

The global financial meltdown has led to a renewed focus on the purposes of securities regulation and on the expansion of these purposes to include considerations of systemic risk; yet the case for such an expansion has been assumed more than argued. This article derives an argument for expansion from developments in the financial markets. Traditionally, mitigating systemic risk has fallen within the realm of financial institution (i.e., prudential) regulation rather than securities law. However, developments in financial markets, including the bundling and sale of securitized products by a variety of complex institutions, are blurring the line between prudential regulation and securities law. This evolution makes systemic risk increasingly relevant to securities regulation. Consequently, the article argues, the securities regulatory regime should expand to encompass mitigating systemic risk.

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Canadian response

I Introduction

The global financial meltdown has led to a renewed focus on the purposes of securities regulation and on the expansion of these purposes to include considerations relating to systemic risk. The International Organization of Securities Commissions (IOSCO), whose membership regulates over 90 per cent of the world's securities markets, has included systemic risk among the three objectives of securities regulation since 1998.¹ More recently, the G-20 in proposing the creation of the

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1 The Financial Stability Board was created in April 2009 as an initiative of the G-20 heads of state, with a mandate to promote global financial stability. Regarding its views on systemic risk, see *Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations* (Background Paper prepared by Staff of the International Monetary Fund and the Bank for International Settlements, and the Secretariat of the Financial Stability Board) (October 2009);

Financial Stability Board, for example, also tied systemic risk to the mandate of securities regulators. Thus, it is curious that only a handful of countries has integrated the concept of 'systemic risk' into their securities laws.² This fact suggests that the merits of incorporating systemic risk are not self-evident but rather are in need of argument. The present article offers such an argument, stemming from developments in financial markets, including the bundling and sale of securitized products by a variety of complex institutions, which blurs the line between the regulation of financial institutions (prudential regulation), the area of law traditionally responsible for mitigating systemic risk, and securities regulation.

For present purposes, 'systemic risk' is defined as involving the risk of break down among institutions and other market participants in a chain-like fashion that has the potential to affect the entire financial system negatively.³ Defining 'systemic risk,' in fact, is not straightforward. The Bank for International Settlements defines the term as 'the risk that the failure of a participant to meet its contractual obligations [specifically, counterparty risk in the case of credit default swaps used primarily in synthetic collateralized debt obligations] may in turn cause other participants to default with a chain reaction leading to broader financial difficulties.'⁴ The term may also refer to the potential for substantial volatility in asset prices, corporate liquidity, bankruptcies, and efficiency losses brought on by economic shocks.⁵ The risk of a 'domino effect' certainly seems central to the concept of systemic

see Eilis Ferran & Kern Alexander, *Can Soft Law Institutions Be Effective? The Case of the European Systemic Risk Board* (European Central Bank Legal Working Paper Series) (forthcoming). Regarding IOSCO, see IOSCO News Release, 'Objectives and Principles of Securities Regulation' (18 September 1998) [IOSCO Principles]. The three objectives, *ibid.*, are as follows: 'the protection of investors; ensuring that markets are fair, efficient and transparent; and the reduction of systemic risk'; see also 'Global Market Watchdogs to Focus on Systemic Risk' *Reuters* (10 October 2009), online: Sify <<http://sify.com/finance/global-market-watchdogs-to-focus-on-systemic-risk-news-international-jkkiXghjfd.html>>.

- 2 A review of the securities laws of IOSCO member countries reveals that of 109 countries, the securities laws of 11 countries contained the words 'systemic risk(s),' with only one country (South Africa) actually defining the meaning of that term.
- 3 See Claudio Borio, 'Towards a Macropprudential Framework for Financial Supervision and Regulation' (2003) 49 CESifo Econ. Stud. 181 at 186 [Borio].
- 4 Bank for International Settlements, *64th Annual Report* (Basel, Switzerland: BIS, 1994) at 177.
- 5 See also Steven L. Schwarcz, 'Systemic Risk' (2008) 97 Geo. L.J. 193 at 197 [Schwarcz] citing Paul Kupiec & David Nickerson, 'Assessing Systemic Risk Exposure from Banks and GSEs under Alternative Approaches to Capital Regulation' (2004) 48 J. Real Estate Fin. Econ. 123 at 123.

risk,⁶ as does the risk of some triggering event that causes the first domino to fall.⁷

On a formal level, monitoring systemic risk has traditionally been the responsibility of financial sector regulators.⁸ Securities regulation, in comparison, has been concerned with ensuring that investors are protected, that markets function efficiently, and that the investing public has confidence in the market.⁹ While systemic risk bears some relation

6 US Commodity Futures Trading Commission, *CTFC Glossary*, online: CFTC <http://www.cftc.gov/opa/glossary/opaglossary_s.htm> cited in Schwarcz, *ibid.* at 197.

7 See Borio, *supra* note 3; see also Schwarcz, *supra* note 5, who states that, in defining the risk, it is not clear whether the trigger event must occur or whether it merely has the potential to occur. See also Bank for International Settlements/Central Banks of the Group of Ten Working Group, *Recent Developments in International Interbank Relations* (Basel, Switzerland: BIS, 1992) at 61, which defines systemic risk as 'the risk that a disruption (at a firm, in a market segment, to a settlement system, etc.) causes widespread difficulties at other firms, in other market segments or in the financial system as a whole.' From October 2008 to March 2009, mistrust among counterparties and uncertainty in credit quality in the inter-bank lending market was evident, as the spread above LIBOR exploded and commercial paper and short-term lending markets seized up. The prevalence of collateral calls forced asset sales at almost any price.

8 In Canada, authority for regulating systemic risk has rested with four institutions: the Office of the Superintendent of Financial Institutions (OSFI), the Bank of Canada, the federal Department of Finance, and the Canadian Deposit Insurance Corporation (CDIC): see *Office of the Superintendent of Financial Institutions Act*, R.S.C. 1985 (3rd Supp.), c. 18, s. 4(d) [*Office of the Superintendent of Financial Institutions Act*]. The Bank of Canada has a particular role to play in the reduction of systemic risk. In its preamble, the *Bank of Canada Act*, R.S.C. 1985, c. B-2 provides the bank with the mandate 'generally [to] promote the economic and financial welfare of Canada.' The bank regulates credit and currency in the best interests of the economic life of the nation and controls national monetary policy, in addition to its role in regulating systemic risk. The CDIC insures savings in case a customer's bank or other financial institution fails or goes bankrupt. Thus, in providing insurance, the CDIC is a central facet of the stability of financial institutions. If deposit insurance did not exist or did not function effectively, uncertainty could increase, reducing confidence and making the system more vulnerable to economic shocks.

9 Section 1.1 of the *Securities Act (Ontario)* states the purposes of the legislation as follows: 'to provide protection to investors from unfair, improper or fraudulent practices; and ... to foster fair and efficient capital markets and confidence in capital markets'; *Securities Act*, R.S.O. 1990, c. S.5 [*Securities Act (Ontario)*]. Initially, securities law focused only on one of these objectives: investor protection. See Province of Ontario, *Report of the Attorney General's Committee on Securities Legislation in Ontario* (Toronto: Queen's Printer, 1965) 6 at para. 1.07 [Kimber Report]. In terms of efficiency, it is likely that the use of the term in securities legislation is based on the concept of allocational efficiency (*i.e.*, the effectiveness with which a market channels capital to its highest, most productive uses); see Anita I. Anand, *Balancing the Objectives of Securities Regulation* (Background Study for the Task Force to Modernize Securities Legislation) (2006), online: <<http://taxprof.typepad.com/files/anand.pdf>>.

to these objectives, market confidence in particular, this link has not generally been drawn in discussions regarding the rationales for securities regulation.

The link may be drawn as follows: securities legislation developed as a response to the fact that companies issuing securities via the public markets did so without adequate disclosure. Legislation, therefore, mandated that firms completing a public offering had to issue a prospectus. Because the transaction costs of issuing a prospectus are onerous, another set of rules developed that allowed firms to issue securities via the 'exempt' or private market without a prospectus, as long as either the firm or prospective investors met certain criteria. However, information asymmetries between issuers and investors in both public and private markets gave rise to systemic risk and now compel us to reconsider the objectives of securities regulation.

This article contributes to such a reconsideration by addressing two questions: is systemic risk relevant to securities regulation? If so, what role, if any, should securities regulators play in regulating systemic risk? The article espouses a broad conception of the appropriate objectives of securities regulation. Ensuring that investors are protected and that they have confidence in the capital markets involves reference to whether particular market transactions could increase market volatility and give rise to systemic risk. Thus, focusing on systemic risk is a logical extension of securities regulation's current objectives.

Thus, on the first question, this article will argue that the reduction of systemic risk has become a pertinent goal of securities law as risks arise from increasingly complex products (such as derivatives) and the highly leveraged institutions (such as hedge funds and banks that have lent irresponsibly) that distribute these products. On the second question, it will argue that compelling disclosure of information from both public and private issuers, regulating hedge funds, and reforming the exempt market are all desirable reforms in which securities regulators could play an enhanced role. Admittedly, the ability of regulators to identify, monitor, and, indeed, reduce systemic risk, and an acknowledgement of these limitations is important as regulatory reforms are considered.

The discussion throughout revolves around two central features of financial markets: information and reputation. In the case of the most recent crisis, a lack of information regarding complex securities caused issuers and investors to rely on agencies to provide assurances relating to the quality of the securities (*i.e.*, the 'reputation mechanism'). Yet those agencies faltered for various reasons, including a lack of information about the products they were valuing, conflicts of interest,

limited competition, and lack of transparency.¹⁰ The loss of information and failure of the reputation mechanism underpin the need for reform initiatives and are the focus of the policy prescriptions discussed here.

Part II explains more specifically the break down in agency relationships between issuers and sophisticated parties, such as credit-rating agencies, on which they relied as well as the lack of comprehensive disclosure requirements, both of which contributed to the financial meltdown. Part III focuses on three specific facets of the capital markets that exemplify the argument in the previous part regarding agency relationships and information problems. Part IV considers policy options largely from a Canadian perspective, exploring how securities regulation should be reformed in order to address systemic risk. It also probes the fact that separate regulatory bodies oversee various aspects of financial market activity; this separation makes less sense as capital markets activities demand that securities regulators coordinate with other regulatory bodies, including prudential regulators. Part V concludes.

Because of the focus on Canada in the analysis, it is useful, at the outset, to note the generally held view that Canadian financial institutions fared well through the financial crisis relative to their international peers.¹¹ During the crisis, the World Economic Forum reported that economic stability improved in Canada while other countries, both industrialized and developing, struggled.¹² Canada's oligopolistic market consisting of five big banks; macroeconomic policies implemented by the Bank of Canada; a sound policy framework, with stringent capital-adequacy requirements emanating from the Office of the Superintendent of Financial Regulation (OSFI); and a generally conservative approach that pervades the banking sector have all been cited as the reasons for Canada's economic success.¹³ The lack of fraud by mortgage brokers and the absence of the exotic mortgage products

10 John Hunt, 'Credit Rating Agencies and the "Worldwide Credit Crisis": The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement' (2009) Colum. Bus. L. Rev. 109.

11 See, e.g., Paul Krugman, 'Good and Boring' *The New York Times* (31 January 2010), online: New York Times <<http://www.nytimes.com/2010/02/01/opinion/01krugman.html>>; see also Lev Ratnovski & Rocco Huang, *Why Are Canadian Banks More Resilient?* (IMF Working Paper No. WP/09/152) (2009), online: SSRN <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1442254>.

12 World Economic Forum, *The Global Competitiveness Report 2009–2010* (2009), online: WEF <<http://www.weforum.org/en/initiatives/gcp/Global%20Competitiveness%20Report/index.htm>>.

13 International Monetary Fund, *Canada: 2008 Article IV Consultation, Preliminary Conclusions of the IMF Mission* (2007), online: IMF <<http://www.imf.org/external/np/ms/2007/121707.html>>; Anita I. Anand, 'Canadian Banks Conservative by Nature' *National Post* (30 March 2009), online: FP Comment <<http://network.nationalpost.com/np/blogs/fpcomment/archive/2009/03/30/canada-s-banks-conservative-by-nature.aspx>>.

that were prevalent in the US banking market also contributed to the relative strength of Canadian financial institutions.

While Canadian markets were relatively stable during the crisis, it is not the case that they were unaffected. In fact, they experienced sudden declines largely tracking US stock market ebbs and flows.¹⁴ In addition, as discussed below, Canada experienced its own crisis relating to asset-backed commercial paper, where a CAN\$30-billion market froze, highlighting the importance of reforms to the exempt market, credit-rating agencies, and securitizations generally.¹⁵ There was also federal – albeit relatively limited – intervention in the banking sector.¹⁶ Finally, the recently proposed federal securities act includes a provision in which a purpose of the Act is ‘to contribute, as part of the Canadian financial regulatory framework, to the integrity and stability of the financial system.’¹⁷ Thus, an analysis relating to managing systemic risk continues to be pertinent to Canadian markets and the corresponding regulatory securities regime.

II Causes of the crisis

Many would agree that the US financial crisis of 2008, a crisis that reverberated throughout global capital markets, arose from a multiplicity of

- 14 David Olive, ‘2008: A Year to Forget: Banks Collapsed, Markets Crashed, Housing Prices Tumbled amid a Global Recession, but the Year Held Valuable Lessons’ *The Toronto Star* (30 December 2008) B4; Christopher Donville, ‘Canada Catching US Subprime Cold: America’s Housing Slump Appears to be Hitting Here Despite Belief We Are Immune’ *Calgary Herald* (23 November 2008) C3. See also comments by Bank of Canada Governor Mark Carney, quoted in ‘Carney Calls for New Regulator Body: Says ABCP Fiasco Could Have Been Avoided’ *Canadian Press* (7 May 2009), online: *Journal Pioneer* <<http://www.journalpioneer.com/Business/Personal-finance/2009-05-07/article-1396720/Carney-calls-for-new-regulator-body-says-ABCP-fiasco-could-have-been-avoided/1>> .
- 15 See Investment Industry Regulatory Organization of Canada (IIROC), *Regulatory Study, Review and Recommendations Concerning the Manufacture and Distribution by IIROC Member Firms of Third-Party Asset-Backed Commercial Paper in Canada* (IIROC, 2008), online: *Investor Voice* <http://www.investorvoice.ca/Research/IIROC_ABCP_Report.pdf> [IIROC Study].
- 16 The Canadian government has not made capital injections of this sort into the banking system. Rather, the level of its intervention has been relatively limited; e.g., purchasing CAN\$125 billion of insured mortgages (thereby increasing banks’ capacity to make new loans) and increasing the borrowing limit of the Canada Deposit Insurance Corporation. See Kevin Carmichael, ‘New Moves to Ease Strain of Credit Crisis’ *The Globe and Mail* (28 November 2008) B1; Tara Perkins & Boyd Erman, ‘Why Canadian Banks Work’ *The Globe and Mail* (7 March, 2009) B1; Tara Perkins, ‘Banks Begin to Decline Federal Aid in First Sign of Recovery’ *The Globe and Mail* (17 March 2009) A1.
- 17 Department of Finance Canada, ‘Preamble’ in *Draft of the Proposed Canadian Securities Act* (25 May 2010), online: Department of Finance Canada <<http://www.fin.gc.ca/drlag-apl/csa-lvm-eng.htm>> [Draft Act] section 9 (c).

factors: the prevalence of sub-prime mortgages, the housing boom and decline; loose monetary policy which encouraged excessive risk taking; the prevalent trading of securitized derivative products, including mortgage-backed securities (MBS), collateral debt obligations (CDOs), and credit default swaps (CDS); the failure of mortgage insurance systems, including the institutions that provided this insurance (*e.g.*, Fannie Mae and Freddie Mac); and the absence or inefficacy of capital-adequacy rules.¹⁸

At the heart of the crisis, and relevant to many of these factors, were information asymmetries between issuers of complex securities, on the one hand, and investors in those securities, on the other. In particular, the sell side of the market, including dealers, banks, and managers, understood the complexity of the chain that began with the issuing of sub-prime mortgages to a greater extent than did the buy side of the market, which consisted of retail and institutional investors.¹⁹ Furthermore, some information about risk was simply unknown, given the complexity of the chain of securities and the way in which they were interrelated.²⁰ The lack of information occasioned an over-reliance on credit ratings to indicate the quality of securities, which also contributed to the problem, since these ratings did not accurately reflect the value of the securities being rated. Information problems and the failure of credit agencies to provide ratings that accurately reflected the securities being evaluated highlighted gaps in the regulatory regime of which securities regulation was an important component.²¹

The chain can be traced to banks throughout the United States issuing sub-prime mortgages,²² which allowed mortgagors to finance their homes

18 For an excellent discussion of these factors, see Robert Pozen, *Too Big to Save* (Hoboken: Wiley, 2010) [Pozen].

19 Gary Gorton, *The Panic of 2007* (Yale ICF Working Paper No. 08-24) (25 August 2008), online: SSRN <<http://ssrn.com/abstract=1255362>> at 4 [Gorton, *Panic*]. Gorton documents in detail the various aspects of this chain, some of which are discussed here also.

20 See Gorton, *Panic*, *ibid.* at 45, who states, 'It is very hard to determine the location of risk, partly because of the chain of interlinked securities, which does not allow the final resting place of the risk to be determined. But also, because of derivatives it is even harder: negative basis trades moved CDO risk and credit derivatives created additional long exposure to subprime mortgages.' This position was affirmed by Charles W. Calomiris, 'The Subprime Turmoil: What's Old, What's New, and What's Next' (2009) 15 J. Structured Fin. 6 at 21.

21 Stiglitz traces many causes of the crisis but places 'the onus of responsibility on financial markets and institutions'; Joseph E. Stiglitz, *Free Fall: America, Free Markets, and the Sinking of the World Economy* (New York: W.W. Norton, 2010) at xvii.

22 Gorton, *Panic*, *supra* note 19, explains that the term 'sub-prime' refers to borrowers who are perceived to be more risky than average, given a poor credit history. A later development, though not consistent across banks, was to attribute to borrowers 'FICO' scores (a credit score developed by Fair Isaac & Company), which ranged

based on the capital gains that resulted from the appreciation of their houses. Banks were willing to provide these mortgages with little assurance that mortgagors would be able to pay down the mortgage via income from employment or investment. Typically, the mortgages were short-term and contained refinancing provisions with a step-up rate at the end of the first period as well as a prepayment penalty. Between 1998 and 2006, the sub-prime mortgage market worked well: housing prices increased and mortgage prepayments readily occurred.²³

During this period, banks also relied on securitizations to finance the sub-prime mortgages that they had issued.²⁴ They rolled the mortgages into bonds, such as MBS, which they then sold to other financial institutions and investment banks. Investment banks, in turn, divided MBS into high-, middle-, and low-risk tranches to form asset-backed securities (ABS) in the form of CDOs. The tranches were then sold to off-balance-sheet investment vehicles. Investment banks essentially created debt securities from these low-quality mortgages. They were able to sell the debt in a variety of ways and, when housing prices were on the rise, these distributions were easier to make, since the value of the securities themselves continued to increase.²⁵ It was possible for levered hedge funds holding the CDOs to mark up their value for this reason also.

Yet, in mid-2006, as housing prices began to decline, so did the value of the CDOs. It was difficult for investment banks to value these securities, and one of their responses was to create 'synthetic CDOs' in order to insure against the risk of default. Insurance firms such as AIG would protect against or partially mitigate the risk of default by selling credit default swaps, and the holder of the CDOs, typically an investment bank, would pay a premium in return (the credit default swap buyer). The investment banks, in turn, separated the CDOs into streams and obtained credit ratings on the tranches, with banks often holding the most toxic equity (or first-loss) tranche, exacerbating their balance-sheet woes when the credit crisis hit. The insurance firms were also required to post collateral if the price of the insured security declined.

from 300 to 850. A higher score meant more likelihood that the loan would be repaid. See also John C. Hull, 'The Credit Crunch of 2007: What Went Wrong? Why? What Lessons Can Be Learned?' (2009) 5 J. Credit Risk 1 at 3.

23 Approximately US\$3.2 trillion in sub-prime loans were made to homeowners between 2002 and 2007.

24 Gorton presents data that shows that sub-prime mortgages that originated in 2005 and 2006 amounted to US\$1.2 trillion and 80 per cent of this was securitized; Gorton, *Panic*, supra note 19.

25 See Paul Tustain, 'Subprime Mortgage Collapse: Why Bear Stearns Is Just the Start' *Money Week* (5 September 2007), online: MoneyWeek <<http://www.moneyweek.com/investment-advice/how-to-invest/subprime-mortgage-collapse-why-bear-stearns-is-just-the-start.aspx>>.

Internationally, sales of CDOs reached US\$503 billion, purchased primarily by institutions (*e.g.*, Calpers invested US\$140 million).²⁶ It was the inability to make collateral payments that ultimately caused AIG and other institutions to falter.²⁷ Goldman Sachs and several other large US banks had the largest exposure to AIG, which occasioned massive contagion risk, as AIG insured trillions in securitized products through CDS sales over the years. The collateral calls on its CDS positions were impossible for AIG to satisfy, and the Federal Reserve Board stepped in due to systemic-risk concerns.²⁸

The sell side of the market (comprised primarily of investment banks) held information about the source and magnitude of risk inherent in these securitizations, while the buy side was less informed. Investors purchased MBS, CDOs, and other securitized liabilities without knowing crucial information about the securities they were purchasing, such as the value and performance history of the assets underlying the securities. Even sophisticated institutional players lacked information, instead relying simply on previously well-established agency relationships (such as those with credit-rating agencies and banks). After all, reputable credit-rating agencies had given investment-grade ratings to these securitizations. Several US states have begun litigation against the rating agencies for their ratings on such securitized products (*e.g.*, California and Massachusetts).

When the ABX index was established in 2006, sub-prime values were aggregated and revealed, whereas previously, the sub-prime risk was not publicly visible.²⁹ But when prices on the ABX fell in 2008, information contained on the index, together with lack of information about where

26 David Evans, 'Banks Sell "Toxic Waste" CDOs to Calpers, Texas Teachers Fund' *Bloomberg* (1 June 2007), online: Bloomberg <<http://www.bloomberg.com/apps/news?pid=20601109&sid=aW5vEJn3LpVw>>.

27 Stiglitz, *supra* note 21 at 170.

28 One of the most notable examples of moral hazard was that Goldman Sachs avoided severe losses because of failed CDS by taking a Federal Reserve bailout (along with several non-US institutions, such as Deutsche Bank and Société Générale). One reform suggestion was to separate traditional banking (deposit taking, on-balance-sheet loans, conforming securitization funding, etc.) from more aggressive investment banking and its proprietary trading activities. The simple view was that only critical, core, traditional banking, not investment banks, should have access to the Federal Reserve's liquidity source called the Fed 'Discount Window.'

29 The ABX Index is a series of CDS based on twenty bonds consisting of sub-prime mortgages. The ABX Index has four series and five tranches per series. Valuing sub-prime mortgages usually involves weighting the twenty available ABX values. See 'ABX Marks US Subprime Mortgage Inventory at Approx. 65 Cents on the Dollar' *Housing Derivatives Blog* (1 March 2008), online: Housing Derivatives <www.housingderivatives.typepad.com/housing_derivatives/ABX_index/>. See also Gorton, *Panic*, *supra* note 19; Markus K. Brunnermeier, 'Deciphering the Liquidity and Credit Crunch 2007–2008' (2009) 23 J. Econ. Perspect. 77.

these risks were located, led banks to question the ability of their counterparties to honour contractual commitments.³⁰ Thus, even with ABX in place, the securities and securitizations of which sub-prime mortgages were a part gave rise to information problems. As Gorton lucidly explains, '[F]or CDO investors and investors in other instruments that have CDO tranches ... it is not possible to penetrate the chain backwards and value the chain based on the underlying mortgages. The structure itself does not allow for valuation based on the underlying mortgages, as a practical matter.'³¹ Banks were also using proprietary models to which only they had access to value these products. Crucial information either did not exist or was unavailable to the market.

Gorton's point is that information was not present because it was difficult, if not impossible, to penetrate – and ascertain the value of – the core or ultimate assets. Those holding sub-prime mortgages similarly could not use information that they had regarding their mortgages to value the chain 'upwards.'³² In short, the securities and securitizations comprised of sub-prime mortgages were especially sensitive to the decline in the housing market, and this became especially apparent when the housing market stopped rising in 2006.³³ It was not possible to look through to the underlying mortgages³⁴ and it was particularly difficult to price these securities in the downward market.³⁵ The inherent leverage in many CDOs that used extensive CDS positions, together with an illiquid and opaque market, exacerbated the value decline.

Even acknowledging that information about securitized products was unavailable or difficult to obtain, one must question why the incentives for financial institutions to inform themselves were so weak. Banks i.e. sophisticated parties issued sub-prime mortgages, and many institutions down the chain purchased instruments that derived from sub-prime mortgages. A persuasive response rests in basic aspects of banking transactions. Depositors do not and, practically speaking, cannot enter into enforceable contracts with banks that dictate the bank's investments. Furthermore, as limited liability corporations, banks have distorted incentives to invest in risky assets in light of the downside protection provided by limited liability in the first place.³⁶

30 Gorton, *Panic*, supra note 19 at 3.

31 Gorton refers to this as 'lost' information; *ibid.* at 61.

32 *Ibid.*

33 *Ibid.*

34 *Ibid.* at 3. Also see Gorton, *Panic*, supra note 19, for an excellent overview of the sub-prime crisis and the design of these instruments.

35 See Andrew Ross Sorkin, *Too Big to Fail* (New York: Viking, 2009) at 6.

36 See Stewart C. Myers, 'Determinants of Corporate Borrowing' (1977) 5 J. Finan. Econ. 147 noting that, in debt contracts, it is not possible for the lender to require the borrower to take on all positive NPV investment projects.

There is also the matter that the investment banks relied on banking products (mortgages) to feed their highly profitable securitization machine. As long as they could intermediate this product and not take it on their balance sheet, they earned lucrative fees and passed on the risks to the buyers of the MBS and CDO products. The incentive structure for all parties at each step in the process contributed to the crisis (lenders did not assess credit risks thoroughly because they knew they were selling the loans quickly rather than holding the loans, assessors inflated values to help borrowers get bigger loans, investment banks did not hold the securitized loan product on their books, rating agencies received lucrative fees for rating the product, etc.).

Existing regulation, with its limited disclosure obligations, prevented parties down the chain from grasping the magnitude of the risk they assumed in investing in these securities. The result was massive US government intervention; while the US government did not rescue Lehman Brothers (whose failure has been blamed as a cause and/or catalyst of the global credit crisis), it did step in to bail out AIG, Goldman Sachs, Fannie Mae, and Freddie Mac as well as orchestrate the takeover of Bear Stearns by JP Morgan Chase.³⁷ In ensuing debates about necessary legal reforms, the lack of information about securitized products has been a central issue. Before examining these debates and corresponding reform suggestions, however, we need to analyse further the relationship between systemic risk and securities regulation.

III *Securities regulation and systemic risk*

Securities regulation began as an area of law focused on protecting investors and sought to regulate primary and eventually also secondary public markets.³⁸ Disclosure of information requirements became the centre-piece of the regulatory regime in order to ensure that investors were well informed before making investment decisions and to ensure that they were on a level playing field vis-à-vis corporate insiders.³⁹ Over

37 Under the Emergency Economic Stabilization Act, of which the Troubled Asset Relief Program (TARP) was one aspect, the US government stepped in to aid ailing investment banks by committing to purchase assets and equity from financial institutions at a cost of US\$109 billion. This figure was issued in March 2010 and included cost estimates of completed, outstanding, and anticipated costs; see US Department of the Treasury, *Road to Stability*, online: FinancialStability.gov <<http://www.financialstability.gov/roadtostability/programs.htm>>.

38 See Kimber Report, *supra* note 9.

39 Regarding disclosure rules and principles in the Canadian context generally, see Mary Condon, *Making Disclosure: Ideas and Interests in Ontario Securities Regulation* (Toronto: University of Toronto Press, 1998). Regarding the exempt market and the financial crisis, see Luigi Zingales, 'The Future of Securities Regulation' (2009)

time, the regulation became bifurcated into that relating to public markets, on the one hand, and those relating to private or 'exempt' markets, on the other. This part examines the growth and regulation of the exempt market, hedge funds, and derivatives (many of which are sold in the exempt market) in order to probe further the relationship between systemic risk and securities regulation.

A EXEMPT MARKET

An 'exempt' distribution is one in which the distribution of securities need not comply with the rules pertaining to issuers that have 'gone public,' including those rules relating to the prospectus process, continuous disclosure, and corporate governance.⁴⁰ Once a transaction satisfies any one of the exemptions, it can proceed without the consistent regulatory oversight that typifies the prospectus process. The rationale has been that a prospectus should not be required when investors do not need such disclosure or the regulator does not need to review the particulars of the transaction because the investors are sophisticated, because they are closely associated with the issuer, or because another regulatory regime applies.⁴¹ Historically, the transactions facilitated by the exempt market tended to be smaller distributions completed by firms that were issuing equity securities to a select number and group of players. Firms sought to raise enough capital to undertake specific business projects and/or to position themselves to access public markets via an initial public offering in the future.

47 J. Accounting Res. 391, online: SSRN: <<http://ssrn.com/abstract=1378290>> [Zingales].

40 Frequently used exemptions include the minimum-investment exemption, which sets the minimum investment amount by investors at CAN\$150,000; the accredited investor exemption, which requires that investors have a minimum net worth; and the offering memorandum exemption, which requires the issuer to compile and distribute a disclosure document in the required format. Other exemptions, such as the private-company exemption, seek to facilitate financing by smaller issuers. Finally, if an issuer such as a bank or other financial institution is regulated under another legal regime, it can fall within another set of exemptions, the underlying rationale being that the securities are relatively safe investments because of the application of another legal regime to those institutions. See *Prospectus and Registration Exemptions*, O.S.C. NI 45-106 (14 June 2005) [NI 45-106]. In the United States, see, e.g. Rule 144A adopted pursuant to the *US Securities Act of 1933*, 17 C.F.R. § 230.144A (1933) [Rule 144A].

41 See Ontario, Legislative Assembly, Standing Committee on Finance and Economic Affairs, 'Five Year Review of Securities Regulation in Ontario' in *Official Report of Debates (Hansard)* (18 October 2004), online: Legislative Assembly for Ontario <http://www.ontla.on.ca/web/house-proceedings/house_detail.do?locale=en&Date=2004-10-18&Parl=38&Sess=1&detailPage=/house-proceedings/transcripts/files_html/2004-10-18_L073A.htm>.

However, in both Canada and the United States, the rules relating to the exempt market have led to a growth in systemic risk.⁴² The Canadian asset-backed commercial paper (ABCP) crisis is a case in point. In July 2007, investors in ABCP began to question the quality of their securities and appeared to lose confidence in the values of the longer-term assets underlying their securities as they witnessed the sub-prime mortgage crisis in the United States. These investors included retail and institutional investors, such as the Caisse de dépôt et placement du Québec, which was reported to have held CAN\$13.2 billion of third-party ABCP.⁴³ Non-bank financial companies (referred to as 'sponsors') then announced that new ABCP would not be placed and that the maturity date on extendible notes would be extended. They also requested funding under their liquidity facilities and the requests were denied by chartered banks and in some cases off-shore foreign financial institutions. The result was that issuers were unable to refinance maturing ABCP and the \$35-billion ABCP market froze.⁴⁴ *Ex post* information reveals that 'leveraged CDO were the single largest component of third-party ABCP assets'⁴⁵ and that the back-up liquidity facilities meant to mitigate refinancing risk were not, in fact, on demand, as institutions refused to honour the ABCP conduits' liquidity requests.

ABCP was issued in the private market pursuant to an exemption stipulating that issuers could only distribute short-term debt without a prospectus if they had an 'approved rating from an approved credit rating organization.'⁴⁶ As a result of this exemption, credit-rating

42 See Zingales, *supra* note 39.

43 See Bertrand Marotte, 'Caisse Has \$13.2-billion of ABCP' *The Globe and Mail* (28 November 2007), online: *The Globe and Mail* <<http://www.theglobeandmail.com/report-on-business/article799959.ece>>.

44 For a thorough study on the ABCP crisis, see IIROC Study, *supra* note 15. The crisis was ultimately resolved as a result of private negotiations led by lawyer Purdy Crawford on behalf of the investors and as a result of legal restructuring under the *Companies Creditors' Arrangement Act*, R.S.C. 1985, c. C-36. The restructuring plan was approved at two levels of court in Ontario, with the Supreme Court of Canada denying leave to appeal; see Miller Thomson, *eSecurities Notes* (3 October 2007), online: Miller Thomson <http://www.millerthomson.com/docs/eSecurities_Notes_October_32007.pdf>; 'Timeline of ABCP crisis' *Financial Post*, (19 August 2008), online: *Financial Post* <<http://www.financialpost.com/reports/credit-crunch/story.html?id=734495>>.

45 IIROC Study, *supra* note 15 at 17.

46 NI 45-106, *supra* note 40, s. 2.35, which states, 'The prospectus requirement does not apply to a distribution of a negotiable promissory note or commercial paper maturing not more than one year from the date of issue, if the note or commercial paper distributed ... (b) has an approved credit rating from an approved credit rating organization.' See also John Chant, *The ABCP Crisis in Canada: The Implications for the Regulation of Financial Markets* (Research Study Prepared for the Expert Panel on Securities Regulation), online: Expert Panel on Securities Regulation

agencies, not securities regulators, became the sole gatekeeper for distributions of ABCP.⁴⁷ Once a credit-rating agency provided a favourable rating,⁴⁸ ABCP could be distributed without other investor protection measures, such as disclosure regarding the securities and the underlying assets themselves.⁴⁹ And it seems that there were shortcomings in the information that reached investors. One report on ABCP states that the information voluntarily provided by ABCP sponsors 'was often incomplete, untimely, opaque, and complicated ... investors were not initially sure how much exposure they had to US sub-prime mortgages ... it was not widely understood that the riskiest, most highly complex and leveraged structured finance products in the Canadian market were in the form of ABCP ...'⁵⁰ As examples, the report cites a lack of detail with respect to the underlying assets and their performance as well as non-disclosure of important contingencies such as those contained in liquidity contracts. The conspicuous lack of information contributed both to the loss of investor confidence in ABCP and to the system-wide financial crisis.

Some may question the idea that inadequate disclosure was one of the underlying causes of the ABCP crisis and, indeed, of the financial market issues stemming from MBS and CDOs described in the previous part. They may argue, instead, that it was sophisticated (*i.e.*, information-seeking) investors, such as the Caisse de dépôt and Calpers, which were purchasing these securities. However, even these investors remained inadequately informed, as they continued to rely on agency relationships, such as long-standing relationships with credit-rating agencies, as a substitute for information that they lacked.⁵¹ In the ABCP case, it seems clear that

<<http://www.expertpanel.ca/eng/reports/research-studies/the-abcp-crisis-in-canada-chant.html>> [Chant].

47 See Chant, *ibid.* at 13.

48 Dominion Bond Rating Service (DBRS) was the primary credit-rating agency rating ABCP and rated Canadian ABCP at the highest rating possible: R-1 (High); see IIROC Study, *supra* note 15 at 21.

49 See Chant, *supra* note 46 at 22.

50 Scott Hendry, Stephane Lavoie, & Carolyn Wilkins, 'Transparency in Securitized Products' *Bank of Canada Financial System Review* (June 2010) at 47, online: Bank of Canada <http://www.bankofcanada.ca/en/fsr/2010/fsr_0610.pdf> [Hendry, Lavoie, & Wilkins], who also cite N. Kamhi & E. Tuer, 'Asset-Backed Commercial Paper: Recent Trends and Developments' *Bank of Canada Financial System Review* (June 2007) at 24-7; N. Kamhi & E. Tuer, 'The Market for Canadian Asset-Backed Commercial Paper, Revisited' *Bank of Canada Financial System Review* (Dec. 2007) 13 at 13-6.

51 This is a typical problem where investors who do not have the resources (time, money) to review each individual structure instead rely on repeated agency relationships; Gary Gorton, *The Subprime Panic* (Yale ICF Working Paper 08-25) (30 September 2008), online: SSRN <<http://ssrn.com/abstract=1276047>> at 37.

a credit-rating agency's seal of approval was sufficient for even significant institutional investors.⁵²

B HEDGE FUNDS

Hedge funds are investment vehicles that generally seek to 'hedge' or 'manage' risk while making a return on capital by utilizing a variety of investment strategies (such as short-selling and trading in derivatives). Although the goal of a hedge fund, like that of most funds and corporations, is to generate positive returns for its investors, hedge fund investors usually form a select and limited group (such as accredited investors who meet 'net worth' tests).⁵³ A hedge fund is like a mutual fund, with one important caveat: its investment mandate is typically much broader in terms of the techniques employed to generate profit.⁵⁴ These techniques vary in terms of the risk/return profile sought, and funds can employ both long- and short-term investment strategies.⁵⁵ Hedge funds tend not to make public offerings and therefore are not required to register with a securities regulatory authority or list with a stock exchange. Rather, much hedge fund activity occurs in the exempt market.⁵⁶

52 Another great loss was incurred by the Caisse de dépôt and Calpers in a real-estate-project development, intermediated by Blackrock and Goldman Sachs, called 'Stuyvesant Town,' which has proceeded to a bankruptcy situation. This is yet another case of supposedly sophisticated investors not understanding the risk of a transaction and of asymmetrical risk and information access; see Charles V. Bagli, 'NY Housing Complex Is Turned Over to Creditors' *The New York Times* (25 January, 2010), online: The New York Times <http://www.nytimes.com/2010/01/25/nyregion/25stuy.html?_r=1>. See also Samantha Gross, 'Stuyvesant Town, Peter Cooper Village Turned Over to Creditors' *The Huffington Post* (25 January 2010), online: Huffington Post <http://www.huffingtonpost.com/2010/01/25/stuyvesant-town-turned-ov_n_434967.html>; Michael B. Marois, 'Calpers' Board Approves Policy Shift to Protect Rent Control' *Business Week* (19 April 2010), online: Business Week <<http://www.businessweek.com/news/2010-04-19/calpers-board-approves-policy-shift-to-protect-rent-control.html>>.

53 René M. Stulz, 'Hedge Funds: Past, Present, and Future' (2007) 21 *J. Econ. Perspect.* 175 at 177; see also Pozen, *supra* note 18 at 11.

54 Task Force to Modernize Securities Regulation in Canada, *Canada Steps Up: Final Report*, vol. 1 (2006) 99 at 100, online: Task Force <<http://www.tfmsl.ca/docs/T45758-Vol%201%20Chpt%206.pdf>> citing A. Fok Kam, 'A Canadian Framework for Hedge Fund Regulation' in Task Force to Modernize Securities Regulation in Canada, *Canada Steps Up: Evolving Investor Protection*, vol. 3 (2006) 87, online: Task Force <[http://www.tfmsl.ca/docs/V3\(2\)%20FokKam%20HF.pdf](http://www.tfmsl.ca/docs/V3(2)%20FokKam%20HF.pdf)>.

55 On the variety of strategies employed by hedge funds, see Marcos M. Lopez De Prado & Achim Peijan, 'Measuring Loss Potential of Hedge Fund Strategies' (2004) 7 *J. Altern. Inv.* 7.

56 In the United States, hedge funds grew from less than US\$250 billion in assets in 1995 to \$1.8 trillion at the end of 2007; see Pozen, *supra* note 18 at 112. This growth was spurred also by the growth of funds of hedge funds.

The relationship between hedge funds and systemic risk is bound up in hedge funds' defining characteristic: to pursue aggressive investment strategies to make immediate returns while maintaining significant levels of leverage *vis-à-vis* other market participants.⁵⁷ Hedge funds' reliance on leverage means that their positions are often larger than the collateral posted in support of these positions.⁵⁸ From a systemic-risk standpoint, the danger is that adverse fluctuations in market prices can negatively affect the market price of the collateral and dry up credit. Rapid fluctuations in market prices can lead funds to liquidate large positions over short periods of time.⁵⁹ A vicious cycle can develop as contracting counterparties seek to protect themselves by closing out their positions. Collateral is liquidated, assets are sold, and prices decline sharply.⁶⁰ This decline in prices can cause investors to rush to close out their positions and remove their money from capital markets. Remaining investors are disinclined to snap up securities at deflated prices as they lack confidence that their investments will be profitable.

Thus, hedge fund activity can lead to the build-up of risk in financial markets. Various examples support this claim, including Long-Term Capital Management (LTCM)⁶¹ and Amaranth⁶² in the United States and Portus⁶³ and

57 See Nicholas Chan *et al.*, 'Do Hedge Funds Increase Systemic Risk?' *Federal Reserve Bank of Atlanta Economic Review* (Fourth Quarter, 2006), online: Federal Reserve Bank of Atlanta <http://www.frbatlanta.org/filelegacydocs/erq406_lo.pdf> [Chan *et al.*]; see also Schwarcz, *supra* note 5 at 203–4.

58 Chan *et al.*, *ibid.* at 50.

59 *Ibid.*

60 See Schwarcz, *supra* note 5 at 213–4.

61 As discussed below, LTCM was a highly leveraged hedge fund that lost US\$4.6 billion in 1998; see Roger Lowenstein, *When Genius Failed: The Rise and Fall of Long-Term Capital Management* (New York: Random House Trade Paperbacks, 2001); Franklin R. Edward, 'Hedge Funds and the Collapse of Long-Term Capital Management' (1999) 13 J. Econ. Persp. 189.

62 Amaranth suffered a US\$6.5 billion dollar loss (70 per cent of its capital) in 2006; see Katherine Burton & Jenny Strasburg, 'Amaranth's \$6.6 Billion Slide Began With Trader's Bid to Quit' *Bloomberg* (6 December 2006), online: Bloomberg <<http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aRJS57CQQbeE>>.

63 It was alleged that Portus had invested approximately CAN\$52.8 million that it had received from its customers and that over \$17 million was unaccounted for. The Ontario Securities Commission filed a lawsuit against the hedge fund manager, seizing all of its assets. Portus was banned from trading securities under a temporary cease trade order: *Re Portus Alternative Asset Management Inc. and Boaz Manor* (10 February 2005), OSC Temporary Order, online: OSC <http://osc.gov.on.ca/en/Proceedings_rad_20050210_portus-temp-ord.htm> and ultimately reached a settlement agreement with the Ontario Securities Commission: *Re Portus Alternative Asset Management Inc., Portus Asset Management Inc., Boaz Manor, Michael Mendelson, Michael Labanowich and John Ogg*, OSC Order, online: OSC <http://www.osc.gov.on.ca/en/Proceedings_enr_20060621_portus.jsp>.

Norshield⁶⁴ in Canada. To explore one case that occurred ten years before the financial crisis of 2008, LTCM's portfolio was over US\$100 billion, with net asset value of \$4 billion and swaps notionally valued at \$1.25 trillion, which, in 1998, equalled 5 per cent of the global market. It was an active player in mortgage-backed securities, a major supplier of index volatility to investment banks, and was also investing in emerging markets.⁶⁵ When Russia devalued its currency and declared a moratorium on US\$13.5 billion of its treasury debt at that time, investors sought to liquidate their holdings and move to more secure US government bonds. Within months, this liquidity crisis caused LTCM's equity to decline to \$600 million. While the crisis was ultimately resolved,⁶⁶ LTCM illustrates how hedge funds can give rise to systemic crises. First, investors suffered as a result of bets they made on the cheaper treasury bonds. Second, because all of the leveraged treasury-bond investors held similar positions, the stability of global financial markets was in jeopardy.

Some may rightly argue that hedge fund activity is important because it stabilizes markets, thereby maximizing social wealth.⁶⁷ Hedge funds can promote capital formation and facilitate risk management and can be a stable investment vehicle for long-term investors.⁶⁸ They may further contend that, during the credit crisis, there appeared to be little contagion from hedge funds per se, and, in fact, hedge funds emerged as conspicuous survivors of the crisis, although the industry itself suffered. Hedge funds kept trading even when financial markets were low, and when hedge funds failed, they generally did not seek government rescues.⁶⁹ During the ABCP crisis, for example, some hedge funds sought

64 When the hedge fund Norshield filed for receivership, about 1 900 investors had CAN\$131.9 million invested, while institutional clients had \$210 million invested; see Keith Damsell, 'Banks, Clients Look to Dodge Norshield Bullet' *The Globe and Mail* (5 April 2009), online: *The Globe and Mail* <<http://www.theglobeandmail.com/report-on-business/article813754.ece>>.

65 See Sungard Ambit Erisk, 'LTCM-Long-Term Capital [Capital] Management' Case Study (2010), online: Ambit Erisk <<http://www.erisk.com/learning/casestudies/long-termcapitalmanagemen.asp>>.

66 The Federal Reserve Bank of New York organized a consortium of leading banks to contribute US\$3.5 billion to the fund and take over its management in exchange for 90% of its equity.

67 Soren Packer, *Hedge Fund Activity Defined by the Social Good of Wealth Maximization* (SSRN Working Paper Series Abstract No. 1529) (30 December 2009), online: SSRN <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1529801>.

68 See Troy Paredes, 'Hedge Funds and the SEC: Observations on the How and Why of Securities Regulation' (Paper presented to the Seminar on Current Developments in Monetary and Financial Law, Washington, DC, 23–7 October 2006) at 3, online: IMF <<http://www.imf.org/external/np/seminars/eng/2006/mfl/tap.pdf>> [Paredes].

69 See, e.g., McKinsey Global Institute, *The New Power Brokers: How Oil, Asia, Hedge Funds and Private Equity Firms Are Faring in the Financial Crisis* (July 2009) at 28, online: McKinsey & Company <http://www.mckinsey.com/mgi/reports/pdfs/the_new_power_brokers_financial_crisis/MGI_power_brokers_financial_crisis_chapter_3.pdf>.

to return value to investors by offering creative solutions to deal with their frozen assets.⁷⁰

Yet hedge funds also have the propensity to give rise to systemic risk.⁷¹ LTCM is only one conspicuous example; the financial crisis of 2008 is another. At the height of the recent crisis, hedge funds began to lose money, with the average fund losing over 20 per cent, total net outflows across the industry at US\$200 billion and aggregate assets decreasing from \$1.8 trillion in 2007 to \$1.2 trillion in 2008.⁷² Recognizing that the potential for investor losses with hedge funds is high, the Securities and Exchange Commission (SEC) had previously mandated that hedge-fund managers must register⁷³ and subsequently passed an anti-fraud rule preventing manipulative and deceptive conduct by investment advisers.⁷⁴ As will be discussed below, however, the crisis suggested that further regulation may be necessary, and, in particular, that exceptions to the registration rule for hedge fund managers should not be permitted.⁷⁵

The concern with hedge funds relates not only to investor losses but also to lenders, which often do not receive sufficient information from hedge funds with high leverage ratios (*i.e.*, ratio of average assets to capital).⁷⁶ This lack of information gives rise to systemic concerns: when banks began to recognize the problems with MBS, they called in margin loans from highly leveraged funds, funds that were also facing redemption requests en masse from their clients. The redemption pressure also occurred in Canada during the ABCP crisis.⁷⁷ These hedge funds, in turn, needed to raise cash and did so by selling their securities,

On the potential of hedge funds for long-term investors, see John M. Mulvey, 'The Role of Hedge Funds for Long-Term Investors' (2004) 10 J. Finan. Man. 23, online: CAPCO <http://www.capco.com/files/pdf/74/02_RISKS/02_The%20role%20of%20hedge%20funds%20for%20long%20term%20investors.pdf>.

70 John Greenwood, 'Hedge Funds Fishing around in ABCP Mess' *Financial Post* (4 April 2008), online: Financial Post <<http://www.financialpost.com/story.html?id=419689>>.

71 See Paredes, *supra* note 68.

72 Pozen, *supra* note 18 at 114.

73 *Registration under the Advisers Act of Certain Hedge Fund Advisers*, 17 C.F.R. § 275 & § 279 (2004), online: SEC <<http://www.sec.gov/rules/final/ia-2333.htm>>.

74 SEC Release No. IA-2628. *Final Rule: Prohibition of Fraud by Advisors to Certain Pooled Investment Vehicles*, 17 C.F.R. § 275 (2007).

75 Pozen, *supra* note 18 at 114 advocates a similar position; see also Stephen Brown *et al.*, 'Mandatory Disclosure and Operational Risk: Evidence from Hedge Fund Registration' (2008) 63 J. Fin. 2785.

76 See Barry Eichengreen & Donald Mathieson, *Hedge Funds: What Do We Really Know?* (Washington, DC: International Monetary Fund, 1999), online: IMF <<http://www.imf.org/external/pubs/ft/issues/issues19/index.htm>>.

77 Ontario Securities Commission, *OSC Staff Notice 33-733: Report on Focused Reviews of Investment Funds, September 2008–September 2009* (Toronto: Ontario Securities Commission, 2010), online: OSC <http://www.osc.gov.on.ca/documents/en/Securities-Category3/sn_20100119_33-733_rpt-rev-inv-funds.pdf>.

contributing 'to the glut of debt securities on the market and to the rapid drop in the prices of more liquid stocks.'⁷⁸ This drop in prices resulted in stock markets' declining to extremely low levels in the fall of 2008, which, in turn, spurred a call for heightened regulation of these funds throughout the world.⁷⁹ In hearing these calls, we can hark back to LTCM: why was the systemic weakness or risk in the system not recognized as fully as it should have been? What regulatory changes were implemented in response to LTCM?⁸⁰

C. SECURITIZATIONS AND OTC DERIVATIVES

CDS and CDOs are derivative securities that, generally speaking, have not been regulated by securities commissions. In the United States, derivatives have had a complicated history but have generally been regulated under the Commodity Futures Trading Commission (CFTC).⁸¹ In Canada, a fragmented regime exists in which different provinces have adopted different approaches to these products.⁸² In neither jurisdiction were OTC derivatives regulated, although the United States has introduced new legislation that is discussed below. The reasons that these instruments have not traditionally been classified as securities are not completely clear but may relate to the fact that the derivative was understood to be a contract used to hedge risk, as opposed to a security to earn profit.⁸³ The financial crisis dispelled the persuasive value of this and other such rationales.

78 Pozen, *supra* note 18 at 119.

79 See U.S., Bill H.R. 4173, *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*, 111th Cong., 2010 (enacted as Pub. Law. 111-203), signed into law by President Obama, 21 July 2010 [*US Financial Reform*]. However, note that the FSA has recently concluded that UK hedge funds do not pose systemic risk: Louise Armitstead, 'Hedge Funds Do Not Pose Systemic Risk: FSA Concludes' *The Telegraph* (23 February 2010), online: *The Telegraph* <<http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/ditch-the-directive/7300888/Hedge-funds-do-not-pose-systemic-risk-concludes-FSA.html>>.

80 It can be argued that the repeal of Glass-Steagall Act – *Banking Act of 1933*, P.L. 73-66, 48 Stat. 162 – in 1999 following LTCM and subsequent implementation of the *Gramm-Leach-Bliley Act*, 15 U.S.C. § 6801–9 seemed to encourage *more* risk taking by financial institutions. In hindsight, this particular change in law immediately following LTCM is surprising.

81 See Thomas Lee Hazen & Philip McBride Johnson, *Derivatives Regulation*, 3d ed. (New York: Aspen Publishers, 2004).

82 For example, Quebec has stand-alone legislation governing OTC and exchange-traded derivatives: *Derivatives Act*, S.Q. 2008, c. 24; Ontario regulates this area less comprehensively: see *Over-the-Counter Derivatives*, O.S.C. Rule 91-504 (8 September 2000) (proposed but not implemented).

83 See *Pacific Coast Coin Exchange of Canada v. Ontario Securities Commission* (1977), 80 D.L.R. (3d) 529 (S.C.C.), which sets the test for what factors are necessary to reach a finding that an investment contract is a 'security.'

What is the systemic-risk concern with OTC derivatives? Securities, including derivatives, that are traded over the facilities of a stock exchange, are monitored by a third party, the exchange, which serves not only as an intermediary but also as a counterparty to the contract. The rules of the exchange apply to these contracts, and performance is thus guaranteed by a third party. By contrast, as the name suggests, OTC derivatives are not traded over traditional stock exchanges but are traded directly between two individuals or entities. No exchange or intermediary is involved, and the performance of the contract is not guaranteed; in other words, there is exposure to counterparty risk.⁸⁴

As was evident in the financial meltdown, OTC derivatives (which included private distributions of CDS and CDOs) allowed risk to be concentrated among a small number of institutions.⁸⁵ The original lender (*e.g.*, the bank that granted the sub-prime mortgage) did not need to monitor the debtor because it did not bear the risk of default as did parties down the chain.⁸⁶ If a firm failed as a counterparty, as AIG did, the web of arrangements it had entered into was often impossible to disentangle. The failure of multiple firms to meet their obligations as counterparties created broad systemic issues, especially if the firm defaulted on numerous contracts. Furthermore, these products facilitated regulatory arbitrage as they allow a flow of funds out of the regulated (*i.e.*, public) into less regulated (*i.e.*, private) markets.⁸⁷

OTC derivatives consisting largely of securitized products gave rise to the informational problems described above. Unlike securities traded on the secondary market over the facilities of a stock exchange, the value of securitized products can be difficult to ascertain because they are traded in a completely private market. The assets on which the security is based can themselves change in value and carry risk profiles that are unknown to the investor population.

Governments and legislators throughout the world view OTC derivatives as having the potential to give rise to systemic risk, as is evident from the multiple jurisdictions in which reforms to this market are being considered

84 Consider Amaranth (which suffered a US\$6-billion loss) and Long-Term Capital Management (which lost US\$4.6 billion in 1998) as two examples of failed funds trading in OTC derivatives.

85 See Henry T.C. Hu, 'Testimony Concerning the Over-the-Counter Derivatives Market Act of 2009,' Testimony before the US House Committee on Financial Services (7 October 2009), online: SEC <<http://www.sec.gov/news/testimony/2009/ts100709hh.htm>> [Hu].

86 Janis Sarra, *The Financial Crisis and the Incentive Effects of Credit Derivatives* (2010) [unpublished; paper on file with author].

87 Hu, *supra* note 85.

and implemented.⁸⁸ Also of concern to legislative authorities are the agencies that rated these securities and allowed various layers of risk to develop in the same securitization. On the basis of credit ratings, insurers such as AIG would insure the senior Triple-A aspect of the securitized product. However, when the prices on the Triple-A tranches declined in the United States, insurers of CDS experienced tremendous losses, and financial institutions holding CDS demanded cash payments to back them.⁸⁹ Why were privately distributed securities, whose value was unknowable, rated so highly? High ratings from reputable agencies implied very low probabilities of default, which with the benefit of hindsight, was an incorrect assessment of many of these securitized products.

IV Policy directions

The discussion above suggests that exempt market transactions, hedge-fund activity, and derivative securities exemplify significant concerns that have arisen for securities regulators in terms of systemic risk. Thus, the overarching policy reform advocated here is to give securities regulators responsibility for regulating systemic risk. The mandate of securities regulators should be expanded along the lines of the IOSCO principles, which state that the objectives of securities regulation are to protect investors; to ensure that markets are fair, efficient and transparent; and to reduce systemic risk.⁹⁰ While the precise wording of the mandate could be to 'manage,' 'mitigate,' or 'reduce' systemic risk; the point is that the mandate of securities regulators should be explicitly expanded in the way that IOSCO suggests.⁹¹

In terms of specific policy reforms, analysis should focus on two broad issues: providing more information regarding securitized products and fixing the reputation mechanism with regard to credit-rating agencies. In terms of information, one of the most conspicuous aspects of the

88 See, e.g., *US Financial Reform*, supra note 79; UK Financial Services Authority, *Implementing Aspects of the Financial Services Act 2010* (April 2010), online: FSA <http://www.fsa.gov.uk/pubs/cp/cp10_11.pdf>. European Commission, *Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and Amending Directives 2004/39/EC and 2009/.../EC* (2009), online: European Commission <http://ec.europa.eu/internal_market/investment/docs/alternative_investments/fund_managers_proposal_en.pdf>.

89 E.g., AIG paid out US\$62 billion to settle its CDS contracts; see Pozen, supra note 18 at 78.

90 See IOSCO principles, supra note 1.

91 Under the recently released draft securities act for Canada, the new Canadian Securities Regulatory Authority must contribute 'to the integrity and stability of the financial system'; *Draft Act*, supra note 17. See also Anita I. Anand, 'Draft National Securities Act Looks Good So Far' *The Lawyers Weekly* (25 June 2010) at 5, online: *The Lawyers Weekly* <<http://www.lawyersweekly-digital.com/lawyersweekly/3008/#pg6>>.

financial meltdown was the inability of investors to obtain information about the value of their securities. As discussed above, it was not simply that there were information asymmetries between issuers and investors; it was also that the information was unknowable to investors. Off-balance-sheet special investment vehicles, together with complex securities, allowed investment banks to create securities whose values could be manipulated and whose underlying assets could not be easily discerned. In addition, hedge funds, as private investment vehicles, were not required to make standardized disclosures to investors. Much of the public information was voluntarily provided, resulting in uncertainty regarding its veracity. Finally, the exempt market rules allowed the issuances of securities, such as commercial paper, without any disclosure at all, including without disclosure regarding the performance of related parties and underlying assets.

To address deficiencies relating to information, more comprehensive disclosure obligations are warranted. Of course, this argument raises the question of why mandatory disclosure improves, or is likely to improve, market performance. After all, the parties to transactions involving asset-backed securities tend to be sophisticated (sometimes conducting their own valuations) and therefore able to seek additional information prior to making their investment decision.

In response, one can argue that if information would raise the value of a given security, disclosure from issuer to investor regarding the security is desirable.⁹² If information would not raise its value, disclosure would not matter and efforts taken to acquire it can give rise to social waste.⁹³ The key point is that, if the information has been provided voluntarily, it may not always be possible for investors to determine what information is needed or whether they have received sufficient information for risk-assessment purposes. Mandatory disclosure may, therefore, serve to raise value and prevent social waste.

Furthermore, mandatory disclosure can prevent firms from hiding 'bad news,' since, in the absence of such an obligation, information will have a positive private expected value, with issuers having a bias to disclose favourable information.⁹⁴ In a voluntary disclosure regime, the possibility that firms might not disclose unfavourable information gives rise to a lemons problem. Investors are unable to discern which issuers are

92 Steven Shavell, 'Acquisition and Disclosure of Information Prior to Sale' (1994) 25 *RAND J. Econ.* 20 at 21.

93 *Ibid.*

94 Shavell, *ibid.*; see also Frank Easterbrook & Daniel Fischel, 'Mandatory Disclosure and the Protection of Investors' (1984) 70 *Va. L. Rev.* 669 at 680: 'In a world with an anti-fraud rule but no mandatory disclosure system, firms could remain silent with impunity. If they disclosed, they could do so in any way they wished, provided they did not lie . . . A mandatory disclosure system substantially limits firms' ability to remain silent.'

truthful and disclose material information fully. They therefore discount the prices that they will offer for all securities.⁹⁵ High-quality issuers effectively subsidize low-quality issuers and therefore exit the public market. High-quality issuers end up forgoing potentially valuable investment opportunities because they are unable to obtain a fair price for their securities.⁹⁶ Low-quality issuers remain in the market and '[a]s a result, investors discount still more the prices they will pay. This in turn only drives more honest issuers away from the market and exacerbates the adverse selection problem.'⁹⁷ Mandatory disclosure can prevent the downward cycle that the lemons problem can create.⁹⁸

When the information to be revealed is extremely complex or simply unknowable, enhanced mandatory disclosure rules may not, in and of themselves, be sufficient to enable investors to understand the securities in which they seek to invest. They may turn to other market participants to provide an assessment of the credit quality of potential investments. Thus, the regulation of credit-rating agencies (CRAS) – the second broad theme of reforms recommended here – goes hand in hand with changes to mandatory disclosure rules. In markets where the securities are complex and innovation regarding the securities continues to develop, investors will rely not only on disclosure but also on CRAS as an important source of information. We turn now to the specific policy prescriptions that securities regulators should consider.

A ENHANCED DISCLOSURE OBLIGATIONS

What information, in particular, should be disclosed? The discussion distinguishes between securitized products issued in the private versus the public markets and focuses on the extent to which associated disclosure obligations in each of these markets should be reformed. It is important to recognize throughout that it is an extremely complex task (and beyond the scope of this article) to delineate precisely the types of disclosure requirements that would enable a straightforward and comprehensive assessment of risk.

95 George A. Akerlof, 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism' (1970) 84 *Quar. Jr. of Economics* 488 (elucidating the adverse selection problem).

96 See Stewart C. Myers & Nicholas S. Majluf, 'Corporate Finance and Investment Decisions When Firms Have Information That Investors Do Not Have' (1984) 13 *J. Finan. Econ.* 187 at 209.

97 Bernard S. Black, 'Information Asymmetry, the Internet, and Securities Offerings' (1998) 2 *J. Small & Emerging Bus. L.* 91 at 92.

98 It is generally accepted that mandatory disclosure can provide a solution to the lemons problem; see, e.g., Brian Cheffins, 'Does Law Matter? The Separation of Ownership and Control in the United Kingdom' 30 *J. Legal Stud.* 459; Sharon Hannes 'Comparisons among Firms: (When) Do They Justify Mandatory Disclosure?' (2004) 29 *J. Corp. L.* 669.

i *Private markets*

At present, private actors such as hedge funds are able to utilize the exempt market to distribute securitized products without any disclosure. Under the current regime of exemptions, specifically (in Canada) the short-term debt exception and the accredited investor exemption, these products (including asset-backed commercial paper) are subject to no disclosure requirements.

The short-term debt exemption allows issuers and investors to rely on the views and ratings of credit-rating agencies, bodies which have, until recently, been unregulated and which, even under the newly introduced reforms discussed below, will not be required to take into account concerns relating to systemic risk. It is true that issuers or sponsors may release periodic investor reports with information regarding pool levels and so on. However, this disclosure is voluntary and, unlike required disclosures, does not carry any liability under securities laws.⁹⁹

A first possibility, therefore, is to remove the exemption for short-term debt. Yet this reform would result in eradicating some of the efficiency benefits associated with the exemption, such as issuers' ease of raising capital quickly (*i.e.*, without needing to comply with the prospectus process). A second, preferable alternative is to require greater disclosure of information when the debt being distributed is a securitized product, recognizing that not all debt carries systemic-risk concerns. The short-term debt exemption would continue to be available, therefore, but would carry with it a limited disclosure requirement when the product being offered was securitized.

What information, in particular, should be disclosed? Issuers of securitized products should be required to disclose all information that would be relevant to calculating the fair value and/or to performing a valuation of the securities being distributed. The defining feature of a securitized product is the fact that there are underlying assets that can affect the value of the security itself. Thus, investors should be given specific information regarding the type and size of the underlying assets, historical information regarding defaults, credit facilities relating to those assets, and loan-repayment schedules. They should also have information relating to the risks inherent in, and the performance of, the underlying assets over the life of the assets as well as an explanation relating to any historical or expected declines in value of these assets. Finally, they should be provided with information relating to liquidity risks of the securities themselves and the propensity of the security to give rise to systemic risk, insofar as this latter piece of information is knowable. All of this information is central to enabling investors to estimate the fair value of the securities in which they are investing.

99 See Hendry, Lavoie, & Wilkins, *supra* note 50.

Requiring issuers to provide this level and type of information would not be unprecedented. For example, when the Bank of Canada accepts ABCP as collateral under its standing liquidity facility, it requires the provision of an information document.¹⁰⁰ Although the Bank makes no stipulation relating to a fair-value principle, it requires that a comprehensive list of items be disclosed: identities of key parties, including the sponsor; the range of assets, including minimum or maximum proportions; the manner in which the ABCP program gains exposure to the underlying assets; a brief description of the underlying assets and the securitizations under which they were issued; nature of liquidity facilities and credit enhancements; payment allocations, rights and distribution priorities, and so on.

Admittedly, information relevant to fair-value calculations can be sensitive, which can breed reluctance among issuers to disclose it. For example, revealing the identity of asset originators may make parties reluctant to continue to participate in the ABCP program. Hendry, Lavoie, and Wilkins have, therefore, proposed setting a threshold, in terms of the proportion of assets contributed to the pool, above which the identity of the originator must be disclosed.¹⁰¹ Any threshold of this sort, however, is likely to be arbitrary and would potentially skew investments downwards to fall just below the threshold so that material information could remain undisclosed. Such a threshold does not advance the aim of ensuring that investors have sufficient information about the securitized products to enable them to calculate fair value and fully assess risk.

Thus far, the discussion has focused on the short-term debt exemption, but securitized products are also distributed under the accredited investor exemption, an exemption which also requires no disclosure. While the notion that net worth or a certain level of assets is a proxy for sophistication is not inherently unsound, prospective investors have no uniform, standardized check on the information that an issuer may voluntarily provide under the exemption. And, when securitized products are being offered, the risks are obscure. As with the short-term debt exemption above, issuers of securitized products should, therefore, be required to provide a standardized document or term sheet to investors who fall within the definition of 'accredited.' The document would contain information regarding the assets, the underlying assets,

100 For further details, see Hendry, Lavoie, & Wilkins, *ibid.*; Bank of Canada, *Assets Eligible as Collateral under the Bank of Canada's Standing Liquidity Facility* (Ottawa: Bank of Canada, 2010), online: Bank of Canada <<http://www.bankofcanada.ca/en/financial/securities.pdf>>.

101 Hendry, Lavoie, & Wilkins, *ibid.*

performance of the underlying assets, risk profile, credit facilities, indebtedness, and liquidity.¹⁰²

Some may argue that requiring disclosure in exempt market transactions undermines the very purpose of the exempt market itself: enabling issuers to get to market quickly without the burden of preparing and distributing disclosure documents. To begin, the disclosure recommended here is not as extensive as that which is required in a prospectus. Other exemptions already contain a disclosure requirement which, in some cases, is quite onerous (as in the offering memorandum exemption). Furthermore, the financial crisis including ABCP demonstrated that voluntarily provided information was insufficient, as it did not enable value and risk assessment. Thus, in distributions of these securities, some disclosure is necessary in order to enable investors to calculate the fair value of the securities and more fully assess the risks that underlie such securities.

In addition to amending existing exemptions, another important reform would be to create a specific exemption for securitized products themselves. However, under this exemption, a full-fledged information document containing the information set forth above would be required; that is, information that enables investors to determine the fair value of their securities. As with the offering memorandum exemption, the information document should contain extensive information about the issuer and the securities as well as a statement to the effect that the document does not contain a misrepresentation and should be signed by the CEO, CFO, directors (or those authorized to sign on the directors' behalf), and promoters of the issuer.¹⁰³ It must also contain a right of rescission as in the offering memorandum exemption. Certification and a right of rescission are necessary because there is no additional check on the issuer or its securities, unlike in the case of the exemptions discussed above. Specifically, in the short-term debt exemption, a designated credit-rating agency provides its stamp on the securities prior to their being distributed and this agency operates under the oversight of the securities regulator. In the accredited investor exemption, only certain sophisticated investors are able to participate in the distribution.

Some may argue that an exemption for securitized products is unnecessary and, indeed, only facilitates the trading of securities that give rise to systemic risk. Yet these securities can contribute to wealth creation on both the issuer and investor side.¹⁰⁴ Further, other countries are

102 Consideration should be given on a regular basis to the financial thresholds contained in the exemption, as over time they tend to become outdated (*i.e.*, too low).

103 See NI 45-106, *supra* note 40, s. 2.9.

104 *E.g.*, Sabry & Okongwu point to increased availability of credit; Faten Sabry & Chudozie Okongwu, *Study of the Impact of Securitization on Consumers, Investors, Financial Institutions*

choosing not to ban these securities outright, which is relevant given the interdependence of global securities markets.¹⁰⁵

ii *Public markets*

One main difference between private and public market disclosure is that the latter must contain 'full, true and plain' disclosure of all material facts.¹⁰⁶ Failure to meet this threshold leads to liability for those who sign the prospectus, including directors of the issuer and its underwriters.¹⁰⁷ Currently, offerings of asset-backed securities require the disclosure of certain information, including corporate structure; general development of the business, and risk factors (cash flow and liquidity problems, risks inherent in the business, reliance on key personnel, etc.); dividends declared and dividend policy, in addition to restrictions that might prevent payout of dividends; capital structure; market information, such as price ranges of each class of shares issued; escrowed securities; securities subject to contractual restriction; and executive officers and a summary of any penalties or bankruptcy orders against them.¹⁰⁸

Although this list is long, there are items not currently required to be disclosed that should be mandatorily disclosed in accordance, first, with IOSCO principles for public offerings of asset-backed securities (ABS),¹⁰⁹ and second, with the legal principle that public disclosure should include 'full, true, and plain' disclosure of all material facts. 'Material facts' are facts that would be reasonably expected to have a significant effect on the price or value of the securities.¹¹⁰ Given the requirement

and the Capital Markets (June 2009), online: NERA <http://www.nera.com/extImage/PUB_ASF_Report_June_2009.pdf>. See also *Global Financial Stability Report: Navigating the Challenges Ahead* (October 2009) 77, online: IMF <<http://www.imf.org/External/Pubs/FT/GFSR/2009/02/index.htm>>; Keith W. Dam, 'The Subprime Crisis and Financial Regulation: International and Comparative Perspective' Chicago J. Int'l L. (forthcoming).

105 E.g., the recently adopted *Dodd-Frank Wall Street Reform and Consumer Protection Act* which addresses regulatory issues related to the asset-backed securitization process: *US Financial Reform*, supra note 79, § 941–§ 946.

106 The definition of 'material fact' is 'when used in relation to securities issued or proposed to be issued, means a fact that would reasonably be expected to have a significant effect on the market price or value of the securities': *Securities Act (Ontario)*, supra note 9, s. 1 and s. 56(1).

107 See, e.g., *Securities Act (Ontario)*, ibid., s. 130ff.

108 See *General Prospectus Requirements and Related Amendments*, O.S.C. NI 31-103 (17 July 2009), online: OSC <http://www.osc.gov.on.ca/documents/en/Securities-Category4/rule_20061222_41-101_national-instrument.pdf>; *Continuous Disclosure Obligations*, O.S.C. NI 51-102 (2 April 2004) s. 6.2, online: OSC <http://www.osc.gov.on.ca/documents/en/Securities-Category5/rule_20040402_51-102-cont-disc-ob.pdf> for specific provisions in Canada for asset-back securities and what must be disclosed.

109 See Hendry, Lavoie, & Wilkins, supra note 50.

for full, true, and plain disclosure, it should be unnecessary for regulators to stipulate further the precise information that should be disclosed. Yet issuers' views of materiality (*i.e.*, what constitutes material information) may differ from those of investors and/or regulators. Specific information to be disclosed, therefore, needs to be set forth to aid investors in calculating and understanding value.

Thus, for example, disclosure regarding static pool data, which explains how the assets originated at different periods and how they have performed over time; pool assets, including the composition of the asset pool; any loss of information; and significant obligors of assets would be warranted.¹¹¹ Furthermore, while some risks currently need to be disclosed (such as those relating to cash flow and liquidity problems, business risks, and reliance on key personnel), nothing relating to systemic risk is required to be disclosed. Yet, post-financial crisis, it is clear that securitized products carry more risk than other securities and can, indeed, give rise to systemic risk. Issuers should, therefore, be required to make some disclosure relating to the riskiness of these securities from a macroprudential or systemic-risk standpoint.

B HEDGE FUNDS

Hedge fund activity implicates the mandate of securities regulators in two ways: first, the regulation of those who manage the fund, and second, the extensive activity of hedge funds in exempt and public markets. A three-pronged approach to hedge fund regulation is proposed here. First, if fund managers are not registered with securities regulators, they are not subject to regulatory oversight, and they are not accountable to investors (*e.g.*, in the way that managers of other funds are). Thus, it is important for hedge funds to be required to register with securities regulators in both Canada and the United States as they will be required to do under new law.¹¹² However, the available exceptions are numerous.¹¹³ Exceptions

110 See *Securities Act (Ontario)*, *supra* note 9, s. 56(1) & s. 1.

111 See Hendry, Lavoie, & Wilkins, *supra* note 50; IOSCO Technical Committee, *Disclosure Principles for Public Offerings and Listings of Asset-Backed Securities: Final Report* (8 April 2010), online: IOSCO <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD318.pdf>>.

112 It appears as though, under this instrument, a universal requirement that Canadian hedge fund managers register has been put in place. However, the same cannot be said for US managers, as there still exists potential registration exemptions as set forth *infra* note 113.

113 Registration requirements and exemptions in respect of hedge funds exist for advisers, funds, and hedge fund securities. For US exemptions, see *US Financial Reform*, *supra* note 79 at pt. 4 for exemptions relating to advisers and the *Investment Company Act of 1940* 15 U.S.C. § 80a-3(a)(1)(A) for exemptions relating to funds themselves. In Canada, while NI 31-103, *supra* note 112 at pt. 8, contains numerous adviser exemptions, it is questionable whether these would be used by hedge funds to avoid registration. Furthermore, there are no Canadian equivalents to the exemptions

to the requirement to register should be minimal, given the propensity for hedge funds to give rise to systemic risk as discussed above.

Second, current legal obligations relating to hedge fund disclosure are minimal and should be increased. Given that issuers in public markets must disclose risks associated with the securities they issue, it makes sense to compel private market entities such as hedge funds to disclose such information also, especially in light of the systemic-risk concerns raised above.¹¹⁴ A hedge fund disclosure bill is presently before Congress, although Canadian securities regulators have not yet moved to impose disclosure requirements for hedge funds.¹¹⁵

In particular, hedge funds over a certain size should be compelled to disclose material information, including information relating to risk profile (*e.g.*, what risks stem from their investments), the effect that potential losses could have on the fund, and information about which financial institutions have outstanding loans to the fund and clear its trades. Specifically, disclosures could include the performance of the fund; the assets underlying the securities that the fund holds; aggregate loans held by the hedge fund relative to its capital; composition and percentage of illiquid assets; concentration of assets held in its portfolio; counterparties for trading its assets; and risk management strategies.¹¹⁶

During the financial crisis, ultimate counterparty risk was difficult to ascertain because the collapse in value of one class of securities occasioned defaults on many securities throughout the system. Admittedly, with such complicated risk interactions, it may not be possible to reveal the *full* impact of the fund's losses. However, mandatory disclosure of certain information is, nevertheless, warranted to enable investors and regulators to understand risks associated with their investments and act on such assessments if need be. Recalling the discussion above, the absence of mandatory disclosure can allow firms to remain silent when information does not reflect well on them.¹¹⁷

contained in the Investment Company Act. Finally, regarding hedge fund securities, in both Canada and the United States, the distribution of securities occurs through private placements utilizing minimum purchase and/or accredited investor exemptions from the applicable registration/prospectus requirements.

114 See 'Should Hedge Funds Disclose Risk Information?' *Hedge Fund Software Industry Blog* (15 June 2009), Hedge Fund Software Industry <<http://www.hedgefundsoftware.net/should-hedge-funds-disclose-risk-information/>>.

115 See U.S. Bill S. 344, *Hedge Fund Transparency Act*, 111th Congress (2009–2010), online: Library of Congress <<http://thomas.loc.gov/cgi-bin/query/z?c111:S.344.IS>>. See also 'Congress Gets Obama Hedge Fund Disclosure Bill' *Reuters* (15 July 2009), online: Reuters <<http://www.reuters.com/article/idUSTRE56E7DF20090715>>. This Bill was enacted as Part IV of *US Financial Reform*, *supra* note 79 at pt. 4.

116 Pozen, *supra* note 18 at 120.

117 It is, perhaps, for this reason that G-20 countries are moving to increase disclosure requirements for hedge funds generally. See, *e.g.*, the final declaration of G-20

Third, hedge funds and other institutions should be subject to trading limitations in times of financial crisis. Short-selling is the practice of borrowing securities in an issuer and selling them in anticipation that the security's price will decline. The objective is to buy the securities back at a lower price in order to return the securities to the original owner with the difference accruing as profit. 'Naked' short-selling occurs when the trader makes a trade without having access to the securities. These practices can undermine struggling institutions and manipulate markets by artificially depressing the share price.

When hedge funds and other institutions engage in these practices, they aggravate financial uncertainty and accelerate the decline of financial institutions, sovereign nations, and other market participants known to bet on the failure or default of such participants.¹¹⁸ During the height of the crisis, regulators in countries around the world (the United States, England, Germany, Australia, Canada, etc.) banned short-selling and some jurisdictions such as the United States banned naked short-selling permanently.¹¹⁹ One powerful explanation for Greece's financial crisis points to hedge funds that bet on the country's default,¹²⁰ leading the US Department of Justice to order hedge funds to retain trading records relating to euro bets.¹²¹

These bans related to public markets, and thus, to the extent that hedge funds operated in public markets, affected hedge funds. However, as discussed above, hedge funds also trade in private markets, highlighting the

leaders emerging from the Toronto 2010 Summit, in which the G-20 countries agreed to implement 'strong measures to improve transparency and regulatory oversight of hedge funds, credit rating agencies and over-the-counter derivatives in an internationally consistent and non-discriminatory way . . .'; *The G-20 Toronto Summit Declaration* (26–7 June 2010), online: Government of Canada <<http://g20.gc.ca/toronto-summit/summit-documents/the-g-20-toronto-summit-declaration/>>; see also Financial Stability Board, *Improving Financial Regulation: Report by the FSB to G20 Leaders* (25 September 2009) at 11, online: FSB, <http://www.financialstabilityboard.org/publications/r_090925b.pdf>, recommending 'a consistent framework for oversight and regulation of hedge funds, including requirements for mandatory registration, ongoing registration, provision of information for systemic risk purposes, disclosure and exchange of information between regulators . . .'

118 Paul Usman Ali, 'Short Selling and Securities Lending in the Midst of Falling and Volatile Markets' (2009) 24 J. Int'l Banking L. & Reg. 1.

119 Securities and Exchange Commission, News Release, 2009-172, 'SEC Takes Steps to Curtail Abusive Short Sales and Increase Market Transparency' (27 July 2009), online: SEC <<http://www.sec.gov/news/press/2009/2009-172.htm>>.

120 'Hedge Funds Probe Exposes Heart of Greek Crisis' *The Washington Post* (6 March 2010), online: The Washington Post <<http://www.washingtonpost.com/wp-dyn/content/article/2010/03/05/AR2010030504236.html>>.

121 'US Said to Tell Hedge Funds to Save Euro Records' *Bloomberg Businessweek* (3 March 2010), online: Businessweek <www.businessweek.com/news/2010-03-03>.

need for regulatory attention here also. Specifically, in times of financial crises, regulators should have the ability to limit the activity of hedge funds and other market participants which is reasonably deemed to increase the instability of the financial system. In terms of securities regulation in Canada, this may mean creating an additional rule-making power.¹²²

C OTC DERIVATIVES

From a regulatory standpoint, two main difficulties with OTC derivatives are lack of transparency regarding these products and weaknesses in managing counterparty risk.¹²³ Regarding transparency, issues include the need to disclose information not only about the securities but also about the risks associated with the underlying assets, both of which were discussed above. Additional issues stem from the domino effect that an institution's default can have on counterparties, especially when simultaneous collateral calls are made.¹²⁴ In trying to manage these intertwined relationships, the question becomes: how should counterparty risk be mitigated?

Reform proposals generally point to the need to better manage the trading process, given that there is no third-party guarantor. Standardization in OTC contracts has been proposed as a means to improve efficiency, facilitate the use of central counterparty (CCP) clearing and trading on organized trading platforms, and enable trade information to be compared and evaluated more easily.¹²⁵ The efficiency benefits of standardization are well documented¹²⁶ and should be readily accepted. Standardization of OTC derivative contracts, however, is difficult to achieve because these contracts are often customized according to the needs of counterparties. Furthermore, the details of some

122 Heads or areas in which the Ontario Securities Commission can make rules are found in *Securities Act (Ontario)*, supra note 9, s. 143.

123 Many countries have moved to address the systemic issues arising from OTC derivatives. See, e.g., Financial Services Authority and HM Treasury, *Reforming OTC Derivative Markets: A UK Perspective* (December 2009), online: FSA <http://www.fsa.gov.uk/pubs/other/reform_otc_derivatives.pdf> [FSA Proposal]; *US Financial Reform*, supra note 79.

124 See ISDA, *Best Practices for OTC Derivatives Collateral Process* (30 June 2010), online: ISDA <http://www.isda.org/c_and_a/pdf/ISDA-Best-Practices-for-the-OTC-Derivatives-Collateral-Process.pdf>; FSA Proposal, *ibid.*; Manmohan Singh & James Aitken, *Counterparty Risk, Impact on Collateral Flows and Role for Central Counterparties* (IMF Working Paper 9/173) (August 2009), online: SSRN <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1457596>.

125 FSA Proposal, *ibid.*; US Department of Treasury, News Release, tg-129, 'Regulatory Reform: Over-the-Counter Derivatives' (13 May 2009), online: US Department of Treasury <<http://www.ustreas.gov/press/releases/tg129.htm>>.

126 See, e.g., Michael Klausner (1995) 'Corporations, Corporate Law, and Networks of Contracts' 81 Va. L. Rev. 757; Marcel Kahan & Michael Klausner (1997) 'Corporate Contracting: Standardization, Innovation and the Role of Contracting Agents' 83 Va. L. Rev. 713.

derivatives ('bespoke' derivatives) are not released but are a result of private negotiations between the financial institution and the buyer. While the Master Agreement issued by the International Swaps and Derivatives Association (ISDA) is a possible means to achieve greater standardization, and Canadian OTC derivative contracts tend to take this form,¹²⁷ it is not clear that complete standardization can be fully achieved. Regardless, more national and international coordination is required to work towards this goal.

Standardization is also a means to facilitate CCP, a key facet of the recent US Financial Reform Bill, which mandates the creation of a clearing house for OTC derivatives.¹²⁸ Given the counterparty risks discussed above, it is important that CCP be implemented in Canada also in order to provide a visible market for completed derivative contracts, to facilitate the making of calls as prices fluctuate, and to allow the netting of multiple exposures among firms. While the scope of the services would need to be isolated, other benefits include collateral administration, credit guarantee, and standardized valuation services.¹²⁹

In Canada, one of the barriers to achieving uniform legislation relating to OTC derivatives as well as CCP is the fact that securities regulation has operated under provincial jurisdiction. Certain provinces (Alberta, BC, and Quebec) have adopted differing relevant legislation while other provincial jurisdictions have not.¹³⁰ Thus, despite the benefits discussed above, it is not clear whether a central clearing house for derivatives will be adopted in Canada; no such reform has been proposed to date.¹³¹ The recently released proposed federal legislation does, however, contain a separate part on derivatives and includes a broad

127 McMillan LLP, *The Law of Derivative Structures in Canada* (2005), online: Findlaw <<http://library.findlaw.com/2005/Jun/7/246682.html>>.

128 Although Congress passed legislation calling for the establishment of a clearing house for OTC derivatives after LTCM (through U.S. Bill H.R. 5660, *Commodity Futures Modernization Act of 2000*, 106th Cong., 2000 [enacted]), no such institution was created in the United States. However, the recent US Financial Reform Bill, *US Financial Reform*, supra note 79, recently signed into law, has approved the creation of a clearing house for OTC derivatives.

129 Andre A. Cappon, 'Clearing for the OTC Market' *The CBM Group* (Jan. 1998), online: The CBM Group <[http://www.thecbmgroup.com/publications/Capital Markets_Exchanges/Clearing%20for%20the%20OTC%20Market%20-%20FIBV%20-%20Jan1998.pdf](http://www.thecbmgroup.com/publications/Capital_Markets_Exchanges/Clearing%20for%20the%20OTC%20Market%20-%20FIBV%20-%20Jan1998.pdf)>.

130 As noted above, Ontario has not implemented Rule 91-504, while Alberta, British Columbia, and Quebec have implemented rules related to OTC derivatives. For related discussion, see Expert Panel on Securities Regulation, *Creating an Advantage in Global Capital Markets: Final Report and Recommendations* (Ottawa, 2009) at 75–8, online: Expert Panel on Securities Regulation <http://www.expertpanel.ca/eng/documents/Expert_Panel_Final_Report_And_Recommendations.pdf>.

131 There are reports that a Quebec-based organization is discussing the establishment of a central clearing platform in Quebec with Canada's big banks, which have expressed

definition of ‘derivative’ that would include OTC products.¹³² Whether the proposed act will become law is still an open question, leaving the OTC market poorly (and unacceptably) regulated in Canada at present.

D REGULATION OF CREDIT-RATING AGENCIES

One of the reasons that certain tranches of CDOs and MBS were attractive to investors was that they carried with them Triple-A ratings from what appeared to be reputable credit-rating agencies (CRAs). In the United States, these agencies were Moody’s, Standard and Poor’s, and Fitch. In Canada, the main CRA is the Dominion Bond Rating Service (DBRS). In both countries, CRAs have been unregulated and therefore potentially susceptible to incentives that compromise their neutrality. In particular, because CRAs want to maintain a relationship with the issuer that seeks the rating and pays their fees, they have an incentive to provide a rating with which the issuer is satisfied.¹³³ This potential can undermine CRAs’ neutrality as arm’s length agencies that offer objective assessments of the creditworthiness of the securities.¹³⁴ Furthermore, the monetary incentives for providing favourable ratings have grown with the market for CDOs, likely because corresponding expected revenue from these ratings would increase also.

For investors, credit ratings are important because of the signal they send about the credit quality of an issuer so that, on the basis of this signal, investors can evaluate the debt.¹³⁵ The importance of CRAs thus rests in a well-functioning ‘reputation mechanism’ which provides CRAs with optimal incentives for producing high-quality ratings.¹³⁶ A reputation mechanism that works well enables CRAs to maintain their value as long as they provide ratings of high quality and integrity. If investors determine that ratings are of low quality or that the CRA is not objective, they will

interest in establishing a domestic clearing house of this nature; see ‘Canadian Clearing, Interoperability Take Shape’ *Derivatives Week* (5 April 2010) at 5.

132 *Draft Act*, supra note 17, pt. 7.

133 See, for general discussion, Frank Partnoy, ‘How and Why Credit Rating Agencies Are Not Like Other Gatekeepers’ in Yasuyuki Fuchita & Robert E. Litan, eds., *Financial Gatekeepers: Can They Protect Investors?* (Washington, DC: Brookings Institution Press, 2006), online: SSRN <<http://ssrn.com/abstract=900257>>. With regard to the current crisis, see Securities and Exchange Commission, News Release, 2008-135, ‘SEC Examinations Find Shortcomings in Credit Rating Agencies’ Practices and Disclosure to Investors’ (8 July 2008), online: SEC <<http://www.sec.gov/news/press/2008/2008-135.htm>>.

134 ‘Debt Rating Agencies Didn’t Cause the Crash’ *Vancouver Sun* (30 April 2010), online: *Vancouver Sun* <<http://www.vancouversun.com/business/Debt+rating+agencies+didn+cause+crash/2969999/story.html>>.

135 Ronald Gilson & Reinier Kraakman, ‘The Mechanisms of Market Efficiency’ (1984) 70 *Va. L. Rev.* 549.

136 Hunt, supra note 10.

stop valuing the ratings produced by the CRA, which, in turn, will lose value.

Following the financial crisis of 2008, fixing the reputation mechanism is of central importance. One approach would be to establish an independent body, which could be established by government or a government agency (such as the relevant securities commission), to mediate the relationship between the issuer and the CRA.¹³⁷ However, this policy approach would require the establishment of yet another regulatory body and may not address institutional and informational failures that can arise. Another suggestion has been to impose liability for CRAS that fail to comply with rules relating to conflicts of interests and disclosure.¹³⁸ CRAS may be willing to bear the cost of potential liability, however, and the underlying issues relating to reputation and conflict of interest may not be resolved.

In considering reform alternatives, we should note that CRAS generally perform a useful function in rating debt. They are well positioned to access risk, including systemic risk, associated with securitized products. However, the credit-rating process requires some tweaking, since CRAS, like many others, overlooked systemic-risk concerns that result from securitized products. Thus, it would be worthwhile to incentivize CRAS to consider and assess systemic risk during the rating process. Increased regulatory oversight that encourages CRAS to do so would improve the dissemination of information regarding systemic risk to the market, to the benefit of all stakeholders.

Reform initiatives relating to CRAS have recently been proposed in Canada. Under a newly proposed instrument, CRAS would need to apply to become designated rating organizations (DROS).¹³⁹ Once the

137 This is essentially an 'issuer-pays' model which allows completion to flourish but with a centralized clearing platform through which all debt to be rated flows. The model, of course, turns on a well-functioning regulator (or central clearing platform); Barbara Kiviat, 'A Bolder Approach to Credit Rating Agency Reform' *Time Blog* (18 September 2009), online: Time.com <<http://curiouscapitalist.blogs.time.com/2009/09/18/a-bolder-approach-to-credit-rating-agency-reform/>>.

This proposal derives from Matthew Richardson & Lawrence White, *The Rating Agencies: Is Regulation the Answer?* (NYU Stern White Papers Project) (2008), online: NYU <<http://whitepapers.stern.nyu.edu/summaries/ch03.html>>. Pozen also supports the insertion of third parties into the rating process; Pozen, *supra* note 18 at 65.

138 The imposition of civil liability requires a weighing of costs and benefits to the affected parties which is beyond the scope of this article. However, see Hunt, *supra* note 10 and Pozen, *ibid.*, who support the imposition of liability on CRAs (Hunt, disgorgement of profits; Pozen, civil liability).

139 *Proposed National Instrument 25-101 Designated Rating Organizations, Related Policies and Amendments*, O.S.C. Notice and Request for Comment (July 2010), online: CSA <http://www.nbsc-cvmnb.ca/nbsc/uploaded_topic_files/25-101-CSAN-2010-07-16-E.pdf> [*Proposed National Instrument 25-101*]; see also *Securities Regulatory Proposals Stemming from the*

application to become a DRO is granted, the DRO would be able to have its credit ratings utilized for various purposes covered by securities regulation.¹⁴⁰ Furthermore, DROS would be required to develop and enforce a code of conduct that follows the IOSCO code. DROS would be required to manage conflicts of interest and the inappropriate use of information, appoint a compliance officer, and annually file a report relating to these activities. Once designated, DROS would become subject to potential enforcement actions and compliance reviews.¹⁴¹

Because of the regulatory oversight that would exist, this reform will likely be an improvement on the complete absence of regulation relating to CRAS. The regulation would be similar to laws relating to self-regulatory organizations (SROs) under which SROs apply for 'recognition.' If granted, recognition renders the SRO subject to regulatory oversight. The main drawback of the proposed rule, however, is that securities regulators would not oversee the content or methodology of ratings (even though unjustifiably high ratings were at the heart of the ABCP crisis). Even where there was a compliance officer in place and an annual report filed with securities regulators, investors in securitized products could continue to lack full and accurate information relating to systemic risk that might be inherent in the securities they were purchasing.

CRAS need to be cognizant of the potential for securities that they rate to give rise to systemic risk, something that CRAS did not foresee during the financial crisis. Systemic-risk considerations should be built into the ratings, and investors should know what considerations were taken into account in arriving at the ratings. CRAS should be encouraged to analyse and comment on systemic-risk considerations when completing their ratings, given that some types of securities may be more susceptible to systemic risk than others.¹⁴² In addition, in order for the reputation mechanism to work well, ratings provided must be objective. Thus, regulators should implement a system of review of the ratings provided, designating specific members of the commission to review ratings periodically.

2007–08 Credit Market Turmoil and Its Effect on the ABCP Market in Canada, O.S.C. C.S.A. Consultation Paper 11-405 (October 2008), which proposes implementing a code of conduct for CRAs as has been developed by IOSCO; reforming the short-term-debt exemption and making it unavailable for certain types of securities, including ABCP; and reducing the reliance on CRAs in securities legislation.

140 *E.g.*, issuances of debt securities under the short-form prospectus rules will require a credit rating from a DRO; see Canadian Securities Administrators, News Release, 'Canadian Securities Regulators Propose Regulatory Regime for Credit Rating Organizations' (16 July 2010), online: CSA <<http://www.lautorite.qc.ca/pdf/com16juillet2010-acvm-ang.pdf>>.

141 *Ibid.*; *Proposed National Instrument 25-101*, *supra* note 139.

142 *E.g.*, My General Electric bonds are likely less to be susceptible to systemic risk than are securitized mortgages.

E INTEGRATED MARKET REGULATION

The discussion thus far assumes the existence of 'sectoral regulation'; that is, multiple regulators that oversee specific sectors of the financial market. In Canada, these regulators include a financial services regulator (the Office of the Superintendent of Financial Institutions), a central bank (the Bank of Canada), and provincial and territorial securities regulators. Some may agree that systemic risk is relevant to securities regulation but question whether reforms to securities regulation will be effective in the absence of broader structural reforms. Thus, in considering whether to empower securities regulators to mitigate systemic risk, it is essential to analyse the overall framework of financial regulation.

There are various alternatives. The first is to retain the current model consisting of fragmented, sectoral-based regulation, where power is distributed between federal and provincial or state regulators.¹⁴³ The second is to maintain separate central-banking, prudential, and securities regulators at the federal level, without state or provincial involvement. The third is to merge securities and prudential regulators so that the merged regulator and the central bank would stand as the two pillars of the regulatory structure. At present, Canada's structure represents the first of these alternatives (if a national securities regulator is achieved, it may represent the second, although, as will be argued here, the third alternative is preferable).

The multitude of securities regulators currently in place in Canada, together with a prudential regulator, has given rise to 'regulatory abundance,' where coordination and cooperation among regulators can exist but is voluntary. For example, provincial securities regulators cooperate under the aegis of the Canadian Securities Administrators (CSA) but they are not mandatorily obliged to agree with the CSA's legislative initiatives or to implement them provincially. The ability of any one province to exit can mean that policy initiatives with regard to (*e.g.*, to financial turmoil) can be implemented unevenly or not at all. This fragmented system has meant that harmonization in securities regulation does not exist in crucial areas such as enforcement, the regulation of derivatives, and exempt distributions (although exemptions are generally harmonized under one instrument, differences do exist among jurisdictions in the instrument itself).¹⁴⁴

143 See Lawrence Cunningham & David Zaring, *The Three or Four Approaches to Financial Regulation: A Cautionary Analysis against Exuberance in Crisis Response* (SSRN Accepted Paper Series 1399) (2 June 2009), online: SSRN <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1399204>.

144 On enforcement, see Mary Condon, 'The Use of Public Interest Enforcement Orders by Securities Regulators in Canada' *WPC Research Studies* (2003), online: WPC <http://www.wise-averties.ca/report_en.html>. Regarding derivatives, see note 130 *supra*. Regarding exemptions, see NI 45-106, *supra* note 40.

By contrast, in other areas of financial market regulation, cooperation and sharing of information is mandatory. For example, the Superintendent of OSFI is required to chair a committee comprised of the governor of the Bank of Canada, the deputy finance minister, the chair of the Canada Deposit and Insurance Corporation, and the Commission of the Financial Consumer Agency of Canada.¹⁴⁵ The committee's purpose is to facilitate the exchange of information on matters relating directly to financial institutions. This structure is laudable, as it facilitates information sharing among key regulatory players. However, securities regulators are not required to be at the table, which has become a conspicuous omission in light of the argument above relating to the relevance of systemic risk to securities regulation.¹⁴⁶

The lack of mandatory cooperation and coordination among securities regulators (and between securities regulators and prudential regulators, a topic addressed further below) is a hindrance to effective financial market regulation. In response, some may argue that Canada fared relatively well through the financial crisis with a decentralized securities structure, implying that no structural reform is required. But is this the case? Regulators' responses to the ABCP crisis were disparate, with securities regulators initially not shouldering responsibility regarding the crisis associated with these securities.¹⁴⁷ Further, while the CSA published a proposed rule relating to credit-rating agencies following the crisis, the rule does not address key issues relating to systemic-risk concerns. In addition, Canada has no comprehensive legal regime governing OTC derivatives, instruments that contributed to the systemic volatility discussed above. In short, it is not clear that either the substance or the structure of securities regulation was effective through the financial crisis. Certainly, a consideration of substantive and structural reforms seems appropriate.

The federal government has recently proposed the creation of a national securities regulator and has introduced a draft national

145 *Office of the Superintendent of Financial Institutions Act*, supra note 8, s. 18(1) & (2), online: <<http://laws.justice.gc.ca/en/O-2.7/FullText.html>>.

146 See Borio, supra note 3 at FP 13; Anita I. Anand, 'Why Macro Is Prudent' *The Financial Post* (23 September 2009) (op. ed.) [Anita I. Anand].

147 See Anita I. Anand, *ibid.* IIROC ultimately acknowledged some jurisdiction relating to ABCP. The OSC, in prosecuting the Coventree case (case of Canada's largest player in the ABCP market), also suggests that it has jurisdiction over these securities; *Re Coventree Inc.*, *Geoffrey Cornish and Dean Tai* (7 December 2009), OSC Statement of Allegations, online: <http://www.osc.gov.on.ca/documents/en/Proceedings-SOA/soa_20091207_rev_coventree.pdf>. See also Canadian Securities Administrators, *2009 Enforcement Report*, online: CSA <http://www.osc.gov.on.ca/documents/en/About/csa_20100201_csa-rpt-enf-2009.pdf>; Janet McFarland *et al.*, 'Playing the Blame Game' *The Globe and Mail* (11 August 2008) B4.

securities act.¹⁴⁸ If a national securities regulator is achieved (the federally created transition office provides a start date for the new regulator of 1 July 2012), some of the issues raised here relating to harmonization of laws and cooperation among regulators will be addressed. One securities regulator will better be able to coordinate regulatory responses to financial market crises such as ABCP, crises that do not respect geographical boundaries. The concern with jurisdictions' opting out of regulatory initiatives will be alleviated, except, of course, to the extent that the existing 'passport system' which allows provinces to act unilaterally in many respects remains in place.

If a national securities regulator is created, Canada should then move to achieve the next phase of regulatory restructuring by emulating the United Kingdom's Financial Services Authority (FSA). The FSA regulates the financial services industry in the United Kingdom, setting standards for financial institutions and taking action against firms if they fail to meet the required standards.¹⁴⁹ Securities regulation and prudential regulation are not separated. When examining systemic risk, a single regulator of this sort can seek information and respond to market events as needed. It can work in tandem with the country's central bank to monitor and mitigate systemic risk.

Some may argue that the FSA did not regulate UK financial markets effectively through the financial crisis, given the fall of financial institutions there, including the Royal Bank of Scotland.¹⁵⁰ However, UK financial markets (like most markets) were not immune to the massive financial-institution failures in the United States and the worldwide repercussions that these institutional break downs caused. In addition, mitigating systemic risk is not among the FSA's objectives, though adding this objective is on the reform agenda.¹⁵¹ An integrated market regulator cannot prevent financial meltdowns, but barriers to information sharing that exist with multiple market regulators in place should be removed.¹⁵²

148 It has referred the constitutionality of a national securities regulator to the Supreme Court of Canada; see also the Web site of the Canadian Securities Transition Office at <<http://www.csto.ca/en/default.aspx>>, which contains links to the *Draft Act*, supra note 17.

149 Financial Services Authority (UK), *What We Do* (30 June 2010), online: FSA <<http://www.fsa.gov.uk/Pages/About/What/>>.

150 See Jon Menon & Andrew MacAskill, 'RBS, Lloyds Get \$51 Billion in Second Bank Bailout (Update6)' *Bloomberg* (3 November 2009), online: Bloomberg <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a9MBFPNg_6mY>.

151 Ibid.

152 Along with the FSA, the Bank of England plays a role in maintaining the stability of the financial system through 'risk assessment and risk reduction work, market intelligence functions, payments systems oversight, banking and market operations, including, in exceptional circumstances by acting as lender of last resort, and resolution work to

In the absence of such a merged structure, the focus of any regulatory reform relating to systemic risk should not simply be on the role of securities regulators but also on the relationship between securities and prudential regulators and on the cooperation and information sharing that occurs between these bodies in order to mitigate systemic risk. The recently released proposed federal securities act contains a provision which allows securities regulators to share information with other 'securities or financial regulatory authority' in order to contribute to the integrity of the financial system.¹⁵³ This type of provision that facilitates information sharing is crucial, whether or not a national securities regulator is achieved.

OSFI may argue that the efficacy of Canadian prudential regulation arises from the ability of one regulator to monitor closely the handful of big banks that comprise the Canadian financial market. Further, OSFI may be reluctant to share information because its monitoring role may be undermined if it shares information that it has obtained from the institutions within its purview. To the extent that these issues have an impact on the regulation of securities markets, however, it seems that securities regulators should at least be at the table to discuss issues of systemic risk that affect players in the market that they regulate. Such cooperation is unlikely to occur in the absence of legislation premised on the notion that securities regulators are a relevant and important player in mitigating systemic risk.

A final point relates to the importance of international cooperation in global financial markets, markets that are increasingly integrated, especially in terms of electronic cross-border trading and derivatives. International cooperation is crucial, given that many market crises, such as LTCM and ABCP, were precipitated, at least in part, by events outside of the home jurisdiction. Further, effective securities regulation in one market may have little benefit in limiting contagion if there is a less robust regulatory regime in another market. This point underlines the importance of the G-8 finance ministers' initiatives and their attempts to achieve a common set of principles for financial market regulation.¹⁵⁴

deal with distressed banks'; see the Bank of England, *The Bank's Financial Stability Role* (n.d.), online: Bank of England <<http://www.bankofengland.co.uk/financialstability/>>. This role is akin to the Bank of Canada's role in Canada's financial system.

153 See *Draft Act*, supra note 17, s. 224.

154 *Statement of G8 Finance Ministers* (Leece, Italy) (13 June 2009), online: US Department of Treasury <<http://www.ustreas.gov/press/releases/tg171.htm>>; *G-8 Muskoka Declaration: Recovery and New Beginnings* (Muskoka, Canada) (25–6 June 2010), online: Government of Canada <<http://g8.gc.ca/g8-summit/summit-documents/g8-muskoka-declaration-recovery-and-new-beginnings/>>. See also Ethan B. Kapstein, *Architects of Stability? International Cooperation among Financial Supervisors* (BIS Working Paper No. 199) (2006), online: SSRN <<http://ssrn.com/abstract=891904>>.

In sum, neither securities regulators, central banks, nor other financial market authorities can prevent systemic risk. The function of securities regulators envisioned in this article is to adopt a risk-monitoring role whereby they seek to understand, and alert market participants if necessary, when a build-up of systemic risk is likely to occur as a result of securities transactions within their regulatory purview. Gathering and sharing information with other regulatory bodies, domestically and internationally, is part of this function.

V *Conclusion*

While securitized products such as MBS, CDOs, and CDS can have positive effects in terms of wealth creation, concerns regarding their use include the systemic volatility that can arise when original lenders in these transactions do not bear the risk of default, when the underlying assets for the derivative contracts consist of capital of little or no value, when leverage ratios are highly concentrated among a few institutions, and when investors do not have sufficient information on which to base their investment decisions. This article has argued that such occurrences can give rise to systemic risk – risk that should not be monitored solely by existing prudential regulators. A sounder approach to regulating current financial markets is to ensure that the securities regulatory mandate can and does cover all aspects of capital market activity.

These reform proposals are not meant to exaggerate the potential impact of securities regulators' ability to address systemic risk. The financial crisis illustrated the need for reforms in many areas, including evaluating the true leverage exposure of financial institutions by stress testing correlated risk and changing the definitions of leverage exposure to encompass all forms of derivatives in setting capital ratios. Perhaps, such policy changes would ensure that if hedge funds did not have banks and large investment firms as counterparties, they would not be able to take on excess leverage (and that if they did fail, those affected would be their own investors and other hedge funds that were their counterparties). But these types of reforms are best suited to prudential rather than securities regulators, underlining that securities regulators should not be the sole bodies responsible for reducing systemic risk, although they should have a role in this regard.

A further point relates to how financial markets as a whole are regulated. What is the rationale for having separate areas of law governing related, if not similar, aspects of financial market activity? When securities law was introduced over forty years ago, financial markets were less complex than they are today. Securities law has sought to ensure that investors in the public markets are adequately informed and that they purchase securities from credible individuals who are registered to

engage in such transactions. In contrast, prudential regulation has focused on individual financial institutions and their stability, including capital adequacy, among other things. It seems that a strict separation between these two areas of law is no longer tenable and that a new, integrated framework for financial market regulation is warranted.

Finally, we should ask whether financial markets and their regulators are in a better position to address the next financial crisis than they were two years ago. To date, there has been little accountability from entities that were root causes of the crisis, such as financial institutions with reckless lending practices and credit-rating agencies that provided faulty ratings. Further, some of the culprits have, in fact, been rewarded with government bailouts, despite the moral hazard that they created. The amount of debt in the financial system has not been reduced but is, in fact, higher.¹⁵⁵ The relatively small amount of private-sector deleveraging has been more than offset by the public-sector debt increase to fund bailouts and offer liquidity to keep the financial system functioning.¹⁵⁶ While a prolonged period of slow growth and deleveraging on a global basis is likely on the horizon, the next financial crisis may well be a sovereign one ultimately stemming from government bailouts during the 2008 crisis. The insurmountable challenge will be that there is no one to save a sovereign (except its citizens) when the crisis hits.

155 James Rowe, 'Government Borrowing Is Rising Risk to World Financial System' *IMF Survey Magazine* (20 April 2010), online: IMF <<http://www.imf.org/external/pubs/ft/survey/so/2010/res042010a.htm>>.

156 IMF, *A Fair and Substantial Contribution by the Financial Sector: Final Report for the G-20* (Washington, DC: IMF, 2010), online: IMF <<http://www.imf.org/external/np/g20/pdf/062710b.pdf>>.

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