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# Legal Origins, Investor Protection, and Canada

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Poonam Puri

## Legal Origins, Investor Protection, and Canada

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**Poonam Puri**

**LEGAL ORIGINS, INVESTOR PROTECTION, AND CANADA**

**Abstract:** In *Legal Determinants of External Finance*, Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny (“LLSV”) argue that the reason that some countries have bigger capital markets than others can be traced to the legal origin of the country i.e. whether it is a common law or a civil law jurisdiction.

This paper explores the LLSV thesis in the context of Canada, which is a common law jurisdiction that also is home to Quebec which has a civil law tradition.

Three issues are examined in this paper: first, how and why Canada fared relatively well in the recent financial crisis; second, why Canada has not yet created a national securities regulator; and third, how Quebec, a civil law jurisdiction, operates within an overarching common law framework, and the implications of this cross-fertilization of systems.

These three issues are explored by examining the *development* of various investor protection laws and structures over time in Canada (as opposed to examining investor protection laws at a point in time, as the LLSV studies do), and also by providing *context* to explain why certain rules and structures have been adapted and others, while economically efficient, may have been rejected.

In Canada, as in many other jurisdictions, securities laws and securities structure have an impact on investor protection, as do banking laws and the banking regulatory framework and business culture. Not all investor protection mechanisms are located in the corporate statutes, as LLSV assumes. LLSV did not explore securities law rules, securities law structures, or banking laws. As well, the Canadian system is both structured in such a way and has evolved in such a way that investor protections are fairly consistent between the common law and civil law provinces, even when the civil law statute does not necessarily mimic the common law statute.

**Keywords:** Legal origins, LLSV, development of investor protection, common securities regulator, common law, civil law, Canada

**JEL classification:** K 20, K 22

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# Legal Origins, Investor Protection, and Canada

Poonam Puri\*

## I. INTRODUCTION

Beginning with their publication of *Legal Determinants of External Finance*,<sup>1</sup> Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny (“LLSV”) asked: “Why do some countries have so much bigger capital markets than others?”<sup>2</sup> According to them, the answer lies in the legal environment of the country—its legal origin.<sup>3</sup> LLSV conclude that because common law countries have better investor protection mechanisms and better enforcement, bigger capital markets are more achievable.<sup>4</sup> They also find that the concentration of ownership of shares in the largest public companies is negatively related to investor protection.<sup>5</sup> Their theories have led to a number of influential papers, either in agreement, or as a critique to their work—collectively turning LLSV “into the most cited economists in the world over the past decade.”<sup>6</sup>

While LLSV classified Canada as a common law jurisdiction in their studies, Canada actually stands out as somewhat unique in the world financial markets as one of the few countries with both common and civil law traditions. While the federal government and twelve of the thirteen

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<sup>1</sup> Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997).

<sup>2</sup> *Id.* at 1131.

<sup>3</sup> *Id.* at 1149.

<sup>4</sup> *Id.*

<sup>5</sup> *Id.* at 1132.

<sup>6</sup> Nicholas Thompson, *Common Denominator*, LEGAL AFF., Jan.–Feb. 2005, [http://legalaffairs.org/issues/January-February-2005/feature\\_thompson\\_janfeb05.msp](http://legalaffairs.org/issues/January-February-2005/feature_thompson_janfeb05.msp).

provinces and territories operate under the common law system, Quebec operates a civil law system in its province within the larger Canadian common law framework. This fact makes Canada an interesting jurisdiction for exploration of the LLSV theories, conclusions, and critiques.

Canada's capital markets are also different than the United States or the United Kingdom. Canada is a small player in the world's capital markets, with Canadian issuers representing only 3% of the world's capital.<sup>7</sup> Despite Canada being such a small player, the number of Canadian public companies is relatively high compared to other countries, with about 4,000 issuers listed on the TSX and TSX Venture Exchange.<sup>8</sup> Canada also has a small number of very large issuers and a large number of very small issuers. For example, the market capitalization of the 200 largest issuers listed on the TSX accounts for more than 88% of the total market capitalization of all TSX and TSX Venture Exchange listed companies.<sup>9</sup> Over 190 of Canada's largest issuers are also listed on major U.S. exchanges.<sup>10</sup> In addition, a significant number of the largest non-financial public companies in Canada have controlling or major shareholders.<sup>11</sup>

Studies show that valuations of Canadian companies cross listed in the United States is higher than those listed only in Canada.<sup>12</sup> Studies also show that the cost of capital in Canada is approximately twenty-five basis points higher than in the United States.<sup>13</sup> These differences in valuation and cost of capital could be the result of differences in the quality of investor protection between Canada and the United States. It is reasonable to attribute these differences to investor concerns about Canada's fragmented regulatory structure for securities, concerns about ineffective enforcement vis-a-vis the United States, and concerns about the significance of large number of controlling or major shareholders in Canada. These factors suggest that context is important in the relative strengths of the capital market and investor protection and that there is much more at play than can be found in examining the system of laws.

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<sup>7</sup> *Id.*

<sup>8</sup> The June 2009 statistics show 1,503 issuers listed on the Toronto Stock Exchange ("TSX") while 2,429 issues are listed on the TSX Venture Exchange. See TMX GROUP INC., MARKET STATISTICS, [http://www.tmx.com/en/pdf/MarketStatistics\\_TMXGroup\\_Q22009.pdf](http://www.tmx.com/en/pdf/MarketStatistics_TMXGroup_Q22009.pdf).

<sup>9</sup> NICHOLLS, *supra* note 8, at 133.

<sup>10</sup> New York Stock Exchange, Listing Directory, [http://www.nyse.com/about/listed/lc\\_all\\_region\\_1.html](http://www.nyse.com/about/listed/lc_all_region_1.html) (last visited Nov. 3, 2009); NASDAQ, Listed Companies, <http://www.nasdaq.com/asp/NonUsOutput.asp?page=C&previousCount=30&region=Northamerica> (last visited Nov. 3, 2009).

<sup>11</sup> NICHOLLS, *supra* note 8, at 134; see also Stephanie Ben-Ishai & Poonam Puri, *Dual Class Shares in Canada: A Historical Analysis*, 29 DALHOUSIE L.J. 117, 126–32 (2006).

<sup>12</sup> Michael R. King & Dan Segal, *Market Segmentation and Equity Valuation: Comparing Canada and the United States*, 18 J. INT'L. FIN. MARKETS, INST. & MONEY 245, 246 (2008).

<sup>13</sup> Paul Halpren & Poonam Puri, 'Canada Steps Up'—Task Force to Modernize Securities Legislation in Canada: Recommendations and Discussion, 2 CAP. MARKETS L.J. 191, 191 (2007).

Canada (and Quebec within Canada) provides an excellent context in which to explore the nuances of the LLSV theories, conclusions and critiques on investor protection, capital markets and legal families. Three issues are explored in this paper. The first issue is how and why Canada fared relatively well (in contrast to the United States in particular) in the recent financial crisis. The second issue is why Canada still has not created a national regulator for securities, despite more than forty years of attempts to do so. The third issue explored in this paper is how Quebec, as a civil law jurisdiction, operates within an overarching Canadian common law framework and what are the cross-fertilization implications of a civil law system within a common law jurisdiction.

I explore these three issues by examining the *development* of various investor protection laws and structures over time in Canada (as opposed to a point in time as the LLSV studies do), and also by providing context which helps to explain why certain rules and structures have been adapted and others, while economically efficient, may have been rejected. This exploration of Canada highlights that context matters when looking at the laws related to investor protection within a country. Not all investor protection mechanisms are located in the corporate statutes, as LLSV assumes. LLSV did not explore securities law rules, securities law structures, or banking laws. In Canada, as in many other jurisdictions, securities laws and securities structure have an impact on investor protection and the debate on a common securities regulator has focused on improving investor protection and improving enforcement. Furthermore, banking laws and the banking framework play an important role in investor protection, in the broader sense. In Canada, investor protection is reflected in the conservative nature of its banking system which allowed Canadian financial institutions to escape relatively unscathed from the recent financial crisis. Finally, the Canadian system is both structured in such a way and has evolved in such a way that investor protections are fairly consistent between the common law and civil law provinces, even when the civil law statute does not necessarily mimic the common law statute. The unifying role of the Supreme Court of Canada and the unifying effect of various bodies such as the Canadian Securities Administrators for provincial securities laws that work to ensure that the laws and regulations are consistent across the country.

This paper proceeds as follows. Part II explores the details of the LLSV studies. Part III highlights critiques of the LLSV studies and their conclusions. Part IV explores the case of Canada in relation to investor protection and capital markets. It first explores how Canada fared during the recent financial crisis. It then explores the debate over a national securities commission. Finally, it considers the position of Quebec, as the only civil law province, within Canada, and how investor protections have remained relatively harmonized between legal families. Part V concludes.

## II. WHAT DOES LLSV SAY?

This part of the paper summarizes the findings and contentions of LLSV noted at the beginning of this article.<sup>14</sup> In their well-known 1998 paper *Law and Finance*,<sup>15</sup> LLSV looked at laws

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<sup>14</sup> See *supra* notes 1–6 and accompanying text.

<sup>15</sup> Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998).

pertaining to investor protection. Their goal was to “establish whether laws pertaining to investor protection differ across countries and whether these differences have consequences for corporate finance.”<sup>16</sup> In order to reach their goal, they distinguished between common families of law within civil law (French, German, and Scandinavian), and those within common law (British colonies, United States, Canada, Australia, and India), using a sample of 49 countries.<sup>17</sup> While they acknowledge that legal scholars often disagree upon the definition of a “legal family,” they based their research on the approach used by scholars that enabled the identification of civil law and common law traditions.<sup>18</sup> Furthermore, to classify countries into legal families, LLSV relied on the works of Reynolds and Flores.<sup>19</sup>

The measurement of investor protection was done by looking at shareholder rights, anti-director rights, and creditor protection rights.<sup>20</sup> Some of the criteria they used for coding shareholder and anti-director rights were: one share-one vote, proxy by mail allowed, shares not blocked before meeting, cumulative voting, oppressed minority, pre-emptive right to new issues, and percentage of share capital to call extraordinary shareholder meeting.<sup>21</sup> In terms of creditor protection rights, LLSV scored countries in both reorganization and liquidation.<sup>22</sup>

Based on a regression analysis, they concluded that common law countries tend to afford more protection to their investors than do civil law countries, while French civil law countries offer the weakest protection.<sup>23</sup> They also noted that the ranking is roughly the same for both shareholder protection and creditor protection, meaning “[i]t is not the case that some legal families protect shareholders and others protect creditors.”<sup>24</sup>

With these findings in mind, LLSV further posed the question of whether countries with poor investor protection compensate in other ways, such as having quality law enforcement.<sup>25</sup> To evaluate the quality of law enforcement, LLSV used five criteria: efficiency of judicial system, rule of law, corruption, risk of expropriation, and likelihood of contract repudiation by the government.<sup>26</sup> From their data, LLSV answer their question in the negative.<sup>27</sup> They ultimately

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<sup>16</sup> *Id.* at 1121.

<sup>17</sup> *Id.* at 1115–16.

<sup>18</sup> *Id.* at 1117–19.

<sup>19</sup> *Id.* at 1119 (citing THOMAS REYNOLDS & ARTURO FLORES, FOREIGN LAW: CURRENT SOURCES OF BASIC LEGISLATION IN JURISDICTIONS OF THE WORLD (1989)).

<sup>20</sup> *Id.* at 1127–28, 1134.

<sup>21</sup> *Id.* at 1122–25 (listing the variables used in the study).

<sup>22</sup> *Id.* at 1134.

<sup>23</sup> *Id.* at 1129.

<sup>24</sup> *Id.* at 1139.

<sup>25</sup> *Id.* at 1139–40.

<sup>26</sup> *Id.* at 1140.

conclude that law enforcement is stronger in common law countries, and weakest in the French civil law countries.<sup>28</sup> But while quality of law enforcement does not compensate for the quality of laws, countries tend to develop substitute mechanisms, like ownership concentration, for poor investment protection.<sup>29</sup>

However, do countries with poor investor protection actually suffer? While LLSV had no definitive answer to this question, they do suggest a positive association between the legal system and economic development.<sup>30</sup> In subsequent research, LLSV attempted to expand on their findings. In 1999, they set out to study the effect of protections on valuation and found that countries with better shareholder protection are associated with a higher valuation of corporate assets.<sup>31</sup>

The Legal Origins Theory debate continues and has led to a surge of publications on this subject matter. While LLSV have paved the way with their arguments and findings, they have garnered a lot of support and criticism at the same time. But ultimately, the discussions and debates will further our understanding of the differences in investor protection and market outcomes around the world.

### III. CRITIQUES OF LLSV

The LLSV legal origins theory has been critiqued in several ways including: A. methodology, B. coding and variables, C. context, and D. other explanations.

#### A. METHODOLOGY

The methodology that LLSV employ in their studies is one of the more obvious criticisms. The problem with using regression analysis as a main tool is simply the fact that correlation does not equal causation, and that correlation can be misleading. For example, while no law in the United States or United Kingdom requires board of directors to be independent of management, correlation makes it seem like legal rules “caused” this independence because it is the norm in both these countries.<sup>32</sup> Law in general is hard to quantify, and thus, some

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<sup>27</sup> *Id.* at 1141.

<sup>28</sup> *Id.*

<sup>29</sup> *Id.* at 1141 and 1145.

<sup>30</sup> *Id.* at 1153.

<sup>31</sup> Rafael La Porta et al., *Investor Protection and Corporate Valuation*, 57 J. Fin. 1147, 1166–69 (2002)..

<sup>32</sup> John C. Coffee, Jr., *Do Norms Matter? A Cross-Country Examination of the Private Benefits of Control* 6–7 (Colum. L. & Econ. Working Paper No. 183, 2001), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=257613](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=257613)).



speculate on the usefulness of such quantitative studies.<sup>33</sup> In his 2005 paper, Siems reviewed the use of numerical comparisons of laws and found both arguments for and against the use of numerical comparisons. The critiques include the argument that numerical comparisons oversimplify the complex legal systems that exist where historical context and institutional dimensions play an important role,<sup>34</sup> as discussed further below. Furthermore, law is extraordinary by the dynamic nature of the law-and-society systems, including extra-jurisdictional complexities, which need to be considered when studying the impact of laws.<sup>35</sup> Laws are prescriptive and reactive and are more about values than they are quantifiable.<sup>36</sup> Finally, the focus of legal rules, especially in the context of comparative law, should be on the functionality of laws rather than the legal similarities and differences.<sup>37</sup> LLSV's focus on whether a rule exists or does not exist in various countries ignores the possibility of other legal solutions which achieve the same result, but in a different manner.<sup>38</sup> The legal context of laws within the social fabric of a country is a critical element of comparative law that cannot be established by applying simplifying numerical comparisons of law between countries, although it may apply to a comparison of laws within the same country.<sup>39</sup>

While there is criticism of the use of numerical comparisons in legal research, the LLSV theories could be seen as a way to reduce the complicated endeavour of comparative law into something that is more understandable and therefore useable.<sup>40</sup> There are also arguments that law is no more extraordinary than any other social science, such as economics or political science, and yet these sciences are able to use statistics to analyze data to some degree of success.<sup>41</sup> Finally, since the study of comparative law is relatively new, especially in terms of methodology, there are no set rules on how to conduct these types of studies.<sup>42</sup>

In addition, it is argued that the categorization of law seems arbitrary and the distinction between common and civil law is not useful in terms of a law-and-finance analysis.<sup>43</sup> As a result, some have suggested a more precise criteria consisting of four identifiers: European

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<sup>33</sup> Mathias M. Siems, *Numerical Comparative Law: Do We Need Statistical Evidence in Law in Order to Reduce Complexity?*, 13 CARDOZO J. INT'L & COMP. LAW 521 (2005).

<sup>34</sup> *Id.* at 529.

<sup>35</sup> *Id.*

<sup>36</sup> *Id.* at 530.

<sup>37</sup> *Id.* at 531.

<sup>38</sup> *Id.* at 532.

<sup>39</sup> *Id.* at 531, 533.

<sup>40</sup> *Id.* at 534.

<sup>41</sup> *Id.* at 535.

<sup>42</sup> *Id.* at 537.

<sup>43</sup> See Mathias M. Siems, *Legal Origins: Reconciling Law & Finance and Comparative Law*, 52 MCGILL L.J. 55 (2007).

colonization (colonizing power), language, relative importance of statutory law and courts, and formality/flexibility of a legal system.<sup>44</sup> Clear criteria are necessary in order to categorize law, otherwise it may result in measurement errors and biased coefficients.<sup>45</sup>

## B. LLSV CODING AND VARIABLES

Besides concerns with methodological tools, the LLSV coding may also be questionable.<sup>46</sup> One specific example is that it may be misleading to code the components of investor protection in a binary manner as being satisfactory or not satisfactory since it is often in the middle.<sup>47</sup> Spamann has argued that there is inconsistent treatment in the coding, and when he corrected the values of the “Antidirector Rights Index,” he obtained data showing that the findings of LLSV did not hold—there was no difference between common and civil law jurisdictions.<sup>48</sup>

Apart from this coding inconsistency, other variables are inconsistently coded or used as well.<sup>49</sup> For example, whereas a “mandatory dividend” variable appears on the LLSV 1998 study,<sup>50</sup> it is left out in the LLSV 2000 study.<sup>51</sup> LLSV 1998 also did not differentiate between default and mandatory legal rules.<sup>52</sup> Furthermore, many of the shareholder protection variables have not been theoretically or empirically determined, the number of variables used to measure the legal frameworks is insufficient, and there may be bias in the variables chosen because they are derived from common law.<sup>53</sup>

In reconsidering LLSV’s shareholder protection measures for Austria and the United Kingdom,

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<sup>44</sup> *Id.* at 70–73.

<sup>45</sup> *Id.* at 70.

<sup>46</sup> See Stefan Voigt, *Are International Merchants Stupid? Their Choice of Law Sheds Doubt on the Legal Origin Theory*, 5 J. EMPIRICAL LEGAL STUD. 1 (2008).

<sup>47</sup> Caspar Rose, *The Challenges of Quantifying Investor Protection in a Comparative Context*, 8 EUR. BUS. ORG. L. REV. 369, 384–85 (2007).

<sup>48</sup> Holger Spamann, *‘Law and Finance’ Revisited* 16–17 (Harvard Law School John M. Olin Ctr., Discussion Paper No. 12, 2008), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1095526](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1095526).

<sup>49</sup> *Id.* at 7.

<sup>50</sup> La Porta et al., *supra* note 18, at 1123.

<sup>51</sup> La Porta et al., *supra* note 34 at 1156–57.

<sup>52</sup> Rose, *supra* note 51 at 391. To their credit, this aspect was later incorporated by expanding the variable descriptions. Simeon Djankov et al., *The Law and Economics of Self-Dealing* (Nat’l Bureau of Econ. Research, Working Paper No. 11883, 2005).

<sup>53</sup> Robert Schmidbauer, *On the Fallacy of LLSV Revisited—Further Evidence About Shareholder Protection in Austria and the United Kingdom* 10 (Feb. 2006) (unpublished manuscript), available at <http://ssrn.com/abstract=913968>.

Schmidbauer compiled his own shareholder protection score for the index, and concluded that law is *not* the main link—it only plays an assisting role.<sup>54</sup> Perhaps one of the more important limitations is that the indices that LLSV create only provide us with a cross-sectional view of the law at a point in time.<sup>55</sup> When legal rules are coded as they have evolved over time, including norms derived from takeover codes and corporate governance codes,<sup>56</sup> the differences between civil and common law jurisdictions converge over time.<sup>57</sup> Further, while using this new index,<sup>58</sup> there was no link between shareholder protection and stock market development. This suggests that perhaps strength of shareholder protection may not matter for financial development.<sup>59</sup>

### C. CONTEXT

The critiques related to methodology lead into a discussion of context. LLSV have been criticized for focusing largely on legal families and very little on the way by which the law has developed within the specific country.<sup>60</sup> The context in which laws are developed is important. The history of a country matters when looking at how laws are developed, as it may help to explain why there are similarities and differences between jurisdictions. In addition, the political economy and the social and cultural circumstances of a country are important to demonstrate that although the laws may be different, the effect may be similar in terms of investor protection. This may be especially true when countries are at different stages of development, as the law then must deal with different social problems, not just investor protection.<sup>61</sup>

In a similar manner, Pistor proposed that the process in which legal change occurs is crucial for the development of effective law.<sup>62</sup> She argues that “for law to be effective, it must become part of the institutional fabric of a society, contributing to the process of institutional

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<sup>54</sup> *Id.* at 44.

<sup>55</sup> John Armour et al., *Shareholder Protection and Stock Market Development: An Empirical Test of the Legal Origins Hypothesis* 11 (Eur. Corp. Governance Inst., Working Paper No. 108, 2008), available at <http://ssrn.com/abstract=1094355>.

<sup>56</sup> *Id.* at 12.

<sup>57</sup> *See id.* at 37–39.

<sup>58</sup> *Id.* at 32–35.

<sup>59</sup> *Id.*

<sup>60</sup> *See* Daniel Berkowitz, Katharina Pistor & Jean-Francois Richard, *Economic Development, Legality, and the Transplant Effect* 16 (William Davidson, Working Paper No. 410, 2001), available at <http://deepblue.lib.umich.edu/handle/2027.42/39794>.

<sup>61</sup> Siems, *supra* note 24, at 532.

<sup>62</sup> Katharina Pistor, Yoram Keinan, Jan Kleinheisterkamp & Mark D. West, *Evolution of Corporate Law and the Transplant Effect: Lessons from Six Countries*, WORLD BANK RES. OBSERVER, Spring 2003, at 89, 90.

innovation and change.”<sup>63</sup> Formalizing laws on the books is not sufficient, rather it is “[o]nly when the law is used—when it is modified in response to changing demands or socioeconomic conditions.” that the law truly becomes operationalized.<sup>64</sup> In essence, the “success of a legal system is not determined by having miraculously enacted good law at the outset but by developing the capacity to continuously find solutions to new problems.”<sup>65</sup>

There is also debate as to whether laws can be successfully transplanted to other jurisdictions, given the specific context in which the laws were first developed. Armour et al. suggested that laws derived from corporate governance standards considered to be international best practice do not work well when transplanted into contexts removed from those of the systems in which they originated.<sup>66</sup> It was suggested that while investor protections relating to independent board members and the mandatory bid rule, which both originated in the common law, “may be wellfitted to a dispersed ownership regime, they may work less well in systems with concentrated ownership.”<sup>67</sup> The view was that “[i]ndependent directors do little to . . . [improve] majority-minority agency costs where they are appointed by the majority shareholder; similarly, the mandatory bid rule can, in this context, make it more difficult for acquirers to purchase a company, by forcing the bidder to share the control premium with minority shareholders.”<sup>68</sup>

#### D. OTHER EXPLANATIONS

The last category of critiques in regards to LLSV’s studies concerns the view that legal origins cannot be the only explanation for investor protection in capital market development. It is possible that norms also play a factor in this equation.<sup>69</sup> Legal rules are rooted in an environment where norms and conventional practices play an important role in the development, implementation, and enforcement of laws.<sup>70</sup> The common law versus civil law argument advanced by some commentators oversimplifies this complex development.<sup>71</sup> Instead, perhaps non-legally enforceable social norms, social cohesion, and signals<sup>72</sup> can show that norms do matter. In fact, they matter the most as a practical substitution for law when law

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<sup>63</sup> *Id.* at 90.

<sup>64</sup> *Id.*

<sup>65</sup> *Id.*

<sup>66</sup> Armour, *supra* note 46, at 40.

<sup>67</sup> *Id.*

<sup>68</sup> *Id.*

<sup>69</sup> Coffee, *supra* note 23.

<sup>70</sup> *Id.*

<sup>71</sup> *Id.* at 11–12.

<sup>72</sup> *Id.* at 24.

is the weakest.<sup>73</sup> For example, signals about a corporation's intentions become extremely important when the law and norms about shareholder rights are weak.<sup>74</sup>

Another interesting perspective in the legal origins debate is through the lens of international transactions. In such transactions, businesspeople have a choice as to where they want to conduct the transaction: under common law or civil law.<sup>75</sup> Voigt's study revealed that in structuring their transactions, businesspeople chose American law less frequently than expected, while choosing French and Swiss law more frequently than expected.<sup>76</sup> This seems contrary to LLSV's contentions because according to them, if common law more effectively protected transactions, it should have been more frequently chosen by businesspeople.<sup>77</sup>

## IV. INVESTOR PROTECTION AND THE CANADIAN CAPITAL MARKETS

### A. CANADA'S BANKING SYSTEM AND THE FINANCIAL CRISIS

Throughout the recent credit and financial crisis, the Canadian banking system has managed to maintain a level of profitability, liquidity, and financial stability not seen in other jurisdictions. The Canadian banking system has recently been regarded by the IMF as a paragon of international best practices.<sup>78</sup> The World Economic Forum also recently ranked it the soundest in the world.<sup>79</sup> While financial institutions around the world have collapsed or survived on government bailouts, Canadian banks have had access to a more modest mortgage purchase program. Moreover, as of early 2009, the banks have no longer needed it.<sup>80</sup> Canadian banks are well capitalized and more conservative than banks in many other jurisdictions of the world.<sup>81</sup>

How and why did Canada fare better than other jurisdictions? This Article offers three related explanations. First, as discussed below, Canada had developed more conservative banking laws

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<sup>73</sup> *Id.* at 29.

<sup>74</sup> *Id.* at 29–30.

<sup>75</sup> Voigt, *supra* note 37.

<sup>76</sup> *Id.* at 16.

<sup>77</sup> *Id.* at 17.

<sup>78</sup> Pietro S. Nivola & John C. Courtney, *Know Thy Neighbor: What Canada Can Tell Us About Financial Regulation*, THE BROOKINGS INSTITUTION, April 23, 2009.

<sup>79</sup> Michael E. Porter & Klaus Schwab, *The Global Competitiveness Report 2008-2009*, WORLD ECON. FORUM, 2008, at 129.

<sup>80</sup> *Id.*

<sup>81</sup> *Id.*

than other jurisdictions, which no doubt played a part in the relative survival of its financial sector. This explanation is consistent with a generalized version of LLSV's thesis that law matters (noting however that LLSV do not explore legal rules in banking when exploring investor protection, instead focusing only on corporate law rules). However, legal rules offer only a partial explanation.

A second and contributing factor is legal structures. The performance of Canadian banks during the economic crisis and recession is due in part to the *manner* in which these banks are regulated as well as the legal rules themselves. The design of the regulatory bodies that oversee banking appears to play a part in Canada's relative survival. This idea is evidenced by the fact that countries such as the United States are attempting to transplant Canadian structures such as the Financial Consumer Agency of Canada into their own regulatory framework for banking.<sup>82</sup> LLSV did not consider the impact of regulatory design and structure on investor protection, whereas I argue in this paper that it is an important component.

A third factor at play is culture and norms. A more conservative culture in the Canadian banking industry certainly had an impact on the amount and type of risk taken on by banks, allowing them to avoid the extent of losses of their competitors in other jurisdictions.

#### 1. HISTORICAL DEVELOPMENT OF CONSERVATISM IN THE CANADIAN BANKING SYSTEM

The historical context of Canada's banking system has played an important role in the development of the current regulatory system, the particular legal rules, and the relatively conservative culture of Canadian bank management. A historical analysis of Canada's banking system reveals a trend of major banking failures that pushed Canada into a conservative approach towards banking, including heavy regulation and strict government oversight. Banking in Canada is centralized at the federal level and there is no provincial equivalent in Canada to the U.S. state chartered banks.<sup>83</sup>

Banking in Canada formally started in Canada when the British government granted a charter that created the Bank of Montreal in 1817, subsequently granting additional charters to other banks. The Constitution Act, 1867 subsequently gave the federal government legislative authority to deal with all issues related to "Banking, Incorporation of Banks, and the Issue of Paper Money".<sup>84</sup> However, Canada continued to have a decentralized banking system until the early 1900's with the provinces being able to issue paper money. It was in these years that Canadians learned the vulnerabilities and dangers of independent, autonomous banks and the need to develop a system of sufficient government oversight and regulation to govern Canada's banking system.

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<sup>82</sup> *House Panel Set to Start Work on Consumer-Finance Agency*, WALL ST. J., September 30, 2009, available at <http://online.wsj.com/article/SB125432239442852629.html>

<sup>83</sup> *Id.*

<sup>84</sup> Constitution Act, 1867, 30 & 31 Vict. Ch. 3 (U.K.), as reprinted in R.S.C., No. 5 (Appendix 1985).

Several large bank failures in the 1920's, including the Merchants Bank of Canada and the Home Bank of Canada, highlighted to the government that some sort of regulatory oversight was required to protect the banks' stakeholders. In both the cases above, practically no warning was provided to stakeholders, depositors and investors that a failure was imminent.<sup>85</sup> Not only did the collapse of major banks create a discussion of the government's role in the operations of chartered banks, but specific provisions were being established in order to prevent further stakeholder destruction and ensure stability of Canadian banks.<sup>86</sup> In 1933, a Royal Commission<sup>87</sup> was established to study the Canadian banking system and determine whether a central banking institution was needed.<sup>88</sup> The Commission recommended in favor of a central bank and offered specific suggestions that were incorporated into the *Bank of Canada Act* ("BOC Act"),<sup>89</sup> and the Bank of Canada was created in 1935 as a private bank.<sup>90</sup> In 1938 the BOC Act was amended and the Bank of Canada became nationalized.<sup>91</sup>

One important aspect of the BOC Act is the deferral of standard setting of key bank requirements to the "Office of the Superintendent" ("OSFI"). OSFI currently plays a role as one of six regulatory oversight bodies<sup>92</sup> that regulate aspects of the banking system and acts as the main banking regulator. OSFI's mandate partially explains the reasons for Canada's sound banking system. It states that OSFI was created to contribute to public confidence in the Canadian financial system by "supervising institutions and pension plans to determine whether they are in sound financial condition . . . and are complying with their governing law and supervisory requirements."<sup>93</sup> OSFI has traditionally and consistently set Canadian bank requirements higher than those set out or recommended by other major economic powers, including Basel II; the most relevant example of this is the capital adequacy guidelines required

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<sup>85</sup> *History*, BANK OF CANADA, 2009, <http://www.bankofcanada.ca/en/about/history.html>.

<sup>86</sup> *Id.*

<sup>87</sup> *Proceedings of the Royal Commission on Banking and Currency, Canada, Ottawa*, ROYAL COMMISSION ON BANKING AND CURRENCY (1933), available at <http://www.scribd.com/doc/9626270/Royal-Commission-on-Banking-and-Currency-1933-CANADA-Proceedings-Vol-1-to-6-Highlights>.

<sup>88</sup> *History*, BANK OF CANADA, *supra* note 89. . See generally James L. Darroch & Charles J. McMillan, *Entry Barriers and Evolutions of Banking Systems: Lessons from the 1980s Canadian Western Bank Failures*, 50 CANADIAN PUB. ADMIN. 141, 141-66 (2007); M.H. OGIIVIE, *BANK AND CUSTOMER LAW IN CANADA* (Irwin Law 2007).

<sup>89</sup> Bank of Canada Act, R.S.C., ch. B 2 (1985).

<sup>90</sup> *Supra* note 76.

<sup>91</sup> *Id.*

<sup>92</sup> The Department of Finance, the Canada Deposit Insurance Corporation, the Bank of Canada, the Financial Consumer Agency, and the Office of the Superintendent of Financial Institution set standards, coordinate the overall regulatory structure, and enforce it with sanctions. The Canada Mortgage and Housing Corporation (CMHC) plays a dominant role in shaping mortgage default-insurance policy.

<sup>93</sup> *Our Mandate*, OFFICE OF SUPERINTENDENT OF FINANCIAL INSTITUTIONS CANADA, Mar. 3, 2007, [http://www.osfi-bsif.gc.ca/osfi/index\\_e.aspx?DetailID=2](http://www.osfi-bsif.gc.ca/osfi/index_e.aspx?DetailID=2).

for Canadian banks.<sup>94</sup>

## 2. LEGAL RULES AND IMPLEMENTATION GOVERNING THE CANADIAN BANKING SYSTEM

An important aspect of banking stability is the ability of banks to manage their capital during economic downturns. One area that OSFI regulations have protected the stability of banks in the face of economic downturn is the Tier 1 capital requirement<sup>95</sup> placed on Canadian banking institutions. OSFI has set out a minimum requirement on Canadian financial institutions to carry a Tier 1 capital ratio of 7% and an overall capital ratio of 10%.<sup>96</sup> As a comparison, the 2004 Basel II Accord, which sets out international recommendations for banking regulations, set minimum requirements of 4% Tier 1 capital ratio and 8% total capital ratio.<sup>97</sup> The United States have a Tier 1 capital requirement of 6% and a total capital requirement of 10% while the United Kingdom followed the Basel II requirements of 4% and 8% respectively.<sup>98</sup> After reflecting on the toxic assets that doomed many of the major institutions in the United States during the crisis and recession, it becomes even clearer why strict and effective capital requirements are so important for financial institutions.

Stricter legal rules in Canada for mortgage loans may have also had an impact. In Canada both OSFI and the CMHC exercise prudential oversight and influence over mortgage underwriting. Mortgage lending in Canada tends to happen in the banking system and relies less on the securitization of loans as is more typical in the United States.<sup>99</sup> Moreover, the United States has a substantially larger sub-prime market at 13% of current outstanding mortgage credit, while Canada has less than 3%.<sup>100</sup>

This is not to overemphasize the role of legal rules. Historically, in both Canada and the United

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<sup>94</sup> Bank Act, 1991 S.C., ch. 46 (Can.).

<sup>95</sup> Tier 1 capital is a measure of an institution's ability to deal with unexpected losses.

<sup>96</sup> *Consultative Paper on the New Basel II Framework*, OFF. OF THE SUPERINTENDENT OF FIN. INSTITUTIONS 40 (2004).

<sup>97</sup> *Guideline – Capital Adequacy Requirements*, OFF. OF THE SUPERINTENDENT OF FIN. INSTITUTIONS, (2007), [http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/guidelines/capital/guidelines/CAR\\_A1\\_e.pdf](http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/guidelines/capital/guidelines/CAR_A1_e.pdf). Capital requirements are crucial in OSFI's "Assets to Capital Multiple" test, which is placed on all financial institutions. OSFI requires that this ratio does not exceed 20, meaning that an institution's total assets can be more than 20 times greater than the sum of its tier 1 and tier 2 capital. Since this type of capital is strictly calculated, it ensures that an institution will always have an adequate degree of permanent capital in relation to its total assets. Therefore, even if a number of assets are written down or written off, the institution will still have an adequate level of "permanent capital" to ensure that it remains financially stable.

<sup>98</sup> *Canada: 2009 Article IV Consultation—Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion*, INTERNATIONAL MONETARY FUND (2009).

<sup>99</sup> Nivola & Courtney, *supra* note 69.

<sup>100</sup> *Impacts of the U.S. Mortgage Crisis*, DESJARDINS ECON. STUD. (2007), [http://www.desjardins.com/en/a\\_propos/etudes\\_economiques/actualites/point\\_vue\\_economique/pve70814.pdf](http://www.desjardins.com/en/a_propos/etudes_economiques/actualites/point_vue_economique/pve70814.pdf).



States, the four separate pillars of the financial system—banking, trust companies, insurers, and securities dealers—have not been allowed to operate within one organization.<sup>101</sup> Both Canada and the United States changed their rules in the 1980s and 1990s allowing banks to acquire investment dealers but with different results.<sup>102</sup> In the 1980s, Canada allowed commercial banks to acquire and own investment dealers. Accordingly, each of the five Canadian banks acquired a major dealer as a subsidiary that then became subject to the regulatory framework governing commercial banks in Canada. Independent dealers still remain in Canada but the major players have been absorbed by the commercial banks. By contrast, when the four pillars were dismantled in the United States, some of the largest investment dealers stayed independent—Lehman Brothers and Bear Stearns to name two—and continued to be subject only to oversight by the SEC, not by the U.S. Federal Reserve as a commercial bank. As a result of the bailouts, Morgan Stanley and Goldman Sachs agreed to become chartered as bank holding companies, and are therefore under tighter supervision by the U.S. Federal Reserve.<sup>103</sup> Thus, despite the same legal rules permitting similar industry structures, the nature of the of the Canadian commercial and investment banking industry had a different risk profile than that in the United States.

### 3. CULTURE OF OPERATIONAL CAUTION IN THE CANADIAN BANKING SYSTEM

A more conservative culture is also a contributing factor. While Canadian laws are more conservative than international standards, Canadian banks tend to be even more conservative than the OSFI regulations. While OSFI set out a minimum Tier 1 capital requirement of 7%, Canadian banks have been at 9.8%, several percentage points above the regulatory requirement.<sup>104</sup> This is in contrast to the average capital ratio for United States investment banks which was at 4% and for European commercial banks which was at 3.3%.<sup>105</sup>

On the one hand, the analysis of Canadian banks and the financial crisis appears to support LLSV. Canada's more conservative Tier 1 capital requirements and asset to capital multiple, in comparison to international standards (and its U.S. neighbor), has played an important part in Canada's banks avoiding the extent of the financial crisis in the United States.

On the other hand, this brief discussion also highlights that context, norms, and culture also play a critical role. Even though the laws set certain caps or ratios on the banks' capital, most Canadian banks maintained a less risky capital ratio than required by the law, reasonably

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<sup>101</sup> *The Canadian Financial Services Sector*, DEP'T OF FIN. CANADA (2005), <http://www.fin.gc.ca/toc/2005/fact-cfss-eng.asp>.

<sup>102</sup> *Id.*

<sup>103</sup> Jon Hilsenrath, Damian Paletta & Aaron Lucchetti, *Goldman, Morgan Scrap Wall Street Model, Become Banks in Bid to Ride Out Crisis*, WALL ST. J., September 22, 2008, available at <http://online.wsj.com/article/SB122202739111460721.html>.

<sup>104</sup> Erik Heinrich, *Why Canada's Banks Don't Need Help*, TIME, Nov. 10, 2008, available at <http://www.time.com/time/business/article/0,8599,1855317,00.html>.

<sup>105</sup> *Id.*

reflecting a more conservative nature as a product of the development of its banking system. This is not to say that all Canadian banks were or are equally conservative or that they will necessarily remain so. As some of Canada's larger banks expand internationally, some have been more exposed to the United States credit crisis, resulting in large write offs of bad mortgages or lending to high risk entities that have failed.<sup>106</sup> In gaining exposure to foreign markets where the culture is not so conservative, one can only question to what degree their conservative nature will transplant to these new environments and vice versa.

## B. WHY DOES CANADA NOT YET HAVE A NATIONAL SECURITIES REGULATOR?

While the rest of the world is discussing the merits of a common or integrated financial regulator in the wake of the financial crisis<sup>107</sup>, Canada continues with its long standing debate over a single Canadian securities regulator. Canada has thirteen provincial and territorial securities regulators, each with its own securities act, fees, and processes. Historically, public companies that wished to raise money across Canada had to file with each securities regulator and pay the associated fees; similarly, intermediaries carrying on business across Canada had to register with multiple commissions across the country.<sup>108</sup>

The debate over a common securities regulator has persisted over 40 years with little success in achieving agreement on its creation.<sup>109</sup> A common sentiment throughout all attempts at

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<sup>106</sup> Duncan Mavin, *CIBC's Writedown Woes Not Over, Say Analysts*, FIN. POST, June 23, 2008, available at <http://www.financialpost.com/story.html?id=608460>.

<sup>107</sup> See generally John C. Coffee & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. 707, 2009).

<sup>108</sup> There have been significant strides made to harmonize securities regulation across Canada. Since the 1990s there has been harmonization of rules through the Canadian Securities Administrators and the creation of National Instruments which sets out common regulations. In addition, there is now a passport system to streamline administrative processing of prospectuses and applications and in 2009 a national registration system was created.

<sup>109</sup> The calls for a national securities regulator began in earnest in 1964 when the Royal Commission on Banking and Finance recommended that the federal government establish a single federal agency which would take over the major responsibility for securities regulation from the provinces. Although this initiative failed, it did result in more interprovincial cooperation. In 1979, the federal government published *Proposals for a Securities Market Law for Canada*, which also proposed a single securities commission for Canada to regulate international and interprovincial issues of and trading in securities. Between 1994 and 1996, the federal government made several attempts to get provincial agreement on a proposal to create a Canadian Securities Commission. While there were periodic negotiations and an agreement was drafted, the federal government dropped the initiative due to opposition in Québec and the western provinces. In December 2003, the federally commissioned Wise Persons' Committee once again proposed a single national regulator and attempted to address local interests, but nothing came of it. In June 2006, the Ontario-appointed Crawford Panel released a *Blueprint for a Canadian Securities Commission* where the call was once again for a model for a "common securities regulator" for Canada, operating under common legislation. The most recent attempt at building support for a national securities regulator was the January 2009 report by the Expert Panel on Securities Regulation. The Expert Panel again recommended a Canadian Securities Commission and even presented a draft securities act.

reforming Canada's securities regulatory system has been that the current system, as presently operated, is inadequate to meet the challenges of today and tomorrow. While the system is not broken in the sense of regulatory oversight, it must be improved significantly in order for Canada to remain competitive in attracting capital.<sup>110</sup> The international community has also waded into the debate. The IMF has repeatedly indicated that Canada needs a single securities regulator.<sup>111</sup> A Canadian securities regulator is currently one of the issues on the table for the proposed Canada-EU trade deal.<sup>112</sup>

In this part of the paper, I argue that securities regulatory structure matters for investor protection. LLSV, however, do not take into account regulatory structure (or securities law rules for that matter). Rather, they focus on legal rules and specifically, only corporate law rules. While corporate law is not unimportant, it is based on a system of self-regulation, where market actors must pursue litigation in the courts themselves. While corporate law remains an important framework of protection of investors in private companies, securities laws are a primary source of investor protections for public companies in Canada and in many other jurisdictions.<sup>113</sup> Similarly, while courts are important (a factor that LLSV take into account), securities regulators' actions are arguably even more important in certain instances in ensuring investor protection.<sup>114</sup>

I also argue in this part of the paper that context is critical in the debate on a national securities regulator and that political, economic, and historic circumstances constrain the choices and decisions that are possible. Most reasonable people would agree that if Canada were starting from scratch in designing a regulator for securities matters, it would create a single regulator for the entire country; however, the provinces having occupied this space for so long and Quebec having a special place in Canada result in a tremendous obstacle to the possibility of a federal or single structure. A related point is that in the absence of a change in formal legal structures in Canada, there have been reasonable attempts at functional changes, by way of harmonizing laws and streamlining processes to create, for example, the Passport system.<sup>115</sup>

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<sup>110</sup> Five Year Review Committee, *Five Year Review Committee Final Report: Reviewing the Securities Act (Ontario)*, at 7 (2003), available at <http://www.fin.gov.on.ca/en/publications/2003/5yrsecuritiesreview.pdf> (recommending that "the provinces, territories and federal government work towards the creation of a single securities regulator with responsibility for the capital markets across Canada").

<sup>111</sup> *Canada Needs National Securities Regulator: IMF*, CBC NEWS, Jun. 19, 2007, <http://www.cbc.ca/money/story/2007/06/19/imf.html>.

<sup>112</sup> Lee Berthiaume, *Canada-EU Trade Deal Could Require National Securities Regulator*, EMBASSY MAG., Jan. 21, 2009, available at <http://www.embassymag.ca/page/view/eu-1-21-2009>.

<sup>113</sup> See JEFFERY MACINTOSH & CHRISTOPHER NICHOLLS, *ESSENTIALS OF SECURITIES REGULATION* (2002); Anita Anand, *Securities Regulation at an Impasse: Developing Effective Regulation in an Ineffective Regulatory Regime*, 20 BANKING & FIN. L. REV. 191, 216 (2005).

<sup>114</sup> POONAM PURI, *ENFORCEMENT EFFECTIVENESS IN THE CANADIAN CAPITAL MARKETS* (Dec. 2005) (commissioned by the Capital Markets Institute).

<sup>115</sup> The Passport System was designed to simplify the regulatory approval process by allowing market participants to deal with a regulator in a centralized way and have the regulator's decisions recognized across all Canadian

One of the principle debates over a common securities regulator relates to the question of whose jurisdiction does securities regulation fall within: the federal government or the provinces? In Canada, the supervision of the securities industry was not explicitly given to either the provincial or federal levels of government within the *Constitution Act, 1867*. Over the years, as the capital markets have grown, the provinces and territories have begun to regulate securities under the “property and civil rights” clause of the *Constitution Act, 1867*,<sup>116</sup> which has resulted in each province and territory having its own securities regulator.<sup>117</sup> While there have been expert opinions<sup>118</sup> indicating that the federal government could assert jurisdiction over capital markets, possibly pursuant to its power to legislate in respect of the “regulation of trade,”<sup>119</sup> the federal government has always been reluctant to use this jurisdiction. To date, the jurisdiction of the federal government to override provincial securities law has never been tested in a court.<sup>120</sup>

While the current system of multiple regulators has strengths, including a local presence, development of industry expertise, responsiveness to distinct local and regional issues and innovation, there are a number of weaknesses.<sup>121</sup> The weaknesses include enforcement, or lack thereof, inefficient allocation of resources, coordination difficulties, and inconsistent priorities within investor protection, and policy development. There are also costs associated with 13 securities regulators, including duplication of costs, cost of compliance, time delays, opportunity costs, and the perception in the international community of a fragmented regulatory system.<sup>122</sup>

Enforcement of securities law is considered weak as compared to other jurisdictions, somewhat as a result of the fragmented system of securities regulation.<sup>123</sup> In the Task Force to Modernize

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jurisdictions. The Passport System replaces the principal regulator and mutual reliance review system for prospectuses and for certain exemptive relief applications. See Ward Sellers & Daniel Yelin, *Canadian Securities Regulators Implement Next Phase of Passport System*, available at [http://www.osler.com/expertise\\_mergers.aspx?id=14604](http://www.osler.com/expertise_mergers.aspx?id=14604). The national registration system, which creates a new Canada-wide registration regime, came into effect on September 28, 2009.

<sup>116</sup> Constitution Act, 1867 § 92(13) (Can).

<sup>117</sup> Andrew Kitching, *Securities Regulation: Calls for a Single Regulator*, at 2 (Feb. 16, 2009) (on file with the Library of Parliament), available at <http://www.parl.gc.ca/information/library/PRBpubs/prb0838-e.htm#jurisdiction>.

<sup>118</sup> The Wise Persons’ Committee commissioned three opinions as to the constitutional issues related to a national securities regulator, available at [http://www.wise-averties.ca/report\\_en.html](http://www.wise-averties.ca/report_en.html).

<sup>119</sup> *Constitution Act, 1867*, § 91(2) (Can).

<sup>120</sup> Kitching, *supra* note 105, at 2 n.4.

<sup>121</sup> Wise Persons Committee to Review the Structure of Securities Regulation in Canada, *It’s Time*, at 25 (2003), available at [http://www.wise-averties.ca/main\\_en.html](http://www.wise-averties.ca/main_en.html).

<sup>122</sup> *Id.*

<sup>123</sup> Poonam Puri, *Will Canada Step Up?: Improving Enforcement in the Canadian Capital Markets*, CAN. INVESTMENT REV., Spring 2007, at 53; See also Mary G. Cordon, *Rethinking Enforcement and Litigation in Ontario Securities Regulation*, 32 QUEENS L.J.1, (pincite); Halpren and Puri, *supra* note 3, at (pincite); John C. Coffee, *Law and the*

Securities Regulation, Bhattacharya found that the enforcement of securities laws reduces the cost of capital, which in turn increases liquidity in the capital markets and, as measured against the United States, enforcement of securities laws is weak in Canada.<sup>124</sup>

The inefficient allocation or lack of resources is another criticism of the current structure, as each province and territory has a securities commission with similar mandates.<sup>125</sup> However, with the exception of Ontario, jurisdictions do not typically have sufficient resources to perform all the tasks of oversight, policy development, and enforcement.<sup>126</sup> This leads to coordination difficulties between provinces and territories in terms of timing and priorities. Priorities among provincial or territorial securities commissions may differ, often on political grounds, in terms of investor protections and policy development.

Issuers and intermediaries also criticize the costs associated with complying with the requirements of thirteen securities regulators. While public companies pay fees to each jurisdiction, fees are in some cases paid to the provincial government, not directly to the securities commission for their use. The costs of complying with thirteen different securities acts or legislation, while significantly harmonized, are nonetheless imposed on public companies.

On the international front, Canada is not represented at the International Organization of Securities Commissions, but rather two of Canada's largest provinces, Ontario and Quebec, sit as members.<sup>127</sup> The inability for Canada to have a single, consistent voice on the international stage has the potential to create problems in terms of implementing effective change to Canada's capital markets.

Despite the numerous studies, commissions, and panels that have been organized, the lack of political will of the federal government to move to a national regulator exists for several reasons. First, while not necessarily efficient or cost effective, the thirteen provincial and territorial securities commissions have taken a number of steps to harmonize their regulations and streamline their processes, which some will argue gets Canada functionally to the same point without a constitutional challenge.<sup>128</sup> Secondly, similar to other issues that have a constitutional jurisdictional element to them, the proposals for a national securities regulator

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*Market: The Impact of Enforcement*, (2007), available at [http://papers.ssrn.com/sol3/cf\\_dev/AbsByAuth.cfm?per\\_id=80028#show\\_967482](http://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=80028#show_967482).

<sup>124</sup> Utpal Bhattacharya, *Enforcement and its Impact on Cost of Equity and liquidity of the Market*, 4 Canada Steps Up (Task Force to Modernize Securities Legislation in Canada, May 24, 2006).

<sup>125</sup> See generally The Task Force to Modernize Securities Legislation in Canada, available at <http://www.tfmsl.ca>.

<sup>126</sup> See Puri, *supra* note 102

<sup>127</sup> International Organization of Securities Commissions, available at [http://www.iosco.org/lists/display\\_members.cfm](http://www.iosco.org/lists/display_members.cfm).

<sup>128</sup> Council Of Ministers Communiqué, Council of Ministers Continues to Implement Passport System (Oct. 22, 2008), available at [http://www.securitiescanada.org/2008\\_1022\\_communique\\_english.pdf](http://www.securitiescanada.org/2008_1022_communique_english.pdf).

have not historically garnered much support from the provinces, with the exception of Ontario.<sup>129</sup> Quebec and Alberta have constantly expressed their disagreement with this strategy and have recently indicated that they will bring a court challenge to prevent a national securities regulator.<sup>130</sup> While British Columbia has previously been opposed to a national regulator, its position has recently shifted.<sup>131</sup> Third, the political will to create a national securities regulator has historically not been strong. The recent financial crisis and a number of high profile fraud cases are some of the major events that have spurred the federal government to move forward with a solid proposal for a national securities regulator.

The Federal government recently announced a Transition Team and gave it a budget of \$150 million to negotiate with the provinces to establish a common securities regulator, based on the report and recommendations of the Expert Panel on Securities Regulation.<sup>132</sup> Needless to say, political, economic and cultural influences have played a role in the development of securities structure, and functional forms will have an impact on the negotiations and the model that is ultimately adopted. The Transition Team is currently working on draft legislation and expects that a national securities regulator will be running by 2012.<sup>133</sup>

The case of Canada highlights why regulatory structure matters when it comes to investor protection—corporate law cannot be considered in isolation without considering securities law. In addition, context plays an important role when considering the impact of the regulatory structure on investor protection as the historical, political and economic circumstances all play a part in whether an effective investor protection regime has been created.

### C. QUEBEC - A CIVIL LAW PROVINCE WITHIN A COMMON LAW COUNTRY

Canada is somewhat unique in that both common law and civil law operate within the same country. The federal government and the provinces, other than Quebec, follow the common law. Mixed legal systems are also found in Louisiana, Scotland, St. Lucia, Puerto Rico, South

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<sup>129</sup> *Canada doesn't need national securities regulator: Stelmach*, CBC NEWS, Jan. 14, 2009, <http://www.cbc.ca/canada/edmonton/story/2009/01/14/edm-stelmach-regulator.html>.

<sup>130</sup> Chantal Hébert, *Tories See Opportunity in Regulator Feud*, TORONTO STAR, Jan. 14, 2009, available at <http://www.thestar.com/News/Canada/article/570624>; see also Francois Shalom, *Quebec to Contest Single Regulator Plan*, MONTREAL GAZETTE, July 9, 2009, at B1.

<sup>131</sup> At the time of writing (November 2009), the Government of Canada had announced that it intends to seek the opinion of the Supreme Court of Canada on constitutionality of proposed Canadian securities legislation. Press release available at [http://www.justice.gc.ca/eng/news-nouv/nr-cp/2009/doc\\_32437.html](http://www.justice.gc.ca/eng/news-nouv/nr-cp/2009/doc_32437.html)

<sup>132</sup> The Canadian Securities Transition Office was established in July 2009 to assist in establishing a Canadian securities regulator. See generally, available at <http://www.csto.ca>.

<sup>133</sup> Vancouver Sun, *Canada Aims for National Securities Regulator by 2012*, September 25, 2009, available at <http://www.canada.com/vancouversun/news/business/story.html?id=c2314556-2883-4d98-b4bf-2af8032273d0&k=81939>.

Africa, Zimbabwe, Botswana, Lesotho, Swaziland, Namibia, the Philippines, and Sri Lanka.<sup>134</sup> Civil law, which is based on a written “civil code,” covers only matters of private law including: the legal attributes of a person, the relationship between individuals, property, and the legal institutions governing or administering these relationships. Civil codes are intended to be easy to understand and apply to facts through the specific nature of each regulation. It does not rely on precedent (or principles) to the same extent as common law.<sup>135</sup>

LLSV suggest that civil law jurisdictions provide investors weaker legal protection than common law jurisdictions.<sup>136</sup> LLSV also suggest that common law countries give shareholders and creditors the strongest protection while French civil law countries provide the weakest protection.<sup>137</sup> But they did not address the situation where a country has both common law and civil law systems. The LLSV 1998 study categorized Canada as a common law country, with the result that Canada was considered average for shareholder protection<sup>138</sup> among common law countries, low for creditor protection,<sup>139</sup> and high for enforcement of the laws.<sup>140</sup> This part of the paper compares shareholder remedies and rights in the Quebec provincial corporate law statute with the federal business corporations act and finds that several important statutory remedies that are found in the federal corporate law statute are absent—by historical choice—from the Quebec statute. Nonetheless, Quebec courts have developed judicial versions of the derivative action and oppression action.

In Canada, the *Constitution Act, 1867*, gives the federal and provincial governments similar legislative authority over business incorporation. Each government, federal and provincial/territorial, has its own incorporation statutes. During the 1970’s, the corporate legislative framework in Canada underwent significant reform inspired by the recommendations published in the Dickerson Report.<sup>141</sup> The purposes of this reform were threefold. First, it attempted to offer a more pragmatic approach in regard to the mechanics, operations and incorporation of companies. Second, it introduced a contractual approach with

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<sup>134</sup> William Tetley, *Mixed Jurisdictions: Common Law vs. Civil Law (Codified and Uncodified) (Part I)*, 4 UNIF. L. REV. 591, 592–93 (1999); William Tetley, *Mixed Jurisdictions: Common Law vs. Civil Law (Codified and Uncodified) (Part II)*, 4 UNIF. L. REV. 877 (1999).

<sup>135</sup> See, JOHN E.C. BRIERLEY & RODERICK A. MACDONALD, QUÉBEC CIVIL LAW: AN INTRODUCTION TO QUÉBEC PRIVATE LAW (PINCITE NEEDED) (1993); Canadian Bar Association - Ontario, et al., *The New Civil Code: A Practical Guide to What Every Ontario Lawyer Needs to Know about Québec Law* (Ottawa: CBAO, 1994); Pearl Eliadis, *The Legal System in Quebec*, in GERALD GALL, THE CANADIAN LEGAL SYSTEM, 263–84 (5th ed. 2004).

<sup>136</sup> Rafael La Porta et al., *Law & Finance*, *supra* note 18, at 1116.

<sup>137</sup> *Id.*

<sup>138</sup> *Id.* at 1130.

<sup>139</sup> *Id.* at 1136.

<sup>140</sup> *Id.* at 1142.

<sup>141</sup> Margaret Smith, *Canada Business Corporations Act: Directors’ Residency Requirements and Other Residency Issues*, at 2, available at <http://www.parl.gc.ca/information/library/PRBpubs/prb9931-e.pdf>.

respect to how relations between internal actors of the corporation were to be governed. Finally, it offered a protective dimension to the interests and rights of shareholders.

These aspects of the reform initiative were adopted in the *Canada Business Corporations Act*<sup>142</sup> (“CBCA”) that was enacted in 1975. Following the federal initiative, provinces responded by either enacting amendments to their respective corporate legislation or by opting to proceed with a reform inspired by the federal model. Quebec opted for the former by integrating Part IA to the *Quebec Companies Act* (“QCA”).<sup>143</sup> However, the Quebec legislature did not strictly follow the Dickerson recommendations but rather chose to refrain from adopting a shareholder protection regime similar to the one found under the federal regulation. As a result, the QCA contains certain provisions designed to protect shareholders but falls short of offering similar remedies found in its federal counterpart, the CBCA. Consequently, litigants in Quebec have to refer to judicially created recourses found under the *Civil Code of Quebec*<sup>144</sup> (“CCQ”) and the *Code of Civil Procedure*<sup>145</sup> (“CCPC”) in order to fill the gap. However, the judicially created recourses lack the flexibility and clarity usually associated with those found under the CBCA.

In considering investor protection within Canada, it is necessary to consider the distinctions between the CBCA and the QCA statutes. Specific areas of corporate law that are of interest when comparing the QCA and the CBCA are shareholder protection and remedies.

While the QCA has specific preventive measures relating to shareholder protection, it contains no explicit provision giving rise to a derivative action, an oppression remedy, or a recourse seeking a restraining and compliance order. In addition, the QCA does not offer the possibility for shareholders to exercise their right to dissent in the event a significant change similar to the ones listed in section 190(1) CBCA occurs. Nonetheless, the Quebec law still provides certain powers of control and supervision to the courts in order to attempt to remedy this gap.

Unlike the specific statutory provisions of the CBCA, the Quebec Superior Court has established the conditions under which a shareholder may bring an action in the name of the corporation.

<sup>146</sup> In doing so, the Quebec court has stressed the importance of limiting its superintending role to situations where there is manifest fraudulent conduct committed by the concerned

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<sup>142</sup> See generally *Canada Business Corporations Act*, R.S.C., 1985, c. C-44.

<sup>143</sup> *Companies Act*, R.S.Q., c. C-38.

<sup>144</sup> *Civil Code of Quebec*, S.Q., 1991, c. 64.

<sup>145</sup> *Code of Civil Procedure*, R.S.Q., c. C-25.

<sup>146</sup> *Lagacé v. Lagacé*, [1966] C.S. 489. The four conditions are : (1) the one bringing the action in the name of the corporation must be a shareholder; (2) the individual(s) at the source of the problem must have an absolute control of the corporation in the sense they must control the board of directors as well as shareholder votes (holding a majority of votes); (3) the shareholder bringing the claim must have requested an explanation and rectification of the situation without receiving any positive response prior to engaging and proceeding with the claim; and (4) the reproachable act committed by the individual(s) at the source of the problem must be of fraudulent nature towards the corporation or towards the shareholders. The fourth criterion is very important and illustrates that simple negligence by directors would not trigger the application of a derivative action.



individual(s). In other words, it may be more difficult to proceed with such a claim under the civil law regime since the standing to begin a derivative action is limited to shareholders and there must be a fraudulent element for it to proceed. Under the CBCA, a derivative action does not require the presence of a fraudulent element. Rather, the action must be taken in the best interests of the corporation. Further, the standing isn't limited to shareholders under the CBCA.

Under federal legislation, the oppression remedy is regarded as being a very powerful tool in providing shareholder protection. To this day, the Quebec legislature has not followed suit with its federal counterpart and as a result, litigants are left with section 33 CCPC as a means of trying to bring such an action in Quebec courts. Over the last couple of years, the Quebec Superior Court has been more receptive to the idea of extending its superintending and governing power to offer an action similar to the oppression remedy used in common law provinces. Even though the court's power has only been used in relation to cases dealing with fraud, some judges have been openly considering the idea of broadening the scope of its superintending and governing power to cases involving abuses of rights or violation of the legitimate expectations of shareholders, in a manner similar to the federal oppression remedy.

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In Canada, there are multiple corporate law statutes, with each province and the federal government having their own statutes. However, all statutes are subject to the interpretation by the courts, ultimately the Supreme Court of Canada. The Supreme Court is a general court of appeal and the final authority on the interpretation of the entire body of law in Canada.<sup>148</sup> The Supreme Court's decisions help to unify the laws within Canada for two reasons. First, they have the power to interpret both common law and civil law legislation, and second, lower courts in all provinces must follow the Supreme Court's decisions, to the extent the facts apply.

This discussion reveals that while Quebec operates a corporate law framework within its civil law system that on its surface provides legal rules that do not offer as much protection as the federal corporate law statute (or other provincial law statutes), the Quebec courts have stepped in to judicially craft remedies for shareholders. That being said, these QCA remedies are currently more difficult to access or achieve recourse under than those in the federal statutory regime. However, Quebec has recently proposed changes<sup>149</sup> to the Quebec Companies Act to incorporate many of the practices that exist elsewhere in Canada, including better protection for shareholders, and new governance rules.<sup>150</sup> Some of the proposed changes relate to protections of minority shareholders including new remedies in the event of abuse or inequity.

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<sup>147</sup> *Desautels v. Desautels*, ([2005] C.S. Que. Montreal 500-11-026015-053) (noting the possibility of the court appropriating powers similar to those found in the case of an "oppression remedy" should the case be deserving).

<sup>148</sup> PETER W. HOGG, *CONSTITUTIONAL LAW OF CANADA* 246–49 (5th Ed. 2007).

<sup>149</sup> At the time of writing the Quebec legislature proposed amendments to the Quebec Companies Act to align the legislation with other provinces and to improve on certain aspects as compared to other jurisdictions. See Reform of the Québec Companies Act: Bill 63, Oct. 9, 2009, available at [http://www.dwpv.com/en/17620\\_24316.aspx](http://www.dwpv.com/en/17620_24316.aspx).

<sup>150</sup> Press Release, Ministère des Finances Québec, Major Reform of the Companies Act (Oct. 7, 2009) [http://www.finances.gouv.qc.ca/documents/communiqués/en/COMEN\\_20091007.pdf](http://www.finances.gouv.qc.ca/documents/communiqués/en/COMEN_20091007.pdf)

Shareholders will have the possibility of tabling a shareholder proposal at company meetings and a minority shareholder who disagrees with a major change made to the structure or the activities of the corporation may be able to demand that his shares be repurchased.<sup>151</sup> In addition, shareholders will have the right to ask the Court for the authorization to act in the name of the corporation, or derivative actions.<sup>152</sup> Nonetheless, this does indicate the reflexive relationship between a civil law province and the common law operating on a national level.

#### V. CONCLUSION

Perhaps one of the most important results of the LLSV study was to facilitate discussion of how law impacts the growth of capital markets. As the three case studies in Canada illustrate, the context of how laws develop is a strong indicator of how and why laws within the capital markets have developed the way they have. It is not as simple as delineating between common law and civil law jurisdictions. Rather the political, economic, and historical backgrounds are some of the important contributors to the development of laws and legal structures.

In this paper I explored the situation of Canada during the recent financial crisis, the efforts to create a national securities regulator, and the role of Quebec, a civil law jurisdiction, within federation of common law jurisdictions. In exploring these issues it was clear that the *development* of various investor protection laws and structures over time in Canada (as opposed to a point in time as in the LLSV studies), and also by providing context which helps to explain why certain rules and structures have been adapted while others, although economically efficient, may have been rejected. This exploration of Canada highlights that context matters when looking at the laws related to investor protection within a country. Not all investor protection mechanisms are located in the corporate statutes, as LLSV assumes. LLSV do not explore securities law rules, securities law structures, or banking laws. In Canada, as in many other jurisdictions, securities laws and securities structure have an impact on investor protection and the debate on a common securities regulator has focused on improving investor protection and improving enforcement. Furthermore, banking laws and the banking framework plays an important role in investor protection. In Canada, investor protection is reflected in the conservative nature of our banking system which allowed Canadian financial institutions to escape relatively unscathed from the recent financial crisis. Finally, the Canadian system is both structured and has evolved in such a way that investor protections are fairly consistent between the common law and civil law provinces, even when the civil law statute does not necessarily mimic the common law statute. This is because of various unifying bodies such as the Canadian Securities Administrators for provincial securities laws and the unifying role of the Supreme Court of Canada for corporate law principles across the country.

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<sup>151</sup> *Id.*

<sup>152</sup> Reform of the Québec Companies Act: Bill 63, *supra* note 151.