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Mr. Michael Phelps
Chair
WPC Committee to Review the Structure
of Securities Regulation in Canada
P.O. Box 10026
700 West Georgia Street
Vancouver, B.C. V7Y 1B3

Dear Mr. Phelps:

I have read with interest the materials on the web site of the Wise Persons Committee and I thought I might offer some ideas. I have practised and taught corporate finance and securities law for 40 years. While I will partly follow the "Our Questions to You" format, it seems evident that the federal government should recognize its responsibilities for a national regulation of the Canadian Capital Markets, regardless of what the provinces do. There is no constitutional impediment to unilateral federal action. Just do it. The various provinces have uneven resources and needs, which are necessarily reflected in their abilities to be effective in this area. To the extent some of them wish to continue despite a federal presence, so be it. Most will opt into a federal scheme if it is well administered. The enormous increase in the role that the chartered banks and their investment dealer subsidiaries play in the capital markets, since the demise of the four pillars, makes federal involvement even more urgent than it was when the current provincial regulatory structures were put in place. I assume a strong federal presence will form the basis of any recommendations.

I think it is important to recognize that the structure of many publicly traded Canadian corporations is quite different from publicly traded American corporations. A majority of the publicly traded corporations in Canada are controlled by a single individual or a family or a group. At a theoretical corporate law level this means that the duty of loyalty is much more important to regulate than the duty of care. The problem with majority control is exacerbated by the holding of multiple voting securities by the control block and single voting or non-voting shares for the public float. In many Canadian corporations, the persons who have the majority of the votes do not have the majority of the equity capital. This is very different from the situation in the United States where the voting power runs in parallel with the equity capital

and most of the important corporations do not have a control block. Canadian regulators need to deal with the Canadian structure.

I also think it is important to recognize that the current securities regime in the United States is 70 years old and in Canada is 40 years old. In both countries it is based on disclosure. While it may seem heretical to those who practice as accountants or lawyers in this area, I suggest to you that these professionals have spent a great deal of time and intelligence to ensure that meaningful disclosure is emasculated and they have carried the regulators along with them, often by drafting new, more obtuse rules. Arthur Levitt has a chapter in his recent book "Take on the Street" entitled "Beware False Profits", which notes several accepted accounting practices that distort earnings. The MD&A is now drafted mainly by lawyers and is largely incomprehensible. The 2002 Annual Report of Nortel is an example. There are 9 pages at the front that are designed to be read. There are then 14 pages of a business overview. That is followed by 43 pages of MD&A plus 66 pages of financial statements with notes. Indeed from page 24 to 192 is a response to rules put out by securities regulatory bodies. I strongly suggest that it is a total waste of paper to send all that material to shareholders. If the financials and MD&A were posted on the Sedar or Edgar web sites that would be adequate. But antiquated ideas are revered by securities market regulators. The current disclosure system is not working. There are far too many rules promulgated by the OSC which increase the cost of disclosure without increasing meaningful disclosure. A dramatic overhaul is past due. This plethora of rules and concentration on disclosure is a major weakness of the current system. The strength of the system is that it is so complex and expensive that it inhibits any attack. It is a dream come true for the large corporate law firms and the four major accounting firms.

You specifically ask about enforcement, which is a topic that is seldom addressed in Canada. In my view there is little effective enforcement of the regulation of the Canadian Capital Markets. Rather than noting the "recent corporate scandals in the United States", Canada should be looking at Bre-X, YBM and Livent. The Toronto Stock Exchange closed at 6940 on June 2, 2003 while the Dow Jones Industrial Average closed at 8897. At the height of the markets the TSE was above the DJIA. Just maybe, the Canadian Capital Markets are even worse regulated than the U.S. Capital Markets. Certainly the major market actors in Canada are seldom criticized and never subjected to huge monetary penalties such as those recently imposed in the United States. Nor do those accused of wrong-doing appear in handcuffs. To me it is shocking to see that two former senior officers of Livent are fugitives from justice in the United States but living well in Canada. The OSC was going to pursue them but has now backed away for five years until the criminal law process is completed. This is a paradigm of effective Canadian enforcement.

I suggest that in order to have any sort of effective regulation of the Canadian Capital Markets, a new approach by the federal government is essential. The efficient capital market hypothesis needs rethinking as it clearly does not work in Canada, given the existing structures. I would suggest that you hire a knowledgeable academic, such as Jeff MacIntosh at the University of Toronto, to develop a new approach.

There may also be a huge problem with the old boys club, which seems to believe in their meritocracy as the best way to govern the capital markets, somewhat like the Family Compact in the middle of the 19th century. Is there a small pool of individuals with important positions who are coddled by the banks and their investment dealer subsidiaries? Do senior officers of public companies who arrange capital raising transactions through a specific investment dealer get first pick of lucrative IPO stocks? Are analysts paid more if they produce positive predictions for the corporations that raise capital through their employer? Do the clients give them perks? As the Report on Setting Analyst Standards (October 2001) said:

“Standards without effective enforcement have no real force. Together with voluntary compliance they do not do enough to inspire investor confidence.”

I suggest to you that no thoughtful person has any belief that regulators have asked the tough questions of the major market participants, in whose pockets they appear to be firmly ensconced.

Recently the CSA and the TSX have set up an Insider Trading Task Force. There is nothing new about the Canadian insider trading rules. Most individuals with material undisclosed information (MUI) do not trade as a matter of morality. Tipping is more common but no scheme has been invented to catch the insider who tips (MUI) but who does not trade himself. Indeed in the United States since the 1983 Supreme Court case of *Dirks v. SEC*, the SEC must prove that the company insider providing the information acted in breach of a fiduciary duty by receiving a personal benefit! Insider trading violations in Canada are difficult to uncover. A new electronic detection and sophisticated enforcement system needs to be devised, not a new task force appointed.

When developing new approaches to regulation, I urge you not to superimpose levels of expensive oversight, such as the Accounting Standards Oversight Council chaired by Tom Allen, which oversees both the Accounting Standards Board and the Public Sector Accounting Board. There is also the Auditing and Assurance Standards Oversight Council, chaired by Jim Baillie which oversees the Auditing and Assurance Standard Board. A third oversight is provided by the Canadian Public Accountability Board

Council of Governors, chaired by David Brown, which oversees the Canadian Public Accountability Board. The optics of three extremely competent, senior, Toronto based lawyers overseeing all Canadian accountants cannot sit well in the rest of Canada and appears to me to be just another layer of red tape.

Finally, I suggest you hire a good, young corporate academic to plan a new approach to corporate governance in Canada. So long as majority control permits family succession and corporate looting through expense accounts and excessive compensation, it is hard to see how Canada can effectively follow the corporate governance concepts of the United States. The structure needs to change if Canada hopes to be an investment venue of choice in the future.

Yours very truly,



Warren Grover

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