-dealers in financial difficulty should continue to be liquidated rather than rehabilitated, that procedures for satisfying customers' claims be speeded up and that increased investor protection be made available.

Perhaps the single most important specific change recommended by the task force is for customers to receive the contents of their accounts just as they were when the broker-dealer went out of business. The recommendation was that:

> "[A] customer should receive securities to the maximum extent possible in satisfaction of a claim for securities. Customers whose claims fall within the limits of protection provided by the act should receive their accounts as they stood on the filing date. In furtherance of this end, the trustee should be authorized to use customer-related assets or SIPC funds to:
>
> "(a) Purchase securities in the open market or complete open contracts, as desired by the trustee, to obtain securities needed to restore customers' accounts.
>
> "(b) Pay or guarantee bank loans and thereby reclaim hypothecated securities."[209a]

The second part of this recommendation relating to margin customers has the effect of putting the margin customer in the same position as cash customers, reversing the effect of section 60(e) and SIPA in which margin customers have a priority following cash customers.

The task force was of the opinion that the margin customer should not bear any greater proportion of the loss occasioned by the failure of a broker-dealer than a cash customer. The objective of the task force was to structure a SIPC liquidation in such a way that there are only two classes of claimants, customers and general creditors apart from subordinate lenders and equity holders. The concept of "a single and separate fund" would be eliminated and

209 SIPC, REPORT OF THE SPECIAL TASK FORCE TO CONSIDER POSSIBLE AMENDMENTS TO SIPA (1974), *reprinted in Hearings on H.R. 8064 before the Subcomm. on Consumer Protection and Finance of the House Comm. on Interstate and Foreign Commerce*, 94th Cong., 1st Sess. 59, 60-61 (1975).

209a *Id.* at 63.

all property which can be identified to customers as a whole would be distributed rateably.

In the interest of speeding up the satisfaction of customers' claims it was recommended that a SIPC trustee be authorized to transfer accounts in bulk to another broker-dealer without the consent of the customer and to indemnify the receiving broker-dealer against loss within certain limits. This would give the customer quick access to his account. He would not however be obligated to leave the account with the new firm. It is recognized that the bulk transfer of accounts is only feasible when the firm that failed has accurate and complete customer records and the trustee is able to find another firm willing to take on the accounts. It was the opinion of the task force that the prompt transfer of accounts coupled with appropriately limited indemnification will prove to be the most practical procedure in terms of satisfaction of customers' claims.

Where bulk transfer is not practical, customers who have debt balances in their accounts would be permitted to pay them and receive securities to which they are entitled.

The task force considered the specific application of their recommendations to the allocation of property to customers. It was the opinion of the task force that the following plan of allocation comports with, and carries out the intent of its recommendations in this regard.

> "(1) Monies in customer segregated bank accounts should be allocated *pro rata* to customers with free credit balances.
>
> "(2) Securities in the possession or control of the debtor should be allocated *pro rata* to customers, issue by issue on the basis of each customer's ownership interest in each issue, without distinguishing between cash and margin customers. Securities registered in the names of individual customers, however, should be returned to customers entitled thereto, as is currently done.
>
> "(3) Each customer's claim for cash and/or securities remaining unsatisfied after application of (1) and (2) above would be valued, using filing date prices. The resultant dollar values would be aggregated to determine the total dollar value of remaining unsatisfied claims.
>
> "(4) The expenditure required to restore each account to its filing date status would be determined by adding to unsatisfied cash claims the amount of funds necessary to purchase in the open market the shortfall in securities claimed by customers beyond those recoverable from bank loan.

"(5) The resources available to the trustee, before consideration of any SIPC advances for the purposes of restoring accounts, would be determined. Such resources would primarily consist of customers' debit balances, the market value on the filing date of customer short security positions and the market value on the filing date of securities on hand which relate to open contracts such as customer-related fails to deliver, stock borrowed, COD contracts, and securities due to CNS systems, which are not to be completed and which were not allocated as possession or control securities.

"(6) If the aggregate dollar value of the resources available to the trustee in (5) above equals or exceeds the aggregate dollar value of the claims in (4) above, each customer's account would be restored to its filing date status without the use of SIPC funds, other than for any net losses due to market fluctuations which would be borne by SIPC.

"(7) To the extent that the resources available are less than the funds needed to restore the accounts to their filing date status, such shortfall will be allocated to customers based upon the proportion that each customer's claim in (3) above bears to the total dollar value of all remaining claims in (3) above.

"(8) Any customer whose *pro rata* share of the shortfall is within the limits of protection provided by the act will have his account restored to its filing date status. For those customers whose *pro rata* share of the shortfall exceeds the SIPC limits, the trustee will determine at his discretion which securities are not to be returned.

"(Note: Each customer's *pro rata* share of the shortfall would first be applied against his unsatisfied claim for securities, if he has claims for both securities and cash.)

"It is important to understand that the steps outlined do not result in any distribution to customers. Rather they constitute a method of ascertaining the aggregate shortfall in customer property and the resources needed to reconstitute customers' accounts. The procedure involves first equitably allocating available or obtainable customer property then computing and allocating rateably the aggregate shortfall in property needed to reconstitute customer accounts. In every instance where a customer's *pro rata* share of the shortfall is less than the protection

> provided by SIPC, the customer would receive his account intact."[209b]

Another recommendation of the task force was that the trustee should have broader authority to operate the business of the debtor:

> "1. For a limited period of time in order to preserve the saleability of certain assets of the debtor, such as branch offices;
>
> "2. To arrange interim financing to facilitate the transfer of accounts from a debtor to a transferee or purchaser of assets; and
>
> "3. To margin and maintain accounts in accordance with prescribed standards."[209c]

On the assumption "that a court will stay banks from liquidating securities held as collateral and that a trustee will be able to hold the debtor's sales and back office personnel together for a short period of time while he determines the aggregate shortage of customer property and negotiates with potential purchasers of the debtor's assets or other transferees".[209d]

The report gave consideration to requiring the trustee to complete all open contractual commitments as if in the ordinary course of business.

> "After deliberation, the task force concluded that this was not a viable alternative. There are situations where completion is not desirable, such as where no orderly market exists. This frequency occurs where the debtor is the principal market-maker for the issue in question. For the trustee to complete all transactions promptly would entail a significant administrative burden during the critical first days of a liquidation; to delay completion would subject SIPC to prolonged market risk. Also, complex problems would have to be resolved concerning the status of clearing corporations and concerning institutions which deal on a COD basis. Finally, completion of all open contractual commitments without regard to whether a customer had an interest in the transactions would result in direct protection of broker-dealers with SIPC funds in some situations. The legislative history of the 1970 act indicates that Congress did not favor extending SIPC protection in such situations, and the task force did

209b *Id.* at 68.
209c *Id.* at 69.
209d *Id.*

not find compelling reasons to suggest modification of that position."[209e]

The report also called for the increase of the present limits of protection to $125,000 per customer, with a $50,000 maximum for cash claims from the present limits of $50,000 and $20,000, respectively.

One significant omission from the report is that it did not propose extending protection to commodity traders. The reason would appear to be that the great majority of broker-dealers do not handle futures trading and the Commodity Futures Trading Commission is working on a plan of its own.[210]

Legislation to amend the SIPA, based on the report, but which would increase the present limits of protection only to $100,000 per customer with a $46,000 maximum for cash claims, was passed by the House on November 1, 1977. Senate hearings are expected by the fall of 1978.

D. PROTECTION OF CUSTOMERS THROUGH LIABILITY INSURANCE

Some broker-dealers in the United States have provided protection to customers through liability insurance additional to that provided by SIPC.

In October 1973 Merrill Lynch, Pierce, Fenner & Smith announced that it would provide up to $250,000 worth of surety insurance on the securities it holds for each customer. This is protection in addition to the $50,000 maximum per customer provided by SIPC. Since then about thirty other firms have introduced similar insurance programs.

Recently, the NYSE spent some time in an effort to develop a plan for excess customer-insurance protection for brokers. This was prompted by the fact that there had been some brokers that had apparently been turned down by insurers at a time when others had obtained supplementary insurance in substantial

209e *Id.* at 71.

210 Section 417 of the Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463 (1974) directs the commission to consider "the need for legislation insuring owners of commodity futures accounts and persons handling or clearing trades in such accounts against loss by reason of the insolvency or financial failure of a futures commission merchant carrying such accounts". In the 37-year period from 1938 to 1974, there were 44 insolvencies of commission merchants dealing in regulated commodities resulting in $1,260,396 of customer funds being jeopardized. Inflated to 1974 dollars, this figure becomes $2,282,614. During the same period there were 13 insolvencies of merchants dealing with non-regulated commodities resulting in approximately $2,925,949 of customer funds being jeopardized which inflates to $3,724,413 in 1974 dollars; J. HELMUTH, REPORT TO CONGRESS CONCERNING COMMODITY FUTURES ACCOUNT INSURANCE (November 1, 1976) (reporting that there was no need for commodity account insurance).

amounts. In November of 1974 the NYSE chairman reported that "the insurance program kind of died of its own weight". He cited member firm resistance to the added cost of increased protection. He also gave as another reason for the lack of strong member firm interest the contemplated increase in SIPC protection from $50,000 to $100,000. The Midwest Stock Exchange and the NASD have also shown some interest in developing a group approach to insurance.[211]

The Securities Industry Association likewise attempted to develop a comprehensive plan of excess customer insurance, which would be available to members on a voluntary basis if there was enough interest. The association believed that excess coverage to about $300,000 could be obtained at an annual premium substantially lower than the $25,000 often mentioned as a minimum. Initially, some broker-dealers believed that firms with coverage might obtain a "competitive edge" in the industry. It seems not to have happened, which is a reason for the less than enthusiastic interest in excess coverage.[212]

The Securities Industry Association recently abandoned its study to provide excess SIPC insurance coverage. After several surveys it was found that there was not sufficient interest among its membership. The prospects for additional SIPC coverage to a maximum of $100,000, to be provided in legislation expected to be considered by Congress shortly, was the principal reason for the marked reduction in interest in excess coverage.[213]

E. REGULATION OF SECURITIES MARKETS IN THE UNITED STATES

Prior to the enactment of the Securities Exchange Act of 1934, stock exchanges, unless incorporated under certain state laws, were "subject to regulation by no governmental authority and...exercised unrestricted dominion over the activities of their members".[214] Exchanges were usually voluntary unincorporated associations, which were regarded both by the exchanges and the courts as private business clubs with the right to establish their own rules for admission, expulsion and discipline without judicial interference. The courts considered that the rules of an exchange as contained in its constitution and by-laws constituted a "contract by which each member had consented to be bound, and which measured his duties, rights and privileges".[215]

211 Securities Week (New York), November 11, 1974, at 3.
212 Securities Week (New York), December 9, 1974, at 20.
213 Securities Week (New York), March 3, 1975, at 10.
214 S. Rep. No. 1455, 73d Cong., 2d Sess. 77 (1934).
215 Belton v. Hatch, 109 N.Y. 593, 17 N.E. 225, 256 (1888); and *see* Securities Industry Study, Report of the Subcomm. on Securities of the Senate Comm. on Banking,

For many years the exchanges of the United States exercised virtually unrestricted control over their members and successfully resisted almost all attempts to place them under state or federal regulation. In 1932, a Senate investigation found that the exchanges had done little to upgrade their standards, and reforms had occurred only "during periods of popular agitation or when legislative action was threatened".[216] The investigating committee summarized its findings as follows:

> "[First] the view that internal regulation obviated the need for governmental control was unsound for several reasons. In the first place, the interests of exchanges and their members frequently conflicted with the public interest. Thus, it was amply demonstrated...that some of the methods employed by the stock-exchange members to stimulate active trading were technically in conformity with stock-exchange rules and yet worked incalculable harm to the public. Second, the securities exchanges have broadened the scope of their activities to the point where they are no longer isolated institutions but have become so important an element in the credit structure that their regulation, to be effective, must be integrated with the protection of our entire financial system. Third, stock-exchange authorities have taken the position that they would regulate only their own members and that they had no power to prevent abuses by operators who were not members of the exchanges, but who used their facilities to impose upon the public. Fourth, the attitude of exchange authorities toward the nature and scope of the regulation required was sharply at variance with the modern conception of the extent to which the public welfare must be guarded in financial matters."[217]

By reason of the "evils and abuses which flourished on the exchanges and their disastrous effects upon the entire nation ... Federal regulation was necessary and desirable", in the opinion of the Senate committee. It was no longer appropriate, it felt, to regard stock exchanges as "private clubs to be conducted only in accordance with the interests of their members".

> "[They were in fact] public institutions which the public is invited to use for the purchase and sale of securities listed therein....The great exchanges of this country upon which millions of dollars of securities are sold are

HOUSING AND URBAN AFFAIRS, 93d Cong., 1st Sess. 137 (Comm. Print 1973).

216 S. REP. No. 1455, *supra* note 214, at 138.

217 *Id.* at 138.

> affected with a public interest in the same degree as any other great utility."[218]

As a result of the Senate report and public agitation, the Securities Exchange Act of 1934 was enacted. Representative Sam Rayburn who was actively involved in the passage of the legislation said:

> "As a complex society so diffuses and differentiates the financial interests of the ordinary citizen that he has to trust others and cannot personally watch the managers of all his interests as one horse trader watches another, it becomes a condition of the very stability of the society that its rules of law and business practice recognize and protect the ordinary citizen's dependent position."[219]

President Franklin D. Roosevelt, in a special presidential message in respect of the legislation, said:

> "Outside the field of legitimate investment naked speculation has been made far too alluring and far too easy for those who could, and those who could not, afford to gamble."[220]

The Securities Exchange Act gave the Securities and Exchange Commission (SEC) a broad rule-making authority over the activities of investors and exchange members. Thus, the commission had direct regulatory power over all exchange members insofar as they engage in "excessive trading". Since 1938 it has had authority to regulate financial responsibility standards for all broker-dealers. The Securities Reform Act of 1975 extended its authority by giving the commission the power to abrogate, add to or delete from, rules of any of the self-regulatory bodies. The commission also has authority to define and prohibit "manipulative and deceptive devices". Notwithstanding these broad powers of regulation, the exchanges were left with a wide measure of initiative and responsibility. The SEC has, however, a powerful "reserved control...if the exchanges do not meet their responsibilities".[221] The rationale of the act was that government regulation be used only to supplement and supervise what in the first instance was self-regulation of the exchanges. The final House committee report said:

> "Although a wide measure of initiative and responsibility is left with the exchanges, reserved control is in the Commission if the exchanges do not meet their responsi-

218 *Id.*

219 H.R. Rep. No. 1383, 73d Cong., 2d Sess. 5 (1934).

220 February 9, 1934, *quoted in* Comment, *Negligent Misrepresentation under Rule 10b-5*, 32 U. Chi. L. Rev. 824, 829 n. 22 (1965).

221 *Hearing on H.R. 7852, H.R. 8720 before the House Committee on Interstate and Foreign Commerce*, 73d Cong., 1st Sess. 513 (1934).

bility. It is hoped that the effect of the bill will be to give to the well-managed exchanges that power necessary to enable them to effect themselves needed reforms and that the occasion for direct action by the Commission will not arise."[221a]

In 1938 Congress amended the Securities Exchange Act of 1934 by adding section 15A, which provided for the formation of one or more national securities associations to police the over-the-counter markets. It set detailed standards which any such association would have to meet and the substantial duties it would have to perform in order to exercise the statutory powers. Pursuant to these provisions, the National Association of Securities Dealers (NASD) was formed and registered in 1939.

The degree of regulatory authority of the SEC used to be significantly greater over NASD than the exchanges. Inversely, the right of self-regulation was greater for the exchanges than NASD. This was changed by the Securities Reform Act of 1975 establishing a new coordinated pattern of registration and regulation for national securities exchanges and securities associations.

A brief statement of the concept of cooperative regulation was contained in a 1964 address by commissioner (later chairman of the SEC) Manuel F. Cohen.

"*First:* Congress vested the Commission with primary responsibility for effectuating the purposes of the law. This requires the Commission to act directly in many areas. But unlike other federal regulatory agencies, the Commission discharges only a portion of this responsibility directly.

"*Second:* A major part of this responsibility is delegated to the self-regulatory agencies. They are to enforce compliance by their members not only with legal standards but with ethical concepts as well. They are authorized to fix standards and control practices of their members, within such concepts as the 'promotion of just and equitable principles of trade' which obviously allow a wide range of activity. In some respects these powers are broader than the Commission's authority.

"*Third:* To discharge these responsibilities, the self-regulatory agencies are vested with governmental powers which are to be exercised in the public interest and for the protection of investors. This is perhaps the key difference between a self-regulatory body and a trade association,

221a *Id.*

which is not the recipient of delegated government powers.

"*Fourth:* To aid in assuring that they perform effectively in the public interest and that they do not misuse their powers the Commission has certain oversight responsibilities. The Commission is empowered to act on its own, directly or through authority with respect to the rules of the self-regulators, when the latter do not or cannot act.

"These are the essential ingredients. Merely listing them demonstrates the cooperative character of the system."[222]

Periodic financial and operational reports must be filed by all registered broker-dealers. As a result of the 1971 *Study of Unsafe and Unsound Practices of Brokers and Dealers*, an office of Broker-Dealer and Investment Adviser Examinations was created with the SEC. The office is designed to develop and administer a program for more frequent and intensive inspection of broker-dealers and through the improved oversight of and coordination with the inspections given by the self-regulatory agencies as well as to strengthen the investment adviser inspection program.

The back office and operations crisis of 1967–1970 prompted the SEC to introduce a wide range of rule changes designed to correct the practices that led to the crisis and in general to protect the customer of a broker-dealer before bankruptcy. The SIPA specifically authorized the commission to prescribe rules and regulations necessary or appropriate in the public interest or for the protection of investors to provide safeguards with respect to the financial responsibility and related practices of all brokers and dealers, whether trading on an exchange or in the over-the-counter market, including, but not limited to, the acceptance of custody and use of customers' securities and the carrying and use of customers' deposits or credit balances.[223]

The most important rules designed to control the financial responsibility of broker-dealers are those that govern their net capital rates. Net capital rules have been described as one of the most important weapons in the commission's arsenal to protect investors.[224] In addition to the rules promulgated by the SEC,[225] rules have also been made by several state securities commissioners, the NYSE and other self-regulatory agencies. The ratio of

222 Address by Manuel F. Cohen, Institute of Investment Banking, Philadelphia, March 10, 1964, *quoted in* SECURITIES INDUSTRY STUDY REPORT, *supra* note 22, at 83, 84.

223 SIPA, s. 7(3).

224 Blaise D'Antoni & Assocs. v. SEC, 289 F.2d 276, 277 (5th Cir. 1961), *cert. denied* 368 U.S. 899 (1961) (*per* Wisdom, J.).

225 Rule 15c3-1, 17 C.F.R. s. 240.15c3-1 (1977).

aggregate indebtedness to net capital currently established by the SEC and all state securities commissioners having net capital rules is 20:1, except for Ohio and the NYSE, where a net capital ratio of 15:1 is required. The SEC is considering reducing the ratio to 15:1.[226] The SEC has reduced the maximum net capital ratio for new broker-dealers for the first year of their operations to 8:1. At the same time, the SEC rule was amended to increase the minimum net capital required by most broker-dealers from $5,000 to $25,000.

In order to speed up the warning that a broker-dealer may be in financial difficulty, the SEC recently promulgated rules intended to provide it and the various self-regulatory organizations with an adequate and timely flow of information on the financial and operational condition of broker-dealers. The rule has four major provisions: (1) immediate telegraphic notice by a broker-dealer to the SEC and any self-regulatory organization of which it is a member followed by a financial report within twenty-four hours when its net capital falls below the level required by any capital rule to which it is subject; (2) the filing by a broker-dealer of special monthly reports until its capital position shows improvement for three successive months when its aggregate indebtedness exceeds 1,200% of its net capital or its total net capital or less than 120% of the minimum net capital required of it by any capital rule to which it is subject; (3) immediate telegraphic notice by a broker-dealer to the appropriate regulatory authorities followed by a written report within forty-eight hours when a broker-dealer's books and records are not current; and (4) notification to the SEC by a self-regulatory organization when it learns that a member has failed to give notice or file any report required by the rule.[227]

A financial responsibility rule (15c3-3) promulgated by the SEC became effective as of January 15, 1973. It is entitled "Customer Protection – Reserves and Custody of Securities". It represents the first comprehensive step by the SEC to regulate the safekeeping of customers' funds and securities in the possession of brokers or dealers. The rule imposes varying requirments on broker-dealers to better safeguard customer property. It deals with the obligation of a broker-dealer to maintain physical possession or control over securities left with it by a customer and to have basic reserves against customer cash, and cash realized through utilization of customers' securities. The rule "addresses itself to three

226 SEC, Securities Exchange Act of 1934 Release No. 10,525, November 29, 1973, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶79,566.

227 Rule 17a-11, 17 C.F.R. s. 240.17a-11 (1977); *see* SEC, 38TH ANNUAL REPORT 59, 60 (1972); Guttman, *supra* note 146, at 894.

primary areas of customer protection: (1) the obligation of a broker-dealer to promptly take possession or control of all fully-paid securities and excess margin securities carried for the account of customers; (2) a formula for a cash reserve for all customer funds not used in customer-related transaction; and (3) separation of the brokerage operations of a firm from its other activities".[228] The restrictions on the use of customers' funds and securities and the requirement that securities be promptly brought under physical possession or control are designed to protect customers' assets on liquidation. The rule was also intended to restrict unwarranted or over-expansion of a broker-dealer's business, as it would prohibit the utilization of customers' funds and customer-derived funds in areas of the firm's business such as underwriting trading and overhead.[229]

In order to provide better physical control over securities the SEC adopted Rule 17a-13 ("Box Count" rule), which requires broker-dealers to make a quarterly physical examination and count of firm and customers' securities held, and to verify securities subject to firm control or direction but not in the firm's physical possession. During the 1967–1970 period the relevant rules relating to the movement and location of securities provided for only a once-a-year check as part of the audit required by a broker-dealer in its annual report of financial condition.

All regulations are primarily directed toward the protection of customers' funds and securities. If the regulations are observed the operation of a securities firm is not risky. When failures have occurred there generally has been some wrongdoing on the part of principals or employees of the firm or neglect in the observation of the regulations promulgated by the SEC or of the exchanges or NASD. In such cases, or where a firm is facing failure for any reason, the exchanges and NASD have developed practices designed to salvage the firms in the interests of protecting customers. Only in the last resort in such cases is it expected that customers would be obliged to look to SIPC for protection.

The recent failure of Weiss Securities, Inc., is a case in point. In April 1973 several principals of Weiss informed the NYSE of which it was a member firm that the firm "may have" been "understating its profit and loss report to the exchange by several million dollars". The exchange immediately launched an intensive investigation of Weiss' problems and attempted to aid it in improving its capital position so that the firm would survive and customer safety would be assured.

228 SEC, 38TH ANNUAL REPORT 59 (1972).
229 *Id.*

As a result of the investigation and study made by the exchange a merger of Weiss with a stronger firm was suggested. Weiss accepted this suggestion and in turn proposed to the exchange that, pending negotiations and consummation of the merger, it transfer some of its larger margin accounts to the other firm in order to effect an automatic and immediate improvement of its debt-capital ratio. This suggestion was approved by the exchange as a time-tested technique of restoring stability to financially troubled firms. Weiss then unilaterally selected and transferred to the other firm those accounts with the largest debit balances.

The director of the SEC's Division of Market Regulation in commenting on the operation said:

> "It is an accepted practice when a broker-dealer is approaching financial difficulty for...self-regulatory organizations, including the NYSE, to undertake various measures in an effort to place the broker-dealer in a stronger financial posture and to thereby limit overall customer exposure. Such efforts frequently result in the merger, rehabilitation or, if necessary, self-liquidation of the broker-dealer without loss to customers and without the delay and inconvenience which may attend a forced liquidation under the SIPC Act. One step often taken to improve a broker-dealer's financial posture is to reduce the firm's liabilities, and accordingly, reduce the amount of capital required to support these liabilities....
>
> "One possible avenue for reducing a firm's net capital ratio is to reduce the amount of bank borrowings collateralized by customers' margin securities thus reducing aggregate indebtedness which in turn effects a lower net capital ratio.
>
> "In order to reduce bank borrowings collateralized by customers' margin securities, customers' accounts with debit balances are delivered to other broker-dealers who are willing to assume responsibility for such accounts....
>
> "While these efforts to unwind the affairs of Weiss without resort to a SIPC liquidation were unsuccessful, such efforts in other instances appear to have been successful in avoiding forced liquidations of broker-dealers and the disruption inherent in such liquidation proceedings."[230]

There is no doubt however that customers' funds and securities are much better protected in the United States by the major changes since the crisis of 1967–1970. The SEC in a recent report summa-

230 Rich v. New York Stock Exchange Inc., 379 F. Supp. 1122 (S.D.N.Y. 1974).

rized the advances in the provision of stricter standards and procedures and the improved surveillance program:

> "While the changes in the securities industry since 1967 culminated with the adoption of Rule 15c3-3, it is important to emphasize other major advances of the past several years which the Commission believes provide a basis for the belief that the operational failures which result from increased trading volume and inadequate systems for the control and delivery of securities should not recur. Also, the Commission believes that the ultimate objective of improving business practices in the securities industry to serve and protect investors is approaching realization.
>
> "Such recent advances include:
>
> "1. The development and almost universal acceptance of the continuous net settlement system ("CNS") for the completion of securities transactions coupled with the use of securities depositories and other processing facilities and the progress toward realization of a nationwide clearance and depository system.
>
> "The improvement of these systems not only reduces exposure to operational problems and exposure to theft inherent in the physical handling and processing of securities, but also protects the broker-dealer community from loss to it or its customers occasioned by the failure of any given broker-dealer. Transactions completed through such systems are marked to the market on a daily basis minimizing the risk to the system and its members who are required to maintain substantial clearing fund deposits with such systems not only as collateral for their own obligations but also to provide additional protection to such systems which should be used only to satisfy losses incurred by the default of other members.
>
> "2. The development of more comprehensive recordkeeping and control requirements including the quarterly count and verification of securities positions and expanded requirements of independent public accountants to (1) review the procedures for compliance with Rule 15c3-3 and margin requirements of the Federal Reserve System; and (2) comment upon any material inadequacies in systems of accounting control and procedures for safeguarding securities.
>
> "3. The implementation by the Commission and the self-regulators of more vigorous buy-in requirements respecting incompleted transactions with both broker-dealers and their customers.

"4. The development by the Commission and the self-regulatory organizations of comprehensive examination and surveillance programs which have been of significant importance in the timely detection of operational and financial difficulties experienced by broker-dealers. Of equal importance is the concern and premium that broker-dealers themselves now place on the effective management and control of their securities processing and other operational areas.

"5. The development of the Joint Regulatory Report and the steps taken by the Commission to develop a FOCUS Report which will ultimately provide for more effective analysis of the financial and operational condition of broker-dealers.

"6. The development by the Commission and the self-regulators of substantially more effective requirements for retaining both equity and subordinated capital which has eliminated impermanent capital and the probability of a recurrence of a dangerous flight of capital from the securities industry at times when permanent capital is most necessary."[231]

The Securities Reform Act of 1975 made important amendments to preserve and reinforce the concept of industry self-regulation with oversight of the SEC. Standards were set to assure that self-regulatory organizations follow effective and fair procedures and to design rules, *inter alia*, to prevent fraudulent and manipulative acts and procedures, to promote just and equitable principles of trade and to protect investors and the public interest. The SEC is given the power to take action against an exchange or an association upon a finding that the organization has failed to enforce its own rules or Securities Exchange Act provisions, or rules or regulations thereunder.

Chapter IV
Commodity Futures Options and Commodity Options[231a]

The struggle for investor protection can be regarded as being only one aspect of the consumer revolution.[232] The general public and government for many years have expressed concern about the

231 SEC, Securities Exchange Act of 1934 Release No. 11094, November 11, 1974 [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶80,006.

231a I gratefully acknowledge the valuable assistance of Peter Bacsalmasi, a graduate student in business administration at York University, in the preparation of this chapter.

232 H. BARUCH, *supra* note 156, at 298.

investor in securities. There has not been anywhere near the same concern demonstrated in respect of the special interests of consumers and indeed the government itself in the operation of commodity exchanges.

A. COMMODITY FUTURES TRADING

Sometimes governments have justified regulating the sale of securities on the ground that shareholders, estimated to number in the neighbourhood of thirty million in the United States, are the largest single consumer group in the country. What is often overlooked is that every citizen is affected by commodity exchanges in that they establish prices of commodities that affect not only producers, merchandisers and processors but also inventory values, domestic consumer prices, world commodity prices and government fiscal policy.[233]

In 1972, The Conference Board, an independent, nonprofit business research organization, reported that despite the obscurity and lack of public awareness of trading activities of commodity exchanges, the dollar value of futures trading in the United States was more than half that of the U.S. security exchanges.[234]

In Canada, most trading in commodities centres around the western grain and gold markets. The Winnipeg Commodity Exchange, founded in 1887 and until 1972 known as the Winnipeg Grain Exchange, limited its futures trading for many years to the five grain products not controlled by the Canadian Wheat Board, namely, rapeseed, flax, rye, oats and barley. Since 1969, the exchange has been branching into other commodities, setting up markets in beef, potatoes and gold. This expansionary policy will continue, said the president of the exchange:

> "We are interested in trading any commodity for which there would be a viable market. At the moment we are studying the possibility of adding markets for rapeseed oil and rapeseed meal and we are also looking into silver and lumber....The exchange recorded 14,500 gold trades in the first fourteen months of the market's operation to the end of December 1973. This year we expect between 60,000 and 70,000 trades."[235]

The following is a list of the different commodities that are at present actively traded on North American markets:

Grain: wheat, corn, oats, barley, sorghums, milo, flax, rye.

233 Vogelson, *Tightened Regulation for Commodity Exchanges*, 55 A.B.A. J. 858 (1969).

234 B. Berlin, Corporate Use of Commodity Futures (Conference Board Report 1972).

235 The Globe and Mail (Toronto), Tuesday, May 14, 1974 (interview with Ronald S. Ennis, president, Winnipeg Commodity Exchange).

Oilseeds: soybeans, rapeseed, flaxseed, cottonseed.
Fats and oils: soybean oil, cottonseed oil, peanut oil.
Livestock feeds: cattle, hogs, broilers, pork bellies, skinned hams, fresh eggs, frozen eggs, boneless beef, turkeys.
Fibres: cotton, wool, wool tops.
Foods: potatoes, apples, orange juice, butter, sugar, coffee, cocoa, tomato paste.
Forest products: plywood, lumber, rubber.[236]
Metals: platinum, copper, tin, mercury, gold, silver, lead.
Other: propane, foreign currency, U.S. silver coins.

Commodities must meet certain requirments or criteria and have special characteristics before they can be listed or feasibly traded on the futures markets. These are:

(1) Units must be homogeneous; *i.e.*, that traders be able to buy or sell according to established grades and descriptions. Each item must be able to be graded or classified whereby every unit of one commodity may be regarded commercially as the equivalent of a certain number of units of the other (*i.e.*, they must be fungible).
(2) Supply and demand must be large, whereby no one financial body might gain control over an item and obstruct the mechanics of the free market. Furthermore, supply and demand must be uncertain and subject to fluctuations from time to time. Otherwise, commodities with definite markets and sources of supply have no need of the organized market machinery.
(3) The commodity must be relatively durable. Contracts may call for delivery many months in the future.[237]

Transactions in commodities can involve either futures contracts or spot (cash) transactions. A futures contract is an agreement executed on a commodity exchange to buy or sell a definite quantity of a specified commodity of a certain grade in the future. Only 1% or 2% of futures contracts ever reach maturity.[238] They are usually settled by an offsetting futures contract, either before or during the delivery month specified in the contract. This is known as a "round-term".[239] A spot (cash) transaction involves delivery of the commodity purchased and accordingly does not

236 The governors of the Commodity Exchange Inc. of New York recently approved preliminary plans for the reactivation of trading in rubber futures contracts; The Globe and Mail (Toronto), August 31, 1974, at B4.

237 T. Hieronymus, Economics of Futures Trading (For Commercial and Personal Profit) 28, 33 (Commodity Research Bureau Inc. 1971).

238 *Id.*

239 American Institute of Certified Public Accountants, Audits of Brokers and Dealers in Securities 7, 105 (1973).

interest commodity investors as they are not interested in making or accepting delivery of a commodity.

The majority of trading activities are carried on by agricultural and industrial producers and manufacturers who must carry large physical quantities of commodities in inventory and are subject to the risk of price fluctuations. The futures market affords these users a means of price protection by enabling them to hedge the physical quantities of commodities in inventory in either their raw or finished state.[240]

> "There are basically two types of hedging operations. A company with a large inventory on hand can protect itself against a loss on the value of its cash stocks by *selling* an equal amount of the commodity in the futures market. This is called 'selling short'. If the value of the cash commodity drops before it is sold, the company would take a loss on its cash transaction. But the value of the futures contracts the company sold would probably decline by an equal amount. The company then buys enough futures contracts to liquidate its position and thereby achieves a profit on its futures transaction. The profit will approximately offset the loss the company suffered on the decline in value of its cash commodity.
>
> "The second type of hedge involves an opposite manoeuvre. When a company has orders to deliver actual commodities over several months in excess of its stocks, it will *buy* futures contracts in amounts equal to its commitments. This is called 'going long' in the futures market. If the cash price goes up, the futures contracts probably will increase in value by a similar amount. So although the company must buy its actual commodities at a price higher than it estimated when it accepted the orders, it can sell its futures contracts at a profit which will offset its higher costs or the company could take delivery of the futures contracts as they came due to fulfil its order commitments.
>
> "In both these examples of basic hedging manoeuvres, it was assumed that a company's purchases of futures contracts offset the losses it would have incurred by adverse price changes in the cash market. The reverse frequently happens, of course, and cash prices move in a direction that would have been favourable to the company. In such cases, the profit in the cash market is wiped out by a loss on the opposite position the company has assumed in the

240 *Id.* at 106.

> futures markets. The companies maintain it makes little difference to them which way the prices move. Their only purpose in entering the futures market is to avoid losses and they consider their trading successful if they merely break even".[241]

One successful commodity speculator described commodity futures and the use of commodity future trading as:

> "There are two groups who trade in futures: those who produce and use the commodities and who are future trading to avoid risks; and speculators who seek the risks because of the great rewards possible. Originally commodity future trading served two purposes:
>
> "1. To enable producers of commodities to be certain of receiving a fair price for their commodity. For example, if a planter is producing sugar there are many months between the time of planting and the time that actual physical delivery of the sugar can be made. If during this interval the wholesale price of sugar were to fall from say 4¢ a pound down to 2¢, the planter might discover that all his labour produced no profit. On the other hand, sugar might have climbed to 6¢, but planters cannot afford to gamble with their crops, and so they seek some way to ensure a fair profit for themselves. They accomplish this by selling their crop, or at least a portion of it, through a future trade. Thus if the sugar were trading at 4¢ a pound for immediate delivery, there should be little difficulty in selling futures on sugar at 4¢ a pound (possibly a little more or less; this will be explained later) for delivery six months hence. In this way the planter has ensured a successful sale of his crop at a good price.
>
> "2. To enable users of commodities to be certain of obtaining supplies of their needed commodities at a reasonable price. For example, a manufacturer of candy bars must contract in advance to deliver the candy to his wholesalers. If while his contract is still in force he finds that the price of sugar has considerably increased, he may be put in the difficult position of having to produce his candy and sell it at a loss. It is not possible for him to store his sugar supplies very far in advance because of the costs and capital involved, so he protects himself by purchasing a sugar future at 4¢ a pound. Regardless of any price

241 N. Miller, *supra* note 153, at 65, 66; ONTARIO MINISTRY OF CONSUMER AND COMMERCIAL RELATIONS, REPORT OF THE INTERMINISTERIAL COMMITTEE ON COMMODITY FUTURES TRADING 21 (1975) [hereinafter cited as COMMODITY FUTURES REPORT].

> fluctuations, the manufacturer is now sure that he can manufacture and sell his candy bars at a profit.
>
> "Who runs the risks that these producers and consumers are seeking to avoid? Unfortunately the times when producers wish to sell futures rarely coincide with those when consumers wish to buy, and so a third party is welcomed to commodity trading – the speculator. Because producers and consumers *must* buy and sell at certain times (or *hedge*, which is the technical term) there are tremendous profit opportunities for the speculator who can buy or sell when and if he chooses.
>
> "Because the speculator has become essential to the smooth running of the futures markets, a huge industry has developed to service and inform him. Numerous firms specialize in handling speculators' accounts and in rushing information about commodities to them. Newspapers carry crop and weather reports, and even the United States government cooperates by simultaneously releasing crop forecasts to all interested parties. Because weather changes or large sales or purchases can rapidly affect commodity prices, the brokerage firm with whom each speculator deals will send him a daily letter, reporting all such changes and giving that firm's opinion as to future changes. Thus it is very easy for the speculator to keep well informed about the current national and world factors which may affect any commodity in which he is interested. In fact it is not uncommon for a speculator in a certain commodity to be far better informed about that commodity's current and prospective market than are the actual producers of the commodity. Certainly it is easier for a sugar speculator in New York City who is reading Merrill Lynch's daily sugar bulletin to be more up-to-date on the world sugar situation than can be any sugar beet grower in Louisiana or Haïti."[242]

Commodity speculators try to buy when they feel the price is too low and sell when the price is thought too high. Their success is most often determined by their ability to play a "hunch". If their hunch is wrong, they may be called upon to replace their margin deposit the next day due to a downward price fluctuation which had wiped out the previous day's deposit.

242 M. SHULMAN, ANYONE CAN MAKE A MILLION 182-84 (1966); COMMODITY FUTURES REPORT, *supra* note 241, at 21-24.

B. COMMODITY FUTURES OPTIONS

The commodity futures contract discussed in the previous section is a contract for the purchase and sale of a specified quantity and quality of a commodity deliverable at a specified future time. Related to commodity futures contracts are commodity futures options (put and call transactions). A commodity futures option is an option to purchase from (*i.e.*, "calling" for) or sell to (*i.e.*, "putting" to) the grantor of the option an underlying commodity futures contract at a fixed price within a certain period. In consideration for this right the option grantor collects a premium which represents the full extent of the purchaser's financial commitment up to the time the option is exercised or expires. The premium is usually between 5% and 15% of the market value of the futures contract at the time the option is granted.[243]

The purchaser of a "call" realizes a profit if the price of the underlying futures contract rises. The purchaser of a "put" realizes a profit if the price of the underlying futures contract falls.

Some hedgers find commodity futures options more attractive than commodity futures contracts because of the absence of margin calls during the life of the option and the uncertainty of their requirments for the particular commodity. An option grantor who produces, deals in or uses a commodity can reduce fluctuations in income and at the same time generate premium income.

Opponents of commodity futures options argue that because of the hedging activities option grantors may undertake to meet their obligations, price movements on the commodity futures markets become exaggerated. Other critics suggest that commodity futures options reduce the liquidity of markets in commodity futures contracts by taking business away.[244]

Trading in commodity futures options is prohibited in the United States in respect to commodities regulated under the Commodity Exchange Act prior to the amendments contained in the Commodity Futures Trading Commission Act of 1974. Trading in options on commodities brought under the Commodity Exchange Act for the first time by the latter act will be permitted if not contrary to the regulations established by the newly established Commodity Futures Trading Commission.

C. SPECULATORS

Apart from those who engage in the futures market for price protection there is a good deal of trading carried on by speculators. This is not unwelcome by the exchanges.

243 *Id.* at 32.
244 *Id.* at 38.

The speculator is attracted to the commodities markets by the opportunity for profit. The futures market speculators do not own or deal in the physical commodities in which they trade. The speculators hope to realize or profit by assuming the risks of price fluctuations. A commodity speculator buys futures contracts when he thinks prices are too low and sells futures contracts when he thinks prices are too high.[245]

The president of the Winnipeg Commodity Exchange recently commented that farmers fear speculators – people who trade in commodities for a profit with no thought of taking delivery. He was of the opinion, however, that the presence of speculators helps to maintain adequate price levels. "If speculators were not in the market, we could have some pretty drastic price fluctuations at certain times of the year. Farmers are too busy in spring to make deliveries so commodity exporters are not buying. So the speculator is always in the market and this helps to stabilize supply and demand."[246]

Futures contracts are always purchased on margin. Margin requirements for trading on securities exchanges range between 50% to 100% of stock value and usually 65% or more. Margin requirements for commodities are 10% to 20% and in some cases as low as 5%. A 5% rise in the futures price of a commodity can mean a 100% profit for the speculator just as a 5% drop means a 100% loss.[247]

A speculator can however be locked into his position and cannot liquidate his position. He may have to continue to accept losses even after his original stake is wiped out. This results from the exchanges setting prices that a particular futures contract can move up or down in a day in order to prevent extreme price fluctuations. In July 1973, for example, soybean prices on the Chicago Board of Trade increased several times, on twelve successive days. In the face of the strong upward price pressure there were no sellers and trading came to a virtual standstill.[248]

The speculators are considered by the futures trading industry to be an integral part of the futures market. The additional volume of trading generated by the speculators reduces the price disturbance which can result from placement of hedges for any

245 COMPTROLLER GENERAL OF THE UNITED STATES, REPORT TO CONGRESS ON IMPROVEMENTS NEEDED IN REGULATION OF COMMODITY FUTURES TRADING (June 24, 1975).

246 The Globe and Mail (Toronto), Tuesday, May 14, 1974, *quoting* Ronald S. Ennis, president, Winnipeg Commodity Exchange.

247 *Personal Investing, the Dangerous Bull in the Commodities Markets*, FORTUNE, July 1973, at 65.

248 *Id.*

large quantities of a commodity and improves the possibilities of effecting a transaction for a hedge order limited to a specific price.[249]

At one time it was doubted in England whether a sale of unspecified goods for future delivery was valid if the seller neither owned such goods at the time of contracting nor had any means of fulfilling the contract except by purchase from a third party.[250] It was ultimately held that a future sale was not invalid merely because the seller did not own the goods and could only satisfy his obligation to sell by purchase from a third party.[251]

A fine line divides speculation from gambling. Certainly a contract for the future sale and purchase of commodities would not on its face be a wager. The real test of the validity of a futures contract that is generally accepted was established by the Court of Common Pleas in 1852. It is the test of "intent of the parties to deliver".[252]

This test was later restated by Mr. Justice Mathews of the United States Supreme Court:

> "...a contract for the sale of goods to be delivered at a future day...valid when the parties really intend and agree that the goods are to be delivered by the seller and the price to be paid by the buyer; and, if under sale of such a contract, the real intent be merely to speculate in the rise and fall of prices, and the goods are not to be delivered, but one party is to pay to the other the difference between the contract price and the market price of the goods at the date fixed for executing the contract, then the whole transaction constitutes nothing more than a wager, and is null and void."[253]

The Criminal Code (section 341) now provides:

> "(1) Every one is guilty of an indictable offence and is liable to imprisonment for five years who, with intent to make gain of profit by the rise or fall in price of the stock of an incorporated or unincorporated company or undertaking, whether in or out of Canada, or of any goods, wares or merchandise,
>
> "(a) makes or signs, or authorizes to be made or signed,

249 Comptroller General of the United States, *supra* note 245, at 4; Commodity Futures Report, *supra* note 241, at 22; Report of the Royal Grain Inquiry Commission 45 (Ottawa 1938).

250 Lorymer v. Smith, 1 B. & C. 1, 3, 107 E.R. 1, 2 (K.B. 1822); Bryan v. Lewis, Ry. & Mood. 386, 117 E.R. 1058 (K.B. 1826).

251 Hibblewhite v. M'Morine, 5 M. & W. 462, 15 E.R. 195 (Ex. 1839).

252 Grizewood v. Blane, 11 C.B. 526, 138 E.R. 578 (C.P. 1852).

253 Irwin v. Miller, 110 U.S. 499 (1884).

> any contract or agreement, oral or written, purporting to be for the purchase or sale of shares of stock or goods, wares or merchandise, without the *bona fide* intention of acquiring the shares, goods, wares or merchandise or of selling them, as the case may be; or
> "(b) makes or signs, or authorizes to be made or signed, any contract or agreement, oral or written, purporting to be for the sale or purchase of shares of stock or goods, wares or merchandise in respect of which no delivery of the thing sold or purchased is made or received, and without the *bona fide* intention of making or receiving delivery thereof, as the case may be;
> "but this section does not apply where a broker, on behalf of a purchaser, receives delivery, notwithstanding that the broker retains or pledges what is delivered as security for the advance of the purchase money or any part thereof.
> "(2) Where, in proceedings under this section, it is established that the accused made or signed a contract or agreement for the sale or purchase of shares of stock or goods, wares or merchandise, or acted, aided or abetted in the making or signing thereof, the burden of proof of a *bona fide* intention to acquire or to sell the shares, goods, wares or merchandise or to deliver or to receive delivery thereof, as the case may be, lies upon the accused."

A contract however is not a gaming contract unless both parties to it intend to gamble.[254] If one party is honestly intending to carry out his contract to the letter and has no knowledge that the other party is engaged in a purely speculative transaction without the intention to either take or give delivery of what is bought or sold, the contract is not unlawful and may be enforced against the person who seeks to escape liability by setting up his own violations of the law.[255]

In *Beamish v. Richardson*[256] some members of the Supreme Court of Canada held that because the customers' intention in a commodity transaction was to speculate in futures merely, with no expectation either for delivery or taking delivery in kind of any commodity, the transaction fell under the ban of what is now section 341 of the Criminal Code. In *Maloof v. Bickell & Co.*[257] which came before the Court five years later Duff, J., however explained:

"*Beamish v. Richardson*, nevertheless, is not a decision

254 Brosseau v. Angevin, 27 Que. C.S. 510 (Ct. of Review 1905).

255 Woodward v. Koeford, [1921] 3 W.W.R. 232, 37 C.C.C. 329 (Man. C.A.).

256 49 S.C.R. 595 (1914).

257 59 S.C.R. 429 (1919).

> upon any point as to the application of that section (*i.e.*, present s. 341). My brother Iddington and my brother Brodeur based their judgment, it is true, upon the view just explained of the effect of the code, but my brother Anglin, though expressing an inclination of opinion in the same direction, explicitly stated that he did not rest his judgment upon that ground, while the remaining members of the court (the Chief Justice and myself) took the opposite view."[258]

In *Maloof v. Bickell & Co.* the majority of the Court agreed that the facts of the transaction which was the subject of the case could not be distinguished from *Beamish v. Richardson* but that the transaction was not within the prohibition of the code. Duff, J., in his reasons said:

> "The purchases authorized by the appellant's orders were to be purchases in the corn pit of the Chicago Board of Trade and in the usual course of business, that is to say, by agents in Chicago; with the consequence that in the absence of agreement to the contrary, the agents would contract as principals and not as representatives, in other words, the purchases and sales would be purchases and sales enforced only by the agent."[259]

Anglin, J., as in the *Beamish* case five years before was still expressing an inclination of opinion in the same direction:

> "While I do not rest my judgment on the grounds of illegality, because in the view I take of the other question it becomes unnecessary that I should do so, I am inclined to think the evidence discloses that neither the plaintiffs nor the defendants at any time contemplated that delivery of the grain sold should be made or taken under the agreements purporting to be contracts for the sale of such grain which the defendant authorized and the plaintiffs made. The intent always was to meet the obligation to deliver by an offset of a contract to purchase a like quantity of grain to adjust the differences between the selling and the buying prices and by thus dealing in such differences to make gain or profit by an anticipated fall in the price of the merchandise. Such transactions are within the literal terms of section 231 of the Criminal Code, and, I believe, are also within the mischief against which it was directed. The difference in morals between thus dealing in differences and speculative transactions

258 *Id.* at 436.
259 *Id.* at 435.

> in which there is an actual purchase accompanied by present or future receipt and a subsequent sale accompanied by delivery, the intent being to make profit by the rise in price of the commodity so dealt in, may not be very clear; but Parliament in its wisdom has deemed it proper to make this distinction, with the result that a transaction of the former class is, while one of the latter is not, *malum prohibitum*.
>
> "For these reasons I would allow this appeal and would dismiss the plaintiffs' action."[260]

Prudential Exchange Co. v. Edwards[261] is the last of the three Supreme Court of Canada decisions in civil actions which have canvassed the applicability of section 341 to commodity futures contracts executed on commodity exchanges. In the *Prudential Exchange* case, Duff, J., while discussing the machinery of the exchange in setting off contractual obligations said:

> "Nor do I think the statute applies, to put the case in its simplest form where the transaction contemplates delivery and payment and the enforceability of the obligations to deliver and pay, merely because one of the parties intends to make use of the machinery of an exchange in such a way as to discharge his obligation to deliver by the acquisition of a converse obligation to deliver to him and the setting off of these obligations one against the other; provided always that the converse obligation is equally real and equally enforceable in point of law."[262]

In the same judgment, Davis, J., said:

> "In one sense it is true, in most marginal trading on a stock market, that the customer does not expect to be called upon to make physical delivery of share certificates representing the shares that he has sold or to take physical delivery and make payment in full for the shares which he has bought. When a marginal trader sells either short or long he probably seldom visualizes the obligation to take or to give delivery – he is so hopeful of a rising or a falling market in the particular stock or commodity in which he is trading that he expects within a short time to be able to close his account and take out a money profit. But the legal obligation is always there and he knows perfectly well that it is there. If a customer who deals on a recognized stock exchange could, every time he loses

260 *Id.* at 519, 520.
261 [1939] S.C.R. 135.
262 *Id.* at 142.

> heavily by the stock going the opposite way from that which he expected, turn 'round and say that he never intended to have any real transactions in the stock or commodities but was merely gambling in breach of the Criminal Code, it would be quite impossible to carry on the business of a well-regulated public stock exchange which renders its own peculiar public service. Here, the respondent admits that he wanted real sales to be made and real purchases to be made for him on the Winnipeg Grain Exchange for future delivery. I cannot see that he can escape from the payment of his losses."[263]

One commentator on section 341 is of the opinion:

> "[W]ith respect to the trade in commodity futures contracts on commodity exchanges, the Supreme Court of Canada has interpreted the requirement of section 341 that contracts for commodities be made with the *bona fide* intention to make or receive delivery to mean that contracts for commodities are to encompass real, legally binding obligations for the making or receiving of delivery. Therefore the accused will apparently discharge the onus of proof under 341 (2) by demonstrating that he has entered into a contract with real, binding obligations to make or receive delivery without necessarily making or receiving delivery. Of course, evidence that actual delivery has been effected will always discharge the burden of proof."[264]

It is apparently the view of the Ontario Securities Commission that section 341 of the code does not prohibit speculators in futures where there is no intention to deliver or take delivery. Certainly this is only the case where there is an intervention in the transaction of agents who contract as principals on behalf of the purchaser or vendor rather than representatives. Whether there are other exceptions it is difficult to say.

It is submitted that Parliament should amend section 341 to make it clear whether or not it applies to speculation in commodities and futures. Certainly there appears to be some confusion in thinking on the part of Parliament and others on the nature of commodity speculation. Commodity speculation does not, for example, cause shortages in a commodity. It is not a case where there is any hoarding or removal of commodities from the market, and

263 *Id.* at 154.

264 *Commodity Futures Contracts and the Significance of the "Bucketing" Provision in Relation to Trade in Commodities*, in COMMODITY FUTURES REPORT, *supra* note 241, at 14 (commentary by Edward Then, Ministry of the Attorney-General of Ontario, discussing s. 341 of the Criminal Code).

the speculator does give some protection to the commodity producer who does not wish to gamble on the sale of an entire crop at an unknown price sometime in the future.

D. REGULATION IN THE UNITED STATES

In the United States, commodity markets have been regulated since 1921.[265] The Futures Trading Act of 1921[266] was a response to the demand for regulation growing out of the high agricultural prices following the first world war. The Grain Futures Act of 1922[267] was essentially the same legislation enacted pursuant to the criminal jurisdiction of Congress purporting to prevent interference with interstate commerce when the Futures Trading Act of 1921 was declared unconstitutional. The Commodity Exchange Act of 1936[268] amended and enlarged the Grain Futures Act.

The Commodity Exchange Authority (CEA) was established under the Commodity Exchange Act. The CEA was responsible for the supervision and regulation of trading of agricultural commodities in interstate commerce and contracts for future delivery. Many important commodities such as aluminum, apples, cocoa, coffee, foreign currency, lumber, silver, sugar and tin which were traded in U.S. commodity exchanges were not regulated.

Largely as a result of the De Angelis Salad Oil Swindle[269] the act was substantially amended in 1968.[270] The Senate report on the amendments pointed out the unique lack of regulation. The report referred to the fact that futures trading in the principal agricultural commodities is at a record level and that the effects of trading are significant factors in the domestic and world economies. Members, brokers and dealers on the national securities exchanges are held to strict financial limitations and their solvency has been considered essential to protect the public interest. But, unlike brokers on the securities markets, commodity consumer merchants have not been required by public policy to meet any financial requirements whatsoever.[271] Among the amendments to the act were imposition of minimum financial requirements, provi-

265 Measures to check speculation in commodity prices date back to at least 301 A.D. when the Edict of Diocletian set a maximum price for provisions and maximum wages. Its effects were ruinous to agriculture and to markets.

266 Pub. L. No. 66, 42 Stat. 86 (1921).

267 7 U.S.C. s. 1, 42 Stat. 998 (1922).

268 Pub. L. No. 675, 49 Stat. 545 (1936).

269 United States v. De Angelis, No. 452-63 (D.N.J., December 23, 1963).

270 Pub. L. No. 90-258, 82 Stat. 26 (1968).

271 S. REP. No. 947, 90th Cong., 2d Sess. (1968).

sions for cease and desist orders coupled with additional power to deal with price manipulation.

The Commodity Futures Trading Commission (CFTC) Act[272] of 1974 made substantial amendments to the Commodity Exchange Act which extended coverage to include all goods, articles and all services, rights and interests in which contracts for future delivery are currently being dealt with, or may be dealt with in the future. Transactions in respect of certain commodities such as foreign currency which are regulated by other agencies are exempted from regulation under the Commodity Futures Trading Commission which replaced the CEA.

The CFTC act specifically directed the commission to consider "...the need for legislation insuring owners of commodity futures accounts against loss by reason of the insolvency or financial failure of a futures commission merchant carrying such accounts".[273] The commission made a study and in its report to Congress stated that the need for insurance protection is low because (a) the level of public confidence in the safety of funds appears to be relatively high, and (b) the benefit-cost ratios demonstrate that insurance protection would not be cost effective. It felt that there was no need for additional legislation.[274]

E. REGULATION IN CANADA

As a result of the *Report of the Royal Grain Inquiry Commission of 1938*, the federal Grain Futures Act of 1939[275] was passed. The act, which was designed to regulate futures trading in wheat, oats, barley, rye, flaxseed and corn, was proclaimed but not implemented.

In 1943, by Order in Council, futures trading in wheat was suspended. The Canadian Wheat Board was constituted the sole interprovincial and international marketing agency for western Canadian wheat. The Wheat Board's power was extended in 1948 to oats and barley. In 1974 the federal government removed from the control of the Wheat Board the purchase and sale of wheat, oats and barley for domestic animal feed use.

The Ontario Securities Commission has taken the position that "regulation(s) designed to apply to capital markets...(were) not designed to regulate contracts which had as their goal facilitating trading in actual commodities".[276] An Ontario Interminis-

272 Pub. L. No. 93-463, 88 Stat. 1387 (1974).
273 *Id.* s. 417.
274 J. HELMUTH, *supra* note 210.
275 S.C. 1939, c. 31; now R.S.C. 1970, c. G-17.
276 COMMODITY FUTURES REPORT, *supra* note 241, at 14.

terial Committee on Commodity Futures Trading recommended legislation to regulate trading in commodity futures contracts.[277] A bill for an Act to Regulate Trading in Commodity Futures Contracts was introduced in the Ontario legislature in 1977. The bill died on the order paper and no further legislative action has been taken.[278]

Apart from the criminal law provisions relating to gaming in stocks and merchandise and enforcing rules of fair play in commodity trading[279] the Canadian and U.S. governments also regulate the commodity markets in the form of international agreements, domestic farm policies and charitable ventures, whereby a commodity's demand, supply and price are most often influenced. A scramble for government contracts often leads to price cutting between competitors that would ultimately benefit the consumer either at home or abroad. Agreements between nations regarding trading limits of one item or another often prevents the producers from glutting the market due to an inaccurate calculation of demand. Unfortunately, governments have been noted to "over pay", especially in cases of foreign aid, for sometimes inferior products from dealers searching for high profits.

The sale of commodities, particularly agricultural commodities, is also greatly controlled in both Canada and the United States by marketing boards.

The industry of options on commodity futures contracts in Canada may be regulated by securities laws, the creation of a Commodity Exchange Authority or a similar agency or through the Criminal Code. The choice among the alternative means of regulation should depend on which route best protects the investing public. But the propriety of bringing some regulation to the industry cannot be doubted.[280] The three principal areas in which regulation is needed in respect of trading in commodity futures contracts and other contracts based on the present or future price of commodities are (a) the marketplace, (b) the participants, and (c) the contracts.

At present in Canada the commodity market is almost completely free of controls and regulations. Unskilled and dishonest dealers who are not members of an exchange or regulatory association may sell commodities without having any capital of their own.[281] Recently, Morton S. Shulman, a member of the Ontario

277 *Id.*

278 Bill 32, 31st Leg. On., 1st Sess. (1977).

279 S. KROLL & I. SHISKO, THE COMMODITY FUTURES MARKET GUIDE (1973).

280 Borton & Abrahams, *Options on Commodity Futures Contracts As Securities in California*, 29 BUS. LAW. 867, 878 (1974).

281 *See e.g.* R. v. John Vance (unreported trial before His Honour Judge Honsberger,

legislature, complained in the House that in Ontario there were "no regulations, no rules, no financing required, no inspectors, no government supervision in the commodities field".[282]

If any Canadian insurance or similar program to SIPC in respect of securities dealers is established, consideration should be given to having it apply to commodity dealers. SIPC does not apply to funds in commodity accounts, which is difficult for the investing public in the United States to understand. Investors know that very often securities and commodity futures may be purchased from the same broker-dealer. It should not be overlooked that the bankruptcy of Ira Haupt & Co. was precipitated by reason of the substantial losses on the commodity side of the firm's business arising out of The Great Salad Oil Swindle.

Not only may consumers and the public in general be hurt by an unregulated commodity exchange: when a broker-dealer defaults, customers are subject to the same problems as when a commodity futures broker fails. The relationship of a commodity broker to his customer is analogous to that of a broker-dealer and his customer. The same general law in respect to the failure of a commodity broker applies in Canada as did the law in the United States before the enactment of section 60(e) of the Bankruptcy Act. Thus, a grain broker holds the commodity accounts he has in pledge for his marginal customers. Tracing and all related doctrines as developed in stockbroker cases involving the failures of broker-dealers would accordingly apply.[283] The same case for simplifying the expensive and time-consuming administration of broker-dealer failures which often result in unfair or arbitrary results can be made for commodity brokers.

Chapter V
Protection of Customers' Funds and Securities in Canada

A. THE INSTITUTIONAL AND REGULATORY FRAMEWORK OF THE SECURITIES INDUSTRY IN CANADA

In most provinces there is a two-tier regulatory structure. It consists of a provincial securities commission at the top and be-

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Ont. Cty. Ct. Conviction registered September 10, 1974). The defendant, who was convicted of defrauding the public of some $185,000, was a former registrant under the Ontario Securities Act. The Toronto Stock Exchange had ordered that he never again should be permitted to have any position of any nature in any member firm. Vance had purported to be effecting transactions on his client's behalf when, in fact, he was not placing any orders with any member of a commodity exchange.

282 The Globe and Mail (Toronto), March 21, 1975, at 2; The Toronto Star, March 21, 1975, at A-6.

283 *In re* Rosenbaum Grain Corp., 112 F.2d 315 (7th Cir. 1940).

neath it the various self-regulatory agencies such as stock exchanges, Investment Dealers Association of Canada, broker- dealer associations and the Canadian Mutual Funds Association.

There are two broad, sometimes conflicting objectives of national policy in the regulation of the securities industry:

(1) the first is to maintain, facilitate and improve the performance of the capital market in the interests of economic development, efficiency and stability;

(2) the second is to ensure adequate protection of those who invest in the securities of public companies and in the securities markets.[284]

A principal and stated purpose of the Ontario Securities Act and the earlier Security Frauds Prevention Acts of 1928, 1929 and 1930 is to prevent fraud and misrepresentation in the sale of securities to the public.

Once a person is elected a member of an exchange he becomes subject to the regulations and requirments of the exchange. Such matters as trading practices, credit policies, procedures for dealing with the public and business ethics are regulated. Control over the financial standing of exchange members is through regulations relating to minimum capital, margin requirements and call loans, coupled with monthly reports and spot investigations of a member's accounts and records by exchange examiners. Shareholders and directors of a member firm are required to give claims of public clients of the firm an overriding priority over those of shareholder clients of the firm if the firm should fail.

Regulations of broker-dealer associations provide for admission-to-membership requirments, conduct, financial responsibility and annual, regular and spot audits.

The Investment Dealers Association of Canada traces its history back to the formation of the Bond Dealers Section of the Toronto Board of Trade in 1914. It does not have the same direct regulatory authority of the securities industry as do the exchanges. Its authority is primarily exerted in the areas of standards imposed on members and education.

The annual audit, spot checks and the requirement that all members carry insurance to cover losses of securities by theft, fire, forgery or unexplained disappearance are among the most important conditions imposed on members of the Investment Dealers Association of Canada.

284 Parliament of the Commonwealth of Australia, 1 Report on Australian Securities Markets and Their Regulation 15, 16 (Australia 1974).

During the early 1960s, the securities industry in Canada was criticized for inadequate standards of self-regulation and the failure of securities commissions to actively supervise the self-regulatory associations. It must be said, however, and it is to the credit of the industry in Canada, that no securities firm failed through a loss of control in its operations when so many failed in the United States for this reason. The principal cause of most failures of securities firms in Canada has been, and is likely to continue to be, mismanagement, fraud and other misconduct. It is difficult to prevent failures and to protect the *bona fide* investor from loss. Failures and losses, however, can be kept to a minimum by vigilant supervision, promotion of good business practices and insistence on a high level of integrity in all members of the industry.

B. CANADIAN CONTINGENCY AND SPECIAL TRUST FUNDS[285]

Although the history of the Canadian securities industry since the second world war has been relatively free of failures involving loss to the public there have been a number of failures during the past twenty-five years. These include C.A. Macdonald & Co. Ltd.; Stanbury Investments Limited; Ord, Wallington & Co. Limited; Waite, Reid and Company Limited; Malone Lynch Securities Limited; Andrews & Belanger Limited; Chartrand, Quinn & Senecal Limitée; Blanchard, O'Connor & Co. Ltd., and L.J. Forget & Company Ltd.

In 1955, as a result of the failure of a member firm of the Toronto Stock Exchange, a group of other members volunteered to cover the public's loss in the amount of about $125,000. In 1956 the exchange established a reserve called a Special Contingency Reserve with undefined purposes. In 1961 public losses of some $180,000 resulting from a second failure and all the costs of administration amounting to about $142,000 were paid out of this Special Contingency Reserve.

The Toronto Stock Exchange rebuilt the Special Contingency Reserve to $275,000 after it had been reduced by the payments made from it during the early sixties. While reluctant to write a

285 I am grateful to D.I. Richardson of The Clarkson Company Ltd. who read an early draft of this section and made several helpful suggestions which have been incorporated into this paper.

"blank cheque" the board of governors recognized a responsibility to the investing public and initiated discussions with other exchanges and the Investment Dealers Association of Canada with a view to creating a national contingency fund. The discussions coincided with and undoubtedly received some impetus from the creation by the New York Stock Exchange in 1964 of its Special Trust Fund to provide "direct or indirect assistance to customers of a member...threatened with loss of their money or securities because such member...is insolvent or is in such financial condition that he or it may be unable without assistance to meet his or its obligations to such customers".

An important reason for the pressure to create a national contingency fund was the fact that an exchange member was often a member of more than one exchange and very often a member of the Investment Dealers Association of Canada. It was not practical and certainly not desirable for the Toronto Stock Exchange to cover only the losses of customers who might, for example, be residents of Ontario. At the same time it would be only equitable for the members of an exchange, which by reason of its insufficient supervision resulted in the failure of a member firm, to share in the satisfaction of public losses with the members of other exchanges of which the firm that failed was also a member.

Another reason for creating a national contingency fund was the feeling that the government might regard the protection of public customers as the price of continued independence for the industry in the light of protection given to customers of other financial institutions such as banks and trust companies.

The negotiations within the industry successfully resulted in the formation of a National Contingency Fund in 1968. An agreement and declaration of trust was entered into by the Montreal Stock Exchange, the Canadian Stock Exchange, the Toronto Stock Exchange, the Vancouver Stock Exchange and the Investment Dealers Association. The agreement stated that the participating institutions considered it advisable that in appropriate circumstances financial assistance should be available to clients of their members who suffered financial loss due to the failure of a member to meet any of its obligations as they fall due. The fund which was initially in the amount of $1,500,000 was established by contributions as follows:

The Montreal Stock Exchange and the Canadian Stock Exchange, jointly	$300,000
The Toronto Stock Exchange	500,000
The Vancouver Stock Exchange	200,000
Investment Dealers Association	500,000

The fund currently stands slightly in excess of $1,500,000. The

difference between the present balance and the initial contributions represents the net effect of operating expenses and interest earned.

There is no liability accepted by the exchanges or the Association for clients' losses. However, the governors of the fund are entitled to make discretionary payments to assist clients of members who have suffered financial loss due to the failure of a member of one or more of the participating institutions to meet any of its obligations as they fall due. In general, when payments are made from the fund, the participating institution of the defaulting member is required to reimburse the fund to 75% of the total amount paid out of the fund up to a maximum amount equal to the amount of the initial contribution of the institution. All of the other participating institutions are required to repay the remaining 25% of the payment out *pro rata,* in accordance with the respective amounts of the initial contributions of capital made to the fund by each participating institution.

The fund has been involved to date in the insolvencies of Malone Lynch Securities Limited, Andrews & Belanger Limited, Chartrand, Quinn & Senecal Limitée and Blanchard O'Connor & Co. Ltd. These have all been insolvencies of stockbrokers. The fund, in addition, was involved in an advisory capacity in the Massey Lavoie insolvency.

The fund has operated in a number of ways. It has paid directly the losses of public customers and taken an assignment of their claims which it thereafter asserted against the estate of the defaulting member. In other cases it has loaned funds to trustees to assist in the orderly liquidation of an estate and in one case guaranteed the loans of a bank thereby permitting the release of pledged securities.

In Malone Lynch the bulk of the claims were acquired by the National Contingency Fund either prior to the first dividend which was paid three months after the bankruptcy or after the first dividend and prior to the second dividend.

To date the fund paid and took assignments of the following claims totalling $4,400,000:

Claims purchased before 1st dividend	$ 890,000
Claims purchased after 1st dividend and before 2nd dividend	3,430,000
Claims purchased subsequent to 2nd dividend	80,000

In Andrews & Belanger the advances were all made in late 1971 or early 1972. In Chartrand, Quinn, it is believed the advances were made mostly in 1974.

In all these cases the National Contingency Fund took assignments of the customers' claims.

The fund would prefer to help a failing broker wind down its business rather than to satisfy the claims of public customers after a massive liquidation of a broker-dealer's business that would usually occur in a bankruptcy. Assisting a broker to wind down its business permits the greatest benefit from the limited resources available. Where it is not possible to prevent a bankruptcy the fund can best be used to guarantee bank loans to facilitate delivery of customers' accounts against payment instead of liquidation of margin account security positions.

Perhaps the most significant aspect of the National Contingency Fund is the important role it plays in coordinating the self-regulatory aspects of the securities industry in Canada. The fund employs a chartered accountant on a full-time basis as a National Examiner. His role is to establish uniform standards and to coordinate the activities of the various examiner groups of the several regulatory bodies in the industry.

In 1974 the Quebec Securities Commission required that non-member brokers coming under its direct jurisdiction participate in a fund to be established for the protection of customers of brokers who incur a financial responsibility towards them. The fund is known as the Contingency Group Fund. Each of such brokers is required to deposit $10,000 in a designated trust company that has been constituted the administrator of the fund. Provision is made for further deposits.

Discretionary payments may be made by the administrators from the fund. Participating brokers in general are then required to repay to the fund on a *pro rata* basis the amount of such payments. The maximum payment that may be made from the fund is $5,000 to any one customer for direct out-of-pocket loss. The maximum aggregate amount of claims that may be paid in respect of the default of any one participant in the fund is not to exceed $10,000, multiplied by the number of participants in the fund not in default at the time of the first default of the particular participant. A default is defined as the failure of a participant to meet any liability or obligation to a *bona fide* customer when due or a conversion of funds or securities of such a customer while in the hands or under the control of such participant.

There is in Montréal a $100,000 Brokers' Clearing Fund designed to smooth losses.

The industry also has in Ontario a fund comparable to the Contingency Group Fund of the Quebec Securities Commission.

By regulation under the British Columbia Securities Act, broker-dealers are required, as a condition of obtaining a licence,

to contribute to a trust fund for the purpose of satisfying certain claims against broker-dealers who might become bankrupt or insolvent. A broker-dealer may be excused from joining the plan if he establishes that he has joined some other plan similar to the one established by the regulation – such as the National Contingency Fund. This regulation has been held to be *intra vires* the powers of the British Columbia legislature.[286]

The National Contingency Fund and funds such as the Contingency Group Fund represent an encouraging affirmation on the part of the participating institutions and brokers that they are prepared to accept a degree of responsibility for the financial loss of public customers of member firms or participants who fail to meet their obligations as they become due. Payments are however discretionary in respect of all funds and there are still many broker-dealers, commodity dealers and others in the securities industry who are not covered by either fund.

New policies in respect of the funds are being formed on an *ad hoc* basis with the result that one can never be certain of the policy of the funds in any particular circumstance. There has, for example, been no failure yet of a member actively involved in commodities or futures contracts, and it is uncertain how the National Contingency Fund would regard the claims of customers who suffered losses arising out of such activities. As previously mentioned, it should not be forgotten that the failure of Ira Haupt & Co. in 1963 was precipitated by the great losses it suffered on the commodity side of its business.

Whether the funds are sufficient to provide reasonable protection to the members of failing firms is difficult to say. To a great extent it depends on the manner in which the fund is used. Although the amounts involved in the failures of Canadian broker-dealers have been very much less than those of defaulting firms in the United States, fortunately there has not been a very large failure by U.S. standards. The possibility, however, should not be ignored. Some idea of the dimensions of the failures of Canadian broker-dealers may be had by comparing the claims filed in three of the recent failures (see tables 1–3).

C. THE CANADIAN BANKRUPTCY ACT

The present Canadian Bankruptcy Act does not contain any special provisions concerning the bankruptcy of securities dealers, notwithstanding that such bankruptcies have regularly proved to be especially difficult to administer. As a rule their administration

286 Malczewski v. Sansai Securities Ltd., 49 D.L.R. (3d) 629 (B.C.S.C. 1974).

Table 1
Stanbury Investments Ltd.
Claims by Stockbrokers, Customers and Trade Creditors per Statement of Affairs[a]

Customers (clients – unsecured)	$712,800	
Brokers (unsecured)	38,000	$ 750,800
Trade creditors (unsecured)		50,000
Subordinated loans (unsecured)[b]		587,000
		1,387,800
According to the trustees' final statement of receipts and disbursements, $587,485 (net receipts) was available for distribution to the following creditors:		
Preferred (with proved claims)[c]		10,000
Unsecured (with proved claims)		827,000

a. The Statement of Affairs was used as the only source of information available to arrive at a reasonable figure.
b. These are advances or loans by the shareholders to the debtor company which are subordinated to the interests of all other creditors in accordance with the requirements of the Montreal and Canadian Stock Exchanges.
c. A breakdown of unsecured proved claims is not available. Proved claims can only be stated in value and not in number.

Table 2
Waite, Reid and Company Limited
Claims by Stockbrokers, Customers and Trade Creditors per Statement of Affairs

Number of possible claims to be filed	Description		Amount
106	Trade creditors (unsecured)		$ 84,000
658	Brokers (unsecured)	$206,000	
	Customers (unsecured)	$538,000	744,000
			828,000
2	Subordinated loans		245,000
			1,073,000

Table 3
Malone Lynch Securities Ltd.
Claims by Stockbrokers, Customers and Trade Creditors per Statement of Affairs

Number of possible claims to be filed	Description		Amount
33	Brokers (unsecured)	$ 564,000	
1,551	Customers (unsecured)	$5,461,000	$6,025,000
65	Trade creditors (unsecured)		97,000
			6,122,000

Note 1

Clients with credit balances may guarantee an account with a debit balance.

Customers with debit balances	$1,920,000
Brokers with debit balances	45,000
	1,965,000

Note 2

There was no information available on the number of proved as opposed to possible claims.

Note 3

According to a progress report as at August 31, 1974, the following dividends had been paid:

Preferred creditors	$ 30,000
Unsecured creditors	2,840,000
	2,870,000

Dividends paid:

December 15, 1971	35%
March 15, 1972	15
February 1973	5
November 15, 1974	5
	60

is time-consuming, expensive and often marked by complex legal and administrative problems. Frequently, greater losses are suffered by customers after bankruptcy than before by reason of the long delays in tracing securities and processing claims. The priority of any particular customer is usually determined by pure chance, depending on such things as the manner in which the broker segregated the customer's securities, the status of the corporate securities register, the whim of a pledgee in selecting the securities to sell to retire his loan and the degree of broker misconduct.

The *Report of the Canadian Study Committee on Bankruptcy and Insolvency* recommended that a special uniform procedure be devised to handle and settle all claims by the customers of bankrupt stockbrokers following generally the model of section 60(e) of the United States Bankruptcy Act.[287] Further study revealed that while section 60(e) was a decided improvement on the common law and equitable rules still prevailing in Canada, it nevertheless resulted in a myriad of legal complications, substantial administrative delays and demonstrable inequities among customers and other creditors of a bankrupt stockbroker.

A wide range of possible alternative models was considered:

(1) Ordinary commercial bankruptcy, subject to identification and tracing rules, that is, the present common law.

(2) Customer preference over trade creditors but no limit on the securities identification and tracing rules.

(3) Customer preference over trade creditors with constraints on the identification and tracing rules, limiting those remedies to the recovery of money or securities a claimant can "...specifically identify as allocated to a customer", which is in essence the U.S. model as set out in the Chandler Act of 1938 (now section 60(e) of the Bankruptcy Act of the United States.)

(4) Customer preference over trade creditors to the extent of cash and securities held by the stockbroker, and customers and trade creditors sharing the other assets rateably.

(5) No customer preference and, instead, all assets placed in a common fund that customers and trade creditors share rateably.

The fifth model is the most attractive from an administrative point of view as it is certain, arbitrary and efficient. It was rejected because where there were substantial trade creditors of the bankrupt stockbroker it could be very unfair to the customers of the

287 REPORT OF THE STUDY COMMITTEE ON BANKRUPTCY AND INSOLVENCY LEGISLATION (Canada 1970).

stockbroker who do not regard themselves as ordinary creditors but as passive depositors of a financial intermediary.

The legislative model that was used by the draftsmen of Bill C-60 for a new Bankruptcy Act was the fourth model above. The proposed system worked as follows:

(1) Two asset pools are created. All monies and securities of customers are placed in the one asset pool and all other assets are placed in the other asset pool.
(2) Customers claim rateably against the first pool.
(3) Customers whose claims are not satisfied in full share rateably with trade creditors against the second asset pool.
(4) Remaining assets are distributed to deferred creditors, related customers and deferred customers in that order.

The system proposed by Bill C-60 largely abolished the present system that permitted "lucky" and "unlucky" customers and distinguished between "good" and "bad" customers. The system went a long way to simplify legal conflicts and to expedite administration.

Bill C-60 was criticized by the securities industry which argued that customers would be reluctant to leave either money or securities in the possession or control of a securities firm if they knew that they would not be entitled to claim specifically identifiable property if the firm became bankrupt.[288] It was also said that the scheme while efficient was excessively arbitrary. A customer, who had specifically instructed his broker to segregate his assets and the broker failed to do so, would nevertheless be required to make a rateable claim against the customer pool with customers who had made no attempt to have the broker segregate their assets.

Persuaded by this criticism, the existence of the contingency and special trust funds and the closer surveillance of security firms by the security commissions and self-regulatory organizations, the government amended the C-60 model. The new model now contained in Bill S-11[289] is similar to section 60(e) of the present Bankruptcy Act of the United States. It, however, has tighter definitions of "specifically identifiable property" so as to minimize the problems of interpretation which has caused so much difficulty in the practical application of section 60(e).

The principal difference of the Bill S-11 model from the Bill C-60 model is that in the former, where the claims of customers of a bankrupt securities firm are not paid in full by the estate or an

288 *But* "[any] reasonable man ought to know that a broker's office is no place to leave money or securities for safekeeping"; McLaughlin, *supra* note 51, at 398 (*quoting* Garrard Glenn).

289 First reading was Tuesday, March 21, 1978.

"insurer", customers are entitled to recover their specifically identifiable property. But where the customers' claims are paid in full, the Bill C-60 model is used. Separate pools of customer assets and creditor assets are created, and non-arm's length customers ("related customers") and persons who caused or contributed materially to the bankruptcy of the securities firm ("deferred creditors") are distinguished, with related customers relegated to a second priority and the deferred customers to a last priority.

> "In brief summary, the proposed model operates as follows: A 'self-regulatory' organization or a creditor may initiate bankruptcy proceedings in respect of a securities firm. In any event, a petitioner must give pre-notice of the proceedings to each relevant securities commission. The general rules concerning the vesting of the bankrupt's property in the trustee (which exclude a customer's specifically identifiable property), the broad powers of the trustee to continue the bankrupt firm's business, and the fraudulent transfer and fraudulent preference rules apply to the bankruptcy of a securities firm.
>
> "More specifically, the trustee is empowered to elect, within 30 days of the date of bankruptcy, to satisfy all or part of any claim of a customer against the estate by delivering to the customer securities of the same class to which he was entitled on the date of bankruptcy, irrespective of any change in value of the securities after that date. In other words, the trustee has discretion to keep the customer at risk during that 30-day period. If during that 30-day period the trustee is able to pay all customers' claims, either because the bankrupt firm owns sufficient money and securities or because an 'insurer' undertakes to furnish sufficient money or securities to the estate, the issue of identifying or tracing a customer's 'specifically identifiable property' becomes completely irrelevant. And because an insurer is not specifically subrogated to the rights of the customers, the insurer is not entitled to claim specifically identifiable property in order to establish its priority over related customers, secured creditors, ordinary unsecured creditors, deferred creditors and deferred customers. The insurer only acquires the priority rank of customers when claiming the aggregate amount it paid to the estate. This model therefore continues some of the undesirable characteristics of the U.S. Chandler Act of 1938, but nevertheless, where an insurer steps in, it resolves the central problem: it obviates customer reliance on the identification and tracing concepts and thus

reduces the customers' recovery costs and even more important, eliminates recovery on the basis of chance.

"Where, however, an insurer does not step in to cover customer losses, each customer is entitled to claim his specifically identifiable property, compelling the trustee to scrutinize with great care each bank account, each cheque, and each security certificate, and relegating the customer to a claim that is based more on luck than on prudence or law.

"In either case, after returning any specifically identifiable property or delivering any securities to a customer in payment of the customer's claim, the trustee is required to divide the remaining assets of the broker into two funds: (1) a 'general fund' made up of all property of the securities firm as of the date of bankruptcy; and (2) a 'customers' fund' made up of all money and securities held for customers other than any customer's specifically identifiable property. In the course of processing proofs of claim against an estate, in addition to distinguishing among secured creditors, preferred creditors, ordinary unsecured creditors and deferred creditors, the trustee must also distinguish among arm's length customers, 'related customers' who are associates or affiliates of the bankrupt firm, and 'deferred customers' who caused or materially contributed to the bankruptcy of the firm.

"Generally, out of the customers' fund the trustee pays the claims of arm's length customers (or of an insurer) and related customers. And out of the general fund the trustee pays the costs of administration, the claims of preferred customers, any remaining claims of arm's length customers (or of an insurer) rateably with the claims of ordinary unsecured creditors, any claims of related customers, the claims of deferred creditors and, finally, the claims of deferred customers.

"Although not mentioned the Bill presumes that the appropriate securities commission and self-regulatory organizations ('SRO') will cooperate fully with the trustee in bankruptcy to enable him to administer the estate of a securities firm with the least possible amount of regulatory delay. Indeed, in the typical case of a security firm insolvency, it is probably that an SRO will initiate the bankruptcy proceeding, the contingency fund ('insurer') will act at once to satisfy the claims of arm's length customers, and then the contingency fund will press the trustee for recovery from the estate, thus ensuring ex-

pert intervention to press customer claims and to maintain oversight of the trustee's administration of the estate. In such a case the contingency fund is declared to be a creditor of the estate to the extent it furnished money or securities to satisfy customers' claims and entitled to vote accordingly. Thus it is only where an insurer does not intervene to pay customers' claims in full that customers have claims as creditors. Where an insurer does intervene, the customers are treated essentially as passive depositors, much like depositors of a bank who are protected by deposit insurance."[290]

Chapter VI
Conclusion and Recommendations

(1) The two broad, sometimes conflicting objectives of national policy on capital markets are well stated in the recent *Australian Report on Securities Markets and Their Regulations:*
"i. The first [objective] is to maintain, facilitate and improve the performance of the capital market in the interests of economic development, efficiency and stability.
"ii. The second is to ensure adequate protection of those who invest in the securities of public companies in the securities market."[291]

(2) The interests of stock exchanges, broker-dealer associations and their members can conflict with the public interest.

(3) The public has a legitimate interest in the operation of stock exchanges, broker-dealer and investment dealers associations. These institutions are among the financial institutions of the country and are comparable to banks, trust companies, loan companies, insurance companies, credit unions and similar institutions. As such they should, in the public interest, be subject to regulation, as is any other financial institution.

(4) The right of stock exchanges and broker-dealer associations to self-regulation should be subject to an overriding right in some public body, such as a securities commission, to supplement and supervise their actions and conduct. This right should be asserted aggressively to provide where necessary meaningful corrective measures having "due regard to the public interest, the protection of investors, the need to assure

290 CONSUMER AND CORPORATE AFFAIRS CANADA, BACKGROUND PAPERS FOR THE BANKRUPTCY AND INSOLVENCY BILL (Ottawa 1978).

291 1 REPORT ON SECURITIES MARKETS AND THEIR REGULATION, *supra* note 284, at 15, 16.

fair dealing in securities, the maintenance of fair, honest, and orderly markets and the need to provide and foster competition in our capital markets".[292] As a minimum this implies that securities commissions should have the human and financial resources to effectively assume this responsibility.

(5) The National Contingency Fund established by the exchanges and the Investment Dealers Association represents a major contribution to investor confidence in the Canadian securities industry. There cannot however be complete investor confidence in the industry when there is no legal liability by the industry to compensate a client of a defaulting member. At present, an investor can never be sure whether he will be compensated in whole or in part in the event the broker-dealer with whom he does business should fail.

(6) The securities industry should undertake to protect and compensate all arm's length and *bona fide* customers up to a maximum amount from losses incurred through the financial failure of a member and demonstrate that it has the capacity to underwrite this reponsibility. In the alternative, some scheme of deposit insurance should be established for the securities industry similar to that provided by the Canadian Deposit Insurance Corporation. The creation of a corporation similar to the Securities Investor Protection Corporation of the United States is not recommended.

(7) The trading in commodities should be subject to greater regulation. Consideration should be given to the enactment of a Commodity Exchange Act. There should be provision for the registration or certification of commodity exchanges and for the registration of commission agents and the regulation of the manner and means by which commodities may be traded on the exchanges.

(8) Section 341 of the Criminal Code was primarily enacted to prohibit "bucket shops" where bets are made against the rise or fall of stocks or commodities and where the pretended transactions or purchase or sale are fictitious. Speculators, however, fulfil a useful function to ensure a smooth-running market, and it is widely accepted that by reason of the restricted interpretation placed upon section 341 by the courts the section does not prohibit speculation in futures or commodities where there is no intention to deliver or take delivery. Section 341 of the Criminal Code should be amended to

292 *National Market Board; Hearings on H.R. 4457 before the Subcomm. on Consumer Protection and Finance of the House Comm. on Interstate and Foreign Commerce*, 94th Cong., 1st Sess. 67 (1975) (statement of James J. Needham).

permit trading in futures and commodities without the necessity to have a *bona fide* intention to make or receive delivery.

(9) The principal cause in Canada for the failure of a broker-dealer is the fraud or dishonesty of customers and both the principals and employees of a firm. This primarily takes the form of theft of securities or funds, or fraudulent stock promotion or manipulation.

(10) Until the stock certificate is eliminated as evidence of ownership, theft will continue to be a serious hazard in the securities industry. All reasonable measures should be taken to minimize this risk. Such measures could involve improved operations systems to reduce the number of hands securities must pass through, stricter regulations in the safekeeping of customers' securities, and the creation of a theft detection system by developing a data bank for lost or stolen securities which would provide instant access to the numbers of all stolen or missing securities.[293]

(11) Customers' funds as well as securities may also be stolen. To minimize this, stricter regulations may be necessary on the use of customers' funds not used in customer-related transactions.

(12) Underlying all fraudulent activity in the securities industry is the growing involvement of organized crime figures in commercial fraud. Many of the top organized criminals have shifted their operations from risky crimes with severe penalties such as trafficking in heroin to stock frauds where the profits can be equally as high or often higher. Moreover, the risks of prosecution and severe punishment are much lower. Investigations are complex, expensive and time-consuming. One recent investigation of a stock fraud by the RCMP took more than three years to complete at a cost of $1 million. It involved thirty-six companies and required outside auditors to examine the books of the companies seized in raids that required one hundred men to make.[294] In the long run the capital markets and those who invest in securities and commodities will be exposed to greater losses through stock frauds than from any other source. The best protection is prevention. The investigative staffs of securities commissions

293 This last suggestion was made in the SECURITIES INDUSTRY STUDY REPORT, *supra* note 22, at 75.

294 The Globe and Mail (Toronto), April 2, 1975, at 3, reporting on an interview with Superintendent Henry Jensen, head of the RCMP Commercial Crime Branch. In the interview, he stated that the RCMP alone investigated $203 million worth of losses suffered by Canadians in 1973; "I couldn't give a good realistic estimate of the total loss by fraud - only a rough estimate. I'd say between $1 [billion] and $2 billion"; *id.*

should be expanded, as should the fraud squads and commercial crime branches of the various police forces in the country. As stock frauds can involve a planned bankruptcy, the Bankruptcy Branch of Consumer and Corporate Affairs Canada may also be involved to a much greater extent than in the past in the investigation of commercial fraud. With so many agencies that can and should be involved, and with the constitutional division of powers in respect to crime prevention and law enforcement in Canada, it is increasingly important to closely coordinate the work of all agencies.

(13) The proposed new system for the administration of a bankruptcy of a broker or securities dealer enormously simplifies and expedites the administration. The following amendments to Bill S-11 might be considered:

(a) The trustee shall be specifically authorized to purchase securities in the open market or complete open contracts, as desired by the trustee, to obtain securities needed to restore customers' accounts.

(b) The trustee shall be specifically authorized to sell or otherwise transfer customer accounts to another broker-dealer without the consent of customers.[295]

295 All of these suggestions except the first are among the recommendations in SIPC, *supra* note 209.

Securities Regulation: Structure and Process

John L. Howard

May 1978

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Abstract

I. Introduction

The purposes of this paper are generally to review a number of basic assumptions about the Canadian securities market and, more specifically, to explain the concept of economic regulation and its application to securities markets, analyze alternative regulatory mechanisms and propose the means the federal government can employ to regulate the Canadian securities market if it decides that it should regulate that market.

II. Nature of Economic Regulation

In a contemporary mixed economy there is an inevitable mix of the institutions of both command and market economies to achieve the three basic functions of government: to allocate resources among alternative uses, adjust the distribution of income and wealth among individuals, and stabilize the operation of the overall economy to achieve a high level of resource use with a minimum of inflation. To reconcile command institutions – partic-

John L. Howard is Assistant Deputy Minister, Corporate Affairs, Consumer and Corporate Affairs Canada. The opinions in this paper are those of the author and do not necessarily reflect the policy of the Government of Canada or of the department.

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ularly planning – with market institutions, the mixed economies have developed a hybrid institution called economic regulation to constrain the market activities of enterprises by equalizing market power, institutionalizing responsibility within the enterprise, or directing the structure and operation of a particular market through an external agency with power to control entry, conduct and prices in that market.

Regulation through an external agency to plan and direct the structure and operation of a particular industry is applied in two common cases: first, where there is a natural monopoly as in the infrastructure industries – energy, transportation and communications; second, where the government has artificially created a monopoly or cartel structure to achieve stability or security for specific actors in a market (for example, an agricultural marketing board to protect producers or a securities commission to protect investors), long-term political goals that are consciously given priority over the goal of ideal market efficiency.

III. Economic Function of Securities Markets

The regulation of capital markets to ensure investor security from fraud is a typical example of a government legitimated cartel structure, but the regulation of securities markets has one unique characteristic: much of the regulatory power is delegated to private sector agencies that exercise this power under the surveillance of the securities commissions. Within the overall capital market complex, however, the securities market – made up of stock exchanges, clearinghouses, brokers, transfer agents and depositories – is one more financial intermediary. Its distinguishing characteristic is that it permits the investor to participate directly in the ownership and control of enterprises on such conditions that the investor bears directly the risk of loss on any security he buys.

The flow of funds calculations in the national accounts of Canada for 1974 disclosed that the capital markets allocated some $7 billion out of an approximate total of $36 billion of savings that were employed by business firms in the economic system. Although the securities market allocated a relatively small amount of these total savings, the securities market is a valuable institution not only because of the still very large absolute value of the transactions executed in that market but also because of the catalytic effect of an issue of securities, which frequently enables a corporation to obtain credit from other sources simply because it has been closely and objectively scrutinized by underwriters, investment advisers and investors. But perhaps even more important are general public benefits that are extraneous to the goals of

the securities market actors: securities markets induce investment in productive enterprise; they empower investors to participate in the ownership and control of firms; and they tend to decrease the need for and so reduce the undesirable effects of extensive foreign direct investment.

IV. Development of Securities Market Regulation

Securities market regulation did not develop from preconceived premises but grew out of a number of separate policy initiatives set out in corporation laws and securities laws. Although the rhetoric to justify securities market regulation varies from one jurisdiction to another, depending on the prevalent political doctrine and economic dogma, there is an implied consensus that a securities market should be cartelized – at least in part – to ensure investor confidence and, as a corollary, should be subjected to close government surveillance, employing techniques analogous to those applied to regulate the public utilities or, in other words, the natural monopolies.

Recent developments in the securities market, particularly the immense growth of the financial intermediaries such as banks, pension funds and mutual funds and the implementation of computer-communications technology, have compelled reconsideration of the cartel-like structure and operations of the market and of the institutions designed to regulate that market. Current proposals – all of which assume a central information system – can be distinguished as four models: (1) a continuation of the present quasi-cartel structure with only service competition, managed by a private sector agency under the surveillance of a securities commission; (2) a straightforward cartel system with only service competition, regulated as a public utility by a securities commission having full powers over entry, conduct and prices; (3) a qualified cartel system, managed in respect of entry and conduct by a private sector agency under the surveillance of a securities commission but subject to negotiated commission rates; and (4) management of the central information system by government as a public utility but with no constraints on market entry or prices and only those conduct constraints required to ensure full and fair disclosure and to prohibit fraud with a view to achieving full price and service competition.

V. Regulatory Mechanisms

Unless the fourth market structure referred to in the foregoing paragraph is adopted, regulators of capital markets will tend to exploit all three regulatory techniques – balancing power to preclude monopoly control, institutionalizing responsibility with-

in firms, and regulating the market through an external agency. The first technique – balancing power–will continue to concern mainly the distribution of capital market functions among competing intermediaries and the reconciliation of securities law with competition law. The second technique – institutionalizing responsibility – will largely concern the reconciliation of securities law with corporation law, including the imposition of personal liability on directors and officers of securities market actors. But the emphasis will continue to be placed on the third technique, that is, the regulation of entry, structure, conduct and prices in the securities market through an external government agency or a self-regulatory agency subject to close government surveillance.

Although there is currently a great deal of criticism of the regulatory commission as an institution, it is probable that legislatures, for political reasons, will continue to invoke the regulatory commission – that is, a commission set up outside the conventional government departments – to resolve problems that are too complex to be resolved through ordinary bureaucratic administrators who apply relatively static statutory rules and standards. Following are the general characteristics of and the advantages frequently attributed to the regulatory commission.

(1) The independent regulatory commission is a minigovernment, which is empowered to exercise legislative, judicial and administrative powers with a view to planning the structure and operations of an industry or a market.

(2) As a general rule, a commission must have a relatively broad delegation of power under its enabling act if it is to be able to regulate imaginatively and effectively. Delegation under broad "public interest" standards is in effect authority to develop and enunciate policy as distinct from applying value-free rules and standards to specific cases. It is in this sense that each regulatory commission is in politics.

(3) For the same reason – the absence of value-free rules and standards – judicial review of the decisions of a regulatory commission is not a satisfactory means to control commission decisions, except to constrain a commission from acting outside the limits of its jurisdiction, acting arbitrarily, or following unfair procedures. A court should adjudge only the legality of a commission's decision, not the correctness of the policy decision made.

(4) Rather than focus on delegation standards or judicial review, it is more appropriate, particularly in the Canadian context where scant attention is accorded separation of powers mythology, to structure a commission in a way that achieves a workable balance between the commission's relative indepen-

dence and its responsiveness to the executive as well as its accountability, through a minister, to the legislature.

(5) Assuming regulation is politically necessary, the legislators and the regulators should be constantly aware when undertaking to regulate an industry or a market that to displace market competition – and particularly price competition – is to bureaucratize the industry or market. To do so is to abandon the price mechanism as a means of determining value and measuring performance and to substitute other performance measures. Wherever possible, therefore, regulation should be limited to conduct rules and standards and should only be extended to govern entry and prices – the strategic elements of a competitive market – when no other solution is politically acceptable.

(6) In summary, in addition to the general economic criticism that regulation is a poor substitute for a competitive market, regulation through a regulatory commission is frequently attacked on three fronts. First, the exercise of broad discretion within the context of a public interest standard may empower a commission to dilute the force or even subvert the original policy of the law, unless the standard is further refined or the agency subjected to continual policy oversight by the executive. Second, again because of the broad discretion exercised by a typical commission, it may act unlawfully, unfairly or arbitrarily unless it is subjected to judicial review. Third, because of its relative independence, a commission may become ineffective or even become a captive of the regulated industry, unless its planning is closely coordinated with the overall plans of the executive to ensure that the commission's goals and priorities are consistent with the government's goals and priorities.

(7) The regulatory commission is widely acknowledged to have a number of specific advantages over the conventional department structures that outweigh its disadvantages.

(a) It permits flexible and expert administration where bureaucratic administration of rules and standards as interpreted by the courts would not work. A commission can take on a novel and complex task, explore and analyze an industry, apply its expertise to refine very broad statutory policy through adjudication and regulation-making, and maintain continuous oversight of the regulated market or industry to determine the effectiveness of that policy.

(b) It permits the resolution of conflicts among rival interest groups, if not free from politics, at least free from the immediate pressure of short-term, partisan politics, permitting it to

avoid expedients and so develop policies that will have considerable continuity. A commission can, particularly when adjudicating a specific case, retain enough independence from the executive to decide the case impartially.
(c) Presumably it can, as a collegiate body, render better judgments and permit broader representation in the regulation-making process than can an agency with a single head.
(d) It enables interested persons better to aim their criticisms and to recommend policy changes to government because the establishment of a commission tends to focus program responsibility. A commission can also serve to balance conflicting interests by considering the interests of groups that are not well represented because the benefits of regulation are widely diffused among the public whereas the costs are concentrated and borne, for example, by a small group of producers.
(e) It can offer a number of administrative advantages, particularly freedom from the constraint of the bureaucratic rigidities of government personnel and financial management rules and from the requirement of queuing up to receive general services such as legal, data processing and public relations services. A commission can achieve better program performance through term employees or contracts. This also precludes the growth of tenured employees and so facilitates winding-up when a limited program goal has been achieved.
(f) It facilitates regional representation and also the coordination of programs that cut across the traditional jurisdiction of several departments.
(g) It is a versatile institution to coordinate intergovernmental programs, which is an especially important characteristic of a commission in a federal system.

VI. Institutions of Federal-Provincial Cooperation

In theory there are three approaches to the development of a system of securities market regulation. The first is a unitary system where the federal government occupies the field and displaces provincial laws. The second is a dual or two-tier system, where the federal parliament and provincial legislatures enact separate laws applying to different subjects or applying different but complementary standards to the same subjects. The third is an integrated system that permits Parliament and the legislatures to delegate administrative power to administer separate federal and provincial laws to one regulatory commission.

In view of the historic development of securities regulation in Canada and the realities of provincial powers, only a dual or an integrated system is likely to be adopted in Canada. A dual system,

such as that in the United States, has the advantage that it permits coexistence of discrete federal and state systems with a minimum of political conflict. The major disadvantage of a dual system is that it institutionalizes multiple statute systems, making practical administration and compliance with the law both complex and costly. In addition to uniform administration, an integrated system has the advantage that it will tend over time to develop uniform laws.

Because of the large number of variables involved, a great many regulatory models can be constructed, depending upon the system of regulation, the system of administration and the several alternative ways of dividing jurisdiction over securities market functions. Table 5 summarizes the dimensions of each model; table 6 illustrates a broad spectrum of possible models.

VII. Alternative Models - Securities Regulation

Models 4, 6, 10 and 13 are the models in table 6 that best reflect the range of alternatives and probably are most acceptable from a political point of view.

(1) Model 4 is a dual system with both federal and provincial securities commissions administering separate statutes and in which a provincial commission would deal only with intraprovincial trading and the federal commission with all other trading.
(2) Model 6 reflects a unitary system in the sense that there would be only one administrator of the securities law in each province, because the federal government would delegate exclusive powers to each provincial securities commission.
(3) Model 10 is a dual system, which presupposes separate federal and provincial securities commissions administering separate federal and provincial statutes, paralleling the U.S. system.
(4) Model 13 is an integrated system, based on the idea of delegation of powers from the federal Parliament and the provincial legislatures to one securities commission. This model does not require uniform laws, but because of the single commission it would tend strongly to the development of such laws and to the development of one disclosure system supported by a common data base.

VIII. Conclusions

Of these three models, model 13, although it engenders formidable political problems, is technically the most desirable. It continues reasonable provincial autonomy, permitting each province to establish for intraprovincial transactions its own substantive standards applicable to market entry and its own additional dis-

closure requirements. It will, because of the centralized policy making structure, tend strongly to the development of uniform laws and procedures. It also has the advantage that it permits the use of experienced personnel to administer the various laws through completely decentralized administrative offices. And finally, it reconciles central policy making with decentralized administration through a mechanism that, because it contemplates separate federal and provincial laws, is flexible in the sense that it can be responsive to local needs and yet be effective to achieve Canada-wide goals.

Chapter I
Introduction

In the introduction to its *Securities Industry Study* the House Subcommittee on Commerce and Finance characterizes the securities market as the "backbone of our economic system".[1] Even if one discounts this description as the hyperbole of technical experts who tend to see their field of expertise at the centre of the universe, it does reflect a broad consensus among the many vocal critics of the securities industry that the securities market is a cornerstone of a market economy serving to match the multitude of different liquidity preferences of savers and users of capital and allocate capital among those enterprises, particularly new enterprises, that can make most profitable use of it.

Notwithstanding the apparent consensus about the essential nature of the securities market, there has been for two generations an almost continuous controversy in the United States, the United Kingdom, Canada and other countries about how the market should be structured, how it should operate, and who should regulate it.[2] Indeed, during the last fifteen years econo-

1 STAFF OF SUBCOMM. ON COMMERCE AND FINANCE OF THE HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, 92D CONG., 1ST SESS., SECURITIES INDUSTRY STUDY (Subcomm. Print 1972) [hereinafter cited as HOUSE SECURITIES INDUSTRY STUDY]; The European Economic Community also stresses the fundamental importance of securities markets; *see* EUROPEAN CODE OF CONDUCT RELATING TO TRANSACTIONS IN TRANSFERABLE SECURITIES; 21 O.J. EUR. COMM. (No. L. 212/37) 41 (1977); INSTITUT UNIVERSITAIRE INTERNATIONAL DU LUXEMBOURG, L'AVENIR DES MARCHÉS DE VALEURS MOBILIÈRES, JOURNÉES D'ETUDES (1976).

2 *General*: OECD CAPITAL MARKETS STUDY, GENERAL REPORT (1967).

United States: SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. No. 95, 88th Cong., 1st Sess. (1963); SEC, INSTITUTIONAL INVESTOR REPORT; HOUSE SECURITIES INDUSTRY STUDY, *supra* note 1; STAFF OF SUBCOMM. ON SECURITIES OF THE SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, 93D CONG., 1ST SESS., SECURITIES INDUSTRY STUDY (Comm. Print 1973) [hereinafter cited as SENATE SECURITIES INDUSTRY STUDY]; J. LORIE, PUBLIC POLICY FOR AMERICAN CAPITAL MARKETS (Dept. of Treasury 1974) [hereinafter cited as the LORIE REPORT]; *Financial Institutions and the Nation's Economy (FINE): Hearings of the House Comm. on*

mists and lawyers have relentlessly probed, dissected, analyzed and criticized the purposes, structure, functions and performance of the securities market. They have questioned not only technical issues such as allocational and operational efficiency but also fundamental issues that had long been accepted as articles of faith – for example, fixed commission rates, private sector control over exchange membership, and confinement of government regulation essentially to the market actors' conduct, particularly by preventing market manipulation and other fraudulent activities.

The securities industry at first reacted strongly to deny many of the charges laid by its critics, pointing out that even if the securities market does not achieve the economist's conceptual model of a perfect market, it works well to allocate capital among business enterprises at relatively low cost. But during the past decade extraneous events overtook the securities industry. Tax laws were changed in a way that rendered high-risk investments less attractive to individual investors. Institutional investors expanded very rapidly, causing many individual investors to abandon the securities markets because they felt they had less information and therefore could not compete with the large intermediaries such as pension funds, mutual funds and trust companies. The institutional investors, seeking cheaper brokerage rates, developed techniques either to avoid fixed commission rates or to trade outside of the formal stock exchange markets. And finally, computer-communications technology developed to the point where it became not only cheaper but obviously essential to automate brokerage office accounting, trading information, clearing, settlement and, to a limited extent, even trading functions.

These extraneous pressures, particularly the brokerage office management problems in the United States and the increasing balkanization of the securities market into a number of regional and specialized markets, compelled the securities industry itself to

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Banking, Currency and Housing, 94th Cong., 1st and 2d Sess. (1975-76) (Pts. 1-4, Compendia Bks. I & II).

Canada: PORTER REPORT at 331-55; G. CONWAY, THE SUPPLY AND DEMAND FOR CANADIAN EQUITIES (1970); D. SHAW & R. ARCHIBALD, THE MANAGEMENT OF CHANGE IN THE CANADIAN SECURITIES INDUSTRY (vols. 1-8, 1972-77); *see* reports *cited in* D. JOHNSTON at 1 n. 1.

United Kingdom: Dept. of Trade, Questionnaire Concerning Supervision of the Securities Market (June 1974); Bank of England, The Council for the Securities Industry (Press Notice March 30, 1978); Reid, *City Launches New Council to Police Standards*, The Financial Times (London), March 31, 1978, at 1, col. 3.

Australia: PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA, AUSTRALIAN SECURITIES MARKETS AND THEIR REGULATIONS: REPORT FROM THE SENATE SELECT COMMITTEE ON SECURITIES AND EXCHANGE (1974) [hereinafter the RAE REPORT].

France: LE MARCHÉ DES ACTIONS (Rapport Baumgartner June 1971).

re-examine first principles. This was to determine whether the securities market should have a different character and, accordingly, whether it should be regulated as an essentially free market, a special kind of cartel, or a closely regulated information network characterized as a public utility that would permit the operation of a relatively free market with respect to entry and conduct. After years of acrimonious debate the United States Congress decided somewhat ambiguously to adopt the latter policy,[3] that is, a comprehensively regulated but relatively open, nation-wide market where price competion will prevail and where all qualified actors will have access to all pertinent information with a view to achieving best execution of their securities trades.

Although it has only been on the fringe of the United States controversy, Canada cannot ignore the fundamental changes taking place in the United States because the North American capital markets are closely integrated. Some changes – particularly negotiated commission rates and improved information systems – have immediate impact in Canada, as evidenced by the debates here concerning fixed commission rates and computerized trading systems. The purposes of this paper, therefore, are generally to review a number of basic assumptions about the Canadian securities market and, more specifically, to explain the concept of economic regulation and its application to securities markets, analyze alternative regulatory mechanisms, and propose some of the alternative means the federal government may employ if it decides that it should regulate the Canadian securities market.

Chapter II
Nature of Economic Regulation

In the literature of economics, political science and law there is no concept more nebulous than government regulation, which is invoked to achieve many purposes ranging from authoritarian control to mere persuasion both at the macro and micro levels of the economy, employs many instruments (both direct and indirect) and, to complicate matters further, is too often seen, analyzed and criticized as a one-dimensional institution. For these reasons it is inadequate simply to define "regulation". Instead I shall try to explain briefly the overall context within which the term is used (except those cases in respect of which the term is not appropriate) and so focus on the aspect of "regulation" that is the central concern of this paper.

3 *See* SECURITIES REFORM ACT OF 1975, H.R. REP. NO. 94-123, 94th Cong., 1st Sess. (1975).

Although an almost infinite variation of themes is possible, if we categorize each in accordance with the coordinating mechanisms it uses to link the activities of all subunits, there are only three basic economic systems: first, a traditional system where all functions and roles are largely predetermined as in a feudal society; second, a market or, in other words, a price system; and third, a command system based on a planning process.[4] In a traditional feudal system the function of each unit was related to specified lands and the role of each individual actor was largely determined by his social status. The fundamental institution was a tacit or even express agreement between each individual and his superior in the feudal hierarchy that set out the reciprocal obligations of each to the other. The feudal system was stable but essentially static and therefore unable, like the dinosaur, to adapt even to glacial changes in society. Government intervention did exist in the feudal system, particularly in connection with the transfer of titles of nobility, the transfer and use of land, and the prices for goods and services,[5] but since even secular change was rare government intervention was infrequent and, because all units were bound tightly together in the system, it was generally seen as natural and unobtrusive.

In contrast, a market system is predicated on the idea of dynamic equilibrium, a system in which each unit is relatively free to decide what, how and when it will produce and consume and to make such decisions with reference to prices that respond generally to the supply and demand for goods and services. How well these conditions are fulfilled depends upon a number of factors – the relative size and power of the different market actors, the free flow of information, and the degree of government intervention, which can include even government ownership if it does not displace the actual operation of the market as a price setting mechanism.

A command system, although it can be dynamic in the sense that it adjusts readily to a changing environment, deliberately eliminates the market as a price setting mechanism and substitutes, instead, a governmental planning mechanism that determines objectives, priorities, input allocations, input costs, output

4 G. Grossman, Economic Systems 18–20 (1974). *See also* H. Jacoby, The Bureaucratization of the World (1973).

5 Two notable interventions were the Statute of Labourers, 1351, 31 Edw. 3, St. 1, c. 6, which was enacted in response to the intense labour shortage created by the great plague of 1348–49 to fix wages and prices and to make it an offence for an unemployed, able-bodied man to refuse a job offered to him; and the Statute of Artificers, 1563, 5 Eliz., c. 4, which was enacted, in contrast, in response to a population boom, and which among other things introduced a work-sharing program; *see* E. Morgan, American Slavery, American Freedom 62–68 (1975).

prices, and ultimate end uses. As a substitute for the price mechanism and the resultant determination of profits to gauge the success of an enterprise, the planning authority sets out a number of alternative performance measures. For the invisible hand of the market system the command system substitutes express controls over the operations - or at least over the objectives - of each subunit in the economy in accordance with an overall economic plan, which may be established centrally by a state agency or through a system of cartels that are coordinated or even directed by a state agency.[6]

There is no such thing as a pure traditional, market or command economy, for each modern economy, usually referred to as a mixed economy, exploits some of the coordinating techniques that characterize each system in order to carry out the three basic economic functions of government: (1) to allocate resources (especially the basic factors - capital, labor, natural resources) among alternative uses; (2) to adjust the distribution of income and wealth among individuals; and (3) to stabilize the overall economy with a view to achieving a high level of resource use with a minimum of inflation.[7] The outstanding characteristic of the traditional system is a set of relatively static controls relating to personal status, land use and the fixing of prices of goods and services. The signal characteristic of the command system is a set of quite dynamic controls relating to objectives, input allocations and end uses. The outstanding characteristic of the market system is the allocation of resources in accordance with price bids made by relatively free subsystem units, subject only to a limited number of controls and a broad spectrum of constraints that serve to miti-

6 The obvious example of the centrally planned economy is the system of the Soviet Union, described in detail in R. CAMPBELL, SOVIET ECONOMIC POWER (2d ed. 1966). There are many versions of attempts at decentralized planning through cartels under varying degrees of government supervision. The U.S. experience during the New Deal era is summarized in M. FAINSOD, L. GORDON & J. PALAMOUNTAIN, GOVERNMENT AND THE AMERICAN ECONOMY 525-69 (3d ed. 1959) [hereinafter cited as M. FAINSOD]; and in C. WILCOX, PUBLIC POLICIES TOWARD BUSINESS 762-66 (4th ed. 1971). Vestiges of these cartels continue to exist in certain sectors of the agricultural industry, *e.g.* through milk or egg marketing boards.

For an interesting comment on regulation in a planned economy, *see* Kurczewski & Frieske, *Some Problems in the Legal Regulation of Economic Institutions*, 11 L. & SOC. REV. 489 (1977).

7 *See* R. MUSGRAVE, THE THEORY OF PUBLIC FINANCE 5-27; Musgrave, *On Social Goods and Social Bads*, in THE CORPORATE SOCIETY 251 (R. Marris ed. 1974). *See also* W. FRIEDMANN, THE STATE AND RULE OF LAW IN A MIXED ECONOMY 3 (1971), where the author uses four similar but different functional categories - provider, regulator, entrepreneur and umpire. *See also* Lowi, *Four Systems of Policy, Politics and Choice*, [1972] PUB. AD. REV. 299, where the author speaks of four categories of policies that determine the form of government action - distributive, constituent, regulatory

gate blind market forces, to fill in gaps where markets do not work effectively, or to make markets work better.

In sum, both traditional and command economies are essentially distinguished by express, detailed controls, whereas the market economy is distinguished by relatively free decision making by subsystem units in a context where absolute controls are applied only in exceptional cases and where regulatory instruments are employed generally to make markets work better and more equitably. In this paper, therefore, "control" means state power to decide resource allocation, production and consumption issues in a manner that displaces the market as an institution. In contrast, "regulation" includes all of the techniques employed in a market economy to mitigate market forces through transfer payments, adjustment payments and stabilization instruments; to restrain market forces through constraints on competition; to reconcile monopoly or cartel activities with an overall market system, particularly so-called natural monopolies; and to make markets work better by equalizing the respective powers of market actors, institutionalizing responsibility for good market conduct in each actor, or setting up an external agency with power to adjust market structures and operations.[8]

But for the purposes of this analysis even this definition of regulation is too broad, encompassing as it does a very broad range of government activities to manage a market economy, therefore the meaning must be further refined, first by distinguishing between mechanisms used at the macro as distinct from the microlevel, and second by distinguishing among direct and indirect mechanisms used at the microlevel.

Macroeconomics, which deals with national income analysis[9] – aggregate flows such as gross national product, national income, aggregate investment and total consumption, as well as relationships among these aggregates and means to adjust them – involves mainly instruments that have direct impact on aggregate demand, particularly taxes, money supply, credit constraints, and government spending, including spending in the form of transfer payments to equalize imbalances among regions, economic sectors and households. Direct intervention at the macrolevel is not pertinent to this paper, which assumes that the proposed techniques of

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and redistributive policies, *cited in* Doern, *The Concept of Regulation and Regulatory Reform*, in CANADIAN PUBLIC POLICY 8 (G. Doern & V. Wilson eds. 1974).

8 Kaysen, *The Corporation: How Much Power? What Scope?*, in THE CORPORATION IN MODERN SOCIETY 85, 103 (E. Mason ed. 1966).

9 *See* C. SCHULTZE, NATIONAL INCOME ANALYSIS 11 (3d ed. 1971).

More specifically, macropolicies regulate aggregate demand with a view to

regulation at the microlevel are consistent with the overall macroeconomic policy context, therefore macrolevel techniques of intervention will not be considered further.

At the microlevel, where we are concerned with determining how the market or price system allocates and distributes particular goods and services among subsystem units (*i.e.*, the composition of the aggregated national accounts), there exists a broad range of direct and indirect intervention mechanisms that render the activity of an economic unit more or less profitable and therefore influence both input allocation and output distribution. The techniques of *direct* intervention at the microlevel include subsidies, tax incentives and disincentives, credit privileges, price supports, supply management, tariffs, import-export restrictions, foreign controls, and foreign investment restrictions.[10] The last two techniques are especially significant in their impact on securities markets, but because all of these techniques are usually applied to achieve policy goals that consciously displace or are extraneous to the operation of the market system, they too will not be further discussed in this paper.[11]

Closely related to these techniques are the methods of *indirect* intervention used by governments to administer public utilities in the infrastructure or natural monopoly sectors, particularly energy, transportation and communications, where a firm is given a specifically circumscribed monopoly licence subject to the conditions that it furnish services to all members of the public on equal terms and that it comply with the policies of the licence-granting authority, policies that are generally determined in accordance with broad public interest, convenience and necessity standards. The state could achieve the same end by directly owning and administering these services, but for ideological reasons it is often

maintaining growth and output over time at a level consistent with reasonable price stability and a sound international payments position.

10 Price and wage controls - or to use the economist's euphemism, incomes policy - are not considered here on the ground that they displace the price mechanism rather than influence input allocation and output distribution. Although selective controls may not completely displace the price mechanism, they do constitute controls, a form of ad hoc planning.

11 *See* on this subject Wilson, *The Politics of Regulation*, in SOCIAL RESPONSIBILITY AND THE BUSINESS PREDICAMENT 135, 136 (J. McKie ed. 1974).

Note too that this paper eschews any discussion of *social* as distinct from *economic* regulation. Although it has clear economic impact, social regulation focuses on social objectives such as consumer protection, safe working environments, and environmental protection. For a very useful comparison of economic and social regulation, *see* W. LILLEY & J. MILLER, THE NEW "SOCIAL REGULATION" (Am. Enterprise Inst., Rept. No. 66, 1977); B. MONTADOR & H. BAUMANN, GOVERNMENT INTERVENTION IN THE MARKETPLACE AND THE CASE FOR SOCIAL REGULATION (Planning Branch, Treasury Board Secretariat, Canada 1977).

more politic to delegate this function to private sector units.[12] In addition, because these utilities operate within the context of at least a proximate market system in which they compete to obtain resources and to sell alternative services, it is frequently possible to apply some extraneous, objective performance measures established by comparison with like units or with the costs of alternative services in order to determine how well the unit performs the economic task assigned to it.[13] This paper does not attempt to analyze or evaluate utility regulation, but since the techniques used to administer utilities apply in part to all forms of market regulation, utility regulation furnishes an abundance of illustrations based on extensive experience and in-depth analyses.[14]

In the securities market context we are not concerned with *direct* microlevel mechanisms that displace market decisions or that constrain market actions. We are concerned, instead, with *indirect* microlevel mechanisms that attempt to minimize market imperfections engendered by government policies to protect investors through cartel-like structures consciously designed to give the objectives of stability and investor security priority over market efficiency. In short, we are concerned not with displacing the market but with making a constrained market work better. The ideal goal is the economist's paradigm of the perfect market in which there are many buyers and sellers, no market actor has enough power to affect prices materially, all products or services exchanged are homogeneous or interchangeable, all buyers have equal information about all variables, transaction costs are immaterial, all buyers and sellers have freedom of entry and exit, all actors behave rationally, and no government constraints are imposed on the market to achieve extraneous goals.[15] The perfect market, particularly because of the last two conditions, is very

12 Any proposed state acquisition of a public utility must also overcome a number of practical hurdles - enormous acquisition costs, the reluctance of foreigners to deal with a state-owned enterprise, and more complicated performance measurement because of the almost inevitable diffusion of enterprise objectives to achieve broad social and economic goals.

13 The performance measure used is the litmus test to distinguish between a price system and a command system, between competitive management and bureaucratic management; *see* A. DOWNS, INSIDE BUREAUCRACY 25 (1967).

14 On this subject *see generally* W. SHEPHERD & T. GIES, UTILITY REGULATION: NEW DIRECTIONS IN THEORY AND POLICY (1966).

15 *See* R. LEFTWICH, PRICE SYSTEM AND RESOURCE ALLOCATION 25 (1963), *cited in* A. Berczi, The Stock Exchange - A Total System Approach vi (unpublished paper of Faculty of Commerce and Administration, Sir George Williams University July 1971). *See also* 1 D. SHAW & R. ARCHIBALD, *supra* note 2, CANADA'S CAPITAL MARKET iv (June 1972); Demsetz, *Perfect Competition, Regulation and the Stock Market*, in ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES 1, 1-11 (H. Manne ed. 1969).

much a hypothetical construct, but it furnishes a useful benchmark when evaluating a regulated market system.

The three techniques of *indirect* market regulations – balancing market power, institutionalizing responsibility within market actors, and oversight of the market by an external agency – assume that the market or price system, where it is politically feasible, is the best mechanism to determine the allocation of resources and distribution of goods and services.[16]

The first technique, the balancing of market power, is best illustrated by the competition laws, which prohibit cartel agreements that restrain competition and attempt to block the development of monopoly,[17] and by the industrial relations laws, which confer legitimacy on corporate bodies designated as appropriate bargaining units that have power to bargain effectively on behalf of wage earners with the professional managers of business corporations.[18] The second technique, the institutionalization of responsibility within market actors, is illustrated by the corporation laws[19] and certain labor union laws,[20] both of which attempt to ensure that professional managers and the majority shareholders or members will exercise their powers fairly and in the interests of the corporate body. Other illustrations are the European corporation laws that attempt, through internal supervisory boards on which wage earners are represented, to further solidarity among the wage earners, managers and shareholders within a corporation with a view to reducing industrial disputes, and the various schemes that are designed to induce wage earners to become shareholders of the corporation that employs them.[21]

16 Wilson, *supra* note 11, at 141-46, demonstrates that the distribution of costs and benefits of a regulatory policy will determine the means of regulation.

17 *See* J. Bain, Industrial Organization 515-17 (2d ed. 1968); R. Caves, American Industry: Structure, Conduct, Performance 93-94 (3d ed. 1972).

18 *See generally* C. Wilcox, *supra* note 6, at 14, 718-20; M. Fainsod, *supra* note 6, at 187-95; V. Mund, Government and Business (4th ed. 1965).

19 This was the principal policy goal of the Canada Business Corporations Act, which received Royal Assent on March 24, 1975.

20 The best illustration is the Labor-Management Reporting and Disclosure Act of 1959, Pub. L. No. 86-257 (1959) (Landrum-Griffin Act), referred to in R. Freeman, Labor Economics 125 (1972) and analyzed in detail in A. McAdams, Power and Politics in Labor Legislation (1964).

The Québec government enacted a similar but more stringent law in response to the sensational disclosures made to and the recommendations of the Cliche Commission; *see* an Act Respecting the Placing of Certain Labour Unions Under Trusteeship, S.Q. 1975, c. 57.

21 *See e.g.* Proposed Statute for the European Company, E.E.C. Bull. Supp. 115, art. 137 (1970). Since this institution is limited to one corporation there is no implication of cartelization of an industry as was attempted through the NRA codes during the New Deal era in the United States; *see* S. Shonfield, Modern Capitalism 309-18 (1965); M. Fainsod, *supra* note 6, at 525-43.

Another interesting variation is the Kelso Plan, designed to induce employee

The third technique, the creation of an external private or public sector agency with power to supervise public utilities or markets such as the securities market, is the central concern of this paper, not only because the North American securities markets have been subject to external regulation for a number of years, but also because the external regulatory agency, particularly in a federal context, is the most versatile instrument of regulation. Looking at the myriad agencies that have been set up to regulate infrastructure utilities and markets in various North American jurisdictions, one is at first dazzled by the permutations of purposes, structures and powers of these agencies, but close scrutiny reveals that, although often not too clearly expressed, they have only one goal and a relatively short list of powers. Their goal is to reconcile natural monopoly enterprises or contrived cartel structures with an overall market economy, seeking as far as possible to exploit the respective advantages of planning and market systems.[22] To achieve this goal they exercise regulation making, administrative, investigatory and adjudicative powers to supervise or constrain the activities of each regulated enterprise. In exercising these powers they tend to concentrate their attention on three market characteristics: (1) market entry; (2) the structure of the market and the conduct of the actors in that market; and (3) the direct setting of prices or the indirect setting of prices through the management of supply of the goods or services exchanged in that market.[23]

The foregoing discussion concerning alternative economic systems, the functions of government, and the techniques of economic regulation (summarized in table 1), furnishes a background to develop a framework for analysis of the regulatory process that can be applied to analyze the regulation of securities markets. This is not a novel undertaking. In a landmark article published in 1940, M. Fainsod outlined the concepts of regulation, summarized the

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share purchases, *discussed in* INTERIM REPORT OF THE SELECT COMM. OF ONT. LEG. ON ECONOMIC AND CULTURAL NATIONALISM, CAPITAL MARKETS, FOREIGN OWNERSHIP AND ECONOMIC DEVELOPMENT 92-99 (1974).

22 Note that these regulatory techniques can be characterized in many ways. C. WILCOX, *supra* note 6, categorizes regulatory techniques as aspects of competition: (1) controlling monopoly by maintaining competition; (2) controlling monopoly ("natural monopoly") by regulation; (3) controlling monopoly by public enterprise; (4) setting the plane of competition (consumer, investor, resource protection); and (5) moderating competition to achieve a higher priority policy goal (labor law, agricultural cartels, etc.). M. FAINSOD, *supra* note 6, at 187-95 employs different categories.

See also Feller, *Public Policy of Industrial Control*, in PUBLIC POLICY 130 (C. Friedrich & E. Mason eds. 1940).

23 B. SCHWARTZ & H. WADE, LEGAL CONTROL OF GOVERNMENT 29 (1972).

Table 1
Alternative Objectives and Techniques of Regulation

Level and nature of regulation	Objective of regulation	Technique of regulation	Selected illustrations
Macrolevel	To stabilize the economy with a view to maintaining a high level of production and employment with minimum inflation	Adjusting aggregate demand through tax, government spending, and money supply and credit policies	Government budget and central bank actions
Microlevel direct intervention	To influence directly input allocation, production and output distribution	Subsidies	Shipbuilding
		Tax incentives	Investment credits
		Price supports	Agricultural product marketing cartels
		Tariffs or quotas	Textiles
		Foreign exchange controls	Exchange only to acquire capital goods
		Export restrictions	Military technology
		Foreign investment controls	Land ownership prohibitions
Microlevel indirect intervention	To influence indirectly input allocation, production and output distribution	Equalizing the respective powers of market actors	Competition laws and labor relations laws
		Institutionalizing responsibility for good market conduct in specific actors	Corporation laws and labor union laws
		Setting up an external agency with power to adjust market structures and operations through constraints on entry, conduct and prices	Utilities (Canada): CRTC; CTC; NEB Utilities (U.S.): ICC; FPC; FCC; CAB Other (Canada): RTPC Provincial securities commissions Other (U.S.): FTC; SEC

basic issues and recommended that any analysis of the regulatory process should proceed on three levels – analysis of (1) the institutional matrix, (2) the parties in interest concerned with the character of the regulation and (3) the policy instruments employed.[24] Fainsod particularized the institutional matrix to include technology, economic organization, ideology and law. He defined the parties in interest concerned with the nature of the regulation or, in other words, with the constraints imposed, to include policy-makers, investors, managers, employees and consumers. And he described the political instruments invoked to implement a regulatory system to include legislation and regulations, administrative discretion and judicial review of the substantive law and its application. In short, Fainsod recommends that any analysis of the regulatory process take into account the many dimensions of the issue as seen from the point of view of the legislator, the administrator, the economist, the political scientist and the lawyer.

Such an analysis, even if restricted only to the securities industry, is a formidable task, but in view of the current controversy over freely negotiated brokerage commission rates and the rapid development of computer-communications technology, this kind of analysis is more important than ever in order to seek answers to questions such as the following. Is there any reason to continue to view the securities industry – particularly the stock exchanges – as a kind of monopoly enterprise that must be treated as a public utility? Can we convert the present utility nature of the enterprise to a free market enterprise by removing fixed commission rates and eliminating barriers to market entry? Are the present constraints on competition – controls over entry, structure, conduct, and rates – essential, or are they required only because the securities industry is artificially structured as a quasi-monopoly? Should an electronic information and trading system be characterized as a pure public utility and controlled accordingly? Does the present system of administrative law applicable to the securities industry, which law is predicated on regulated market assumptions, actually make the securities industry function better or has it become an end in itself to prop up an artificial system? It

24 Fainsod, *Some Reflections on the Nature of the Regulatory Process*, in PUBLIC POLICY, *supra* note 22, at 299, 323. *See also* Bernstein, *Independent Regulatory Agencies: A Perspective on Their Reform*, 400 ANNALS OF AM. ACAD. POL. & SOC. SCI. 14 (March 1972); G. DOERN, I. HUNTER, D. SWARTZ & V. WILSON, APPROACHES TO THE STUDY OF FEDERAL ADMINISTRATIVE AND REGULATORY AGENCIES, BOARDS, COMMISSIONS AND TRIBUNALS 47-60 (Report Prepared for the Canada Law Reform Commission April 1974).

For a recent review of this subject *see* Sabatier, *Regulatory Policy Making: Toward a Framework of Analysis*, 17 NAT. RESOURCES J. 415 (1977).

is impossible to deal exhaustively with each of these issues in a brief monograph, but it is possible to analyze succinctly the economic functions of the securities market, examine the techniques of market regulation, scrutinize the policy assumptions underlying that regulation, and consider alternative means to deal with the securities industry within the analytical framework suggested by Fainsod.

To simplify and abridge the analysis of this vast subject, this paper is expressly predicated on several basic assumptions. First, with respect to the institutional matrix, the ideal securities market is a free market, regulated only as required reasonably to reconcile the conflicting public interests in investor protection and dynamic promotion of new enterprises. Second, also with respect to the institutional matrix, computer-communications technology will within the next decade largely supplant the present securities market institutions and, as a corollary, will require a complete rethinking of present regulatory techniques. Third, with respect to the parties in interest, this paper assumes that regulation of the securities market, because of its strategic role in a market economy, concerns all members of society, whether in their capacity as policy-makers, investors, managers, employees or consumers, and therefore must seek to achieve a reasonable balance among their particular interests. Accordingly, this paper focuses largely on the alternative policy instruments that may be invoked to regulate the securities market.

Chapter III
Economic Function of Securities Markets

Because of the intrinsic difference between a command economy and a market economy, it follows that each system will employ altogether different techniques to allocate capital among government, households and business firms. Between these polar extremes there is the contemporary mixed economy such as the Canadian economy, which employs a broad mix of mechanisms to direct or, more frequently, to influence the allocation of capital.

In a command economy all savings, even those generated internally within subsystem units are taken into account and allocated in accordance with the overall economic plan. In contrast, in a mixed economy, only rarely does government directly allocate savings among users of capital, but it can – and frequently does – invoke several policy instruments to bring to bear a strong, indirect influence on the allocation process. For example, it may grant direct subsidies or tax concessions to a specific sector with a view to developing that sector generally or in a specific region. It

may allocate savings obtained through the tax system or the securities markets directly to government enterprises.[25] It may indirectly allocate capital through government controlled financial intermediaries set up to influence development in certain sectors or regions or to promote small business.[26] It may sponsor the operation of the securities market by furnishing intermediate financing to strategic market actors, particularly underwriters and secondary market-makers.[27] It may regulate the securities market on the assumption that it is a kind of natural monopoly, paralleling the controls over entry, conduct and prices that are applied to regulate public utilities. It may, on the other hand, regulate or even operate the securities market on the assumption that it is intrinsically an absolute monopoly.[28] Or it may employ a mix of two or more of these techniques, depending on the prevailing economic ideology and political environment. There is no one technique that can be characterized as more or less obtrusive than the other, for the technique employed depends on assumptions about whether a market is desirable or even possible and about the prevailing concept of the acceptable role of government.

Before proceeding to determine how the securities market might be regulated, it is essential to determine what functions it

25 *See e.g.* the Petro Canada Act, S.C. 1975, c. 61.

For an excellent analysis of indirect techniques of capital allocation employed in the United States, *see* L. YEAGER, PROPOSALS FOR GOVERNMENT CREDIT ALLOCATION (American Enterprise Institute 1977).

26 *See e.g.* the Canada Development Corporation Act, S.C. 1970-71-72, c. 49, s. 2, which states that the purpose of the Act is "to establish a corporation that will help develop and maintain strong Canadian controlled and managed corporations in the private sector of the economy and will give Canadians greater opportunities to invest and participate in the economic development of Canada".

See also the Federal Business Development Bank Act, S.C. 1974-75, c. 14, s. 4, which was created "to promote and assist in the establishment and development of business enterprises in Canada...".

27 Arguing that the pervasive influence of development banks has prevented the development of a securities market in developing countries, Kleinman advocates that governments sponsor a liquidity fund to finance the interim holdings of securities by underwriters and market makers; *see, Hearings on Capital Markets and Economic Development: The Kleinman Plan, Subcomm. of Inter-American Affairs of House Comm. on Foreign Affairs*, 92d Cong., 2d Sess. 2-17 (1972) [hereinafter cited as the *Kleinman Plan*].

28 *See* J. STONE, AN ECONOMIC STUDY OF THE SECURITIES INDUSTRY 40-41 (1975), where the author argues that economic analysis requires government ownership or full regulation. For a similar argument *see* F. Weil, The Securities Industry: Myth v. Reality - And a Proposal (paper published by Paine, Webber, Jackson and Curtis, N.Y. June 1975), *reprinted in Securities Amendments Act of 1975: Hearings on S. 249 Before Subcomm. on Securities of Senate Comm. on Banking, Housing and Urban Affairs*, 94th Cong., 1st Sess. 268 (February 1975).

One author underlines, however, that at least in the U.S., government has a strong bias toward regulation and away from public ownership or management; *see* Wilson, *supra* note 11.

performs, show how they fit into the overall capital market structure and consider whether they are important enough to justify costly, detailed government surveillance. In conceptual terms, securities markets make available formal trading centres, establish guides to the value of securities, and furnish a mechanism to enhance the liquidity of government and corporate securities in the sense that they permit an investor to exchange his freely transferable securities for money at low cost with a minimum reduction of market price engendered by the transaction. Indeed, it is this latter function that is the principal reason for having a securities market, that is, to bridge the manifold liquidity preferences of savers and the requirements of governments and enterprises for medium-term and long-term capital. In more concrete terms, the functions of the securities market can best be expressed by reference to five general categories of market outputs (table 2).[29]

In short, the general function of the securities market complex – which includes underwriters, stock exchanges, clearinghouses, transfer agents, investment advisors, securities depositories and, at least peripherally, the accounting profession – is to act as one more financial intermediary in the overall capital market.[30] Virtually all financial intermediaries are subject, like public utilities, to regulation designed to protect those persons who entrust their savings to the intermediaries as money managers. It is not surprising, therefore, that analogous techniques are employed to regulate the securities market, particularly utility-type controls over market entry, structure, conduct and prices, which vary from one jurisdiction to another depending upon prevailing attitudes about the desirability of open competition – as distinct from mere service competition – among financial intermediaries. The policy in each jurisdiction will reflect the weight given on the one hand to investor security and on the other to

29 J. STONE, *supra* note 28, at 14-15. *See also* Friend, *The SEC and the Economic Performance of Securities Markets*, in ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES, *supra* note 15, at 185.

30 *See* Werner, *Management, Stockmarket and Corporate Reform: Berle and Means Reconsidered*, 77 COLUM. L. REV. 388, 407 (1977) where the author points out that the nexus between distributing corporations and the securities market and the integration of the securities markets into national and international financial markets has even obscured the distinction between financial and non-financial institutions, for the latter, when they use funds obtained externally to finance the sale of their products or to purchase money market instruments or other securities, are themselves functioning as financial intermediaries.

For a general discussion on financial intermediaries *see* D. BOND & R. SHEARER, THE ECONOMICS OF THE CANADIAN FINANCIAL SYSTEM (1972); ECONOMIC COUNCIL OF CANADA, EFFICIENCY AND REGULATION: A STUDY OF DEPOSIT INSTITUTIONS (1976).

Table 2
General Categories of Securities Market Functions

Function	Description
Nondiscretionary exchange services	Matching buyers and sellers, clearing and settling securities ownership claims and cash claims
Liquidity services	Assumption of risk by an intermediary acting as an underwriter or secondary market-maker both to spread the risk of loss and to satisfy immediate liquidity preferences
Information services	Disclosure of information about each market actor and about market trades that can affect price decisions
Administrative services	Investment advice, portfolio management, and record keeping
Corporate finance services	Advice to and distribution services for issuers of securities

Table 3
Financial Intermediaries: In Order of Increasing Direct Investor Exposure to Risk

Financial instrument employed	Financial intermediaries							
	Commercial bank	Savings bank	Trust company	Insurance company	Loan company	Mutual fund (open-end)	Investment company	Securities market
Demand deposit contract	X							
Term deposit contract	X	X	X					
Life insurance policy				X				
Annuity contract				X				
Variable life insurance policy				X				
Variable annuity contract				X				
Trust agreement (pension fund, etc.)			X					
Variable share of mortgage portfolio					X			
Variable share of securities portfolio						X	X	
Broker's pooled account						X		
Individual's securities trading contract								X

speculative enterprise or, in other words, will reflect the relative community values attributed to order and to creative freedom.

Refracted through an analytical prism, the broad spectrum of financial intermediaries can be divided into several discrete kinds of institution, the salient characteristic[31] of each being the potential risk[32] of loss borne by the owner of savings channeled through a particular intermediary. Table 3 attempts to illustrate concisely this characteristic of each financial intermediary, setting out in the columns the kinds of intermediaries in order of increasing investor risk from left to right, and setting out in the rows the kind of financial instrument employed, again in order of increasing investor risk from top to bottom.

Table 3, because it cannot set out all the variables that relate to each intermediary, only reflects generally the trend of investor exposure to increased risk of loss. For example, at the one extreme, with respect to a commercial bank the first risk of any loss is borne directly by bank shareholders and not depositors; but even this security is reinforced by minimum net capital rules and deposit insurance. At the other extreme, with respect to the securities market complex – where the investor bears directly all risk of loss connected with the security – the investor who leaves cash or securities in the custody of a broker is further protected from loss caused by the insolvency of a broker – whether caused by mismanagement or fraud – by minimum net capital rules and a form of deposit insurance furnished by the industry Contingency Fund. In between these polar extremes are a number of variations that relate to the instrument employed, the relative stability of the issuer of the instrument, and the regulatory safeguards used to support payment by a defaulting intermediary. In any event, it is clear that the investor faces the greatest potential risk of loss when he purchases securities for his own account in the securities market. This is partly because he does not have the benefit of professional portfolio management, but more importantly, because he generally cannot, as an individual, spread his risk of loss over a broadly diversified portfolio of loans or securities as can the manager of a bank, trust company, insurance company, investment company, mutual fund or pooled account.

Notwithstanding his relatively greater exposure to potential

31 Another important characteristic is the transferability of the financial instrument purchased, which largely determines the liquidity of the investment. All these instruments are, however, only various means to carry out the intermediation function.

32 The emphasis is on *potential* as distinct from *actual* risk, since an investor may invest relatively very securely through the intermediary that makes available the

risk of loss, an investor who acquires securities through the facilities of the securities market can narrowly confine his risk by purchasing only securities issued by governments or very stable business corporations. As a result, assuming fair disclosure and reasonable protection from fraud, an extensive and complicated system to regulate the securities market could not be justified only on the basis of the investor's exposure to risk of loss of his savings. There is, however, another very important factor which must be considered; that is, the aggregate amount of savings channeled each year through the securities market.

Although the relative importance of the securities market is frequently – and understandably – overstated by industry participants, who tend to characterize it as the hub of all business activity, it is clear that it forms only a relatively small part of the overall capital market in Canada. To show its role in general perspective table 4 summarizes the approximate total funds raised through the Canadian financial markets in 1975.[33]

For the purposes of this analysis, the ideal graphic presentation would show the sources of funds (saving of households, businesses, governments), the financial intermediaries through which they flow, and the ultimate uses of those funds.[34] Unfortunately, however, the data available tend to ignore the intermediation function and to focus instead on the sources and uses of funds, thus only implying by the kind of borrower and the nature of the financial instrument used by the financial intermediary that linked the source and the user of funds. If one defines the securities market arbitrarily to encompass only funds raised by the issue of bonds or shares of non-financial private corporations and non-financial government enterprises, then the flow of funds through that market in 1975 as shown in the national accounts of Canada totalled some $6.36 billion.[35] While a relatively small percentage of the total (about 18%), this $6.36 billion is still an enormous absolute

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greatest possible risk - the securities market - by investing only in blue-chip securities.

33 These data are derived from the *Financial Market Summary Table* set out and described in McCollum, *Measuring Financial Activity: A Macroeconomic Perspective*, [1977] CAN. STAT. REV. 9. McCollum also sets out a summary Total Sources and Uses of Funds table.

34 An excellent model for such a graphic presentation is set out in BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, INTRODUCTION TO FLOW OF FUNDS 12 (February 1975).

35 This is the total of the following items set out in table 4 *supra*: Funds raised in credit markets for bonds and shares by non-financial private corporations and by non-financial government enterprises.

To this one could justifiably add both government bonds and short-term paper (money market instruments) issued by governments and non-financial institutions. They have been omitted, however, because of problems of data definition.

Table 4
Financial Market Summary, Canada

1975
In millions of dollars

Funds raised in credit markets by:		
Persons and unincorporated businesses		13,541
Nonfinancial private corporations		
Bank loans	1,307	
Other loans	893	
Short-term paper	102	
Mortgages	345	
Bonds	2,160	
Shares	1,054	5,861
Nonfinancial government enterprises		
Bank loans	375	
Other loans	452	
Short-term paper	-57	
Mortgages	123	
Bonds	3,065	
Shares	80	4,038
General government		8,823
Total borrowing by domestic nonfinancial sectors		32,263
Rest of world (foreign borrowing)		1,495
Total borrowing excluding domestic financial institutions		33,758
Domestic financial institutions		2,320
Total funds raised		36,078
Funds supplied directly to credit markets by:		
Persons and unincorporated businesses		3,954
Nonfinancial private enterprises		543
Public sector (general government and nonfinancial)		2,331
Public financial institutions		2,283
Rest of world		5,438
Bank of Canada		747
Chartered banks		8,903
Private domestic financial institutions (except banks)		11,879
Total funds supplied		36,078

Source: Statistics Canada, Financial Flows Division.

amount that is of special significance for two reasons. First, it probably tends to be used more to extend the productive capacity of Canadian enterprises rather than to finance inventories or credit sales.[36] Second, because of the relative objectivity of allocation by the securities market, any funds raised through that market – particularly where a corporation issues shares – tend to have a catalytic effect, often qualifying the user to receive funds from other sources simply because its overall business prospects and management have been so closely scrutinized by underwriters, investment advisors and securities purchasers. It is clear, therefore, that the very substantial amount of funds channeled through the securities markets justifies a regulatory system similar to that applicable to other financial intermediaries.

But to look only at the risk of investor exposure to loss and the aggregate amount of securities traded is to ignore what are probably – even if unquantifiable – still more important aspects of the issue; that is, the extraneous goals that are achieved by a properly functioning securities market. In addition to allocating capital on a competitive basis, it permits individuals and institutions to participate in the ownership and control of business enterprises; it encourages the investment of savings in equity securities issued by productive enterprises as distinct from investments in passive assets such as unproductive land and gold;[37] it furnishes a means to encourage Canadian ownership of domestic enterprises and so reduces our obligations to pay dividends and to repay capital to foreigners and so also reduces the upward pressure on our exchange rates that is a corollary of large capital inflows; it furnishes a means to attract foreign portfolio investment instead of foreign direct investment, thus contributing further to Canadian control of domestic enterprises; and, as a result of these factors, it assures that the Canadian government can control more effectively the domestic economy.

In summary, because of the exposure of the investor to risk of loss, because of the very large, absolute dollar amount of securities traded, and because of the extraneous goals attained through a smoothly functioning securities market, there is no doubt that the securities market is important to Canada as a whole and, if that

36 For an interesting analysis of the decline of common share issues of Canadian corporations, *see* Gorman, *The Decline of the Equity Market System in Canada*, [1977] Bus. Q. 48 (Summer).

A detailed statistical analysis of the Canadian financial market is set out in two other papers in this volume: *see*, *Williamson*, *Financial Institutions*; *Williamson*, *Capital Markets*.

37 *See* P. DRUCKER, THE UNSEEN REVOLUTION 75 (1976), where the author argues that Canada has the lowest rate of "true savings" of any industrialized nation and has for forty years made up its capital formation deficiency by borrowing U.S. savings.

market is not performing satisfactorily, that considerable government intervention is justified. But the appropriate form of intervention can only be determined by analysis of the kind of market that now exists or can be foreseen and the regulatory mechanisms available.

Chapter IV
Development of Securities Market Regulation

Reading through the foregoing explanation of the nature of regulation, a contemporary securities regulator, unlike Molière's bourgeois gentleman, would not be too surprised to learn that he had been speaking prose for a long time, and that he had been acting as an objective, external agent to impose constraints on market entry, conduct and prices with a view to making the securities market more stable and more secure, or, in other words, trading off ideal market efficiency for stability and investor security. Like most legal institutions, however, the present securities laws did not develop deductively from preconceived, clearly understood principles but rather grew out of a consolidation of a number of separate policy initiatives designed over some three centuries to resolve specific problems.

During the seventeenth century, at the same time as the closed guilds of the feudal period were being forced to yield to a market system, more and ever larger trading corporations with transferable shares were being set up in England, particularly to take part in foreign trading ventures. Until the end of the century the constraints set out in the corporate charters constituted a sufficient safeguard for investors and creditors, but as the volume of share trading grew fraud became more frequent, causing the English Parliament to enact the first law to regulate the activities of stockbrokers in 1698.[38] After the passage of the Bubble Act in 1720, which was intended to curb the fraudulent promotion of speculative enterprises, until 1844, when the Joint Stock Companies Act, 1844 became law, few corporations were created, although substantial trading in the shares of existing corporations did continue. The latter Act of 1844 established the foundation of modern English company law: it distinguished between partnerships and companies by introducing a companies registration system; it enabled incorporation by registration under the general law; and it required full disclosure in the company's constitution

38 Act of 8 & 9 Wm. 3, c. 32, *cited in* L. GOWER at 38 n. 82. The modern English statute is the Prevention of Fraud (Investments) Act, 1958, 6 & 7 Eliz. 2, c. 45 *as amended*.

and in any prospectus issued by promoters. But it did not grant limited liability, a policy that was not adopted until 1855.[39] Subsequently, the Directors Liability Act, 1890 made it clear that a director was liable for misstatements negligently set out in a prospectus, and the Companies Act, 1900 introduced the modern concept of broad prospectus disclosure,[40] completing the basic policy framework of English corporations and securities law as it remains to this day. In sum, the policy expressed by the statutes and implied by the leading cases[41] was as far as possible to institutionalize responsibility in the promoters, directors and the company itself rather than to regulate the market activities of issuers, underwriters and brokers through an external government agency, the latter function having been left to the discretion of self-regulatory bodies such as the stock exchanges and the City Working Party, which drafted and enforces the City Code on Take-overs and Mergers through the City Panel. Whether the present English system, which is administered at four levels – the courts applying the laws concerning fraud, the Department of Trade through the companies and broker registration laws, the council of the Stock Exchange, and the City Panel – should be supplanted by some form of regulatory commission is currently being considered by the United Kingdom government. Predictably, the topic generates a great deal of heated discussion.[42]

In contrast, throughout North America, apparently because markets were more open to newcomers and speculative securities promotions more commonplace, state and provincial governments from the beginning of this century impliedly characterized the securities market as a kind of public utility and accordingly regulated it in each jurisdiction through an external state agency.

L. Gower at 35 n. 58 points out that Parliament made several rather ineffective attempts during the 18th century to preclude stock market abuses.

39 *Id.* at 28-48. *See also* J. Williamson, Securities Regulation in Canada (1960) at 4-6.

40 *Id.* at 5-6.

41 Ashbury Carriage Co. v. Riche, L.R. 7 H.L. 653 (1875), introduced the notion of *ultra vires* to constrain adventurous management; Trevor v. Whitworth, 12 App. Cas. 409 (H.L. 1887), barred a corporation from acquiring its own shares; Erlanger v. New Sombrero Phosphate Co., 3 App. Cas. 1218 (H.L. 1878), made clear that promoters, directors and officers were fiduciaries and, as such, had a duty to act in good faith even if not a duty of care.

42 *See* the responses to the Questionnaire of the Department of Trade (U.K. June 1974): Capital Markets Committee, The Industry Bill (memorandum June 3, 1975); Panel on Take-overs and Mergers (memorandum January 1975); The Law Society (memorandum January 1975).

The London financial community recently published proposals, under the leadership of the Governor of the Bank of England, to set up a new self-regulatory body, the Council for the Securities Industry, which will exercise broad rule-making and enforcement powers; *see* articles cited in note 2 *supra*.

Beginning with Kansas in 1911 and Manitoba in 1912, nearly all the states and all the Canadian provinces have adopted quite comprehensive securities regulation laws, which tend generally to apply three techniques – licensing market participants such as investment advisors, brokers and salesmen; licensing the distribution of specified issues of securities; and stipulating strict anti-fraud rules.[43] In economic terms these early securities acts regulated the market entry of corporate issuers and market actors and imposed stricter conduct rules with respect to primary distributions of securities. In most cases there was no direct regulation of prices charged by market actors for the services they rendered in connection with primary distributions, although some corporation laws and some securities commissions did set limits on the charges of promoters and underwriters. The salient characteristic of these state and provincial securities laws, commonly called "blue sky" laws, is the broad delegation of discretionary power to the pertinent securities commission to license salesmen and other actors and to determine what constituted full prospectus disclosure or, in other words, to determine when a prospectus is free of any fraudulent misrepresentation, whether made by way of omission or commission, and even to refuse to qualify a prospectus where, in the opinion of the commission, a proposed business is not a viable enterprise. Since 1911 both the scope and application of the state and provincial securities laws have expanded considerably; for example, in most jurisdictions the scope of the laws has been extended by broadening the definition of "securities" to encompass almost any kind of scheme to raise money from the public for investment in an enterprise. In Canada, moreover, the provincial securities laws have been extended to apply to secondary trading activity through the stock exchanges and even to the objectives and practices of certain intermediaries, particularly mutual funds.

In each case the securities laws were pragmatically adapted or expanded to resolve specific problems with a minimum of conceptual soul searching about the nature and purposes of economic regulation, the best means to regulate securities markets, or the acceptable role of a government agency as a regulator. Thus at the state and provincial levels in North America the legislatures tacitly cast the securities commissions as public utility regulators with broad discretionary power to regulate market entry, conduct and even prices for services in respect of primary security distributions, applying broad public interest standards. In Canada these

43 *See generally* 1 L. Loss, Securities Regulation (2d ed., vols. 1-3, 1961 & Supp., vols. 4-6, 1969) at 23-25; L. Loss & E. Cowett, Blue Sky Law 1-10 (1958); J. Williamson

broad discretionary powers were extended with little controversy to apply to the secondary markets, particularly the stock exchanges, giving the securities commissions power to regulate all actors in the securities market complex as one integrated financial intermediary. Securities law did not develop so smoothly at the federal level in the United States, however, partly because of preconceptions that the securities market was indeed a market and not a kind of natural monopoly requiring comprehensive utility-type control, partly because at the time it was introduced – 1933 and 1934 – there was considerable political ferment about the desirability of any markets, and partly because of an innate suspicion of any grant of broad discretionary powers to an independent regulatory agency.

Indeed, the feeling then in the United States that the securities industry did operate in a market context was so strong that there was, notwithstanding the cartel-like powers exercised by the stock exchanges, relatively little debate urging regulation of the securities market as a kind of public utility through a commission in accordance with broad public interest standards. Instead the final debate centered on whether the securities bill – which would apply only to primary distributions – should contain only anti-fraud rules or both anti-fraud rules and comprehensive prospectus disclosure rules as did the English Companies Act, 1929.[44] The Securities Act of 1933 as finally enacted by Congress did contain both anti-fraud and disclosure rules, adopting expressly the English model, and thus encompassing both prospectus disclosure rules and anti-fraud rules that are buttressed by stiff civil sanctions. The disclosure rules did not make promoters, directors, officers and experts the insurers of prospectus statements but did impose a positive standard of care – due diligence – on those persons, making them personally liable where they negligently permitted a false statement to be published in a prospectus.[45] Thus with respect to primary distributions the emphasis of the United States federal law, in contrast to state "blue sky" laws, was on full and fair disclosure, that is, the imposition of responsibility on an issuer and its principals, and not external government regulation based on broad public interest standards. In theory, therefore, any person could have free access to the securities

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at 3-46; Baillie, *The Protection of the Investor in Ontario*, 8 CAN. PUB. ADMIN. 172, 325 (1965).

44 *See* 1 L. Loss at 121-28. The major exception was the Thompson Bill, discussed in Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 31 (1959); M. PARRISH, SECURITIES REGULATION AND THE NEW DEAL 42-72 (1970); R. DE BEDTS, THE NEW DEAL'S SEC 35-38 (1964).

45 Landis, *supra* note 44, at 34-35.

market for any purpose, subject only to compliance with the disclosure rules.[46] After its passage, administration of the Securities Act of 1933 was assigned to the Federal Trade Commission while Congress considered how it should deal with the regulation of secondary trading in securities through the stock exchanges and the over-the-counter market.

Concurrently with their consideration of the securities market, the President and Congress were wrestling with the overall economic problems engendered by the great depression, particularly the implementation of the National Industrial Recovery Act (NIRA), which had become law on June 16, 1933, and which, had its full potential been realized, would have structured each sector of the economy into a cartel that would operate under government supervision, in effect substituting a command system for the market economy. Under NIRA each sector was required to develop a plan called a "code" that would include production and price controls and set out clear labour standards for the protection of employees. Each code was then submitted to the responsible agency, the National Recovery Administration (NRA) and, if accepted, became the law applicable to that sector, thus displacing the competition or anti-trust laws that would otherwise apply to prohibit such cartel agreements as being in restraint of trade.[47] One of the early codes accepted under the NIRA was the code of fair competition for investment bankers that was approved in November 1933, encompassing the activities of underwriters, brokers and dealers.[48] Although that specific code was abrogated when the Supreme Court held the NIRA to be unconstitutional,[49] its basic concept of regulating the securities industry as a kind of cartel subject to the scrutiny of a government regulatory agency proved to be a tenacious idea.

The NRA policies were not yet crystallized when the Securities Exchange Act of 1934 was enacted to expand the scope of regulation to include secondary trading and to create the Securities and Exchange Commission (SEC) as the agency to administer both the Securities Act of 1933 and the Securities Exchange Act of 1934. The latter act, although somewhat ambiguously, did tacitly adopt a philosophy of cooperative regulation, that is, stock exchange control – or in other words, cartel control – over market entry, conduct and prices, subject to a number of express

46 But Congress deliberately did not preempt the field and therefore left to the states the power to impose any higher public interest standards at the local level: *see* L. Loss & E. Cowett, *supra* note 43, at 237.

47 *See* M. Fainsod, *supra* note 6. *See also* the other works cited in note 6 *supra*.

48 2 L. Loss at 1362; S. Robbins, The Securities Markets 83–123 (1966).

49 Schechter v. U.S., 295 U.S. 495 (1935).

statutory conduct rules and subject to general SEC surveillance. This policy was later expressly adopted in the Maloney Act of 1938, which was clearly based on the earlier NRA code, and which added section 15A to the Securities Exchange Act of 1934 to legitimate the cartel-like activities of national securities associations registered under the Act, giving them an even clearer cartel status than that enjoyed by the exchanges, in particular express power to discriminate against non-members without running afoul of the anti-trust laws.[50]

As a result of these developments, the policies underlying securities regulation in the United States became both obscure and complex. The federal law impliedly denied the existence of a natural or government legitimated monopoly that required comprehensive, utility-type regulation and expressed a policy based on disclosure and self-regulation under vague SEC surveillance. But it did not displace the broad, discretionary state laws and so required compliance at all times with both federal law and the state "blue sky" laws. Moreover, the federal law expressly legitimated the fixing of brokerage commission rates by stock exchanges and also specific trade discrimination rules, which require certain transactions to be executed on the exchange, and which preclude an exchange member from seeking better execution elsewhere until he has determined that the transaction cannot be executed on the exchange of which he is a member. But it did not clearly give the stock exchanges immunity from the application of the anti-trust laws and so left open a major area of conflict between the securities laws and the anti-trust laws.[51] Thus from a

50 The SEC surveillance powers are set out in s. 19 of the Securities Exchange Act of 1934.

Only one association, the National Association of Securities Dealers (NASD), a Delaware non-profit corporation, has ever been registered; *see generally* S. ROBBINS, *supra* note 48, at 112; 2 L. Loss at 1365.

Its Canadian counterpart, the Investment Dealers Association (IDA) is an unincorporated association that has never had statutory legitimacy but has been recognized in statutory provisions such as Ontario Securities Regulations, s. 2(1)3.

51 This subject is discussed generally in 5 L. Loss at 3153-86. *See also* Pozen, *Competition and Regulation in the Stock Markets*, 73 MICH. L. REV. 317 (1974); and *Statement of Dept. of Justice at SEC Hearings on the Structure, Operation and Regulation of the Securities Markets* (December 1, 1971), *reprinted in* 6 *Study of the Securities Industry: Hearings Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 92d Cong., 2d Sess. 3135 (January 26-28, 1972) (app. LL).

For a recent analysis of this issue, *see* Linden, *A Reconciliation of Antitrust Law with Securities Regulation: The Judicial Approach*, 45 GEO. WASH. L. REV. 179 (1977).

The proposed new s. 4.5 of the Combines Investigation Act, R.S.C. 1970, c. C-23, set out in cl. 6 of Bill C-13, 30th Parl., 3d Sess. (first reading November 18, 1977), An Act to Amend the Combines Investigation Act and to Amend the Bank Act and Other Acts in Relation Thereto or in Consequence Thereof, purports to resolve

policy point of view the federal securities laws of the United States reflect an inherent ambivalence: on the one hand they promote competitive markets by forcing broad disclosure and barring misrepresentation, market manipulation and other kinds of fraud; on the other hand they attempt to shield the actors in the securities market – albeit ambiguously – from the rigours of the competition laws with a view to strengthening securities market actors and thus increasing investor protection.

It is because the SEC,[52] the Antitrust Division of the Department of Justice,[53] the Department of the Treasury[54] and a number of private sector critics[55] tried to force a clear resolution of these issues that the proposed Securities Reform Act of 1975 elicited so much sharp controversy, particularly in respect of market entry controls, the fixing of commission rates and the trade discrimination rules – the three strategic cartel powers of the exchanges and the National Association of Securities Dealers (NASD). In the final compromise among the parties in interest the stock exchanges may still require members to pay for exchange seats, the present ban on fixed commission rates is continued but may be lifted at any time by the SEC, and the present New York Stock Exchange (NYSE) Rule 390, which bars an exchange member from dealing in a listed security other than through the exchange's facilities, continues partly in force.[56] In short, although there was broad

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generally the problem of conflicts between specific regulatory laws and the general competition law.

52 *See* studies cited in note 2 *supra*; and *see also* SEC, Policy Statement on the Future Structure of the Securities Markets, February 2, 1972, CCH FED. SEC. L. REP. (extra edition February 4, 1972) (No. 409); SEC, Policy Statement on a Central Market System, March 29, 1973, CCH FED. SEC. L. REP. (extra edition April 2, 1973) (No. 473, pt. II).

53 *Hearings on S. 2519 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 93d Cong., 1st Sess. 194 (November 12-14, 1973).

54 *See* LORIE REPORT, *supra* note 2.

55 *See* studies cited in note 2 *supra*; and *Hearings on S. 2519 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, *supra* note 53.

56 *See* Securities Reform Act of 1975, ss. 6(b)(5), 15A(b)(6), 19(c), discussed in REPORT OF THE SENATE-HOUSE CONFERENCE COMMITTEE, H.R. REP. No. 94-229, 94th Cong., 1st Sess. 99 (1975).

The Congressional Reports relating to the enactment of the 1975 amendments strongly criticized two stock exchange rules, exemplified by NYSE Rules 390 and 394, as being anti-competitive. Rule 390 bars an exchange member from dealing as *principal* in listed securities through over-the-counter facilities. Rule 394 as amended in 1966, barred a member from effecting a trade as *agent* for a customer in a listed equity security off the exchange floor with a third market-maker unless the member demonstrated he could effect execution at a lower price in the third market and also obtained the exchange's consent to the trade.

Rule 394, which even as amended in 1966 continued to be a bar to third market execution, was repealed on March 31, 1976.

agreement on the central objective of the bill – to permit a restructuring of the securities market to allow price competition as well as service competition – there is still no clear resolution of the basic problem. Is the SEC to continue to pretend that the securities industry operates within a relatively free market context and so requires only limited tinkering to remove market imperfections? Or is the SEC to consider the securities industry as a special case of monopoly, which, if not a natural monopoly, is an essential, government legitimated monopoly required to give market stability and investor security clear priority over free market efficiency, and which therefore must be regulated like any other financial intermediary or even as a public utility?

Fortunately, in Canada, we have been spared much of this conflict, not because of any superior wisdom but because the provinces tended from the outset to follow the U.S. state models which presuppose that the securities industry is a kind of public utility and therefore that an external government regulatory body should have broad powers to regulate market entry, conduct and commission rates,[57] subject to full consideration of industry views and to judicial review of the administrative process. That is not to suggest, however, that all problems have been resolved in Canada. Indeed, it is clear they have not. First, we have not yet confronted the fundamental problem of developing a central market system, which will require considerable rethinking about the competitive issues; and second, unless we insulate the Canadian securities market from foreign influences, we must enable it to adapt to major institutional changes in the United States market, in particular fully competitive commission rates and freer access to the proposed central market. It follows therefore that there are two basic policy alternatives available to Canada. The first is to build up protective walls around the Canadian industry and permit it to develop independently of outside influences. The second and obviously preferable strategy is to attempt to coordinate industry and regulatory efforts in Canada with a view to developing a Canada-wide market that does not have to be sheltered from

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Rule 390, however, continues in force. Although uneasy about its anti-competitive effects, the SEC has been clearly concerned that its repeal could damage the auction markets operated through the exchange and substitute dealer markets. The SEC is therefore temporizing on this issue, but it recently decided to prohibit all off-board *agency* restrictions except certain "in-house" agency cross transactions but continues to permit off-board *principal* restrictions: *see* SEC, Securities Exchange Act of 1934 Release No. 14325, December 30, 1977, [1977-78 Transfer Binder] CCH FED. SEC. L. REP. ¶81,397; NYSE, Information Memo No. 78-11 (March 3, 1978).

57 *See e.g.* the reference to the industry as a kind of "combine" in the report on the proposed national brokerage commission rates, [1973] OSC Bull. 107, 108 (August).

international competition and that will serve to attract and allocate both Canadian and foreign capital.[58]

Irrespective of the strategy adopted to regulate Canadian securities markets, and irrespective of the different weights attributed by any one jurisdiction to the policy antinomies of investor security and entrepreneurial freedom, there is broad consensus about the ultimate objective: a securities market that operates fairly and efficiently. It must be fair in the sense that returns are reasonably related to risks, that the actors in the market have unquestioned financial stability and integrity, and that the individual investor is not placed at a disadvantage with respect to the institutional investor.[59] It must be efficient in the sense that the prices of securities respond rapidly to new information, and that the trading, clearing, settlement and ownership transfer functions are effected quickly and at low cost.[60] In other words the goals are to instil confidence in the securities market in order to create an environment that will induce greater saving or at least greater investment of existing savings in equity and long-term debt securities, to enable Canadians to acquire more securities issued by Canadian corporations, and to generate sufficient market activity so that an investor can realize his investment at its fair value at any time.

The first strategy – building protective walls around the Canadian industry to shelter it from outside influences – is, from a market economist's point of view, to compound a felony, building up further entry barriers around a market that is already structured in part along cartel lines.[61] Nevertheless a number of recent Canadian reports have argued forcefully that Canada must maintain considerable governmental control over the securities market complex as well as over other financial intermediaries in order to retain political control over the domestic economy, even if that

58 Details of alternative coordinating mechanisms are discussed in ch. VI *infra* under the heading "Institutions of Federal-Provincial Cooperation".

59 The polarization of individual and institutional investor interests should not be overstated, for the institutional investors indirectly represent the interests of a group of individual investors.

60 LORIE REPORT, *supra* note 2, at 3-6.

61 This extends beyond the secondary market, where there is detailed regulation of entry and commission rates, and includes the underwriting function in the primary market which tends strongly to monopoly because of the inherent need for underwriters to work closely together in order to spread the risk of any underwriting loss; *see* the REPORT ON FOREIGN DIRECT INVESTMENT IN CANADA 101-02 (Gray Report 1972), where it is argued that barriers to competition should be lowered and the need to collaborate lessened by creation of a special insurance fund. *Compare* the *Kleinman Plan*, *supra* note 27.

In any event, on the basis of long experience, there is good reason to doubt that

requires foregoing the stimulus of greater competition from foreign firms.[62] But even if some such constraints are essential, we should be aware of their heretical character and therefore should seek other alternatives where feasible.

The second strategy – fostering development of a Canada-wide market – implies dealing effectively with a number of topical background issues that have been forced to the front of the stage by fundamental changes in the political and technological environment, changes that require a rewrite of much of the original play by amending the plot and recasting certain roles. Indeed, the rapid acceleration of change since 1960 has compelled all jurisdictions to reconsider not only the ends and means of securities regulation but also the more basic issue whether governmental regulation is required at all. At the one pole proponents argue that the present cartel nature of the securities industry should be further fortified against competitive influences, subject to detailed government regulation.[63] At the other pole the market oriented critics argue that cartel control, to the extent it is required at all, should relate only to the central information and operational system and not at all to market entry or commission rates.[64] The fundamental changes that gave rise to this sharp debate are both structural and technological.

A. STRUCTURAL CHANGES

The structural changes that are taking place in the securities market can be attributed to several causes: the growing complexity of financial instruments and the resulting consumer desire for comprehensive service from one firm; the rapid growth of the securities holdings of institutions such as pension funds and mutu-

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any protective walls - even detailed foreign exchange controls - can effectively control capital outflows.

62 *See* especially the REPORT OF THE COMMITTEE TO STUDY THE REQUIREMENTS OF CAPITAL AND THE IMPLICATIONS OF NONRESIDENT CAPITAL FOR THE CANADIAN SECURITIES INDUSTRY (May 1970) [hereinafter cited as the MOORE COMMITTEE REPORT]; STUDY OF THE SECURITIES INDUSTRY IN QUEBEC (June 1972) [hereinafter cited as the BOUCHARD REPORT]; OSC, REPORT OF THE SECURITIES INDUSTRY OWNERSHIP STUDY (April 1972).

In contrast to the MOORE COMMITTEE REPORT, the BOUCHARD REPORT at 135-36, recommends permitting foreign securities firms to enter the Quebec markets but subject to broad discretionary powers of the Securities Commission to bar entry where required to prevent destructive competition.

63 *See* W. MARTIN, THE SECURITIES MARKETS (1971) [hereinafter cited as the MARTIN REPORT] *reprinted in* 6 *Study of the Securities Industry: Hearings Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, *supra* note 51, at 3189; F. Weil, *supra* note 28.

64 *See* J. STONE, *supra* note 28, at 40-41.

al funds that have sufficient market power to circumvent the formal market and so avoid paying the fixed brokerage commission rates;[65] the need of brokerage firms to have access to outside capital, particularly in an environment of negotiable commission rates; the doubt about the securities market as a fair means to furnish capital for highly speculative resource undertakings; the balkanization of the Canadian market by regional exchange rivalry and provincial regulatory policy; and finally the desire to achieve as much Canadian control as possible over brokerage firms.

The strong demand of consumers for financial department stores that offer comprehensive services has compelled financial intermediaries of all kinds to extend the services they offer, with the result that the functional distinctions among intermediaries are tending to appear arbitrary and artificial. Currently, in Canada, banks are moving into the fields of underwriting and management of trusteed plans such as the registered home ownership plans. Trust companies are offering demand deposit services. Brokers are selling mutual fund shares, managing pooled accounts and even selling insurance. Insurance companies are selling variable life insurance and variable annuities. And an affiliate of two department stores – Eaton's and The Bay – offers a wide range of financial services, from money management to liability insurance.[66] As a result a great deal of service competition exists among intermediaries in the Canadian capital markets, giving the individual investor greater choice but also luring him away from direct securities trading, which is now dominated by the institutional traders.[67]

65 The SEC required all U.S. stock exchanges to eliminate fixed commission rates on May 1, 1975, a move that has already had deep impact upon the market: *see* Securities Week (New York), May 26, 1975, at 1-3; SECURITIES AND EXCHANGE COMMISSION, REPORT TO CONGRESS ON THE EFFECT OF THE ABSENCE OF FIXED RATES OF COMMISSION (December 1, 1975).

66 The ultimate financial department store is the Merrill Lynch scheme which will enable customers to borrow, write cheques and make Visa card purchases against funds held in client margin accounts: *see* BUSINESS WEEK, August 8, 1977, at 50.

Underlining the present concentration in the Canadian banking industry, the securities industry has recommended that banks not be allowed to participate in underwriting, distributing, market-making functions, or even advisory functions in the securities market context: *see* Submission of the Joint Industry Committee of the Canadian Securities Industry on the Proposed Revision of the Bank Act (September 1975).

CANADA, DEPARTMENT OF FINANCE, WHITE PAPER ON THE REVISION OF CANADIAN BANKING LEGISLATION 34-35 (August 1976) had recommended that banks be barred from underwriting securities issues but be allowed to continue to distribute government securities and to participate in a selling group (and be referred to in the prospectus) in respect of corporate securities.

67 In the U.S. individuals have been net sellers of securities consistently since 1959: *see*

The growing size and power of these intermediaries enabled them to seek means to circumvent the formal securities markets – or at least the exchange rules – and so obtain brokers' services at less than the fixed commission rates. To this end a large intermediary would compel a broker to give up part of his commission to other brokers who furnished services to the intermediary or to furnish research and other ancillary services free of charge. Alternatively the intermediary would acquire membership on an exchange with a view to executing its own trades.[68] And if these tactics didn't work the intermediary could execute its transactions through the third market (over-the-counter market for listed securities) or the fourth market (direct trades among intermediaries) and so circumvent the stock exchanges altogether.[69] The result was a partial balkanization of the securities market into a number of specialized markets that could serve the intermediaries at lower cost.

This pressure on commission rates – particularly in the United States now that rates are fully negotiable – and progressive tax rates have reduced the amount of capital that brokerage firms can generate internally, compelling firms to seek outside capital, that is, capital from persons who are not active principals of the firm. This form of capitalization departs radically from the original concept of reliance on the individual member of a brokerage firm for the financial security of the firm and its customers. Although the standards vary from one jurisdiction to another,[70] certain brokerage firms are now entitled to incorporate and, at least in the United States, even to distribute securities to the public, substitu-

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CHASE MANHATTAN BANK, BUSINESS IN BRIEF No. 115 (April 1974). Institutions now account for some 70% of NYSE trading. The amount was 59.7% in the U.S. in 1971; NYSE FACT BOOK 53 (1972). The dominance of institutions is probably the same or even greater in Canada. Meyer alleges 75% in normal times and as high as 90% during the current recession; Meyer, *Where Lies the New Jerusalem*, EXECUTIVE, July 1974, at 13.

For more detail about the Canadian market *see, Cleland, Applications of Automation.*

68 These practices have been adduced as evidence that fixed commission rates did tend to excessive monopoly rents: Mann, *The New York Stock Exchange: A Cartel at the End of Its Reign*, *in* PROMOTING COMPETITION IN REGULATED MARKETS 301, 314 (A. Phillips ed. 1975). The latest refinement, introduced after fixed commission rates were abolished in the U.S., is a cooperative that remits to a customer a patronage dividend based on the volume of the customer's business, in effect returning to the customer the brokerage commission less a management surcharge. *See* Elia, *Broker Firm...Structured Like a Co-op*, The Wall Street Journal, May 27, 1975, at 33, col. 3.

69 *See* S. ROBBINS, *supra* note 48, at 252-61; HOUSE SECURITIES INDUSTRY STUDY, *supra* note 1, at 77; INSTITUTIONAL INVESTOR REPORT at 2311-22.

70 This topic is discussed at length in the MOORE COMMITTEE REPORT, *supra* note 62, at 70-78; BOUCHARD REPORT, *supra* note 62, at 130; OSC, REPORT OF THE SECURITIES INDUSTRY OWNERSHIP STUDY, *supra* note 62, at 95, 120.

ting a large capital base for the personal wealth of the firm's principals. There is, as yet, no uniform policy in the Canadian provinces with respect to this issue. Even less uniform are the policies concerning the entry of foreign owned firms into Canada, although the trend is clearly to require dominant Canadian control of all financial intermediaries.[71]

Far more serious than policy conflicts about the capitalization or degree of foreign ownership of brokerage firms is the recent tendency of provincial jurisdictions to impose rules on brokers that preclude them from seeking better execution on a market outside Canada, in effect building up barriers to an international market to insulate Canadian brokers from the impact of competition rates in the United States.[72] Moreover, recent Ontario and Québec reports have recommended that certain trades initiated in a province must be executed through registrants licensed as brokers in that province, policies that would constrain not only international trading but also interprovincial trading,[73] adding a further barrier to service competition in the Canadian securities market.

A final illustration of an externally imposed structural issue is the current consideration by the provincial securities commissions of new issues of securities by speculative resource enterprises.[74] Since nearly all successful resource exploration and development in Canada is now carried on by large corporations, the commissions are questioning whether the shares of small, speculative resource firms are an appropriate investment for the small investor who must bear directly the risk of loss. Indeed, can any amount of

71 *See* the reports cited in note 62 *supra*.

72 *See*, *Must Deal Canadian*, The Financial Post (Toronto), May 24, 1975, at 16, col. 3 (concerning alleged QSC pressure on institutions to execute in Canada).

73 *See* OSC, REPORT OF THE SECURITIES INDUSTRY OWNERSHIP STUDY, *supra* note 62, at 122; BOUCHARD REPORT, *supra* note 62, at 146.

These recommendations are not being adopted. Indeed, the Canadian securities market is moving gradually away from balkanized submarkets to a Canada-wide market.

(1) As of September 1, 1977, the QSC repealed its Policy No. 4, which required a Quebec broker to execute a securities trade in Quebec where possible even if the broker could obtain better execution for his client on some market outside Quebec; *see* 8 QSC Bull., No. 35 (Decision No. 5316, September 6, 1977).

(2) On February 3, 1978, the MSE announced that the MSE and the TSE were negotiating removal of the prohibitions against arbitrage transactions between the two exchanges: *see* The Globe and Mail (Toronto), February 3, 1978, at B2, col. 1.

74 *See* QSC Statement further to Repeal of its Policy No. 8 imposing higher standards on new issues by mining, oil and natural gas corporations; 5 QSC Bull., No. 42 (Decision No. 4463, October 21, 1974); and *see* OSC Enquiry discussed in Zehr, *OSC Gets Noticeably Tougher*, The Northern Miner (Toronto), April 14, 1975.

This re-examination led to new, parallel policies applicable to junior mining exploration development companies in Québec and Ontario: *see* QSC Policy No. 8, April 1, 1976, 3 CCH CAN. SEC. L. REP. ¶66-019; OSC Policy No. 3-02, April 1, 1976, 2 CCH CAN. SEC. L. REP. ¶54-896.

disclosure and regulation of promoters' profits adequately protect the small investor in such cases? In short, ignoring the usual market rhetoric, is the securities market fulfilling a useful function in allocating capital to such undertakings when we know that very little of the capital is actually spent on exploration and development and, even if it is so spent, that the likelihood of establishing a new resource enterprise is very small?[75] To examine this issue is to question long established dogma, but given the rapidly increasing demands for capital it is clear that no economy can afford to dissipate its savings on highly improbable ventures or even less to legitimate a market institution that exposes individuals to demonstrably unreasonable risk. If it is more efficient to develop resources through very large private or even public sector firms because the structure of the resource industry has changed, then the securities industry must adapt accordingly to such change.

B. TECHNOLOGICAL CHANGES

Concurrently with attempting to adapt to these structural changes, the securities industry is being compelled to adapt to the new computer-communications technology that in turn can require further structural changes, particularly because it enables creation of a single electronic market where all material information can be relayed contemporaneously to all actors. Beginning with the rapid capture, processing and dissemination of trading data, the elctronic system is logically and inevitably expanding to encompass also the clearing and settlement functions, brokerage office accounting, new issues, and even ownership transfer through entries in the records of securities depositories. Although still only in the development stage, the ultimate electronic system is possible and, within a decade, is even probable; that is, the execution of securities trades (whether new issues or secondary trades) through remote, direct access terminals and the immediate capture of the trading data to generate market reports, to clear and settle inter-broker claims and to transfer ownership, thus eliminating the need for specialized markets, formal stock exchanges, market-makers, clearinghouses, transfer agents and even depositories, which will have to transform completely their character when electronic records instead of security certificates are relied on as proof of ownership.[76] The logical complement of

75 This issue was also raised in the PORTER REPORT at 341.

76 These ideas are discussed in detail in M. MENDELSON, FROM AUTOMATED QUOTES TO AUTOMATED TRADING: RESTRUCTURING THE STOCK MARKET IN THE UNITED STATES

such an automated trading system is the integration of trading data with current data about issuers that is disclosed on a continuous basis. This in turn will permit continuous disclosing corporations to enter the securities market at any time to increase or decrease their capital requirements, which will, as a corollary, free such corporations from reliance on the present underwriting system with its emphasis on snapshot disclosure and immediate distribution through a large network of wholesalers and distributors.[77]

Although the structural issues such as the growth of financial intermediaries and the concentration of the resource exploration and development industry have forced sweeping changes in the securities market, the market as presently constituted probably can adapt to these changes without serious trauma. But the new computer-communications technology is change of an altogether different order, a Copernican turn that compels reconsideration not only of all facets of securities market structure and operations but also of the nature, means and required degree of securities market regulation, for to the extent computerized systems coupled with continuous disclosure obviate the use of present primary and secondary market institutions they also render redundant many if not most of the regulatory techniques directed at limiting or removing the perceived imperfections of those market institutions.

There is a broad consensus about the inevitable development of a unique, nation-wide - and even international - securities market,[78] but the computer-communications issue has brought

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(1972); A. Berczi, *supra* note 13; 5-6 *Study of the Securities Industry: Hearings Before the Subcomm. on Commerce and Finance of the House Committee on Interstate and Foreign Commerce*, 92d Cong., 2d Sess. (1972); *National Securities Market System Act of 1973, Hearings on S. 2519 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 93d Cong., 1st Sess. (1973).

The first major step in this direction was implementation of the "Consolidated Tape" on June 16, 1975, to report concurrently all trades of NYSE listed securities on several markets; *see* 3 AUTOTRANSACTION INDUSTRY REPORT OF INTERNATIONAL DATA CORPORATION, No. 5 (June 11, 1975).

77 Under the present system liability for false representations focuses on statements set out in the prospectus, which remains in force for only a limited period of time. Moreover, to minimize their risk of loss, underwriters attempt to distribute a new issue in the shortest possible time, a requirement that gives great market power to any one firm having a comprehensive network of retail outlets.

78 *See* the reports cited in note 52 *supra*. Even the MARTIN REPORT, *supra* note 63, which has a strong bias toward cartel control of the market, concedes this point. For a critical view of the inevitability of this development, *see* Werner, *Adventure in Social Control of Finance: The National Market System for Securities*, 75 COLUM. L. REV. 1233 (1975).

With respect to Canada, *see* HONEYWELL CORP., CANADA-WIDE SECURITIES MARKET SYSTEM - PRELIMINARY PROPOSAL (MSE report March 1975).

into even sharper focus the central regulatory issue: who will control entry, trading conduct and prices with respect to the system? Although this problem has existed since the inception of regulation, as long as there existed considerable service and even price competition among regional exchanges and specialized securities markets it caused little concern. In a unique central market, however, power to determine rights of market entry and prices becomes almost an absolute power over the securities industry, since it is unlikely that any alternative to central market membership will be feasible. A number of mechanisms have been proposed to exercise this power, and although many variations are possible the mechanisms can best be categorized with reference to three basic models.

The first model, advocated by W. Martin,[79] is essentially a private sector cartel that would regulate entry, conduct and prices, subject to indirect public regulation through public representatives on the board of directors governing the central market[80] and subject to comprehensive securities commission surveillance. The securities industry would be immune from the competition laws to the extent it is subject to external securities commission control. And since commission control, although not clearly expressed in the *Martin Report*, would in theory be unlimited, the industry would be almost completely immune from the strictures of the competition laws.

The second model, proposed by F. Weil,[81] would continue a cartel structure but would give an external government agency rather than a private sector agency power to create a central electronic market and to regulate prices in and presumably entry into that market. Weil defines the central problem as the concentration of savings in a small number of institutions who trade through a small number of brokers, displacing both the small investor and the small retail broker to such an extent that the

79 MARTIN REPORT, *supra* note 63. *See also* the commentaries on the MARTIN REPORT reprinted in 6 *Study of the Securities Industry: Hearings Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, *supra* note 51.

80 The value of public representatives on the board of an exchange has been seriously questioned in Canada, partly because they are always in a minority position, and partly because they do not purport to represent the public but only to furnish policy criticism from the viewpoint of an objective outsider; *see* Pritchard, *Not Exchange Watchdogs*, The Globe and Mail (Toronto), May 14, 1977, at B1, col. 1.

81 F. Weil, *supra* note 28. For a similar Canadian view *see* R. Lafferty, A New Design for Capital Markets in Canada (paper presented to Invest. Sec. of the Can. Life Ins. Assoc. May 12, 1970). Davant, chairman of Paine, Webber disagrees with Weil, arguing that the SEC has done enough by removing fixed commission rates and that the industry should be empowered to develop any required new structure; 303 BNA SEC. REG. & L. REP., May 21, 1975, at A-17.

traditional auction market has largely disappeared. To resolve this problem he would empower the regulating agency to control, in addition to prices and entry, the activities of financial institutions with a view to maximizing service competition (as distinct from price competition) among the largest practicable number of individual and institutional investors on the one hand and the largest possible number of retail brokerage firms on the other. The effect would be to reverse the trend toward a dealer market and back to an atomized auction market dominated by brokers, where securities prices are determined principally by the supply of and demand for securities in the market.[82]

The third model, proposed by J. Stone,[83] would eliminate all the cartel characteristics of the securities industry by charging the securities commission to set up and administer an electronic market system, which would be open to all qualified persons upon payment of a rateable fee to cover operating costs, and by abolishing any fixed brokerage commission rates. Stone would also repeal most of the current regulatory rules relating to primary distributions by continuous disclosing corporations and relating to secondary trading, most of which – particularly prospectus qualification and market-making – are responses to current market imperfections that inhere in any market regulated as a cartel system. In brief, he would, like Weil, acknowledge that the central electronic market is a natural monopoly that must be operated by government or under close government surveillance; but in contrast to Weil he would abolish any artificial constraints on market entry or brokerage rates, leaving it to market forces to determine how many firms should survive[84] and what prices would be charged.

All three of the foregoing models are predicated on the assumption that an external government agency must control, directly or indirectly, the structure and operation of any central

82 In this context an auction market is a market that determines prices through the matching of buyers' bids and sellers' offers, whereas in a dealer market a dealer holds large inventories, giving the dealers some control over supply and probably power to influence price.

One analyst argues that trading on the NYSE is now made up of only 6% auction trading and 94% dealer trading; *see* Brown, *Small Orders and Auction Market Myths*, The Commercial and Financial Chronicle, January 13, 1975, at 8, cols. 3-4.

83 J. STONE, *supra* note 28, at 37-41, 96-110, 111-22. A computerized securities market remains a hypothetical construct, but the SEC is moving incrementally in that direction, beginning with a composite quotation system that will present all trading information in one market centre; *see* SEC, Securities Exchange Act of 1934 Release No. 14416, January 26, 1978, CCH FED. SEC. L. REP. (extra edition February 1, 1978) (No. 735). The Canadian market appears to be moving even faster toward a computerized market, using the CATS (Computer-Assisted Trading System) developed by the TSE; *see*, *Cleland*.

84 J. STONE, *supra* note 28, impliedly assumes the existence of an insurance system to protect investors from losses caused by securities firm failures.

electronic market, which is by definition an unqualified monopoly. Although difficult to forecast, it is probable that the model of the future Canadian central market will be a composite of the Weil and Stone models, largely eliminating artificial barriers to entry and fixed prices and thereby fostering greater competition.[85] This change in the structure and operation of the market will require a corresponding change of the philosophy and techniques of market regulation. Reflecting a truism of systems analysis that you can never change just one element of a system, the regulatory philosophy must expand from a narrow focus on specific entry, price and conduct rules to include not only an overview of the system and its function within the overall capital markets but also the design and implementation of alternative systems that render much of the traditional approach to securities regulation - entry constraints on actors, fixed rates, and anti-fraud rules - largely irrelevant.[86] As in the United States, the probable system will evolve from a Canada-wide trading disclosure system coupled with continuous disclosure by large corporations to the ultimate system of automated trading and automatic capture of the data required for clearing, settlement and ownership transfer purposes. If so, then the strategy of regulation will swing away from cartel management to continuous surveillance of the conduct of actors in the system with a view to minimizing market manipulation. In this context any conflict between self-regulation and government regulation becomes minor since both the market actors and the regulators have a common interest in identifying and disciplining any actor who attempts to beat the system and so bring discredit on the entire industry.[87] In sum, the securities industry of the relatively near future will probably be far less a regulated cartel and more a free market and therefore should require less but much more sophisticated government surveillance to detect more subtle and more complicated schemes of market manipulation.[88]

85 This is the practical result of the U.S. Securities Reform Act of 1975 that became law on June 14, 1975; *see* discussion in text accompanying notes 52-56 *supra*.

86 This development from reacting to block abuses to design of an overall system - *i.e.* from policing to planning - is not a new phenomenon; *see* M. FAINSOD, *supra* note 6, at 267-70; *see also* Wilson, *supra* note 11, at 152; T. LOWI, THE END OF LIBERALISM 141 (1969).

87 *See* SENATE SECURITIES INDUSTRY STUDY, *supra* note 2, at 2, 158. *Contrast* the fuzzy platitudes about cooperative regulation in HOUSE SECURITIES INDUSTRY STUDY, *supra* note 1, at viii-xvii.

88 The economic case is cogently urged by Mann, *supra* note 68.

C. SUMMARY

Keeping in mind M. Fainsod's admonition that any analysis of the regulatory process should encompass the institutional matrix, the parties in interest concerned with the regulation and the policy instruments employed, I shall summarize briefly the concepts already outlined before proceeding to consider the specific mechanisms that might be employed to regulate the securities market.

(1) In a contemporary mixed economy there is an inevitable mix of the institutions of both command and market economies to achieve the three basic functions of government: to allocate resources among alternate uses, adjust the distribution of income and wealth among individuals, and stabilize the operation of the overall economy to achieve a high level of resource use with a minimum of inflation. To reconcile command institutions – particularly planning – with market institutions, the mixed economies have developed a hybrid institution called economic regulation to constrain the market activities of enterprises by equalizing market power, institutionalizing responsibility with the enterprise, or directing the structure and operation of a particular market through an external agency with power to control entry, conduct and prices in that market.

(2) Regulation through an external agency to plan and direct the structure and operation of a particular industry is applied in two common cases: first, where there is a natural monopoly as in the infrastructure industries – energy, transportation and communications; and second, where the government has artificially created a monopoly or cartel structure to achieve stability or security for specific actors in a market (for example, agricultural marketing boards to protect producers or a securities commission to protect investors), long-term political goals that are consciously given priority over the goal of ideal market efficiency.[89]

(3) The regulation of capital markets to ensure investor protection from fraud is a typical example of a government legitimated cartel structure, but the regulation of securities mar-

89 For an excellent discussion of this phenomenon, *see* Wilson, *supra* note 11, at 135-36. Section 4.1 of the Combines Investigation Act, R.S.C. 1970, c. C-23, *as amended*, reconciles one central problem, *i.e.* the potential clash between the competition law and underwriting arrangements. The proposed new s. 4.6 set out in cl. 6 of Bill C-13, 30th Parl., 3d Sess. (1977), *supra* note 51, extends much further and attempts to codify a variation of the U.S. primary jurisdiction concept to reconcile generally the conflict that inheres between the competition law and any regulatory law.

kets has one unique characteristic:[90] much of the regulatory power is delegated to private sector agencies that exercise this power under the surveillance of the securities commissions. Within the overall capital market complex, however, the securities market complex – made up of a stock exchange, clearinghouse, brokers, transfer agents and depository – is one more financial intermediary. Its distinguishing characteristic is that it permits an investor to participate directly in the ownership and control of enterprises on such conditions that the investor bears directly the risk of loss.

(4) A securities market is a valuable institution because of the large aggregate value of the transactions executed in that market, but probably even more important are the secondary consequences of those transactions: that is, to induce investment in productive enterprise, to empower investors to participate in the ownership and control of firms, and to decrease the need for and so reduce the undesirable effects of extensive foreign direct investment.

(5) Securities market regulation did not develop from preconceived premises but grew out of a number of separate policy initiatives set out in corporation laws and securities laws. Although the rhetoric to justify securities market regulation varies from one jurisdiction to another, depending upon the prevalent political doctrine and economic dogma, there developed an implied consensus that a securities market should be cartelized – at least in part – to ensure investor confidence and, as a corollary, should be subjected to close government surveillance, employing techniques analogous to those applied to regulate the public utilities or, in other words, the natural monopolies.

(6) Recent developments in the securities market, particularly the immense growth of the financial intermediaries such as banks, pension funds and mutual funds and the implementation of computer-communications technology, have compelled reconsideration of the cartel-like structure and operations of the market and of the institutions designed to regulate that market. Current proposals – all of which assume a central information system – can be distinguished as three models: (a) a continuation of the present quasi-cartel structure with only service competition, managed by a private sector agency under the close surveillance of a securities commission; (b) a

90 While unique in the domain of conventional regulation, this strategy has long been employed with respect to the professions, which in most jurisdictions, exercise very broad powers through self-regulatory organizations.

straightforward cartel system with only service competition, regulated as a public utility by a securities commission having full powers over entry, conduct and prices; and (c) management of the central information system by government as a public utility but with no constraints on market entry or prices and only those conduct constraints required to ensure full and fair disclosure and to prohibit fraud with a view to achieving full price and service competition.

Chapter V
Regulatory Mechanisms

Even assuming the development of an electronic market over the next decade, there remains the obvious need to regulate the existing system, to participate in the development of the new system during the transition period, and also to develop new regulatory techniques to maintain surveillance over the electronic market. As at present, future securities market regulators must exploit all three regulatory techniques – balancing power to preclude monopoly control, institutionalizing responsibility within firms, and regulating the market through an external agency. But the first technique – balancing power – will continue to concern mainly the distribution of capital market functions among competing intermediaries and reconciliation of securities law with competition law; and the second technique – institutionalizing responsibility – will largely concern the reconciliation of securities law with corporation law, including the particularly thorny problem of imposing personal responsibility on directors and officers of securities firms. The emphasis of this paper, therefore, will continue to focus on the third technique, that is, the regulation of entry, structure, conduct and prices in the securities market through an external government agency or a self-regulatory agency subject to close government surveillance. Indeed, the institution of the so-called independent regulatory commission is so established as the means to regulate a securities market that the only practical way to analyze this issue is to outline briefly the background, structure, functions, constraints on and the criticisms of the independent regulatory commission and then proceed to consider the relative advantages of the independent commission as compared with administration through a department or an integrated department-commission.

Beginning with the Massachusetts Banking Commission created in 1838,[91] governments in North America have continually

91 M. FAINSOD, *supra* note 6. Canadian authors frequently admonish us to be wary of

exploited the concept of the independent regulatory commission to deal with economic problems that appeared too intractable to be resolved through the existing government agencies applying conventional legal techniques. That the institution has been frequently invoked for 150 years, however, does not mean that it has been uncritically accepted. Indeed, political scientists have castigated it as a "headless fourth branch" of government,[92] lawyers have commonly condemned it as a usurpation of judicial powers to deal with property, contract and unfair competition issues,[93] and economists never tire of demonstrating that it is a poor substitute for the market to allocate resources.[94] While there is some merit in all three criticisms, each is largely predicated on a false assumption: first, that it is possible to effect a clear separation of government powers;[95] second, that a commission is essentially a regulation making or adjudicative body created to achieve specific objectives as distinct from a political body set up in part to select among alternative policy objectives;[96] and third, that policy-makers can satisfy public demands by achieving presumed market efficiency relying on nineteenth century laissez-faire mythology.[97] Although the point is frequently reiterated by leading authors,[98] because of their ideological preconceptions critics will not readily acknowledge that a regulatory commission is a complete anomaly

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drawing conclusions from comparisons between U.S. and Canadian regulatory commissions; *see* Bailllie, *Securities Regulation in the Seventies*, in 2 STUDIES IN CANADIAN COMPANY LAW 343, 350 (J. Ziegel ed. 1973); Doern, *supra* note 7, at 29. Close study shows however, that the problems defined and the solutions proposed are close analogues. Similar problems in the U.K. are commonly resolved by departmentalization or state ownership rather than by regulatory agencies; *see* B. SCHWARTZ & H. WADE, *supra* note 23, at 20; and *see* text accompanying note 115 *infra*.

Ironically, U.K. experience was heavily relied upon to justify setting up the first U.S. federal commission; *see* M. BERNSTEIN, REGULATING BUSINESS BY INDEPENDENT COMMISSION 25 (1955).

92 REPORT OF THE PRESIDENT'S COMMITTEE ON ADMINISTRATIVE MANAGEMENT (1937) [hereinafter cited as BROWNLOW COMMITTEE], cited in Bernstein, *supra* note 24.

93 *See e.g.* Zimmerman, *The Legal Framework of Competition Policies toward Regulated Industries*, in PROMOTING COMPETITION IN REGULATED MARKETS, *supra* note 68, at 367; Schwartz, *Legal Restriction of Competition in the Regulated Industries: An Abdication of Judicial Responsibility*, 67 HARV. L. REV. 436 (1954).

94 *See e.g.* Wilson, *The Dead Hand of Regulation*, 25 PUB. INTEREST 39 (1971); PROMOTING COMPETITION IN REGULATED MARKETS, *supra* note 68.

95 *See* M. Bernstein, *supra* note 91, at 291-93.

96 *See* W. CARY, POLITICS AND THE REGULATORY AGENCIES 139 (1967); Jaffe, *The Illusion of the Ideal Administration*, 86 HARV. L. REV. 1183, 1197 (1973); C. WILCOX, *supra* note 6, at 467.

97 *See* M. BERNSTEIN, *supra* note 91, at 126, where the author discusses the political effects of this doctrine.

98 J. LANDIS, THE ADMINISTRATIVE PROCESS 11-15 (1938); Jaffe, *The Effective Limits of the Administrative Process: A Re-evaluation*, 67 HARV. L. REV. 1105, 1129 (1954); T. LOWI, *supra* note 86, at 140, 141.

in a market economy: it is a mechanism to substitute planning in large part for market forces, for example, to minimize the wasteful allocation of resources in natural monopoly sectors, to stabilize the income of agricultural producers, or to ensure greater security for investors.

Like all generalizations this statement of the nature of a regulatory commission is only partly true, for the regulatory commissions developed at different times for different reasons to exercise different functions and to achieve different goals. There is therefore no homogeneous mass of agencies that can be subsumed under the category of regulatory commission, although there are some characteristics common to all commissions. For example, where the purpose of the regulatory law was to equalize bargaining power in markets as under the competition laws and the labor laws, a commission was set up not to plan markets but to make the markets work more effectively. In theory this power could have been left to the common law and the courts, but when these laws were enacted there was a widely felt distrust that for three reasons the judiciary was incapable of achieving such broad goals: first, the judiciary had no powers of investigation and economic analysis and therefore could not initiate action but must rely on actions begun by private persons and on the evidence furnished by them; second, the judiciary could not maintain the required continuous surveillance over the operation to determine whether the policies were working or whether they needed adjustment; and finally, the judicial process was too cumbersome a means, with its lengthy appeal processes, to achieve reasonable uniformity of policy. Moreover, where the purpose of the regulatory law was to displace a market with a view to directing the structure and operations of an industry, the commission was set up to exercise a broad spectrum of legislative and administrative as well as judicial powers to enable it to achieve its planned goals.[99]

A regulatory system tends to develop by accretion. At first regulation is restricted to specific, concrete goals that can be achieved merely by prohibitions enforced in accordance with clear standards. Gradually power is extended to a typical commission to deal with the structure and quality of conduct in an industry. Finally regulatory power is further extended, usually under the pressure of an economic crisis, to plan the overall system, that is, to set objectives within the overall framework of a public interest standard to establish priorities and to control the details of entry, structure, conduct and prices. As Landis has pointed out, the development of the institution of the regulatory commission re-

99 J. LANDIS, *supra* note 98, at 1-46.

flects an understanding that where the state undertakes to direct a sector of the economy it must give the planning agency broad powers to plan, promote and police that sector, powers that had been traditionally characterized as exclusively legislative, administrative or judicial.[100]

Thus the regulatory commission gradually came to be perceived as a mini-government in itself, created to exercise legislative powers to resolve detailed problems with which a legislature could not cope, to exercise judicial powers based on its own investigations and expert analyses, to acquire information to which a court would not ordinarily have access, and to exercise executive powers to plan, measure and control performance. In essence, the independent regulatory commission at its final stage of development is a composite of the executive, the legislature, and the judiciary, which is probably not wholly satisfactory to any one branch of government, but which fulfils an essential planning function without requiring that any one branch abdicate its powers altogether. Although "independent" to a degree, a regulatory commission is constantly subject to legislative control over its enabling legislation and annual budgetary appropriations, subject to executive power over the appointment of commission members and, in some cases, to express executive policy direction,[101] and also subject to judicial power to interpret its enabling statute and to review the exercise of its regulation-making powers and its adjudication procedures.

The regulatory commission has elicited tremendous controversy, but even one of its severest critics concedes that there is a very broad consensus that it is a useful institution, even if different critics like it for very different reasons.[102] As a result, with a few notable exceptions,[103] most of the criticism of the regulatory commission concept has been directed not at its existence but at

100 T. Lowi, *supra* note 86, at 130-43; J. Landis, *supra* note 98, at 15-16, 46; and *see* the works cited in note 86 *supra*.

101 For an excellent discussion on express executive power to issue policy directives to administrative commissions in Canada, *see* H. Jänisch, The Role of the Independent Regulatory Agency in Canada (unpublished paper presented to Canadian Assoc. of Law Teachers May 30, 1977).

102 M. Bernstein, *supra* note 91, at 71; and *see* 9 Ontario Committee on Government Productivity 3, 38 (1973).

103 The Sherman Act of 1890 was originally administered by the Bureau of Corporations in the original Department of Commerce and Labor; *see* T. Lowi, *supra* note 86, at 119. The Brownlow Committee, *supra* note 92, recommended that all programs including those administered by regulatory agencies be integrated in a department under the authority of a cabinet member; *see* Bernstein, *supra* note 24, at 15. This thesis was reiterated in the report by F. Redford, The President and the Regulatory Commissions (1960) (submitted to the President's Committee on Gov-

its performance, not at alternative institutions but at means to make the regulatory commission function more effectively within the context of overall national policy by better defining its legislative goals through more refined statutory standards, by subjecting it to more – or less – judicial review, by tinkering with its structure and functions, or by requiring it to permit more competition, particularly service competition, whenever feasible in a regulated industry.

The ubiquitous problem of standards relating to the delegation by the legislature of broad regulation-making, investigative, adjudicative and administrative powers takes on particular significance in an enabling act setting up a regulatory commission because of its relative independence of the normal political processes. To compound the problem, like any government program it is exceedingly difficult to specify precisely the objective that a regulatory agency is expected to achieve in exercising its powers. For example, if a securities commission is given broad powers to regulate the securities industry in the public interest without further qualification, the commission, even if only to give its own staff a sense of purpose, must specify its own objectives and particularize as far as possible how and when it will exercise its powers to achieve those objectives, which may range from a cautious policy that focuses only on investor protection to a venturesome policy that emphasizes the creation of new enterprises irrespective of investor risk.

In effect, where there is such broad delegation, the legislature is consciously assigning to the commission the task of identifying the specific problems in the industry and working out solutions.[104] That is not to say, however, that the legislature is abdicating its responsibility but rather that it is temporarily empowering an expert body to deal with the problem until such time as further legislation is required to define better the commission's purposes and powers, to expand or restrict those powers, or even to dissolve the commission altogether.

This basic problem of expressing statutory standards was clearly recognized by Landis, who, although he advocated very broad delegations of power to commissions, stated that each case presented a paradox of "applying Procrustean standards to a

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ernment Organization). *See also* Hector, *Problems of the CAB and the Independent Regulatory Commissions*, 69 YALE L. J. 931, 960 (1960).

This parallels the ministry concept recommended in 9 ONTARIO COMMITTEE ON GOVERNMENT PRODUCTIVITY 19-28 (1973).

104 Jaffe, *supra* note 96, at 1183, 1190, 1197. For a general discussion of the application of administrative law principles in the field of securities regulation, *see* 3 L. Loss at 1877.

world that breeds both pygmies and giants".[105] If the standards are too broad the commission may fail to define its objective or be too timid to exercise its powers, or, conversely, may exercise its discretion arbitrarily. If the standards are too narrow the commission may quickly lapse into the kind of bureaucratic routine that precludes it from developing imaginative means to regulate a dynamic industry.[106]

The broad delegation model urged by Landis became the focal point of two criticisms of ineffective agencies: first, an agency with no clear legislative mandate appears unable either to define or achieve its objectives and therefore tends to become the captive of the regulated industry and to characterize the public interest as congruent with the industry's interest; and second, such an agency appears to exercise its discretion arbitrarily in the sense that a person appearing before the agency never knows what case he has to make in order to qualify for the privilege he seeks.[107] The only answer to the first criticism is that the legislature must express the purposes and powers of the commission more clearly and must set up a review mechanism to review commission performance on a continual basis. The second criticism may be answered in two ways: either by clarifying the standards of delegation or by bringing pressure to bear on the commission to compel it to exercise its regulation-making powers continually to refine, particularize and publicize the standards it applies when making a decision, so that like cases will be dealt with in the same manner in accordance with consistent policies. The latter technique in particular will better enable an affected person to predict with reasonable certainty future agency action and also will enable the agency to circumscribe the cases it will consider.[108] One American authority, taking a position between Landis on the one hand and the proponents of regulation-making on the other, argues that regulation-making,

105 J. LANDIS, *supra* note 98, at 72. *See also* the discussion *id.* at 51, 66. To the same effect *see* H. FRIENDLY, THE FEDERAL ADMINISTRATIVE AGENCIES 13 (1962).

Landis, without recanting his earlier views completely, underlined in a later report that the legislature must, to fulfil its planning responsibilities, define each agency's objectives and powers more clearly; *see* J. LANDIS, REPORT ON THE REGULATORY AGENCIES TO THE PRESIDENT-ELECT (1960), *discussed in* McFarland, *Landis Report: The Voice of One Crying in the Wilderness*, 47 VA. L. REV. 373, 425-27, 433-38 (1961).

106 This is a good illustration of the paradox that "any large organization has to strive continuously for the orderliness of order and the disorderliness of creative freedom"; *see* E. SCHUMACHER, SMALL IS BEAUTIFUL 203, 209 (1974).

107 *See* M. BERNSTEIN, *supra* note 91, at 294-95.

108 The leading advocates of expressing clearer, detailed standards are H. FRIENDLY, *supra* note 105, at 142-46; K. DAVIS, DISCRETIONARY JUSTICE 56-65 (1969). *See also* the critique of Davis by Anisman, Book Review, 47 CAN. B. REV. 670 (1969); Jowell, *The Legal Control of Administrative Discretion*, [1973] PUB. L. 178, 203-06.

while undoubtedly beneficial, is at best only a very limited response to the problem.[109]

As usual in dealing with an administrative law problem, one must look at the overall spectrum of administrative agencies and then develop the best mix of techniques to resolve a specific problem. In theory the refinement of statutory standards is always desirable; but some agencies have difficulty developing any specific regulations within a broad statutory delegation because of the dynamic nature of the industry regulated, whereas other agencies with narrowly specified goals in a more static environment can make and thrive on detailed regulations. It is important therefore that the delegation of power be broad enough to enable an agency to act effectively, that pressures to induce continual policy refinement through regulation-making be built into the statutory system, and that the exercise by a commission of broad powers be subject to continued scrutiny by the legislature. Legislative scrutiny is especially important because no broad delegation of power to regulate an industry can be exercised without applying value judgments, which may be based on beliefs ranging between laissez-faire liberalism and cartelism, and which may therefore – consciously or unconsciously – subvert the original policy goal of the enabling act.

Concurrently with bringing pressure on the legislature and the commission better to define statutory standards or to refine those standards through detailed regulations, the critics, particularly the lawyers, have repeatedly pressed forcefully for greater procedural safeguards – characterized as due process or natural justice rules – in order to preclude administrators from exercising arbitrarily the wide discretion implied by broad public interest standards. This movement for law reform led to the enactment of the Administrative Procedure Act of 1946 in the United States,[110] the Tribunals and Inquiries Act, 1958 in the United Kingdom,[111] and, more recently, the Federal Court Act and the Statutory Instruments Act[112] in Canada and the Statutory Powers Procedure Act and the Judicial Review Procedure Act in Ontario.[113] The United Kingdom legislation, because of the ab-

109 Jaffe, *supra* note 96, at 1188-90.

110 K. Davis, Administrative Law Text, s. 1.04 (3d ed. 1972).

111 *See* discussion in B. Schwartz & H. Wade, *supra* note 23, at 152.

112 Federal Court Act; Statutory Instruments Act, S.C. 1970-71-72, c. 38. The Administrative review provisions of the Federal Court Act are discussed in Mullan, *The Federal Court Act: A Misguided Attempt at Administrative Law Reform?*, 23 U. Toronto L.J. 14 (1973).

113 Statutory Powers Procedure Act, S.O. 1971, c. 47; Judicial Review Procedure Act, S.O. 1971, c. 48. Complementary provisions were enacted by the Public Enquiries

sence of the regulatory commission as an institution,[114] effected a largely non-controversial reform of administrative procedures. The United States law and its Canadian counterparts[115] have, however, engendered a long and heated debate that has until recently focused mainly on the regulatory commissions, partly because the commissions are the most visible administrative bodies and partly because the reforms were largely directed at such bodies.

While the procedural safeguards implemented by these laws were generally acknowledged to be desirable, particularly where the administrative action was essentially adjudicative in the sense of applying a relatively narrow statutory rule or standard to a factual situation, administrative law scholars questioned whether such laws, which were frankly modeled after the adverse party trial system, were appropriate to govern the conduct of the regulatory commissions.[116] The American literature on the subject is very extensive, but most of the criticisms can be distilled down to the following basic themes. In general, the adverse party process is ill-suited to the functioning of the regulatory commissions which were set up to enable administrators, acting under the aegis of broad public interest standards, to achieve comprehensive policy goals through the application of expertise to analyze difficult technical fact situations and to make complex judgments affecting many parties and even the general public. These were functions that the courts were not qualified to deal with. Moreover, in an adverse party context the parties tend to control the proceedings by defining the issues, investigating the facts and furnishing the evidence, thus tending to displace expert investigation and analysis that would otherwise be done by objective commission staff. And as a corollary the parties became preoccupied with building a record for the purposes of judicial review instead of concentrating on analysis of the issues. In sum, by emphasizing the judicial approach, the administrative procedure laws frag-

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Act, S.O. 1971, c. 49, and the Civil Rights Statute Law Amendments Act, S.O. 1971, c. 50, all of which are discussed in Baillie, *supra* note 91, at 16-17.

114 B. Schwartz & H. Wade, *supra* note 23, at 26-31. Amendments to the B.C. Securities Act in 1974 have reconstituted that Commission more on an English model, vesting all policy making and administrative powers in a departmental office, the Superintendent of Brokers, and relegating the Commission to the status of adjudicative appellate agency; *see* British Columbia Securities Act, ss. 3-6; and *see* Getz, *Appellate Functions Planned*, [1974] Vancouver Stock Exchange Rev. (October).

115 Professor Willis points out that it is "from the United States that we have borrowed most of our regulatory legislation together with our preference for the American board, as opposed to the English civil service, method of implementing it"; Willis, *Canadian Administrative Law in Retrospect*, 24 U. Toronto L. J. 225, 235 (1975).

116 M. Bernstein, *supra* note 91, at 192-209.

ment the process of policy development by over-emphasizing case by case analysis; they pre-empt the time of the commissions to hear specific cases; and they divert the commissions from their basic task of developing, advocating, evaluating and implementing policy or, in other words, they prevent them from planning.[117]

The recent enactment of administrative procedure laws in Canada, which are clearly predicated on the assumption that more judicial review is inherently desirable, has evoked similar comments as well as criticism that the legislature should not attempt to apply one set of rules to straightforward adjudication cases – such as entitlement to unemployment insurance – and also to complex market regulation cases – such as energy pipelines. Among other things, critics urge that the courts use restraint in reviewing the substance of administrative decisions and that they uphold decisions that do not conflict with the law or with values fundamental to the legal system,[118] or alternatively that judicial review be completely abolished – or at least expressly limited to jurisdiction and procedural issues – and that the enabling acts be reviewed one by one to permit an express right of appeal where an appeal from an adjudicative decision appears appropriate.[119] Whether these broader review powers in the Canadian laws will engender practical problems or whether the courts will show the same kind of restraint shown by the United States courts in applying the Administrative Procedure Act remains to be seen.[120]

In any case, there is a clear even if largely tacit consensus that there are certain functions, particularly the exercise of broad policy-making powers by commissions responsible for the regulation of markets, that are not appropriate matters for judicial review. Assuming the issues are clearly defined and the court has access to all relevant evidence, a court probably could decide these issues as well as a regulatory commission. But this hypothetical case begs the entire question by assuming resolution of the judicial

117 *See id.* at 179-82; Jaffe, *supra* note 96, at 1183; Massel, *The Regulatory Process*, 26 LAW & CONTEMP. PROB. 181 (1961); Jowell, *supra* note 108, at 213.

B. SCHWARTZ & H. WADE, *supra* note 23, at 111, concluded that the U.S. Administrative Procedure Act "has elevated the procedural level without crippling the administrative process".

118 Hogg, *Judicial Review: How Much Do We Need?*, 20 MCGILL L.J. 157, 175 (1974).

119 Willis, *supra* note 115, at 244; Willis, *The McRuer Report: Lawyers' Values and Civil Servants' Values*, 18 U. TORONTO L. J. 351, 359 (1968); Mullan, *supra* note 112, at 50-53.

Note that the U.S. Securities Reform Act of 1975 has substantially amended s. 25 of the Securities Exchange Act of 1934 to extend express judicial review powers, particularly to encompass rule-making as well as adjudicative orders; *see* H.R. REP. No. 94-229, 94th Cong., 1st Sess. 100 (1975).

120 A comparison of trends in the U.K. and the U.S. is made in B. SCHWARTZ & H. WADE, *supra* note 23, at 26-27, 117-20.

shortcomings that constituted the basic reasons for setting up commissions in the first place, that is, the need for expertise to define issues, do in-depth analyses, investigate and determine the material facts, and maintain continuous surveillance over the regulated industry to forecast the emergence of new issues and to adjust policies accordingly. Thus although judicial review is useful – even necessary – to constrain a commission to act within its statutory jurisdiction, to preclude it from acting arbitrarily, and to ensure that it adheres to fair procedures, it is not a useful institution to second-guess the substance of commission decisions. Above all a commission is not a subordinate court conducting an adverse party trial but rather a political body developing, evaluating and applying alternative policies. In short, a reviewing court should only look at the legality of a decision, not the correctness of the policy decision made. The underlying reason is clear. There can no more be value-free adjudication within the context of broad standards than there can be value-free administration. Any decision rendered under such broad standards is a choice of a policy alternative, a choice that is better left to the legislature or, if the policy choices are too nebulous for statutory expression, to a commission that will have the expert resources and the means – investigation powers, powers to adjudicate specific cases, and regulation-making powers – to develop, enunciate and evaluate alternative policies.[121]

Acknowledging that market regulation through a commission requires the exercise of broad policy-making powers to achieve political objectives, many critics have eschewed reform through the better definition of statutory standards or judicial review and have recommended, instead, changes in government machinery that will make the regulatory commissions function better or render them more directly accountable to the executive and the legislature. These changes fall generally into two classes: first, changes directed at the internal structure and functions of the commissions; and second, changes directed at overall government restructuring, particularly by what has come to be called departmentalization, that is, the absorption of commission functions into executive departments or at least the clear subordination of commission policy-making power to executive direction.

The internal changes suggested range from relatively minor matters – such as the substitution of a single chief executive officer

121 *See* Massel, *supra* note 117, at 195-97. Jaffe, *Basic Issues: An Analysis*, 30 N.Y.U.L. Rev. 1273, 1285 (1955). For a recent discussion of this issue, *see* Cutler and Johnson, *Regulation and the Political Process*, 84 Yale L. J. 1395 (1975).

for the present collegiate commissions,[122] the improvement of commission personnel,[123] and the improvement of internal operations procedures[124] – to basic organic changes – such as the complete separation of the investigation and prosecution functions from the adjudication function[125] and the de-emphasis of adjudication (particularly the excessive judicial formalities that have rendered regulation unduly cumbersome) so that a commission may apply more of its time, expertise and experience to other means of policy analysis and formulation.[126] Although they have generated some controversy, these recommendations concerning internal change reflect more a desire to tinker with structures, functions and organizations than to resolve fundamental problems.

In contrast, the recommendations concerning basic changes of government machinery by merging commissions into executive departments[127] (that is, reducing their independence[128]) or at least better coordinating their activities with executive department policies[129] are changes of an altogether different order, requiring reconsideration of the reasons for setting up indepen-

122 These issues are all summarized with respect to the U.S. commissions in Bernstein, *supra* note 24, at 14. *See also* STAFF OF SENATE COMM. ON GOVERNMENTAL AFFAIRS, 95TH CONG., 1ST SESS., STUDY ON FEDERAL REGULATION (Comm. Print 1977); STAFF OF SUBCOMM. ON OVERSIGHT AND INVESTIGATIONS OF H.R. COMM. ON INTERSTATE AND FOREIGN COMMERCE, 94TH CONG., 2D SESS., REPORT ON FEDERAL REGULATION AND REGULATORY REFORM (Subcomm. Print 1976); D. WELBORN, GOVERNANCE OF FEDERAL REGULATORY AGENCIES 131-43 (1977).

123 J. LANDIS, REPORT, *supra* note 105, *cited in* Bernstein, *supra* note 24, at 18.

124 COMMISSION ON ORGANIZATION OF THE EXECUTIVE BRANCH OF GOVERNMENT, LEGAL SERVICES AND PROCEDURE (1955) (Second Hoover Commission), *cited in* Bernstein, *supra* note 24, at 17.

125 *Id.* One of the difficult problems relates to *ex parte* communications, *i.e.* facts considered by an adjudicative commission that are not on the record and not fully disclosed to the affected parties; *see* K. DAVIS, *supra* note 110, c. 13, s. 13.07.

See Cary, *Why I Oppose the Divorce of the Judical Function from Federal Regulatory Agencies*, 51 ABA J. 33 (1965), where the author argues strongly against separation on the ground that case by case adjudication is often the best means to "prick out" an effective policy.

126 Bernstein, *supra* note 24, at 24. B. SCHWARTZ & H. WADE, *supra* note 23, repeatedly point out, too, that the U.S. formalities cannot be reconciled with resolving conflicts that arise in connection with comprehensive social welfare programs.

127 BROWNLOW COMMITTEE, *supra* note 92, *cited in* Bernstein, *supra* note 24, at 15. *See also* materials in note 103 *supra*.

128 M. BERNSTEIN, *supra* note 91, at 145-50. The author points out that independence may be desired by industry to ensure control over the regulators.

One proposed change of U.S. securities laws would have institutionalized industry influence over the SEC. This proposal was rejected at the Conference Committee stage; *see* H.R. REP. NO. 94-229, 94th Cong., 1st Sess. 96 (1975).

129 COMMISSION ON THE ORGANIZATION OF THE EXECUTIVE BRANCH OF GOVERNMENT, THE INDEPENDENT REGULATORY COMMISSION (1949) (First Hoover Report); J. LANDIS, REPORT, *supra* note 105; A NEW REGULATORY FRAMEWORK: REPORT ON SELECTED

dent regulatory commissions in the first place. Fortunately, in Canada, these problems generate far less heat than in the United States.[130] This is partly because we have always assumed that the regulatory commissions must be subject to the oversight of executive departments,[131] at least in respect of strategic policy issues,[132] and partly because, until recently, the operations of the

INDEPENDENT REGULATORY AGENCIES (1971) (Ash Report), *cited in* Bernstein, *supra* note 24, at 16, 18, 19.

The most recent U.S. federal, economic regulatory commission, the Commodity Futures Trading Commission created by Pub. L. No. 93-463 (1974), involved a transfer of regulatory authority from the Dept. of Agriculture to an independent commission; but the commission is structured to ensure close, continuous liaison with the Secretary of Agriculture; *see* STAFF OF SENATE COMM. ON AGRICULTURE AND FORESTRY, THE COMMODITY FUTURES TRADING COMMISSION ACT OF 1974 21 (Comm. Print 1974); DEPT. OF AGRICULTURE, REPORT TO CONG. ON THE COMMODITY EXCHANGE AUTHORITY AND ON COMMODITY FUTURES TRADING 12-13 (May 1974).

130 Bernstein characterizes the concept of "independence" from the executive as a "curious American concept" M. BERNSTEIN, *supra* note 91, at 150. *See also* Massel, *supra* note 117, at 186.

131 *See e.g.* 9 ONTARIO COMMITTEE ON GOVERNMENT PRODUCTIVITY, *supra* note 102, at 45; but Baillie, *supra* note 91, at 353, points out that Canadian securities commissions are in practice substantially independent of both the legislature and the executive.

For an analysis of executive directive powers at the federal level in Canada, *see* H. Jänisch, *supra* note 101; *see also* H. JÄNISCH, Political Accountability for Administrative Tribunals (unpublished paper presented at Conference on Administrative Justice, University of Ottawa, January 1978).

The executive directive powers in the key federal regulatory statutes can be briefly summarized.

	Minister or Governor in Council directive power	Governor in Council power to transfer authority from comm. to minister	Governor in Council power to override comm. or refer back
National Transportation Act, R.S.C. 1970, c.N-17			s. 64(1)
Broadcasting Act, R.S.C. 1970, c.B-11	s. 22		
National Transportation Amendment Act. Bill C-33, 2d Sess. 30th Parl., 1977	s. 3.2	s. 3.1	
Telecommunications Act, Bill C-24, 3d Sess., 30th Parl., 1978	s. 9		ss. 11, 12

132 This theme is frequently reiterated but it defies any kind of clear definition; *see e.g.* Jaffe, *supra* note 98, at 1105, 1135; W. CARY, *supra* note 96, at 25.

regulatory agencies were largely confined to technical problems and therefore not too visible. But recent crises in the energy, communications and transportation sectors have forced these agencies to the front of the stage, compelling Canadian governments to confront and deal with these issues.[133]

While these recommendations to change commission structures and relationships raise alternatives that may be useful in specific cases, preoccupation with them has undoubtedly built up unrealistic expectations about what can be achieved by restructuring organizations and has diverted attention from the basic problem, which is how to make the regulated industries perform better. Whether the task of regulation is assigned to a department or an independent commission, as English experience establishes, is not of central importance. What is essential is to recognize that all regulation problems are multidimensional in the sense that they may involve several conflicting social and economic interests in a changing environment and that they may be subject to numerous alternative regulatory mechanisms. Therefore each regulatory issue – assuming regulation is the best solution – requires careful analysis of all these factors and not just of government machinery.

Indeed, the topical criticism[134] of the regulatory process largely ignores the questions of delegation, judicial review and administrative mechanisms and launches a frontal attack on the regulatory citadel, questioning how much regulation is really essential or even whether regulation is required at all, and advocating more empirical analysis to permit a more rational approach to answering these problems. The critics of this school acknowledge that governments deliberately structure certain industries as monopolies or cartels in order to limit destructive competition.[135] However, they argue that the onus should be on an industry to prove the existence of any destructive competition in an open policy debate in order to justify new regulatory initiatives or even the continuance of existing, well-established regulatory systems.[136] If there is some destructive competition but only of a

133 The federal government has recently taken steps to clarify departmental control over strategic policy decisions with respect to transportation and communications; *see* materials in note 131 *supra*. *See also* Cutler and Johnson, *supra* note 121, at 1395, where the authors recommend greater presidential power to intervene in the process of policy making by regulatory agencies.

134 *See* especially, Wilson, *supra* note 94; Promoting Competition in Regulated Markets, *supra* note 68.

135 *See* Jaffe, *supra* note 98, at 1114, 1127, where the author criticizes a too simplistic free market approach.

136 For an excellent illustration of this kind of analysis, *see* Mann, *supra* note 68, at 301. This approach is not altogether new. In 1954 Schwartz advocated that the courts be

temporary or minor nature, then instead of overall regulation a program of adjustment assistance or insurance can be instituted to permit equitable treatment of any hardship cases, a solution that obviates continuous government surveillance. If, on the other hand, the industry is in fact a natural monopoly or must be cartelized for stability or public security reasons, then the regulatory system should be openly characterized as a planning mechanism that displaces the market and should be designed accordingly, keeping in mind the criticisms outlined above. Particularly, one should note the point that behind each criticism is a political conviction for or against planning as a process or an ingenuous belief that politicians can actually sacrifice equitable treatment in a large number of cases in order to achieve overall economic efficiency for all.[137]

As Wilson has pointed out,[138] all of these criticisms of the regulatory process involve a tradeoff between equity and efficiency. Those who advocate greater equity press for fairer procedures and wider scope for judicial review over jurisdiction, procedures and even substance. Those who advocate greater regulatory efficiency press for better policy coordination with the executive – particularly to specify objectives – through departmentalization or other organic change or better definition of regulatory standards. Finally, the new critics press for overall industrial efficiency on the ground that even the most sophisticated regulatory system cannot achieve what a market does well, that is, evaluate the performance of a firm or an industry through the price mechanism in order to determine whether resources should be allocated to it.[139]

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empowered to quash agency decisions that reduce competition except where the agency establishes that it cannot otherwise achieve its statutory objectives; *see* Jaffe, *supra* note 98, at 1134. Schwartz's idea is now reflected in s. 23 of the Securities Exchange Act of 1934 as amended by the Securities Reform Act of 1975.

137 This form of criticism has been nicely characterized as "a renewed interest in the reductionist theories of economists and philosophers that seek to dissolve collective choice into individual exchange and public law into private law, thus limiting the administrative function". Stewart, *The Reformation of American Administrative Law*, 88 HARV. L. REV. 1667, 1807 (1975).

138 Wilson, *supra* note 93, at 40-42.

139 These critics are currently having great impact. Several U.S. bills have recently been tabled in Congress recommending a study of the functions of the regulatory commissions; *see e.g.* S. 4145 and S. 4167, 93d Cong., 2d Sess. (1974), *discussed in* 690 BNA ANTITRUST AND TRADE REG. REP., at A-17; *but contrast* the views of Stewart, *supra* note 137.

Since then the President and a bipartisan congressional delegation have met to discuss the issues raised by the bills and have concluded that deregulation should be effected wherever practicable, particularly the price-fixing of the commissions regulating infrastructure industries; *see* The Wall Street Journal, June 26, 1975, at 2, col. 3.

In any event it is very probable that legislatures, for valid political reasons, will continue frequently to invoke the institution of the independent regulatory commission – that is, a commission set up outside the conventional government departments – to resolve problems that are too complex to be resolved through ordinary bureaucratic administrators who apply relatively static statutory rules and standards. I shall therefore summarize the above arguments and then outline briefly the advantages frequently attributed to the commission.

(1) The independent regulatory commission is a minigovernment, which is empowered to exercise legislative, judicial and administrative powers with a view to planning the structure and operations of an industry or a market.

(2) As a general rule, a commission must have a relatively broad delegation of power under its enabling act if it is to be able to regulate imaginatively and effectively. Delegation under broad "public interest" standards is in effect authority to develop and enunciate policy as distinct from applying value-free rules and standards to specific cases. It is in this sense that each regulatory commission is in politics.

(3) For the same reason – the absence of value-free rules and standards – judicial review of the decisions of a regulatory commission is not a satisfactory means to control commission decisions, except to constrain a commission from acting outside the limits of its jurisdiction, acting arbitrarily, or following unfair procedures.[140] A court should adjudge only the legality of a commission's decision, not the correctness of a policy decision made in the context of broad public interest standards.

(4) Rather than focus on delegation standards or judicial review, it is more appropriate, particularly in the Canadian context where scant attention is accorded separation of powers mythology, to structure a commission in a way that achieves a workable balance between the commission's relative independence on the one hand and its responsiveness to the executive as well as its accountability, through a minister, to the legislature on the other.

(5) Assuming regulation is politically necessary the legislators and the regulators should be constantly aware when undertaking to regulate an industry or a market that to displace market competition – and particularly price competition – is to bureaucratize the industry or market. To do so is to aban-

140 Note especially the judicial review provisions set out in s. 25 of the Securities Reform Act of 1975.

don the price mechanism as a means to determine value and measure performance and to substitute other performance measures. Wherever possible, therefore, regulation should be limited to conduct rules and standards and should only be extended to govern entry and prices – the strategic elements of a competitive market – when no other solution is politically acceptable.

(6) In summary, in addition to the general economic criticism that regulation is a poor substitute for a competitive market, regulation through a regulatory commission is frequently attacked on three fronts. First, the exercise of broad discretion within the context of a public interest standard may empower a commission to dilute the force or even subvert the original policy of the law unless the standard is further refined or the agency subjected to continual policy oversight by the executive and the legislature. Second, again because of the broad discretion exercised by a typical commission, it may act unlawfully, unfairly or arbitrarily unless it is subjected to judicial review. Third, because of its relative independence, a commission may become ineffective or even become a captive of the regulated industry unless its planning is closely coordinated with the executive to ensure that the commission's goals and priorities are consistent with the government's overall goals and priorities.[141]

(7) The regulatory commission is widely acknowledged to have a number of specific advantages over conventional department structures that clearly outweigh its disadvantages.[142]
(a) It permits flexible and expert administration where bureaucratic administration of rules and standards as interpreted by the courts would not work. A commission can take on a novel and complex task, explore and analyze an industry, apply its expertise to refine very broad statutory policy through adjudication and regulation-making, and maintain

141 *See generally* Massel, *supra* note 121, at 183; M. BERNSTEIN, *supra* note 91, at 24, 100; McFarland, *supra* note 105, at 423.

142 *See* M. BERNSTEIN, *supra* note 91, at 24, 70; ONTARIO COMMITTEE ON GOVERNMENT PRODUCTIVITY, *supra* note 102, at 37; Fainsod, *Some Reflections on the Nature of the Regulatory Process*, in PUBLIC POLICY, *supra* note 22, at 297, 312 n. 6. *See also* J. BALDWIN, THE REGULATORY AGENCY AND THE PUBLIC CORPORATION 6-9 (1975), where the author expresses bluntly the usually only implied, major factor that impels a government to establish an "independent" regulatory agency: to insulate the government from making an enemy in circumstances where the effect of a difficult policy decision is necessarily to benefit one person and to deny another.

The U.S. Senate Committee on Governmental Affairs has very recently, as a result of a comprehensive study of the U.S. federal-administrative system, confirmed its confidence in the concept of the regulatory commission; *see* in particular 5 STAFF OF SENATE COMM. ON GOVERNMENTAL AFFAIRS, *supra* note 122, at 80-81.

continuous oversight of the regulated market or industry to determine the effectiveness of that policy.

(b) It permits the resolution of conflicts among rival interest groups, if not free from politics, at least free from the immediate pressure of short-term, partisan politics, permitting it to avoid expedients and so develop policies that will have considerable continuity. A commission can, particularly when adjudicating a specific case, retain enough independence from the executive to decide the case impartially.

(c) Presumably it can, as a collegiate body, render better judgments and permit broader representation in the regulation-making (that is, policy-making) process[143] than can an agency with a single head.

(d) It enables interested persons better to aim their criticisms and to recommend policy changes to government because the establishment of a commission tends to focus program responsibility. A commission can also be structured to balance conflicting interests. It may include members who are clearly capable of considering the interests of groups that are not well represented because the benefits of regulation or deregulation are widely diffused among the public whereas the costs are concentrated and borne, for example, by a small group of producers.[144]

(e) It can offer a number of administrative advantages, particularly freedom from the constraint of the bureaucratic rigidities of government personnel and financial management rules and from the requirement of queuing up to receive general services such as legal, data processing and public relations services. A commission can achieve better program performance at lower cost through the use of term employees or service contracts. This also precludes the growth of tenured employees and so facilitates winding up when a limited program goal has been achieved.

(f) It permits government to assume a quasi-commercial activity, for example the administration of a computer-communications system, with less hostility from the business community.[145]

(g) It facilitates regional representation and also the coordi-

143 This is an important consideration in Canada, where most - but not all - regulation-making power is vested in the Cabinet to ensure regional representation in the policy-making process; *see* Mallory, *Parliamentary Scrutiny of Delegated Legislation in Canada: A Large Step Forward and a Small Step Back*, [1972] PUB. L. 30.

144 *See* Wilson, *supra* note 11, at 143-46.

145 Weil argues that the U.S. Government should set up a state corporation to adminis-

nation of programs that cut across the traditional jurisdiction of several departments.

(h) And finally, it is a versatile institution to coordinate intergovernmental program, which is an especially important characteristic of a commission in a federal system.

Chapter VI
Institutions of Federal-Provincial Cooperation

Although the regulatory commission is widely acknowledged to be an especially versatile instrument to coordinate intergovernmental programs, it is only an alternative means to achieve an objective and not in any sense a solution of the underlying problem, which is to render overlapping, federal-provincial programs more effective. For as Derthick points out, "Organizations are instruments of purpose, and they ought not to be judged apart from the objectives they purport to serve".[146] In other words, one should not have exaggerated expectations about what can be achieved by organizational change, for absent at least broad consensus among the federal and provincial governments about joint program objectives, not even an ideal form of organization can administer a joint or overlapping program effectively.

It is however, a reasonably safe assumption, if we ignore peripheral issues[147] and bargaining rhetoric, that all Canadian governments share a common general objective with respect to securities market regulation:[148] to develop and maintain a Canada-wide securities market that, within the context of the prevailing general economic policies is effective in the sense that it tends

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ter a computerized securities market as a public utility on a cost recovery basis; *see* F. Weil, *supra* note 28.

146 M. Derthick, Between State and Nation 224 (1974).

147 The most important peripheral issue is the emphasis to be placed on investor protection as opposed to entrepreneurial freedom. These are mutually exclusive goals, therefore one can be increased only at the expense of the other. This problem inheres in any system of securities regulation. It can be dealt with by setting high investor protection standards in federal law and permitting more promoter-oriented standards in provincial laws that apply to intraprovincial trades, and also by establishing different standards in federal and provincial laws with respect to different enterprises (*e.g.* by distinguishing among financial, industrial, resource extraction, and resource exploration firms).

Other peripheral - but important - policy issues are foreign ownership of securities firms, introduction of electronic systems, accounting disclosure standards and the functions of other financial intermediaries.

148 Since 1937 a number of royal commissions have discussed the desirability of securities regulation without any detailed analysis of alternative means; *see* Report of the Royal Commission on Price Spreads 44 (1937); 2 Report of the Royal Commission on Dominion-Provincial Relations 57 (Rowell-Sirois Report, 1940); Porter Report at 348.

to allocate capital to enterprises than can make optimum use of it, and efficient in the sense that it enables capital to flow from savers to users with a minimum of unnecessary cost. The central problem therefore is to determine what institutions of federal-provincial cooperation will best enable the government of Canada to contribute to this objective, which involves consideration of the existing framework of federal-provincial relations and the alternative coordinating mechanisms that can realistically be employed within it.

The present framework of federal-provincial relations can best be explained by a brief explanation of its evolution. The original concept of federalism, both in the United States and Canada, was "dual federalism", which was based on the assumption that federal and provincial powers could be separated into watertight compartments and that any program conflicts could be resolved through the arbitral powers of the supreme court, or, if judicial arbitration did not result in a solution satisfactory to the parties, then through the process of formal constitutional amendment.[149] As government intervention in the social and economic life of the federal states grew, it became obvious that with respect to complex systems all matters become interdependent and the larger the resource commitment to any one program the greater the impact on all other programs. The response to this new state of affairs was the concept of "cooperative federalism", which is based on a negotiating process to define common program goals and determine the amount of resources to be allocated to each common or shared program by each government involved.[150] This ap-

149 *See* R. Van Loon & M. Whittington, The Canadian Political System: Environment, Structure & Process 165-228 (1971) (especially 206-28); J. Sundquist & D. Davis, Making Federalism Work 6-13 (1969); Mallory, *The Five Faces of Federalism*, in Canadian Federalism: Myth v. Reality 55 (J. Meekison ed., 2d ed. 1971); P. Hogg, Constitutional Law of Canada 29-76 (1977).

For an extensive bibliography of these issues, *see* Institute of Intergovernmental Relations, Queen's University, Bibliography of Federalism and Intergovernmental Relations in Canada, Australia, the United States and Other Countries (1967 & Supp. 1976).

150 A further refinement on this in Canada is "consultative federalism", which is based on the idea of intergovernmental consultation, particularly among first ministers, before a proposed new program is introduced with a view to identifying and minimizing program conflicts; *see* D. Smiley, Constitutional Adaptation and Canadian Federalism Since 1945 90-94 (Study No. 4 of Royal Commission on Bilingualism and Biculturalism 1971).

Where consultation does not lead to a satisfactory solution a province may opt out of a shared program and instead accept a lump sum of income tax revenues to finance its own program. This alternative has been raised most recently by the Ontario government with respect to health care programs; *see* speech of Ontario Treasurer, W.D. McKeough, in revised budget; Leg. Ont. Deb., 29th Leg., 5th Sess., No. 95, at 3673 (1975).

The U.S. variation is called "creative federalism", which is based on the idea of

proach, although only a qualified success, has if nothing else highlighted the importance of defining program objectives, particularly where there can be substantial overlap or even conflict among federal and provincial programs.

As already pointed out, there is probably little conflict in principle between federal and provincial objectives with respect to securities market regulation, but absence of conflict about general objectives - and the means to achieve those objectives - does not resolve all the problems. Experience with shared programs has clearly underlined the importance of looking at a whole system and not just its constituent parts. For example, when considering the securities market one should consider the overall capital market of which the securities market is only a subsystem unit, other programs such as taxation and resource development programs that have direct impact on capital market and securities market policies, and also particular regional and local requirements. Since, however, there is at present in Canada no permanent intergovernmental machinery to deal on a continuous basis with capital market or even securities market policies,[151] the federal government must consider the alternative coordinating mechanisms that will best enable it to achieve its program goals and at the same time reconcile those goals with provincial policies before it can consider becoming involved in securities market regulation. Although other, extraneous coordinating mechanisms such as intergovernmental policy committees are possible, assuming the federal government does decide to enter the securities field, then within the context of the securities laws there exist only two probable strategies. The first is a dual system, which implies superimposing a federal law and a federal regulatory system on the existing provincial systems. The second is an integrated system, which implies vesting in one commission authority to exercise powers under discrete federal and provincial securities acts.[152]

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national leadership to establish goals and priorities and to furnish resources to local governments for program execution, a system that sounds good but that fails to resolve the paradox of program execution by local governments that have different or even hostile policies; *see* J. SUNDQUIST & D. DAVIS, *supra* note 149, at 12-13.

151 *See* Smiley, *supra* note 50, at 89-90, where the author outlines a number of alternative institutions of federal-provincial coordination. *See also* A. SAFARIAN, CANADIAN FEDERALISM AND ECONOMIC INTEGRATION (1974); FEDERAL-PROVINCIAL RELATIONS OFFICE, FEDERAL-PROVINCIAL PROGRAMS AND ACTIVITIES, A DESCRIPTIVE INVENTORY (1977).

152 This paper presumes there is no constitutional restriction on the delegation of powers from both Parliament and one or more legislatures to a joint commission; *see* B. LASKIN, CANADIAN CONSTITUTIONAL LAW 39-41 (3d ed. rev. 1969); Lederman, *The Limitations of Co-operative Federalism*, in CONTEMPORARY ISSUES IN CANADIAN POLITICS 22, 28 (F. Vaughan, P. Kyba & O. Dwiredi eds. 1970); P. HOGG *supra* note 149, at 213-37; and *see*, *Anisman and Hogg*, ch. III. I.

These two conceptual approaches to federal-provincial program coordination can best be illustrated by reference to actual experience with attempts to coordinate corporation and securities laws in three federal jurisdictions that share a common legal tradition – the United States, Australia and Canada.

In all three jurisdictions little thought has been given to the kinds of policy goals sought to be achieved by the corporation laws on the one hand and the securities laws on the other, therefore there is considerable confusion about which policy goal should be pursued under one statute or the other. In an ideal world the corporation law would be limited to the institutionalization of responsibility in corporate managers, majority shareholders and the corporation itself with a view to protecting shareholders, creditors and the public generally, whereas the securities law would be limited to regulating, directly or indirectly through self-regulatory agencies, the entry, structure, conduct and price aspects of the securities market. These reasonably clear distinctions did not develop in any one of these jurisdictions, however, because of the different distribution of powers under the constitution of each and because of confusion about certain institutions such as insider trading, proxy, takeover bid, and financial disclosure rules that had to be set out in both the corporation laws and the securities laws to ensure they applied in specific cases to closely held corporations as well as publicly distributing corporations. Moreover, in the United States the securities laws have had to reach out to include such topics as proxies, insider trading, cash takeover bids, and financial disclosure because there is no federal corporation law that can be used to superimpose federal standards on public distributing corporations which raise capital in the federally regulated securities market but which are incorporated under and otherwise governed only by the notoriously lax state laws.[153] In Australia, constitutional powers to enact corporation laws and securities laws (except in respect of federal territories) were until recently assumed to be exclusively state powers. And in Canada, to add to the confusion, the federal and provincial corporation laws are essentially coequal, whereas the securities laws exist only at the provincial level because the provinces first entered the field and because there is some uncertainty about federal powers to enact a securities law. But notwithstanding these constitutional differences, the concepts employed in each jurisdiction

153 *See* Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974); STAFF OF SENATE COMM. ON INTERIOR AND INSULAR AFFAIRS, 93D CONG., 2D SESS., FEDERAL CHARTERS FOR ENERGY PROBLEMS – SELECTED MATERIALS (Comm. Print 1974).

to coordinate these different laws can be related to any federal system.

As already pointed out, when it enacted the Securities Act of 1933 and the Securities Exchange Act of 1934 the U.S. Congress deliberately maintained a dual or two-tier regulatory system based on disclosure and self-regulation at the federal level and broad administrative discretion at the state level, thus assuring a broad, minimum national standard and at the same time permitting more stringent state standards.[154] It follows, therefore, that in connection with each public distribution of securities a prospectus must be qualified at the federal level and in each state where the securities are to be distributed, a policy that is continued in the *ALI Federal Securities Code* on the grounds that the dual system is required to empower the states to enact laws which better reflect local capital market conditions and which give regulators broader, more subjective discretion to deal with local market actors.[155] Starting from this premise, law reform in the United States has therefore been directed not at federal pre-emption or federal-state uniformity but instead at federal-state coordination and state law uniformity. In the federal Securities Act of 1933 coordination is achieved largely through the intrastate exemption, which in effect excepts from the application of the federal law any securities distribution that is confined to a state or a state and certain defined contiguous areas.[156] At the state level coordination is commonly achieved by automatic qualification of a prospectus that has already been cleared at the federal level, obviating repeated scrutiny in several jurisdictions.[157] And both federal and state administrators collaborate to minimize duplication of effort, for example, to reduce the paperwork burden of firms required to file information returns with both federal and state securities commissions.[158]

154 L. Loss & E. Cowett, *supra* note 43, at 237-38.

155 ALI Federal Securities Code, Tent. Draft No. 4, s. 513. *See also* Loss, *The ALI Federal Securities Code Project*, 25 Bus. Law. 27, 35 (1969); Loss, *The Current Status of SEC Codification*, 26 Bus. Law. 555, 557 (1970).

156 Securities Act of 1933, s. 3(a)(ii); Securities Act of 1933, Rule 147, 17 C.F.R. s. 240.147 (1977). *See* 1 L. Loss at 591. *See also* Cummings, *The Intrastate Exemption and the Shallow Harbor of Rule 147*, 69 N.W.U.L. Rev. 167 (1974); Bloomenthal, *SEC Exemptions from Registration - A New Look*, 45 U. Cin. L. Rev. 367 (1976).

157 L. Loss & E. Cowett, *supra* note 43, at 241-42. Similarly some states automatically exempt private offerings that have qualified as exempt offerings under federal law; *see* Delaware and Maryland joint release of October 24, 1974 in 1 CCH Blue Sky L. Rep. ¶11,653.

158 A recent example is the new broker-dealer reporting form adopted by SEC, Securities Exchange Act of 1934 Release No. 11424, May 16, 1975, [1975-1976 Transfer Binder] CCH Fed. Sec. L. Rep. ¶80,176. Moreover, a nation-wide system to register U.S. broker-dealers has been developed in the U.S. and approved by the NYSE

Although cumbersome because based on two contrasting policy views at the federal and state levels, the United States system has worked with a minimum of federal-state conflict. In contrast, in Australia, where the states have long exercised sole jurisdiction over corporate and securities matters, the federal government, basing its policy on a recent constitutional case that extended widely the federal commerce power,[159] moved quickly to occupy much of the traditional corporation and securities law field, apparently without any extensive discussions with the state governments. Shortly after the federal government had set up a committee to determine what role it should play with respect to securities market regulation, three of the state governments – New South Wales, Victoria and Queensland – made an apparent pre-emptive strike on February 18, 1974, setting up an Interstate Corporate Affairs Commission by multilateral agreement to achieve most of the goals projected to be achieved by federal law.[160] Undeterred, the federal Senate Select Committee continued its work and on July 18, 1974 issued a report entitled *Australian Securities Markets and Their Regulation*,[161] which recommended that the Commonwealth – that is, federal – government should enact a statute to occupy and regulate unilaterally much of the corporate and securities law field now occupied by the states. Several months later, on February 26, 1975, the Commonwealth Lower House passed the Corporations and Securities Industry Act to achieve this purpose. The Senate, not satisfied with the House Bill, on April 10, 1975 again set up a select committee and assigned to it the task of reviewing the statute enacted by the Lower House. Concurrently, the state governments urged the federal government to reconsider the statute, particularly to consider restructuring any proposed federal commission as a joint federal-state commission.[162]

While the federal bill was still before the Senate a federal election intervened, the government changed, and the new government undertook a complete review of the previous govern-

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making possible the development of uniform databases; *see* The New York Times, July 3, 1975, TSE Press Clipping Service, Access. No. D90-484.

159 Strickland v. Rocla Concrete Pipes Ltd., 45 Argus L.R. 485 (August 1971), *discussed in*, 1 CCH AUST. CORP. AFF. REP. ¶ 120.

160 *See* Note, *Interstate Corporate Affairs Commission*, [1976] Co. L. BULL. 69, which describes the formation of the Commission and reports the adherence of Western Australia in 1975. The Commission was clearly perceived by at least some states as a means to head off any federal initiative; *see* Davis, *New Share Laws*, The Australian Financial Review, March 1, 1976, at 1, col. 3.

161 The RAE REPORT, *supra* note 2, is discussed in detail in R. BAXT, THE RAE REPORT – QUO VADIS (1974).

162 *See generally* CCH AUST. SEC. L. REP. ¶¶ 70-127–70-128; CCH Aust. Corp. Aff. Bull., No. 72 (April 11, 1975).

ment's policy relating to the corporation and securities laws. To further consolidate their position, the four states that had joined the Interstate Corporate Affairs Commission – New South Wales, Victoria, Queensland and Western Australia, on March 1, 1976 brought into force the uniform Securities Industries Act,[163] which was designed to meet many of the criticisms of balkanized state securities regulation set out in the *Rae Report*.

By July 1976 the new federal government had reviewed the issue and, although it had while in opposition agreed in principle with the conclusions of the *Rae Report*, decided on an altogether different means to implement its policy objective of uniform corporation and securities laws. Instead of pre-empting the field and thus displacing the state laws, the federal government would recommend the creation of a federal-state council of ministers, which would be empowered to determine the policy content of federal laws that would be adopted as the uniform corporation law and securities law in each state.[164] The responsible state ministers met with the federal minister to discuss this proposal and agreed, in early 1977, to recommend to their respective governments a detailed, integrated scheme that adopts the major recommendations of the federal minister.[165] To date, however, no progress has been made beyond this agreement in principle, partly because of an intervening federal election (and a change of ministers) and partly because of basic disagreements among the states as to the substantive provisions to be set out in the proposed uniform law.[166] In the meantime, the larger states continue to consolidate their position through the Interstate Corporate Affairs Commission.

In Canada, as in Australia, there is no federal securities law and therefore the problem of coordinating federal and provincial laws has not yet been faced, although serious efforts have been

163 CCH AUST. SEC. L. REP., Report No. 50 (March 1, 1974).

164 *See* Statement of Honourable John Howard, Minister, Department of Business and Consumer Affairs (July 6, 1976). The point of departure would be the existing laws administered by the member states of the Interstate Corporate Affairs Commission.

165 *See* Joint Statement by Commonwealth and State Ministers Responsible for Company Law and the Regulation of the Securities Industry (March 11, 1977). *See also* Note, *Corporations and Securities*, [1977] AUST. BUS. L. REV. 155.

166 *See* Short, *Securities Reform Dogged by Delays*, Australian Financial Review, February 20, 1978, at 1.

A more recent release of the Australian federal Department of Business and Consumer Affairs dated May 14, 1978, announced that the "Commonwealth and State Ministers responsible for corporate affairs had reached final agreement, for recommendation to their respective governments, on a national scheme of legislation and administration for company law and the regulation of the securities industry".

made for more then forty years to achieve a reasonable degree of uniformity of policy. By 1930 several of the provinces had adopted the Ontario model, but because of differences in local securities markets, policy differences among provincial governments and uneven administration, the uniform base was rather quickly eroded, resulting in a number of similar but still different securities acts across Canada.[167] Following enactment of the Ontario Securities Act of 1966, there was once again a strong uniformity movement that produced relatively uniform securities laws in Ontario and the Western Provinces and a securities law in Québec that adheres closely in principle to the Ontario act. In addition, spurred on by a renewed federal interest in the securities field, the provincial securities administrators have set up a quite formal organization – the Provincial Securities Administrators – to coordinate their policies and procedures with a view to simplifying compliance with the several provincial acts. The securities administrators have together produced a set of uniform policy statements[168] and have collaborated closely to develop a new Ontario Securities Bill,[169] the most recent version of which was tabled in the Ontario legislature on February 28, 1978, and which is intended to be the model statute for all the provinces. In short, the provinces, following the strategy employed by the Australian states, are attempting to develop a system of securities law and administration that will in effect have Canada-wide application and will therefore render unnecessary any federal occupation of or even participation in the securities regulation field.

Like their Australian counterparts the provinces have as part of their in-depth defence strategy another position that can be invoked as an alternative to exclusive federal occupation of the field, that is, a joint federal-provincial commission to administer the securities laws at both the federal and provincial levels. First suggested by the Ontario Securities Commission in 1967 in its published CANSEC proposal, the topic was recently referred to again by the Ontario Securities Commission as a possible means to coordinate federal and provincial activities relating to securities.[170] This alternative approach has the advantage that it can

167 *See* J. WILLIAMSON at 24–28.

168 These policy statements fall into three classes: (1) National Policy Statements that apply in all provinces except Newfoundland and Nova Scotia: (2) Uniform Act Policies that apply in Ontario and the Western Provinces; and (3) Provincial Policies that apply only in the one province. *See* 2 CCH CAN. SEC. L. REP. ¶¶54-838–54-956.

169 Ontario Bill 30, which was tabled for first reading on June 29, 1977.

170 The 1968 CANSEC proposal is discussed in Banwell, *Proposals for a National Securities Commission*, 1 QUEEN'S INTRA. L.J. 3 (1969). The recent references to CANSEC arose during OSC hearings concerning the proposed "national commission schedule" of brokerage commission rates; [1973] OSC Bull. 108 (August).

lead to one uniform law and one set of policies and procedures, whereas the dual system of the United States, based as it is on two different philosophies, institutionalizes a multiple statute system.

Where a dual system obtains, it is probable that the federal and provincial securities laws – even if based in principle on similar policy objectives – will differ in material respects. To minimize conflict-of-law problems and duplication of administrative effort it is therefore essential to distinguish clearly the cases to which either federal law or provincial law applies exclusively and so limit the cases where a person is required to comply with two substantially different legal systems. Although this need to distinguish is true with respect to all aspects of regulatory control over entry and conduct in both the new issues market and the secondary trading market, it is especially significant with respect to documents such as prospectuses, applications for licences and financial statements which, if they are not essentially uniform in all jurisdictions, engender both unnecessary frustration and excessive costs. Indeed, many critics argue that in the long run, in a federal system, it is impossible to maintain uniformity of policy and administration in respect of the securities laws. Thus, although there is no concensus in Canada about an acceptable means of federal involvement in securities regulation, there is a widely-held view that for these reasons alone Canada should not adopt a dual system that would superimpose a second, federal level of regulation on top of the existing provincial systems.

In the United States, where Congress clearly had power to pre-empt the entire securities field (except the relatively unimportant area of intrastate transactions), it opted for a dual system of concurrent jurisdiction that permits a state to impose more stringent rules in any case or less stringent rules where an issue is confined exclusively to that state.[171] For example, in the case of prospectus qualification the federal standard is limited to full and fair disclosure, whereas many state statutes superimpose a more stringent, highly subjective – and therefore broadly discretionary – standard based on the administrator's opinion as to whether the enterprise is viable or whether the transaction is fair, just and equitable to the prospective shareholders.[172] On the other hand, a state may in fact establish lower prospectus qualification stand-

171 Securities Act of 1933, s. 18; L. Loss & E. COWETT, *supra* note 43, at 237-38; 1 L. Loss at 30-31, 156, 591; and *see* Engdahl, *Presumptive Capability of Federal Power*, 45 U. COLO. L. REV. 51 (1973); B. LASKIN, *supra* note 152, at 104-11.

172 *See e.g.* CAL. CORP. CODE, s. 25140 (West 1977). The Quebec Securities Act, ss. 20, 24, like the California law, grants very broad discretionary powers to the administrators. The divergent U.S. state standards are discussed in L. Loss & E. COWETT, *supra* note 43, at 34-42.

ards on intrastate issues with a view, for example, to promoting local resource development.[173] Concluding that the dual system of federal and state securities regulation was too deeply entrenched in the United States to make federal pre-emption practicable there, the most prominent U.S. scholar in this field has concluded that "the only hope for simplification lies in uniformity and federal-state coordination",[174] that is, uniformity of statutory provisions and coordination of statutory systems, administrative forms, and administrative procedures.

The major attempt at uniformity of state statutes in the United States is the Uniform Securities Act sponsored by the National Conference of Commissioners on Uniform State Laws.[175] Although very influential, this model uniform act has not been able to overcome the predilection of local legislatures to attempt to improve policy through subtle drafting changes to substantive provisions and of administrators to develop different procedures. Fortunately, the coordination of statutory systems through the intrastate exemption technique has proved to be a slightly more fruitful approach because it permits a state to express local values in its laws and at the same time to subordinate those laws to federal laws and so give priority to interstate distributions that comply substantially with the local laws.

The key provision in the United States federal law that was designed to accommodate different state laws is the intrastate exemption set out in section 3(a)(11) of the Securities Act of 1933. This exemption was so narrowly interpreted by the courts, however, that it became a trap for the unwary and therefore was seldom relied on as a means to avoid qualification under federal law.[176] In order to clarify the exemption so that counsel can render an unqualified opinion that an intrastate issue is exempt from the federal securities laws, the SEC recently adopted a new Rule 147, which does not render the exemption more flexible but does make clear that an issuer is in a safe haven if it was incorporated in the state, has its principal office in the state, earns 80% of its gross revenue in the state, has 80% of its assets in the state, will employ

173 Québec experimented with lower standards for resource companies between 1967 and 1974 but reimposed the general standards applied to industrial companies by repealing its Policy No. 8; *see* 5 QSC Bull., No. 42, *supra* note 74; *see also* Zehr, *supra* note 74, where the author alleges the QSC policy effectively prohibits use of the securities markets to raise capital for speculative resource exploration ventures. For the present policy, *see* Policy No. 8 referred to in note 74 *supra*.

174 L. Loss & E. Cowett, *supra* note 43, at 238; ALI Federal Securities Code, Tent. Draft No. 3, s. 1603.

175 The Uniform Securities Act is set out in L. Loss & E. Cowett, *supra* note 43, at 245.

176 1 L. Loss at 591-605; ALI Federal Securities Code, Tent. Draft No. 3, at 150. *See also* the articles cited in note 171 *supra*.

80% of the capital raised by the issue in the state, and will bar transfers of the issued securities to persons outside of the state for at least nine months.[177] The *ALI Federal Securities Code* essentially continues this policy but underlines that its purpose is to encourage rather than to constrain exempt intrastate distributions.[178]

This attempt to induce greater use of the intrastate exemption is not just window dressing, for the *Code* also expressly continues the dual system of the present law by empowering a state to superimpose its standards on the federal standards, particularly in respect of substantive market entry standards that apply to prospectuses or licence applications forms.[179] But the *Code* does not forgo altogether federal pre-emption power, which is invoked in a subtle manner to induce each state to harmonize its law with the federal law, employing the concepts of registration by coordination and notification that had been developed under the Uniform Securities Act as alternatives to the usual registration by qualification procedure. Briefly, registration by qualification means compliance with the statutory standards to render an issuer eligible to distribute specified securities to the public. Registration by notification means that a "blue chip" issuer is automatically entitled to distribute its securities to the public upon filing the required disclosure documents unless the securities administrator takes affirmative action to stop the distribution. Registration by coordination, as the name implies, means coordination with federal law, which is effected through two techniques: first, the federal forms are accepted but supplemented by further local documents where required to comply with additional local criteria; or alternatively, qualification is concurrent with federal qualification unless the local administrator takes affirmative action to delay or stop distribution and so advises the issuer before the issuer seeks last minute clearance for the distribution.[180]

The Uniform Securities Act reflects a carrot approach to the problem, suggesting techniques of administration that are more efficient but that still do not detract from local autonomy since the state administrator retains residual power to issue stop orders on an exceptions basis. The *ALI Federal Securities Code*, however, employs a stick approach, continuing state residual control over

177 SEC, Securities Act of 1933 Release No. 5450, January 7, 1974, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶79,617, *discussed in* Kant, *SEC Rule 147 - a Further Narrowing of the Intrastate Offering Exemption*, 30 BUS. LAW. 73 (1974).

178 ALI FEDERAL SECURITIES CODE, Tent. Draft No. 3, at 150-54. Although they can render local distributions more practicable, the private placement and small issue exemptions are ignored here because they are not essentially coordination mechanisms.

179 ALI FEDERAL SECURITIES CODE, Tent. Draft No. 3, s. 1603.

180 *See* L. LOSS & E. COWETT, *supra* note 43, at 241-42, 290-99.

substantive standards but displacing the state laws with respect to disclosure requirements where the state law requires different disclosure or additional disclosure that is not essential to the application of a unique state substantive standard. As a result, although it preserves state power to apply substantive policy differences, the code clearly displaces state law and substitutes federal law with respect to prospectus disclosure and broker and investment advisor disclosure. Even more important the code displaces unqualifiedly any state law relating to secondary trades and "blue chip" securities distributions that can now be qualified by notification only under those state laws that contain the notification procedures of the Uniform Securities Act.[181]

In summary, the *ALI Federal Securities Code* suggests three ways to deal with overlapping federal-state laws in the United States:[182] first, pre-empt the field and largely abrogate the state laws; second, continue the present dual system of substantive laws but urge the states to develop uniform laws and procedures and to adopt notification and qualification procedures that minimize duplication of disclosure; or third, continue the dual system with respect to the substantive standards that apply to the new issues market but impose uniform disclosure standards and regulate the secondary trading market exclusively under federal law, a technique the *Code* characterizes as harmonization of federal and state laws.

Although the constitutional jargon varies slightly,[183] and although federal power to legislate in the field of securities regulation is less clear in Canada, the basic problems identified and the alternative solutions suggested in the *Code* to coordinate federal and state securities laws apply equally to the coordination of any federal and provincial securities laws. But the *Code* does not discuss another alternative that has been frequently invoked and therefore is of special significance in Canada, that is, integration of regulation through a commission exercising both federal and provincial powers, either exclusively or concurrently with regulation through provincial commissions.

Until recently in Canada there was considerable doubt about integrated federal-provincial regulatory schemes, for it was clear under the constitution that one legislature could not delegate any part of its authority to another legislature in order to empower the second legislature to deal with both interprovincial and intra-

181 ALI Federal Securities Code, Tent. Draft No. 3, s. 1603. S. 1603(b)(3) also makes Canadian blue chip issuers eligible for the qualification by notification procedure.

182 ALI Federal Securities Code, Tent. Draft No. 3, at 137.

183 B. Laskin, *supra* note 152, at 104–11.

provincial aspects of a regulatory problem.[184] The legislatures succeeded, however, to break out of this impasse through the patently legalistic device of setting up a regulatory agency under either federal or provincial law to which both federal and provincial legislatures may delegate regulation-making authority. As a result, although the federal government cannot, for example, delegate to a provincial legislature power to legislate with respect to interprovincial highway transport, the federal government can delegate regulation-making, adjudicative and administrative powers to a regulatory agency that has been set up under provincial law to regulate highway transport under broad public interest standards.[185] Even if lacking logical symmetry, this constitutional doctrine has given to the Canadian legislatures an extraordinarily flexible mechanism to deal with regulatory problems that are not clearly exclusively within the jurisdiction of either the federal or a provincial legislature. Although infrequently used, this mechanism has been invoked in at least three statutes by the federal Parliament to legitimate regulation of three sectors – highway transport, agriculture, and energy supplies – that are of strategic importance to the Canadian economy.[186]

The first of these provisions, section 3 of the Motor Vehicle Transport Act, which was enacted specifically to empower provincial transport commissions to make regulations concerning interprovincial transport,[187] directly authorizes a provincial commission to issue an interprovincial licence in accordance with the same standards and subject to the same conditions it applies when it issues an intraprovincial licence. The Energy Supplies Emergency Act sets up a federal board and, under section 9, authorizes that board to subdelegate any or all of its powers to any other person or agency. Even more versatile, the Farm Products Marketing Agencies Act contemplates the creation by the Governor in Council of federal-provincial marketing agencies that are expressly authorized under section 23 to exercise federal powers relating to interprovincial trade, to accept a delegation of provincial powers

184 Attorney-General for Nova Scotia v. Attorney-General for Canada, [1951] S.C.R. 31, [1950] 4 D.L.R. 369, *discussed in* B. LASKIN, *supra* note 152, at 39-41.

185 *See generally id.* at 43-66; P. HOGG, *supra* note 149, at 213-37. The converse case, delegation of powers by a provincial legislature to a federal regulatory agency was assumed to be unexceptionable by Laskin C.J.C. in Reference re Agricultural Products Marketing Act, 19 N.R. 361 (S.C.C. 1978).

186 Motor Vehicle Transport Act, R.S.C. 1970, c. M-14, s. 3; Farm Products Marketing Agencies Act, S.C. 1970-71-72, c. 65, s. 23; Energy Supplies Emergency Act, S.C. 1973-74, c. 52, s. 9(2).

187 In Attorney-General for Ontario v. Winner, [1954] A.C. 541, [1954] D.L.R. 657, 13 W.W.R. (N.S.) 657, the Privy Council had decided that Parliament had exclusive jurisdiction over interprovincial highway transport; *see* B. LASKIN, *supra* note 152, at 522-24.

relating to intraprovincial trade, and also, with the consent of the Governor in Council, to subdelegate federal powers to a local marketing board set up under provincial law.

In the securities regulation context, therefore, it would be possible to set up a federal commission, staff it with outsiders, federal departmental officers, provincial departmental or commission officers, provincial securities commissioners or any combination of these persons,[188] authorize it to exercise federal powers and to accept delegations of provincial powers, and even authorize it to subdelegate any of these powers to a provincial securities commission or to a self-regulatory body.[189] Thus in Canada, in addition to coordinating federal and provincial regulatory functions through complementary statutory provisions (*e.g.*, with respect to primary or secondary markets and disclosure as well as substantive standards), there exists another coordinating mechanism – delegation of broad authority to a regulatory commission – that can be employed with or even as a substitute for complementary statutes. But the creation of any commission exercising both federal and provincial powers poses a paradox: if there are material policy differences between the federal government and a provincial government, how can the commission be given clear policy direction? In other words, what minister is ultimately responsible for the development and enunciation of statutory policy and for the implementation of that policy by the commission? Although it did not clearly resolve this problem, the CANSEC proposal set out in a research paper published by the Ontario Securities Commission in 1967[190] defines the basic issues and recommends an imaginative approach that merits detailed discussion.[191]

188 The executive presumably would have broad staffing discretion as under other federal regulatory statutes.

189 The Farm Products Marketing Agencies Act creates a federal agency called the National Farm Products Marketing Council, which has as its purposes, among others, to advise the federal minister of agriculture with respect to the agriculture industry, to recommend the creation of marketing agencies, and to review agency performance. It is thus more a policy advisory council than a regulatory agency, although it can regulate indirectly through a federal agency set up under s. 17 of the Act. Note too that under s. 23(2) an agency may accept a delegation of powers from a province pursuant to an agreement made under s. 32.

Although the current structure of integrated regulation of farm products marketing was struck down because wrongly predicated on the assumption than an equalization levy was an indirect tax, a recent Supreme Court decision strongly confirms the validity of integrated regulatory schemes; *see* Reference re Agricultural Products Marketing Act, *supra* note 185.

190 The CANSEC research paper is published in [1967] OSC Bull. 61 (November). It is discussed in Langford & Johnston, *The Case for a National Securities Commission*, [1968] U. TORONTO COMM. J. 21; D. JOHNSTON at 17-18.

191 Ontario has on more than one occasion advocated a joint federal-provincial commission to exercise overlapping regulatory powers. With respect to interprovincial

In its discussion paper on CANSEC the Ontario Securities Commission pointed out that with respect to securities market regulation in Canada the ideal system would embody uniform laws, uniform administration, a common data base and an expert staff to do policy analyses and research specific problems, to investigate problem cases and to administer the overall system.[192] However, the discussion paper goes on to point out that the present Canadian system did not develop with ideal goals in mind but rather in response to different problems in different jurisdictions. Consequently the issue was characterized not as development of an altogether new system but coordination of existing systems to increase administrative efficiency and to develop a mechanism that will enable policy makers and administrators realistically to seek to achieve those ideal goals and so overcome the present dilemma of balkanized provincial regulation: on the one hand, if a province puts few resources into securities regulation either the law or its administration must be substandard; on the other hand, only the larger provinces have the volume of securities business to justify both a sound act and the expenditure of substantial resources on effective administration. As a result the larger provinces – through sheer competence – necessarily attract the major business and thus tend to dominate the field. The major problem therefore in designing a Canada-wide securities regulation system is to reconcile centralized policy making with decentralized administration in a way that does not relegate any jurisdiction, federal or provincial, to an ineffective status.

To resolve this problem the CANSEC proposal recommended creation of a Crown corporation with a three-tier administrative structure: (1) a council of ministers made up of the interested ministers from each participating jurisdiction (participation would be optional); (2) a commission made up essentially of the members of the provincial securities commissions;[193] and (3) a

trucking Ontario made a similar recommendation in 1969; *see* Schultz, *Intergovernmental Cooperation, Regulatory Agencies and Transportation Regulation in Canada*, 19 CAN. PUB. ADMIN. 183 (1976).

192 Ontario Securities Commission, CANSEC Proposal ¶22 (research paper presented to Federal-Provincial Securities Conference June 15, 1967).

193 A province would have the option to maintain its provincial commission or merge that commission into CANSEC. In any event it would be subordinated to CANSEC and therefore would not require an independent staff.

The Australian variation of this theme, discussed in the text at note 164 *supra*, assumes one federal law that is adopted in each state and that is subject to amendment on the recommendation of the council of ministers. Any state would be entitled to enact a non-uniform provision recommended by the council of ministers on six-months' notice to the council of ministers, a result that would arise only where the federal parliament refused to enact an amendment recommended by the federal minister who is a member of that council.

director at the central office as well as associate directors at each regional office and at certain local offices. The residual decision-making powers would be vested in the council of ministers, the federal minister to exercise some 33% of the votes and each province to exercise votes in accordance with its relative gross personal and corporate income tax collections at that time, giving Ontario roughly 29%, Québec 17%, British Columbia 7%, and the other provinces the balance of the votes. A decision of the council of ministers would require not only a two-thirds majority vote but also the approval of a majority of the participating governments.[194]

The second tier, the commission, would be a decentralized structure having its head office in Ontario, regional offices in Québec and British Columbia, and a local office in each other province.[195] The commission chairman would be selected from among the regional office commissioners. Each of the commissioners would have tenure of office for a ten-year period, but only five commissioners would be employed full-time, three in Ontario and one at each of the other two regional offices. A quorum for a commission decision would be two commissioners (which assumes at least one part-time commissioner for each region) to ensure that each regional office would be empowered to act for the full commission on a continuous basis. One or more commissioners would go, as required, to a local office to deal with any local issues. The third tier, the director level, would be made up of a director at the regional office where the chairman is located and an associate director at each regional office.

The functions of each administrative tier would be designed to characterize the council of ministers as essentially an overall policy evaluation body, the commission as a policy development and administrative review body, and the director as the chief administrative officer. More specifically, the council of ministers' functions would be to appoint commissioners and senior officers, review budgets and review policies and procedures with a view to recommending legislative changes. The key functions of the commission, continuing the policy of the uniform securities acts, would be to review decisions of the director based on the application of standards and rules set out in the statute, to grant administrative remedies such as orders to freeze assets and stop trading, and to make recommendations to the council of ministers concerning

194 This is a variation of the proposed Fulton-Favreau formula to amend the constitution where all provinces are affected, which formula required the approval of 2/3 of the provinces representing at least 50% of the population; *see* B. LASKIN, *supra* note 152, at 1076.

195 This model assumes that all provinces would opt to join CANSEC.

policy changes.[196] The director, subject to the direction of the chairman, would be the chief administrative officer, responsible in the first instance for application of the law and policies to specific cases, for enforcement,[197] and for the overall administration of personnel, finances, and capital assets.[198]

The CANSEC proposal has clearly been thought through in detail and with great care, and even if it cannot satisfy all Canadian governments, it furnishes a useful benchmark, identifying the structural, substantive, and procedural problems and also underlining, at least by implication, the advantages and disadvantages of such a cooperative scheme.

Certainly the great advantage of the CANSEC proposal is that it furnishes a coordinating mechanism that preserves substantial provincial autonomy, enables the efficient use of experienced commission staffs, and therefore could lead to better and more efficient securities regulation in Canada. More particularly, it could result in more uniform laws and procedures, elimination of much duplication of effort by applicants and administrators, and greater insulation from local, short-term political pressures. In addition, the CANSEC proposal would make possible centralized policy research and information processing that in turn would better enable decision makers to develop, refine and apply policies, looking at the Canadian securities market as an articulated, Canada-wide system. But what is most important, although the CANSEC proposal would require each participating province to yield some powers it presently exercises with respect to securities market regulation, the proposal ensures that each province continues to have substantial policy influence within the overall regulatory system.

From the federal perspective, however, some of these strengths of the CANSEC proposal are also its greatest weaknesses. It does not commit any province to join or to remain in CANSEC. It sets up a very rigid constitutional framework that makes amendment difficult except under threat of withdrawal. It virtually requires withdrawal where there is a sharp policy conflict

196 The CANSEC proposal sets out a random list of ends and means of a commission: (1) to regulate the entry of issuers and other actors; (2) to regulate the conduct of actors through rules concerning proxies, takeover bids, insider trading, financial disclosure, and stock exchange trading; and (3) as means to achieve these objectives - financial audits, investigations, issuing administrative remedies, and seeking court appointments of receivers.

197 The director could initiate administrative proceedings but only recommend criminal prosecutions to the provincial attorney-general who would retain prosecutorial discretion.

198 The foregoing discussion sets out only the more material elements of the CANSEC proposal, which is elaborated in greater detail in the source document.

between the council and any one minister acting under instructions from his government. It tends to perpetuate a system of eleven separate securities laws. It renders the commission extremely independent of and therefore possibly unresponsive to the political process. And it diffuses responsibility in such a way that no minister has clear responsibility to answer to any legislature for program performance.[199] In sum, even if a federal government were to acknowledge that the CANSEC proposal is incisive, imaginative and constructive, for two reasons it would be difficult for it to accede to the proposal as originally presented. First, because the proposal refuses to acknowledge any federal jurisdiction over the interprovincial aspects of the securities markets, it leaves the federal government in a perpetual minority position with no assurance that it will have even residual power to resolve a policy impasse or, indeed, any effective influence over securities market policies. And second, because of the absence of any mechanism to resolve policy conflicts, it might set a bad precedent, substituting for clear political responsibility in one or more legislatures, a complicated structure that diffuses responsibility among three internal organs of CANSEC and among eleven ministers, extending the concept of cooperative federalism to the point where no one is clearly responsible for the good governance of the securities markets.

The main emphasis, therefore, of the CANSEC proposal is to seek uniform *administration* of the different provincial securities laws and a limited federal law. The latter would legitimate the integrated commission concept and delegate to it authority to deal with federal corporate,[200] international, and criminal matters that are not clearly within provincial jurisdiction. As a result it implies a division of jurisdiction that leaves nearly all substantive issues in the several provinces – or undetermined[201] – and so

199 This was one of the principal reasons why the RAE REPORT (Australia) recommended that the federal government should occupy the corporation and securities regulation fields rather than set up an integrated federal-state commission; *see* R. BAXT, *supra* note 161, at 86.

200 The limited federal law would clear up jurisdictional ambiguities in cases such as Multiple Access Ltd. v. McCutcheon, 16 O.R. (2d) 593 (Div'l Ct. 1977), where the Ontario Divisional Court concluded that the federal corporation law provisions relating to insider trading were in essence congruent with the provincial law and therefore, pursuant to the paramountcy doctrine, displaced the like provisions of the Ontario Securities Act; *see generally* P. HOGG, *supra* note 149, at 110-13; and *see*, *Anisman and Hogg*, ch. III.H.

201 The key issue is jurisdiction over interprovincial transactions in both new issue and secondary markets. The question is whether the securities regulation system should be equated with a nationwide commodities market system (federal) or viewed as an aggregate of discrete contracts like insurance contracts (provincial); *see* J. WILLIAMSON at 189-201. A new dimension of this is raised in MacDonald v.Vapour

narrowly confines federal bargaining power. Since jurisdiction, or in other words, decision-making power, is the core of the problem, a brief tabulation of some of the possible models is essential to place this problem in overall perspective.

Literally hundreds of combinations are possible because each alternative model has at least eight dimensions, each of which contains a number of variables as indicated in table 5.

To set out in matrix form all of the possible models based on these variables is patently impossible; therefore table 6 sets out only the more probable combinations of the foregoing elements. Even if not exhaustive these combinations illustrate clearly the broad range of possible models, moving from a strongly centralized system at the top left to a completely decentralized system at the bottom right.

Table 6 brings into sharp focus the fundamental – although largely tacit – conflict between the OSC and the federal government over the CANSEC proposal. What the OSC recommended was a system that would give the larger provinces – and particularly Ontario – power to decide the substantive policy issues, subject to the constraining influence of the federal government with respect to general issues such as the content of the very limited federal enabling legislation, the appointment of key commission personnel, and amendments to the provincial laws. But the residual power to deal with the substance of the basic regulatory system would be determined by the several provincial legislatures, which presumably would be inclined but not required to enact uniform laws as approved by the council of ministers.

At the time the CANSEC proposal was published, the federal government, although it was then deliberating the creation of a federal securities law and a federal commission that would be superimposed on the provincial systems, was not convinced that such a dual system was workable or even desirable. As a result, even if the CANSEC proposal did not elicit an express response from the federal government, it did compel the federal government to temporize and to consider alternative coordinating mechanisms that would obviate a dual or two-tier regulatory system such as the system that obtains in the United States. The need for such further consideration was underlined by the response to the BUSINESS CORPORATION PROPOSALS,[201a] which were published in 1971, and which had recommended superimposing on the provin-

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Canada Ltd., 66 D.L.R. (3d) 1 (S.C.C. 1976) which is discussed in detail in *Anisman and Hogg*, ch. III.B.2.

201a R. DICKERSON, J. HOWARD & L. GETZ, PROPOSALS FOR A NEW BUSINESS CORPORATIONS LAW FOR CANADA, Vol. I, Commentary; Vol. II, Draft Act (1971).

Table 5
Dimensions of Securities Market Regulation

1. System of regulation Separate federal and provincial commissions Integrated federal-provincial commissions Delegation of federal powers to provincial commissions (and converse) Provincial commissions under provincial law alone
2. Regulatory powers based on market functions Primary market Secondary market
3. Regulatory powers based on techniques of regulation Disclosure rules Substantive (discretionary) standards
4. Regulatory powers based on *issuers* Federal issuers Foreign issuers Provincial issuers
5. Regulatory powers based on securities *issues* International issues Interprovincial issues Intraprovincial issues
6. Regulatory powers based on subject matter (criminal law)
7. Regulatory powers based on territory
8. Regulatory powers based on interprovincial computer-communications systems

cial law a federal prospectus qualification system that would apply to federal corporations. The responses were ambiguous with respect to the desirability of a paramount federal system that would largely displace the provincial securities laws; but the responses were virtually unanimous in denouncing the proposed two-tier system. The detailed prospectus qualification provisions were therefore omitted from the Canada Business Corporations Act and federal policy analysts turned their attention to other alternatives.

Because of its ambivalent views at that time – not only about the best means of regulation but also about the need for any federal involvement in the field of securities regulation – the federal government was not in a position to respond in any positive way to the CANSEC proposal. But as already explained, the federal government was clearly aware of two particular shortcomings that inhere in any integrated model such as the CANSEC model; first, the extreme independence of the commission, which would be two steps removed from any legislature (a minister and the council of ministers are in between) and therefore might be unresponsive to the political process at any level; and second, the diffusion of responsibility for policy and administration among several ministers, which might preclude clear accountability to any legislature. Because they are inherent in any integrated system, these elements may have to be accepted as reasonable risks to be taken to make the regulatory system work in a federal context. If they prove to be real problems, probably all governments involved will be highly motivated to work together to resolve them.

There was one other shortcoming of the CANSEC model that is clearly even less attractive to the federal government, that is, relegation of any federal securities legislation to the level of complementing provincial legislation. In contrast, the proposed integrated system for Australia[202] would be based on an inverse policy. The federal government would enact a comprehensive securities law based on a composite of the existing state laws, and each state would adopt the federal law as state law with reservation of the right to each state, with the approval of the proposed council of ministers, to enact non-uniform provisions on giving six-months' notice to the other states and the federal government. The proposed Australian model clearly accords better with the federal perspective, emphasizing as it does central, uniform policy over local autonomy.

Indeed, the CANSEC and Australian models clearly highlight

202 *See* J. WILLIAMSON, *supra* note 201; and *see*, *Anisman and Hogg*, *supra* note 201.

the problem of achieving a policy balance within an integrated system, one that avoids both a centrifugal spinoff of power to the several provinces and an excessive centripetal flow of power to the federal government. The policy antinomies are self-evident. Centralized order is desirable, but it may stultify imaginative development at the provincial level. Local autonomy (*i.e.*, small) is beautiful, but it may result in an overall system that is complicated, costly, and even ineffective. The problem therefore is to achieve a workable balance between centralized order and local autonomy.

Table 6 sets out a broad spectrum of alternative models, ranging on the one hand from a centralized federal system, through several variations of both dual and integrated systems to, on the other hand, a totally decentralized system of discrete provincial laws. In retrospect, had the federal government been in a position seriously to discuss securities regulation in 1967 when the CANSEC proposal surfaced, models 4 to 10 probably would have been negotiable. In the light of the declared public hostility to a dual or two-tier system, however, only three of those models – models 4, 6 and 10 – now merit detailed discussion. Even they, however, are probably less acceptable than model 13. In sum, assuming the federal government decides to regulate the securities markets, only four obviously feasible alternatives can be distilled from among the many alternatives set out in table 6. The first is model 4, a highly centralized dual system that would relegate the application of provincial law to the relatively unimportant area of intraprovincial primary issues. The second is model 6, a decentralized unitary system that would give the federal Parliament broad policy powers but leave administration in the hands of the several provinces. The third is model 10, a dual system where both federal and provincial law would apply to each primary distribution other than an intraprovincial distribution. The fourth is model 13, an integrated system that would acknowledge the desirability of a comprehensive federal securities law but that would in effect give the provinces at least an equal voice in determining the policy content and directing administration of that law.

Although the bias of this paper is admittedly towards an integrated system, its purpose is not to recommend dogmatically – or even emphatically – any particular structural model but rather to analyze the functions that inhere in any securities market regulatory system and to demonstrate how these functions may be synthesized on the bases of different policy premises to establish a number of alternative structural models. Again I underline that an organization is only an instrument of purpose, a means to an end that may have an influence on purpose but that

Table 6
Models of Securities Market Regulatory Systems

Model Number	Federal law: Primary	Federal law: Secondary
1	All except intraprovincial issues	All
2	All except intraprovincial issues but subject to added provincial substantive standards (*proposed U.S. Federal Securities Code*)	All
3	All except intraprovincial issues but subject to added provincial substantive standards and disclosure rules (*present U.S.*)	All
4		
5		
6		
7		
8		
9		
10		
11		
12		All
13		
14		
15		

Concurrent federal and provincial laws		Provincial law	
Primary	Secondary	Primary	Secondary
Federal law federal issuers foreign issuers interprovincial issues Provincial law intraprovincial issues	Federal law — all (except intraprovincial trades not made through an interprovincial system)		
Federal law federal issuers foreign issuers Provincial law interprovincial issues intraprovincial issues	Federal law — all (except . . .)		
Same as 4 but federal law administered by provinces	Federal law — all (except . . .)		
Same as 5 but federal law administered by provinces	Federal law — all (except . . .)		
Either model 4, 5, 6, or 7	Provincial law — all		
Federal law federal issuers foreign issuers Federal *and* provincial law (province of incorporation or head office) interprovincial issues Provincial law intraprovincial issues	Federal law — all (except . . .)		
Federal law *and* provincial law (province of incorporation or head office) federal issuers foreign issuers interprovincial issues Provincial law intraprovincial issues (even of federal or foreign corporation)	Federal law — all (except . . .)		
Either model 9 or 10	Provincial law — all		
		All	
Joint commission that acknowledges federal jurisdiction over interprovincial trades			
Joint commission that does not so acknowledge (CANSEC)			
		All (*present Canada*)	All (*present Canada*)

Table 7
Three Models for a Regulatory System

Model	Concurrent federal and provincial laws	
	Primary market	Secondary market
6	Federal law applies to: federal issuers foreign issuers interprovincial issues Provincial law applies to: intraprovincial issues But all administration powers delegated to the several provinces	Federal law – all (except intraprovincial trades not made through an interprovincial system)
10	Federal law and provincial law (province of incorporation or head office) both apply to: federal issuers foreign issuers interprovincial issues Provincial law applies to: intraprovincial issues (even if federal and foreign corporations)	Federal law – all (except intraprovincial trades not made through an interprovincial system)
13	Joint federal-provincial commission that acknowledges federal jurisdiction over federal issuers, foreign issuers, and interprovincial trades	

should not become an end in itself and thus obscure the substantive policy goal which is to establish an effective regulatory system. Although necessarily more specific because conceived as a comprehensive, stand-alone system, the proposals should be drafted to accommodate virtually any of the structural models set out in table 6, which vary in accordance with the degree of federal participation in the regulatory system.

Chapter VII
Alternative Models - Securities Regulation

In the event the federal government concludes that regulation of the securities market is a high priority issue, if the provinces refuse or fail to negotiate to establish an integrated system within a reasonable time, the obvious federal strategy would be to enact a comprehensive federal law to implement model 4 set out in table 6.[203] That model, as already pointed out, would implement a dual system, but a highly centralized dual system that would leave within provincial jurisdiction only intraprovincial trades. And assuming establishment of a Canada-wide secondary trading network, jurisdiction over intraprovincial trades implies jurisdiction over essentially only intraprovincial primary issues, a locally significant but relatively small part of overall securities market activity. Most secondary trades would be made through the secondary trading network, and most of the intraprovincial secondary trades not made through that network would probably be isolated trades that are excluded from the regulatory system in any event.

Given the existing environment of federal-provincial relations, it is unlikely that any federal government will give such high priority to securities market regulation. Model 4, therefore, is not a probable strategy. But the mere possibility of its implementation confers on the federal government considerable bargaining power. The more probable strategies available to the federal government are reflected in model 6 and model 13.

To place these models in clearer perspective, table 7 recapitulates models 6, 10 and 13 as set out in table 6.

These three models have been selected to highlight the differences among unitary, dual, and integrated regulatory systems. In effect, model 6 would give the federal government an important voice in policy but leave administration to the provinces (unitary administrative system); model 10 would involve the federal gov-

203 This approach assumes broad, federal legislative power under the constitution to implement a comprehensive regulatory scheme; *see id.*

Table 8
Comparative Significance of the Roles of Regulators in Three Model Regulatory Systems

Function	Model 6											Model 10
	Prov. Leg.	Prov. Min. (Cab.)	Council of Min. (Fed.–Prov.)	Courts	Prov. Comm.	Integ. Fed.–Prov. Comm.	Fed. Comm.	Director (each comm. or region)	Fed. Min. (Cab.)	Fed. Parl.	Prov. Leg.	Prov. Min. (Cab.)
Policy – legislative change (overall system)	P (prov. law)	*			*				*	P (fed. law)	P	*
Policy – regulations (major operations)		P			*				P			P
Policy – adjudication of cases					P							
Budget review and appropriations	P	*							*	P	P	*
Articulated information system					P							
Appointment of commissioners		P										P
Appointment of senior staff		P										P
Regulation of market entry (issuers, actors)					P							
Regulation of business conduct (disclosure, etc.)					P							
Oversight of conduct of self-regulatory bodies					P							
Regulation of rates					P							
Investigations					P							
Enforcement – administrative proceedings					P							
Enforcement – civil actions					P							
Enforcement – referring criminal prosecutions					P							
Review of director's regulatory decisions					P							
Administration – application of law to specific cases (regulatory decisions)					*			P				
Administration (personnel, finances, information)		*			*			P				
Review of administrative action (jurisdiction, procedures, arbitrariness)				P								

P means primary responsibility.
* means influence.

Model 13

Council of Min. (Fed.–Prov.)	Courts	Prov. Comm.	Integ. Fed.–Prov. Comm.	Fed. Comm.	Director (each comm. or region)	Fed. Min. (Cab.)	Fed. Parl.	Prov. Leg.	Prov. Min. (Cab.)	Council of Min. (Fed.–Prov.)	Courts	Prov. Comm.	Integ. Fed.–Prov. Comm.	Fed. Comm.	Director (each comm. or region)	Fed. Min. (Cab.)	Fe[d.] P[arl.]
		*				*	P	P	*	P			*			*	P
		*		*		P			*	P			*			*	
		P		P									P				
						*	P	P	*	P						*	P
		*		*									P				
						P			*	P						*	
						P			*	P						*	
		P		P									P				
		P		P									P				
		P		P									P				
		P		P									P				
		P		P									P				
		P		P									P				
		P		P									P				
		P		P									P				
		P		P									P				
		*		*	P								*		P		
		*		*	P				*	*			*		P	*	
P											P						

ernment in both policy and administration through a federal commission that coexists with the provincial commissions (dual system); and model 13 would give the federal government a voice in policy and administration through a joint federal-provincial commission (integrated system).

Table 8 compares graphically these three models, particularizing the functions of the regulatory bodies and assigning primary and secondary roles to those bodies in respect of each major function.

A true unitary system is one that would unite all policy and administration functions in one body, a virtual impossibility in the Canadian federal system where – even assuming very broad federal powers – each province continues to have jurisdiction over intraprovincial trades. Of all the unitary models set out in table 7, the only one that has any probability of adoption is model 6, and it is unitary only in the sense that all administration is vested in one level of government, that is, the provincial level. The several provincial commissions would continue to exist, exercising powers delegated to each commission by the respective provincial legislature and the federal parliament.

Model 6 has several distinct advantages: it gives the federal government considerable influence over Canada-wide securities market policies with a minimum of administrative overlap and, as a corollary, preserves much provincial autonomy; it obviates compliance with two levels of regulation; it makes maximum use of experienced personnel, and it is flexible in the sense that it enables decentralized decision making in a manner that is sensitive to local conditions. The signal disadvantages of such a system are that federal influence may prove to be rather tenuous, particularly where federal policy is not congruent with provincial policy or administrative practice; that there is no strong incentive to develop uniform statutes and procedures, and that centralized information processing is improbable. Although a possible model, for these reasons it is unlikely to obtain much support.

Model 10 has the advantage that it preserves both provincial and federal autonomy within their respective jurisdictions, but because it requires a separate federal commission inherent in it are two clear disadvantages. First, it institutionalizes a dual system and therefore creates few if any incentives to achieve uniformity of policies and administration. Second, and even more important, assuming a decentralized federal commission administered through regional offices, it does not make the most efficient use of experienced regulators. In effect, it would superimpose another level of regulation on the existing system, except to the extent duplication of work could be avoided through the use of common

disclosure standards and the use of techniques of notification and coordination to simplify the qualification of prospectuses. Judging from the almost unanimously hostile response to the partial two-level system proposed in part XV of the BUSINESS CORPORATION PROPOSALS, published by Consumer and Corporate Affairs Canada in 1971, model 10 is not likely to find favor with the federal government, any provincial government, the securities firms, or the professional advisers of those firms.

The third alternative is the integrated system referred to as model 13, which assumes broad, federal legislative power and delegation from the federal Parliament and the several provincial legislatures of comprehensive regulation-making (*i.e.*, legislative), adjudicative and administrative powers to a common regulatory commission. The choice between model 10 and model 13 poses – like most complicated issues – a policy dilemma. Model 10 would lead eventually to a clear demarcation between federal and provincial powers; but it is not likely to gain much support from any quarter. Model 13 would avoid creation of a two-tier, dual system; but it places the federal government in an awkward minority position from which it can extricate itself only with great difficulty, that is, by withdrawing from the integrated system and setting up an independent federal system. Such action would almost certainly result in a lengthy constitutional struggle to determine the respective legislative powers of the federal parliament and provincial legislatures and probably would not gain much public support. As a result, once it agrees to an integrated system the federal government will probably be, in the absence of any crisis, locked into that system.

Nevertheless model 13, a variation of the CANSEC proposal that assumes the existence of a comprehensive federal securities act, has a number of desirable characteristics: it permits some federal and provincial autonomy; it tends strongly to statutory and administrative uniformity; it necessarily leads to a common system of information processing; it renders the duplication of facilities unnecessary; it permits more efficient use of experienced personnel, and it permits flexible, decentralized administration at little added cost. It is the requirement of a comprehensive federal securities act that distinguishes model 13 from the CANSEC proposal. The CANSEC proposal is directed at *uniform administration* of a narrow, supplemental federal law and several discrete provincial laws, whereas model 13 is directed at *uniform administration* of a *uniform law* with a substratum of provincial laws that preserves provincial autonomy with respect to intraprovincial transactions.

Table 9
Comparison of Models for a Regulatory System

Characteristics	Model 6	
	Advantages	Disadvantages
Federal autonomy	Yes but constrained	No administrative control except to withhold resources
Provincial autonomy	Yes but constrained	Federal superimposed at least in part *re* disclosure
Political accountability	Yes	Responsibility diffused therefore accountability is attenuated
Uniform laws and procedures	No	Tends to a dual system
Obviates duplication of regulation	Yes	Tenuous federal control
Makes use of experienced regulators	Yes	Ontario and Quebec dominate
Makes possible central information processing and overall systems analysis	No	Requires coordination of discrete provincial files
Flexible – decentralized decision making and responsive to local conditions	Yes	Lack of uniformity of standards and procedures
Flexible – efficient use of personnel, finances, capital assets	Yes	Ontario and Quebec dominate

Model 10		Model 13	
Advantages	Disadvantages	Advantages	Disadvantages
Yes	Dual system	Yes but constrained	Minority position
Yes	Dual system	Yes but constrained	Threat of federal withdrawal
Yes	Dual system	No	Responsibility completely diffused
No	Dual system	No but tends to uniformity	Less local experi-mentation
No	Dual system	Yes	Complicated system to approve change
Yes at pro-vincial level	No, particularly at regional offices	Yes	
Yes	Yes, except intra-provincial operations	Yes	
No	Dual system of regional offices	Yes	
No	Almost certain duplication	Yes	

The respective advantages and disadvantages of models 6, 10 and 13 are summarized in table 9.

Table 9 indicates that the integrated system reflected by model 13 is, at least in theory, clearly the most advantageous. Assuming that both the federal and provincial governments are willing to negotiate the implementation of an integrated system, they are likely to gain considerable support from the securities industry and the professional bodies that have all been critical in the past of any dual system such as the system that prevails in the United States. Aside from the one clearly negative factor - the diffusion of political responsibility - the integrated system is the easiest case to justify on political, economic and administrative grounds. And as already pointed out, should the diffusion of political responsibility tend to bureaucratize the system excessively in the sense of rendering it unresponsive to political direction, all participating governments probably will be strongly motivated to amend the structure of the system to remedy the problem.

Model 13 does not define a specific model but only connotes a conceptual approach to developing a Canada-wide regulatory system. Aside from the specific problem of political decision-making power, there exists a broad scope of integration models, any one of which is feasible, depending upon the federal-provincial political environment, the specific policy conflicts among the experts involved, and the demonstrable need for a broader-based regulatory system. The three basic types of integrated system - decentralized, median, and centralized - can be recapitulated briefly.

The CANSEC proposal is probably at the one pole as a decentralized type of integrated system, for it relegates federal law to a minor, complementary role, renders participation in the integrated system optional and presupposes the existence of a discrete - and possibly non-uniform - securities law in each province. At the opposite pole is the centralized type of integrated system proposed by the Australian federal government in 1977. It is based on a comprehensive federal law that is in turn adopted by each state,[204] subject to the right of any state to enact a non-uniform provision if the council of ministers recommends that the federal Parliament enact that provision by way of amendment of the uniform federal law, and if the federal Parliament fails to make the recommended amendment within six months of receiving the

204 The Australian model presupposes that the federal law will be based on existing uniform state laws, but the scheme has bogged down because of disagreements among the states about specific, non-uniform provisions in the existing state laws; *see* Short, *supra* note 166. The Australian proposal is an analogue of s. 94 of the BNA Act, which was intended to lead to uniformity of laws among the common law provinces.

recommendation from the council of ministers. This structure clearly renders enactment of any non-uniform provision very unlikely, for it would appear to require intentionally obstructive conduct on the part of the federal government.

In between these two poles – but admittedly much closer to the Australian proposal – is the integrated model recommended by this paper. First, the federal Parliament enacts a comprehensive federal securities act that applies to all primary market and all secondary market transactions other than intraprovincial transactions and that establishes an integrated federal-provincial commission. Second, the federal and provincial governments delegate to the integrated commission authority to exercise the broad policy-making, adjudicative and administrative powers under their respective securities acts. And finally, the federal government and the provinces bind themselves by a multilateral agreement to an express decision-making structure that predetermines how basic policy-making – that is, political – power is to be exercised in the system.

To ensure that the integrated system can be adequately tested, the multilateral agreement should require that each party is bound for a minimum period, say five years. The only mechanism to resolve policy disputes during that term would be the exercise of voting powers pursuant to the agreement. At the end of the term of the agreement any party would be entitled to withdraw from the system and to force determination of any outstanding constitutional issues, which inevitably means determination of whether federal legislative power encompasses foreign issuers and interprovincial transactions as well as federal issuers.

To discuss in detail all the elements of an integrated system is not only beyond the scope but unnecessary for the purposes of this paper. Virtually all the issues have been raised in the CANSEC proposal. All inhere in the constitution of any federal organization and can only be determined by extensive negotiations. What this paper is concerned with is the conceptual foundation of an integrated securities regulation system, its general structure, and the decision-making powers of the parties to it.

A conclusion arrived at with respect to any of these three issues is necessarily based as much on political intuition as analysis since each issue is heavily charged with value judgments – albeit largely tacit – as to the advantages of a federal system, the need for centralized policy-making, the feasibility of local administration, and the desirability of assigning broad policy-making functions to a regulatory commission, which always connotes detracting from direct ministerial responsibility.

In any event, in addition to these value judgments, the forego-

ing analysis inclines me strongly to recommend an integrated regulatory system that is based on comprehensive - and preferably uniform - securities laws at both the federal and provincial levels. Assuming substantial uniformity or, in other words, assuming no fundamental policy conflicts are reflected in the several securities laws, the constitutional disabilities of any one jurisdiction become largely theoretical, for when in doubt in any specific case the commission or administrator will rely on powers under both the federal and the applicable provincial law. The one other feature of an integrated system that has been widely perceived as disadvantageous is the diffusion of power - and responsibility - among a council of ministers, a commission and administrative officers in a manner that could in effect insulate any minister from being held accountable in Parliament or in any legislature. That, admittedly, is a risk. But in reality the risk is probably not great. The perception is largely predicated on an anachronistic concept of direct ministerial responsibility. In an era of detailed regulation a minister rarely if ever attempts to deal with individual cases. His responsibility is to adjudge the fairness and the administrative effectiveness of the overall regulatory system. If as a member of a council of ministers he concludes the system is not working well, he has a responsibility to change it or recommend withdrawal from it. It is in this sense that he is accountable to Parliament or to a legislature.

The general structure of an integrated securities regulation system in a federal context is, if not self-evident, at least largely predetermined by the imperatives of balanced representation in the internal decision-making process and balanced delivery of services to the public at the national, regional and local levels. Accordingly, a council of ministers - whether constituted formally or informally - with general powers of policy oversight, appointment and budget control, as recommended in both the CANSEC and Australian proposals, is clearly essential. In the Canadian political context a regulatory commission, as already demonstrated, is the obvious mechanism to coordinate administration of both federal and provincial securities acts. And experience at the provincial level in Canada has demonstrated the value of assigning all routine administrative functions to one executive officer (usually designated the director), so that the commission decides most specific cases[205] only on an exceptions basis, that is, an appeal from a decision of the director. This basic structure of an integrated

205 The commission may reserve certain strategic decisions such as certain investigation orders, freeze orders, or stop-trading orders for collegiate decision.

system is probably largely unexceptionable.[206] If so, then specific issues such as the number and location of commissioners, the location of the central, regional and local offices, the number and location of administrators, and the distribution of functions among administrators – even if controversial – are negotiable details.

The thorniest problem to be resolved in establishing an integrated securities regulation system – as in the constitution of any political organization – is the distribution of decision-making power at the top policy level.[207]

Under the CANSEC proposal the federal government would exercise 33% of the votes and each province would exercise the number of votes determined as the ratio of its total collections of personal and corporate income taxes to the aggregate collections by all provinces of personal and corporate income taxes. Applying that formula at that time, Ontario would exercise approximately 29% of the votes, Quebec 17%, British Columbia 7%, and the other provinces the remaining 14%. A decision of the council of ministers would require not only a two-thirds majority vote but also the approval of a majority of the participating governments, an added constraint that would preclude the federal government and the large provinces from dominating the system without taking into account the minority interests.[208]

The Australian proposal was similar. Although not very explicit, apparently any change of the federal, uniform law would require the approval – through the council of ministers – of the federal government and at least four of the six states.[209] Where, however, the council of ministers approves a proposed amendment to the federal law, if the federal parliament fails to enact the amendment within six months after the date of approval by the council of ministers, each state would be free to enact the proposed amendment as a non-uniform provision in the state law. The signal difference between the CANSEC and the Australian proposals is

206 As pointed out in note 114 *supra* B.C. has a unique model in the sense that the appellate body is structured to be more remote from the administrator, with the advantage of rendering any administrative bias less likely but with the disadvantage of insulating the appellate body from continuous exposure to administrative problems. Bias is a rare problem that is always subject to judicial review.
On this point *see* Cary, *supra* note 125.

207 The commission too may have some special rules distinguishing between decisions made at the national, region and local level, but the discussion here relates only to the organ having overall policy and administration powers, *i.e.* the council of ministers.

208 *See* text accompanying note 194 *supra*.

209 *See* the speech of the Honourable John Howard, then the federal Minister of Business and Consumer Affairs (August 12, 1976); and *see* text accompanying notes 166, 204 *supra*.

that under the latter the federal government would appear to have an implied veto power, whereas under the CANSEC proposal the federal government would be merely one more voting member, albeit a member with considerable voting strength.

A further variation for confining decision-making power in a federal system that is of particular interest in Canada is the proposed formula to amend the Canadian constitution that was set out in the Victoria Charter of 1971.[210] To preclude domination by the federal government and any specific group of provinces, any proposed amendment would require the approval of the federal Parliament and a majority of the provincial legislatures, which majority must include a province that has or ever had at any time 25% of the population of Canada, at least two Atlantic provinces, and at least two western provinces that together represent at least 50% of all the inhabitants of those provinces. This proposal, although it achieves some balance among the regions of Canada, is in effect quite rigid, for it impliedly confers a veto power on the federal government, on the two largest provinces and on a combination of other provinces. It is therefore even more rigid than the Australian proposal.

Given the history of the development of corporation law and securities regulation in Canada, which has been to treat the federal level as just one more jurisdiction, the CANSEC voting formula - or some variation of that formula - is probably more acceptable. The best way to illustrate that formula (Federal 33%; Ontario 29%; Québec 17%; British Columbia 7%; Other Provinces 14%) is to apply it to a hypothetical case. Assume, for example, a conflict over access of foreign-owned securities firms to the Canadian market. The federal government plus Ontario plus one other province could exercise the required votes to achieve a two-thirds majority, but in addition the vote would have to be supported by a majority of the participating governments. A similar result could be achieved by distributing the voting rights as follows: federal government, Québec and Ontario each 12%; each other province 8%. Assuming only a majority is required to effect a decision, this model diffuses power further than does the CANSEC proposal, enabling seven of the smaller provinces to outvote the federal government, Québec and Ontario combined. If unacceptable to the federal government and the large provinces it too could be modifed to require the approval of at least one or even two of those three jurisdictions. Although necessarily the most difficult problem in any federal system, in the relatively narrow context of

210 This issue is discussed in P. HOGG, *supra* note 149, at 21.

securities market regulation, determination of a workable voting formula should not be an insurmountable problem.

In sum, for historical, political and logical reasons the seemingly obvious securities regulation system in the context of Canadian federalism is an integrated system that operates through a formal or informal council of ministers and a regulatory commission and that assigns decision-making power in accordance with some variation of the CANSEC voting formula.

Chapter VIII
Conclusions

Although there has been much criticism in recent years of the effectiveness of the securities market as a financial intermediary, there is nevertheless a broad consensus that the securities market is an essential institution in a market economy to allocate capital, to direct savings to productive enterprise, to induce investors to invest in equity securities, and to ensure greater Canadian ownership of Canadian enterprise. But recent developments in the securities markets, particularly the growth of intermediaries such as pension funds, insurance companies and mutual funds and the rapid development of computer-communications technology, have compelled a reexamination not only of regulatory techniques but also of the basic assumptions that underlie securities regulation to determine whether the securities market should continue to be regulated as a quasi-cartel, as an outright cartel, or as an essentially competitive market subject only to close public controls over the computer-communications system as a public utility.

Irrespective of the nature of the regulatory goals, there will continue to be available three basic means to regulate markets. The first is to balance power among potential competitors – for example, among banks, underwriters and brokers – to maximize interindustry competition under the aegis of the competition laws. The second is to institutionalize responsibility in market actors, for example, by establishing public councils to advise government, adding public members to stock exchange boards, and imposing personal liability on the principals of securities firms and on individuals connected with a securities issue. The third – and still by far the most important – is to regulate through an external regulatory commission that acts under relatively broad public interest standards, exercising legislative, administrative, adjudicative and investigative powers over the main levers of market control – entry, conduct and prices – to control the behaviour of actors in the market.

Although the regulatory commission concept has recently

come under heavy fire – particularly in respect of the regulation of infrastructure utilities – as being too independent of the political process, too arbitrary, too much under the influence of the regulated industry, and even as being ineffective, the regulatory commission for several reasons offers advantages that more than outweigh its disadvantages. For example, it permits expert policy development and expert administration within a context of broad statutory standards, relative independence from the immediate pressures of partisan politics, freedom from many of the bureaucratic constraints imposed on government departments, and, above all, a very flexible means to coordinate interdepartmental and even intergovernmental programs. Before acceding to criticisms of the regulatory commission, it is therefore essential that the means and ends of each regulatory scheme be closely scrutinized to determine whether the criticisms have any bearing on that scheme.

Indeed, because of the Canadian constitutional law relating to the delegation of powers from the federal and provincial legislatures to a regulatory commission, a commission is an ideal vehicle to coordinate the exercise of federal and provincial powers that relate to a common program objective such as securities market regulation. The present law permits the use of three coordinating techniques: (1) the federal government may delegate authority to administer a federal law to provincial commissions; (2) the federal government may set up a federal commission and invoke statutory coordinating mechanisms to minimize the overlap of functions carried out by discrete federal and provincial commissions; or (3) the federal and provincial governments may agree to set up a joint federal-provincial commission to which legislatures at both levels delegate quite broad regulatory authority.

Although not free from political and technical difficulties, particularly the reluctance of the provinces to acknowledge even tacitly that the federal Parliament has any jurisdiction over interprovincial securities transactions, the third alternative – an integrated federal-provincial commission – is clearly preferable. It tends strongly to the development of uniform laws and procedures without requiring any legislature expressly to yield jurisdiction. It permits continued use of the most experienced securities administrators in a context that allows consideration of local as well as national conditions. And above all, it furnishes a mechanism that can be adapted to the probable future regulatory environment, which will focus less on detailed market structures and functions and more on the overall design and regulation of a Canada-wide securities transactions system based on computer-communications technology.

But to consider only the conceptual and technical advantages of an integrated securities regulation system in Canada is to ignore what is probably the most important consequence of implementing such a system. In a decentralized federal structure like that of Canada, an integrated system – like the banking system – fulfils a vital secondary function of linking the diverse geographic and economic components of the federal system. It is part of the warp on which the pattern of the federal system is woven, usually inconspicuous but continuously functioning to bind together the federal state.

List of Contributors

Philip Anisman, B.A., LL.B. (Toronto), LL.M., J.S.D. (California, Berkeley), is a professor of law at Osgoode Hall Law School, York University, and from 1973 to 1978 was the Director of the Corporate Research Branch in Consumer and Corporate Affairs Canada, Ottawa. He is the author of two books, *Takeover Bid Legislation in Canada: A Comparative Analysis* (1974) and *A Catalogue of Discretionary Powers in the Revised Statutes of Canada 1970* (1975), and of articles on corporate and securities law.

James C. Baillie, Q.C., B.A., LL.B. (Toronto), LL.M. (Harvard), is currently the chairman of the Ontario Securities Commission. He was the director of the study conducted by the Canadian Committee on Mutual Funds and Investment Contracts whose report was published in 1969 and is a coauthor of the *Proposals for a Mutual Fund Law for Canada* (1974) and the author of a number of articles on securities regulation. At the time of completion of the paper in this volume he was engaged in the practice of law in Toronto.

Hugh J. Cleland, B.A. (Harvard), has been a consultant to a number of institutions in the securities industry and since December 1977 has been the Vice-President, Policy Development and External Relations, of the Toronto Stock Exchange.

Mark Q. Connelly, B.A. (Toronto), J.D. (Columbia), is an associate professor of law at Osgoode Hall Law School, York University. He is the author of a number of articles on securities and business law.

Peter Dey, B.Sc. (Queen's), LL.B. (Dalhousie), LL.M. (Harvard), is engaged in the practice of law in Toronto. He was the research director of the Committee of the Ontario Securities Commission on the Problems of Disclosure Raised for Investors by Business Combinations and Private Placements which published its report in 1970 and is the author of several articles on securities regulation.

Byran Gibson, B.A. (Toronto), LL.B. (British Columbia), LL.M. (Yale), is engaged in the practice of law in Vancouver. He is a former assistant professor of law in the Faculty of Law, University of British Columbia, and the author of articles on corporate-securities law.

Warren M. H. Grover, Q.C., B.A.Sc., LL.B. (Toronto), LL.M. (California, Berkeley), is engaged in the practice of law in Toronto. He has been a professor of law at Osgoode Hall Law School, York University and counsel to the Foreign Investment Review Agency. He is a coauthor of the *Proposals for a Mutual Fund Law for Canada* (1974) and the author of a number of articles on corporate and commercial law.

Dleap S. Hall, B.A. (British Columbia), is a member of the staff of the Corporate Research Branch, Consumer and Corporate Affairs Canada, and was formerly director of research of the Montreal Stock Exchange.

Sholto Hebenton, B.A. (British Columbia), B.A., B.C.L. (Oxon.), LL.M. (Harvard), was a visiting professor of law at Osgoode Hall Law School, York University, and the Faculty of Law, University of Toronto, in 1973–74 and is currently engaged in the practice of law in Vancouver. He is the author of articles on international law and the conflict of laws.

Peter W. Hogg, LL.B. (New Zealand), LL.M. (Harvard), Ph.D. (Monash), is a professor of law at Osgoode Hall Law School, York University. He is the author of two books, *Liability of the Crown* (1970) and *Constitutional Law of Canada* (1977), and of numerous articles.

John Honsberger, Q.C., B.A. (Toronto), is engaged in the practice of law in Toronto. He is a sessional lecturer at Osgoode Hall Law

School, York University, and a member of the American National Bankruptcy Conference. He is a coauthor of books on *Bankruptcy in Canada* and the *Canadian Law of Real Property*, the author of numerous articles, and was a member of the Study Committee on Bankruptcy and Insolvency Legislation which published its *Report: Bankruptcy and Insolvency* in 1970.

John L. Howard, Q.C., B.Comm., LL.B. (British Columbia), LL.M. (Harvard), is currently the Assistant Deputy Minister for Corporate Affairs in Consumer and Corporate Affairs Canada, Ottawa. He is a coauthor of the *Proposals for a New Business Corporations Law for Canada* (1971) and the author of several articles on corporation law.

Frank Iacobucci, B.Comm., LL.B. (British Columbia), LL.B., Dipl. Int. Law (Cantab.), is a professor of law in the Faculty of Law, University of Toronto. He is a coauthor of a recent book on *Canadian Business Corporations* and the author of a number of articles on corporation law.

Michael A. Jenkins, B.Sc. (Hons.) (Queen's), M.S., Ph.D. (Stanford), is an associate professor in and head of the Department of Computing and Information Science, Queen's University. He is the author of a number of articles on computer science.

Leonard H. Leigh, B.A., LL.B. (Alberta), Ph.D. (London), is a lecturer in the Department of Law, London School of Economics and Political Science. He is the author of books on *The Criminal Liability of Corporations in English Law* (1969) and *Police Powers in England and Wales* (1976) and is the coauthor of *An Introduction to Company Law* (1971). He has also published articles on corporate, criminal and constitutional law.

Stanley Makuch, B.A. (Toronto), M.A. (Carleton), LL.B. (Osgoode), LL.M. (Harvard), is an associate professor of law in the Faculty of Law, University of Toronto. He is the author of articles on self-regulation, administrative tribunals, municipal law and urban planning.

J. Peter Williamson, B.A. (Toronto), LL.B., M.B.A., D.B.A. (Harvard), is a professor of business administration at the Amos Tuck School of Business Administration, Dartmouth College. He was the director of the Federal Securities Task Force in 1966–67 and is the author of numerous books and articles including *Securities*

Regulation in Canada (1960, Supplement 1966), *Taxation of United States Private Investment In Canada* (1963) and *Funds for the Future: Report of the Twentieth Century Fund Task Force on College and University Endowment Policy* (1975).

Marvin Yontef, LL.B. (Osgoode), LL.M. (Harvard), is engaged in the practice of law in Toronto and has written on securities regulation.

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