Mandatory Disclosure And The CSA Proposed Legislation for Securitized Products

by

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Abstract

One of the main factors that spurred the 2008 financial crisis was the trading of securitized products without a clear understanding of the risks that those products bore. I argue that an appropriate regime of mandatory disclosure is the primary instrument regulators should refer to in order to correct the informational asymmetries that are present in the market for securities products. Subsequently, I take into consideration the CSA proposed legislation for the mandatory disclosure of securitized products and analyze its main components under the light of the principles of investor protection and market efficiency. I find that the new legislation should be welcome by market operators because it is a good balancing effort between the protection of the investors and at the same time fostering the efficiency of the market.
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Introduction

The financial crisis of 2008 has produced widespread consequences around the world that have dramatically affected in the medium and long term the economic growth of the western world in what has been defined as a “geopolitical setback for the west”.\(^1\) The US economy in particular has been hugely affected since 2008. Among the various foreclosures of the banking giants Bear Stearns, Lehman Brothers, Fannie Mae, Freddie Mac and the decrease in value of the S&P 500 by 45% from its high, the value of the housing market plunged from a peak of $13 trillion to $8.8 trillion. On the same note, retirement assets went from a top $10.3 trillion to $8 trillion dropping of a 22%\(^2\).

While in the U.S. the trading and sale of securitized products to unsophisticated investors has had a greater impact on the economy than in Canada, the market, on this side of the border, has not been immune from the spread of the crisis.\(^3\) The ABCP market freeze of 2007 can be considered as a good example of failure in market confidence.\(^4\)

Mandatory disclosure could be one of the regulatory elements to work on in order to prevent any possible future crisis. Whether mandatory disclosure is a necessity of securities regulation has already been subject of discussions\(^5\) and scholars agree on the fact that although capital markets cannot prescind from it, its use must be closely monitored in order to avoid a rise in informational cost and loss of market efficiency.\(^6\) The loss of confidence in the markets that led to the credit crunch was the result of a lack

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\(^1\) Roger C. Altman, “The Great Crash, 2008” (2009) 88 Foreign Aff 2 at 2 [Altman].
\(^2\) Ibid at 5.
\(^3\) 34 OSCB 3811 (2011), at 3814.
of understanding by all market operators of the type of instruments they were dealing with, partly due to the inherent complexity of these instruments.\(^7\) This, eventually, contributed to the outburst of the crisis. In my view, the need for better disclosure is stronger than ever.

The Canadian Securities Administrators (CSA) has decided that a legislative intervention in the field of mandatory disclosure of securitized products is needed. The CSA has published a document which includes all the proposed reforms in the sector and is seeking comments from the public. The proposed draft includes, among other things, the introduction of new prospectus disclosure rules, continuous disclosure, exempt distribution rules and a risk retention rule. These measures are generally aimed at broadening the control of securities regulators over the securitization process, so as to increase the protection offered to investors.

From a legal standpoint, it is paramount to analyze the proposed reform to see what kind of impact these measures may have in the field of securities regulation and more precisely whether the new mandatory disclosure regime is the best suited to respect the principle of investor protection while avoiding at the same time an excessive burden on financial institutions in terms of costs for compliance with the legislation and more generally a decrease in market efficiency. Section 2.1 (1) of the Ontario Securities Act states that regulators should always seek the right balance between the two underlying principles of securities regulation outlined in the Kimber Report: investor protection and market efficiency. However, striking the right balance is never an easy objective to achieve.

Despite the fact that the CSA Proposed Measures on Securitized Products have been subject to more critics than compliments, I find they represent a significant step forward in the field of mandatory disclosure for securitized products because they improve the current regulatory system by clarity and effectiveness of information in such a complex

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field of finance. The reform reaches the goal of providing better information to investors without overwhelming them and this is achieved by restructuring the disclosure requirements by which issuers have to abide. Mandatory disclosure is widely accepted as beneficial for securities markets, allowing to create a set of information issuers must provide. In its absence, investors would not be able to identify good and bad products, thus receiving an incentive to abandon the market.

Part I of this thesis will describe the problems arising from asymmetrical information, namely the “market for lemons”. Part II will explain why mandatory disclosure is the only solution to eliminate the market for lemons and other consequences of informational asymmetry. Finally, in Part III, this thesis will analyze whether the new mandatory disclosure measures in the field of securitized products is the right one to strike a good balance between investor protection and market efficiency. I find that the new regime achieves both objectives.
Chapter 1
The “Market for Lemons” Problem

In 1970, George Akerlof published an article regarding the effects of asymmetrical information in the market for used cars to explain how the lack of a system or measures that impose the dissemination of information regarding the goods can ultimately cause the market to cease existing. After illustrating briefly the content of the theory, I will apply it to the field of securitized products and argue that mandatory disclosure is a necessary regulatory element in this market in order to fill the informational gap and avoid another crisis.

1. Informational asymmetry and the market for lemons

The reason why a certain good is traded is that the seller and the purchaser agree to a price, which is considered to be fair by both parties. If the buyer thinks the price for the good is not worth the utility that it can bring to him, the buyer will not purchase it. Their belief of what is the “right price” is dictated by the fact that the seller and the buyer both have at their disposal a set of information regarding the good. In most cases, the seller has more information available on the good it is trying to sell than the buyer does.

Akerlof explains this concept through the use of the market for cars. Assuming that there are two types of cars, good and bad ones, the buyer has no idea of which car is good and which car is bad until he has owned it for a length of time. There is therefore a difference in the level of information that the purchaser and seller have of the same car.

An asymmetry in available information has developed: for the sellers now have more knowledge about the quality of a car than the buyers. But good can and bad cars must still sell at the same price- since it is impossible for a buyer to tell the difference between a good car and a bad car. It is apparent that a used car cannot have the same valuation as a new car -if it did have the same

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valuation, it would clearly be advantageous to trade a lemon at the price of new car, and buy another new car, at a higher probability \( q \) of being good and a lower probability of being bad. Thus the owner of a good machine must be locked in. Not only is it true that he cannot receive the true value of his car, but he cannot even obtain the expected value of a new car.\(^9\)

For this reason, good and bad cars sell at the same price. The problem is that the buyers are aware at least of the fact that bad cars are present but since they are not able to distinguish them, their natural reaction will be to discount the price they are willing to pay for all the cars on the market, good and bad ones.\(^10\)

This has of course a negative impact on the market for cars because sellers of good cars will not be willing to sell anymore at a discounted price and most cars sold will be “lemons”. In other words, bad cars will tend to drive out of the market the good cars.\(^11\) Where little information is available on the market, buyers cannot distinguish good from bad products. It is therefore in the interest of the sellers of good products to provide the general public with information regarding the products that they sell whereas the sellers of low quality products have an interest in concealing or at least not revealing the real value of the product if they want to stay in the market.

1.1. What are some elements that can counteract the market for lemons effects?

In order to avoid such dramatic consequences, the Akerlof theory explores some institutions that may be able to counteract the negative effects of asymmetric information on the market. The first institution considered is guarantees. By guaranteeing on the quality of a product, the risk is shifted onto the seller. The second institution taken into account is the brand-name good. This creates affiliation with the buyers and offers them a means of retaliation as well in case the good is not up to the standard promised. They can in fact stop purchasing those specific goods and give negative reviews to other potential

\(^9\) Akerlof at 489.
\(^10\) Ibid at 489.
\(^11\) Ibid at 489.
clients. A third way of contrasting the market for lemons can be the use of market licences because they indicate a certain level of proficiency in a certain field.\(^{12}\)

**1.2. Application of the market for lemons theory to securitized products**

But how does this relate to the field of securitized products? The answer is that the market for lemons tells us something very general regarding the use of information in a certain market that can find application in many different fields. It tells us that the market alone presents asymmetric information that needs to be counteracted in some way. This concept equally works for the field of finance. Financial products are created for the purpose of being resold in the primary and secondary market and the decision of an investor to buy these products is the result of an analysis that, basing on the information available to him, leads him to think that it will be a profitable investment. Thus, information plays a paramount role in the securitized market because it can determine the difference between a good and a bad investment.

Excessive discrepancy in information available to the seller and the buyer could drive securitized products out of the market for the same reasons that I have explained above using the example of Akerlof.\(^{13}\) Before purchasing a securitized product, it may be hard for the buyer to distinguish the quality of the products just as it was hard for a customer to distinguish the good from the bad cars. As a consequence of this behaviour, the lemons will drive the good securities out of the market.\(^{14}\)

The misrepresentation of a good’s quality on the market can be very costly.\(^{15}\) Thus, the challenge becomes for the seller to find a way to make his product stand out and make it easier for the buyer to identify its quality. Otherwise, higher quality products will sell for a lower price than they would and lower quality products would vice versa sell for a

\(^{12}\) Ibid at 500.
\(^{13}\) Ibid.
\(^{14}\) Ibid at 489.
\(^{15}\) Ibid at 495.
higher price to the point that good products will leave the market.\textsuperscript{16} The “lemons” (bad securities) gain control of the market as the pool of investments deteriorates.

\textbf{1.3. Counteracting the market for lemons in the field of securitized products}

Many solutions have been proposed to eliminate the detrimental effects of lemons on securities markets: the certification of securities by underwriters, the certification provided by credit rating agencies, the system of voluntary disclosure and a form of guarantee by use of a risk retention rule. In the following paragraph, I provide an overview of all these measures and explain what are their strengths and weaknesses.\textsuperscript{17}

\textbf{1.3.1. Certification by Underwriters}

The first type of certification is based on the fact that banks underwriting securitized products have a reputational interest to maintain and this incentivizes them towards accepting to underwrite only securitized products of good quality. Unfortunately, this solution has proven not to be really effective. According to some research, reputational capital seems not to be influencing as much the role of the underwriter.\textsuperscript{18} In this case, in fact, transactions underwritten by banks with a bigger market share have performed worse than the others. It seems that these banks have more interest in their short-term profit and have taken advantage of their market power (and reputation) to place lower quality products.\textsuperscript{19} In other words, some banks have taken advantage of the information asymmetries in the market rather than trying to fill them.

\textbf{1.3.2. Certification by Credit Rating Agencies}

Scholars have proposed a second type of certification that makes reference to the role of

\textsuperscript{16} Ibid at 499.
\textsuperscript{17} Easterbrook, supra note 6 at 674.
\textsuperscript{19} Ibid.
“gatekeepers” and the way that their interests and involvement aligns the interests of issuers with those of investors.

Gatekeepers are reputational intermediaries who provide verification and certification services to investors. These services can consist of verifying a company’s financial statements (as the independent auditor does), evaluating the creditworthiness of the company (as the debt rating agency does), assessing the company’s business and financial prospects vis-a-vis its rivals (as the securities analyst does), or appraising the fairness of a specific transaction (as the investment banker does in delivering a fairness opinion).

In order to increase transparency for investors, companies allow outsiders to review the books and records to assess the firm situation basing on the fact that the reputational interest of accountants is higher than the gain they would derive from giving an untruthful representation of the firm’s value. Although this statement is true in theory, history demonstrates informational intermediaries are not so efficient. Scandals like Enron, Tyco, Worldcom, Parmalat and AIG are some of the cases that undermine this statement. In these cases, other types of incentives must have intervened in shaping the behaviours of these operators in a manner that turned out to be detrimental for investors. In the words of Coffee,

[P]ut simply, reputational capital is not an asset that professional services firms will inevitably hoard and protect. Logically, as legal exposure to liability declines and as benefits of acquiescence in the clients demands increase, gatekeeper failure should correspondingly increase - - as it did in the 1990's. Market bubbles can also explain gatekeeper failure (and this perspective probably works better in the case of the securities analysts, who faced little liability in the past), because in an environment of euphoria investors do not rely on gatekeepers (and hence gatekeepers have less leverage with respect to their clients).

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21 Easterbrook, supra note 6 at 675.
With respect to securitized products, credit rating agencies were involved in the securitization process in a similar way as accounting firms are involved in the certification of company books. The role of credit rating agencies is exactly to separate the lemons, be the so-called “informational intermediaries that transfer companies information to the public.”\(^\text{25}\) Rating agencies perform a due diligence role that the many single investors would not do otherwise. They become almost necessary in order to sell complex financial products. Ratings help decrease the informational asymmetry by reviewing all the information submitted by clients along with the request to rate one of their products, review the characteristics and express a judgement over the risk the product carries.

Rating agencies should have a reputational interest to conduct their business in a fair manner in order to maintain their reputation on the market like the other gatekeepers should. If these products were not rated correctly, the market would lose confidence in any of their future ratings, with the consequence of leading them out of business. The problem is that rating agencies, like the other gatekeepers, are subject to conflicts of interest that overcome the reputational interest incentive. They have in fact an incentive to depict positively the products that are submitted for review in order to attract more clients and please those that have acquired their services. Frank Partnoy made an even stronger argument by stating that credit rating agencies cover a more important role than other gatekeepers do,

\[\text{credit rating agencies differ from other gatekeepers in several important ways... credit rating agencies continue to face conflicts of interest that are potentially more serious than those of other gatekeepers: they continue to be paid directly by issuers, they give unsolicited ratings that at least potentially pressure issuers to pay them fees, and they market ancillary consulting services related to ratings. Credit rating agencies increasingly focus on structured finance and new complex debt products, particularly credit derivatives, which now generate a substantial share of credit rating agencies’ revenues and profits. With respect to these new instruments, the agencies have become more like “gate openers” than gatekeepers; in particular, their rating methodologies for collateralized debt obligations (CDOs) have created}\]

\(^{25}\) Easterbrook supra note 6 at 675.
and sustained that multi-trillion dollar market.\textsuperscript{26}

During the crisis, it seems as rating agencies failed in assessing the risk that these securitized products bore. As I have explained above, this failure is due to inherent conflicts of interest.\textsuperscript{27} The first

approximately 90 percent of rating agency revenues come from issuers who pay for ratings.\textsuperscript{33} Rating agency fees vary depending on the size and complexity of the issue.\textsuperscript{34} For corporate debt, the fees are in the range of 3 to 4 basis points of the size of the issue, with minimum amounts in the range of $30,000 to $50,000 and maximum amounts in the range of $300,000.\textsuperscript{35} For structured finance issues, fees range up to 10 basis points, and fees for complex transactions are substantially higher, up to $2.4 million.\textsuperscript{36} The rating agencies recognize that conflicts arise from having issuers pay for ratings, but they say that historically they have been able to manage those conflicts. For example, S&P has adopted procedures designed to ensure that no individual is able to link credit rating opinions to fees.\textsuperscript{37} Of course, credit rating agencies and other gatekeepers face some of the same actual and potential conflicts. For example, credit rating agency board members serve in various capacities for companies that the credit rating agencies rate. For example, WorldCom shared a director with Moody’s and received favorable ratings even after its bonds were trading at non-investment grade credit spreads.\textsuperscript{38} Unlike other financial intermediaries, credit rating agencies have not been pressured to eliminate such conflicts.\textsuperscript{28}

I also think that this failure is due to the complex nature of securitized products.\textsuperscript{29} The high complexity of transactions involving securitized products, especially in the originate-to-distribute model, had two undesirable consequences on disclosure: either it oversimplified the complexity of the structure or it provided a level of detail that cannot be fully understood by both unsophisticated and savvy investors.\textsuperscript{30}

\textsuperscript{28} Ibid.
\textsuperscript{29} Steven L Schwarcz, Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures (2002) 70 U Cin L Rev 1309 at 1316-17.
\textsuperscript{30} Ibid at 1316-17.
The failure of rating agencies to properly assess the risk of securitized products was due to two complementary factors: an agency conflict on one side since they were paid by clients to rate the clients’ products and on the other side the high complexity of the transactions that disclosure could not adequately explain. So the investors were relying on the rating agencies for fair evaluations, but the rating agencies were not doing what they were supposed to.

Complexity can also be one of the causes of an important phenomenon called herd behaviour, arising from the known bounded rationality of investors. Where none of the analysts is able to accurately reflect the price of the securitized products from the information available for the reasons outlined above, investors trading believing that a certain product holds different characteristics than in reality. Wrong risk assessment can jeopardize the whole portfolio. Herd behaviour intervenes on market mechanisms and on the theory of the market for lemons in a very strange manner. In fact it can hide the flaws of a market that uses certification as a way to counteract the negative effect of lemons. Irrational investors need to rely on third parties to have an accurate price of a security. However, if the third party is biased or limited in its rationality, certification becomes useless.

In sum, certification of the quality of securities, especially by private parties therefore does not exhaustively counteract the asymmetric-information problem. In cases where there is not merely information asymmetry between originators and investors but also information failure on the part of originators, certification by originators can actually mislead investors. This is exactly what happened in part during the crisis.

1.3.3. Voluntary Disclosure

A third element that can potentially counteract the effect of the market for lemons is the

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31 Schwarcz, “Disclosure Failure”, supra note 7 at 1113.
33 Schwarcz, “Disclosure Failure”, supra note 7 at 1121.
dissemination by the sellers of information regarding their products. Without a regime of mandatory disclosure, this information would be provided on a voluntary basis in order to attract investors just as a start up business would disclose its business plan in order to raise capital or just as the seller of a good car would do in order to be able to sell his car and obtain a fair price in exchange. In fact, “the firm that discloses more can sell its stock for more, indeed for as much more as the full value of all information.”\(^{34}\) The question is whether voluntary disclosure, as a natural market response to asymmetric information, is an effective solution to the market for lemons. The answer is no for three reasons.

Voluntary disclosure may in fact be subject to free riding by the sellers of lemons who could provide accurate and fair information on facts discernible for investors and bogus statements on those facts that cannot be verified, leveraging on the fact that investors are not sufficiently sophisticated to distinguish bogus from real disclosure.\(^{35}\) In other words, issuers of bad products could simply use the same type of disclosure made by good products issuers, impeding investors to distinguish products’ quality. In fact, we must bear in mind that securitized products can present a very high level of complexity that makes it likely for buyers not to be able to distinguish the real from the bogus disclosure. In the words of Easterbrook and Fischel, the amount of voluntary disclosure is rough “because of the certification and verification costs in the informational supply chain.”\(^{36}\)

Secondly, the use of a system of voluntary disclosure seems to me economically inefficient because there is no standard way to present to buyers product information. This can increase the cost that buyers bear in order to understand the different ways that sellers use to present that information.

Thirdly, the problem relating to voluntary disclosure resembles much of the prisoners’ dilemma:

The firms and investors, acting as a group, would want the firms to disclose

\(^{34}\) Easterbrook, supra note 6 at 685.  
\(^{35}\) Ibid at 674.  
\(^{36}\) Ibid at 685.
information with both firm and industry-specific components. Each firm acting individually will not do so, in part because the others would get a free ride and in part because some of the information (such as that pertaining to new products) may give a competitive advantage to rivals. Each firm would be willing to disclose, but only if all others were required to do likewise. Then the costs and any business risks would be distributed more evenly.\textsuperscript{37}

Although the article does not specifically refer to the field of securitized products, we can draw interesting considerations that are specific to the subject at issue. The issuers of securitized products may refrain from disclosing information regarding their product because they know that they could be giving useful information to rivals. Only if they knew that all issuers were to disclose their information, would each issuer singularly disclose its own. The problem is that, if issuers are not compelled to disclose, they fear to give a competitive advantage that will make them hold out.\textsuperscript{38}

\subsection*{1.3.4. Guarantees: Risk Retention Rule}

A fourth solution proposed to eliminate the market for lemons problem is to mandate firm’s managers to hold substantial quantities of their stock,\textsuperscript{39} so as to align their interest with those of the shareholders’ base. It is true that by way of risk retention the buyers’ risk still remains instead of being shifted on to the sellers, but at least the sellers are forced to share part of this risk with their clients. In the case of securitized products this corresponds to the risk retention rule that has been introduced in the United States and Europe and that imposes issuers to maintain part of the securitized products they issue as a guarantee of the quality of these products. In this way, investors’ loss would become their loss as well. However, I will later explain that the introduction of a risk retention rule can have the same effects of lemons on the market if the purchase threshold is not accurately chosen.

\textsuperscript{37} Ibid at 685. \\
\textsuperscript{38} Ibid at 686. \\
\textsuperscript{39} Ibid at 676.
2. Why the market for securitized products has not been driven out by the lemons

Out of all the elements indicated above, I think that disclosure has shown to be the one with the greatest potential to fix the market for lemons problem. Some may think that this is not an issue since the market for securitized products still exists. It must mean that the market itself has found a way not to let good products perish under the lemons. This is partly true. Voluntary disclosure sufficiently counteracts the negative drive of the lemons and allows the market for securitized products to exist. Securitized products, and securitization more in general, are the most effective financial technique to raise capital and spread risk among wide arrays of investors. This allows fostering market efficiency. However, countries also have an interest in making sure that the use of these products does not harm investors. Disclosure, in a mandated form, is the way in which regulators can make sure they are paying due attention to both the principles of securities regulation.
Chapter 2
The Theory Behind Mandatory Disclosure

Provided that all the measures outlined above struggle to different extents in maintaining a market for securitized products and at the same time helping investors come to a conclusion as to the convenience of purchasing a certain product, there must be other ways in which the informational gap can be filled. Mandatory disclosure seems to be the solution to this issue. I will briefly introduce the two principles of securities regulation and how mandatory disclosure is able to consider both at the same time. Once I have explained that mandatory disclosure is the best way to regulate the securitized products market, I will move on to the third part of the thesis in which I discuss whether the new regime of mandatory disclosure proposed by the CSA is an appropriate one.

1. Investor protection and the protecting function of mandatory disclosure

The financial crisis has shown how self-interest and reputational incentives do not suffice in providing citizens with a playing field that is at the same time attractive economically and safe for them to invest. The two main principles of Ontario securities regulation seemed therefore not to be easily respected at the same time. Although these objectives are apparently contrasting, they have more in common than it seems.

1.1. Investor protection

Investor protection was initially considered the only objective of securities law and disclosure was the primary means through which it was pursued. Mandatory disclosure was intended to provide investors with information, in other words to level the playing

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Although the second principle was formally introduced only in the Securities Act, the Kimber Report stressed the importance of guaranteeing both investor protection and efficiency of the markets. The efforts of the legislators remained in the first years on building walls mainly for investor protection. In this optic, disclosure obligations started flourishing in the Act and “full, true and plain disclosure”\textsuperscript{42} became one of the main purposes of the law.\textsuperscript{43}

Investor protection is at the same time the cause and consequence of another important element of a balanced market: “confidence”. Although it is hard to establish what comes first in a causational chain, it is fair to say that market confidence builds on top of the previous two more than actually being put beside them as a third and autonomous objective. Market confidence is in fact the result of an adequate protection of the investors and at the same time the consequence of a market that is efficient.

The decision to invest stems from the public confidence in the potential of the economy. Public confidence itself is the result of a market where information is readily available to allow the anticipation of profits.\textsuperscript{44} Thus, market confidence is strictly interconnected and intertwined with the concept of investor protection and may also be the indirect result of a market that is efficient.

\section*{1.2. Market efficiency}

Market efficiency is the second, yet equally important principle of securities regulation. Mandatory disclosure aims to achieve efficiency by correcting information misalignments that could cause market failures. It is well known that incomplete
information characterizes securities markets, which can cause adverse selection, moral hazard and underproduction of information.45

In modern finance, economists refer to an efficient market when information is rapidly incorporated into asset prices.46 This definition of efficiency is also known as semi strong form of the Efficient Capital Market Hypothesis first introduced by Eugene Fama.47 The theory maintains that the price of a security reflects all publicly known information about the security and, secondly, the market absorbs and discounts new information instantaneously and efficiently when it becomes available. The model relies on the assumption that investors are rational, meaning that they are able to correctly understand all information available to them concerning the security.

In the case of securitized products, this translates into the fact that at least some of them, the analysts, whose job is to understand, interpret and present this information to other investors, know what they are doing. The failure to accurately assess the value of securities on their part would undermine the whole Efficient Capital Market Hypothesis. Other investors are in fact used to simply rely on analysts’ work. If rating agencies failed in their task, the ECMH model would transform in “herd behaviour” in which “irrational individual investors buy and sell based upon whether other irrational investors are buying and selling.”48

In the 2008 financial crisis there are certainly traces of herd behaviour as most of securitized products traders, which are for the vast majority experienced professionals had not conducted a thorough assessment of the products and were simply relying on the ratings provided by the rating agencies, which, on their side, where not reliable. This can

46 Christopher C Nicholls, Corporate Finance and Canadian Law (Toronto, Carswell, 2000) at 90.
be the consequence of bounded rationality and information asymmetries.\textsuperscript{49} Both the lemons problem and herd behaviour were the consequence of bounded rationality, information asymmetries and the conflict of interest of rating agencies. In filling informational gaps caused by market failure, mandatory disclosure attempts to solve these issues.

2. \textit{Mandatory disclosure is necessary to balance market efficiency and investor protection}

In a securities market where not even the most sophisticated investors may be able to identify if the information that is voluntarily provided by the issuers is legitimate or bogus, or at least sufficient, the same concept of market efficiency starts crumbling in front of investors’ limited rationality and products complexity. If regulators wish to maintain these markets in good shape, it is necessary to help investors fill the informational asymmetries since market itself will not do it. Mandatory disclosure can do so by subsidizing investors’ efforts. By imposing on issuers the burden of providing a well-defined set of information, the regulators are substantially decreasing the cost of information for investors with many positive consequences. Regulators are at least as knowledgeable as expert investors and have a greater amount of resources that can be used in determining the most relevant elements that must be disclosed.

By introducing mandatory disclosure, regulators artificially intervene in market mechanisms and can potentially lift investors to a much higher level of understanding of the characteristics of securities. A good system of mandatory disclosure will probably increase investments pro capita but will also allow to widen the base of investors in a certain market. Overall, this can be seen as a quite positive accomplishment since the protection of investors seems to boost the efficiency of the market in which mandatory disclosure is implemented.

Mandatory disclosure seems to eliminate many of the problems in the market that other measures taken into account above were not able to counteract. The inefficiency of capital markets, and in particular the market for lemons problem, applies directly to the case of securitized products and in a very evident manner. For example, it has been found that mortgage-backed securities are composed of assets of a lower quality of those that are not sold to special purpose vehicles.\(^50\) This is due to many factors but one of them is certainly the complexity of securitized products.

In fact, complexity can give rise to asymmetric information problems. The complexity of the structure of the pool of assets plays a major role in the ability of investors to understand data and therefore lead issuers to pick assets that are of good quality. A perceived lack of protection has the effect of making investors look for more transparent markets with all the consequences illustrated above. On the contrary, a well-designed system of mandatory disclosure can solve the market for lemons and its “underdisclosure” problem. The supporters of voluntary disclosure have criticised mandatory disclosure regimes. However, I think Merrit Fox interestingly notices that to really make a case against mandatory disclosure

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\text{The proponents of issuer choice would need to show that the governmental failures associated with regulation exceed the market failures likely to be associated with issuer choice. To date, they have not done so. For the most part, these proponents assume governmental failure and ignore market failure. The crux of their argument for issuer choice is that the resulting competition among regulators will have good incentive effects. This is not a persuasive argument for change without a showing that there is a need for such incentives and that they are worth their costs in terms of the market failures that issuer choice will bring.}^{51}
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Mandatory disclosure is justified exactly on the grounds that creating a market where stock prices are reflected accurately cannot be realized without legislative intervention because the market would not naturally disclose material information relating to the


stock. This belief seems to have proven correct in recent years. Regulation serves as an immediate and direct answer to the flaws and failures of the old regulatory system, thus conveying the message that what was not working before has now been fixed and that the same errors will not be committed twice.

Therefore, the pillar of price accuracy and investor awareness is regulation in both the primary and secondary market by way of mandatory disclosure. The information contained in the prospectus and in continuous disclosure will in fact be useful to the secondary market to evaluate the convenience of a certain investment. The Kimber Report appropriately emphasized the link between confidence in the two markets.\(^ {52}\). It makes sense that regulators are now trying to redefine the information that must be disclosed in both of them through prospectus and continuous disclosure.

According to a statement extracted from the Kimber Report, the purposes of the securities law should be to “assure optimum allocation of financial resources in the economy, to permit maximum mobility and transferability of those resources….”\(^ {53}\) Mandatory disclosure seems effective since it reduces the cost of capital.\(^ {54}\) Moreover, the market is naturally subject to lack of information that can have adverse effects on the market itself such as signalling problems that are twofold. On one side we have the market for lemons problem that I have already discussed. The other facet of the issue is that there is a limit to the amount of time and money that investors are willing to use to research correct information on securities. It is therefore in “the interest of the regulator to publicly subsidize “search costs” to secure both a greater quantity of information and a better testing of its accuracy.”\(^ {55}\)

\(^{52}\) Province of Ontario, Report of the Attorney General’s Committee on Securities Legislation in Ontario (Toronto: Queen’s Printer, 1965) at para 1.12 in Mark R Gillen, Securities Regulation in Canada (Toronto, Carswell 1998) at 82 [Gillen].


In fact, economical incentives appear not to suffice in protecting market confidence. In order for the capital market to be competitive, it is necessary that the opposite interest of issuers and investors be aligned. The intervention of the regulator seems at this point unavoidable if we want to maintain efficient capital markets. Regulation can in fact create or at least shape issuers behaviours by introducing incentives that make issuers and investors’ interests aligned. It is important though that regulation be appropriate to effectively provide transparency, protection, efficiency and stability.

The fact that both rating agencies and sophisticated investors failed in valuing correctly securitized products raises some important doubts over the efficacy of the disclosure system up to the meltdown. In particular, the question at this point is not whether mandatory disclosure is a necessary element of securities regulation, rather the question is whether the regulatory regime in place suites the complexity of the products it is regulating. Financial derivative instruments have been defined as “weapons of mass destruction” because the high amount of data required to correctly assess the risk of default of the underlying pools of assets made it so complex that “even the people running Wall Street firms didn’t really always understand what they were buying and selling.” Thus, regulators need to make sure that the level of mandatory disclosure implemented is the right one for the type of products that are being marketed. This is exactly what I will do by tackling the new measures for securitized products proposed by the CSA.

3. *Proscribing dangerous transactions will not substitute the role of a sound mandatory disclosure system*

One argument could still be made for the case of investor protection in the securitized products market that could shut most of the mandatory disclosure concerns. It could be imagined that the best way to avoid any problem with securitized products and

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57 Schwarcz, “Disclosure Failure”, supra note 7 at 1110.
asymmetric information would be to proscribe all those transactions where information asymmetry exceeds certain boundaries. In this manner, issuers would have no mandatory disclosure costs to sustain and investors would not be subject to risk. Market efficiency and investor protection demand could be satisfied at the same time.

However, this suggestion does not seem to consider many other important factors. The first is that it would be extremely hard to establish the threshold of information asymmetry that triggers the legal prohibition to perform a certain transaction. Not only risk is an inherent factor of all financial products to different extents, but also the complexity of a product can at times depend on the knowledge of market operators.

Although it is true that investors have bounded rationality, we still have to determine exactly until what point complexity and limited rationality can coexist. Just like any other activity or instrument that we use in life, financial products carry an element of risk. What matters is our ability to manage these instruments in a way that will benefit us. The second argument against proscribing more complex transactions is the inevitable detriment that would be procured to the principle of market efficiency. In fact, securitized products cover an important role for the economy as a whole, as they allow to raise capital and share risk like no other financial product does.

4. Why discuss levels of mandatory disclosure when the Canadian market was not affected too much by the crisis?

An element common to both the American meltdown and the Canadian market freeze was the improvise lack of confidence that investors had towards the safety of their investments.\(^{58}\) This was due to the fact they had relative knowledge of the assets underlying the securities being traded and this made them question the value of the securities themselves. The trust element emphasized the importance that proper information dissemination has on capital markets, because it allows accurate stock prices

\(^{58}\) For an interesting article on investor confidence see, Lynn A Stout, “The Investor Confidence Game” (2003) 68:2 Brook L Rev 407 [Stout].
reflection in the value of the stock under the informational efficiency theory and protects investors by providing them with all necessary disclosure to make their investment decision. The higher the complexity of the products being sold, the more and the better the information offered to the investors must be.

The Canadian financial market seems less inflated and generally more sound than the American counterpart. However, securitized product present elements of deficiency that need to be improved and that are intrinsic to their nature and have little to do with the peculiarities of a single capital market. Important factors agreed to be at the root of the 2008 meltdown are asymmetrical information and the conflicts of interest. They poisoned the incentives for originators to properly assess the risk of the instruments and for issuers to disclose all necessary information for investors to properly evaluate securitized products.  

Furthermore, I disagree with another argument made by some commentators. They state that Canada was hit by the crisis in a minor way and that these novelties are “a disproportionate response to perceived issues in the Canadian securitization market.”

Although the past does not show any warning, whether the impact was minor in Canada is not indicative of the fact that this may not happen in Canada in the future. The American experience can be used by Canadian regulators as a good case to study and from which to learn what can be changed and ameliorated in order to avoid something similar to happen in Canada. Made in accordance with the IOSCO disclosure principles for asset-backed securities, the measures introduced by the CSA represent an organic and well-rounded regulating effort in this sense.

Chapter 3
Analysis of the CSA Proposed Legislation on Mandatory Disclosure

After explaining the theory behind mandatory disclosure, it is clear that its importance is widely agreed upon. I can now move to illustrate the characteristics of the new mandatory disclosure rules for securitized products and finally express an opinion as to whether they constitute the right approach to regulate the Canadian securitized products market. The regulations in place before the crisis have been put under huge pressure and areas have emerged where mandatory disclosure can be better tailored around the peculiar characteristics of securitized products. Assuming that investor protection is a natural consequence of market efficiency, mandatory disclosure will be helpful if it can properly determine the right amount of information that should be disclosed in order to create a system that avoids the two extremes represented by the lemons problem and information overload.

The analysis of the content of the reform is divided in four sections. The first section will be concerned with the types of information that issuers must provide in the prospectus, the second section will discuss the possible changes in the exempt market, the third section looks into continuous disclosure rules and last part deals with a potential risk retention rule.

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1. Prospectus disclosure

Investor protection starts from the creation of a market in which securities prices are accurate. Inaccurate pricing can modify the structure of portfolio and risk management, with possible shocks and subsequent disruption of consumption and growth.63

Stock price inaccuracies are thus undesirable if they cause major unexpected declines in stock prices. Consider, for example, the October 1987 crash. Between October 13, 1987, and October 19, 1987, stock prices declined by almost one-third, wiping out $1 trillion in perceived wealth.2 63 Whether stock prices were too high before October 13 or too low after October 19, this sudden reduction in wealth greatly increased concerns over the likelihood of a recession and could have easily caused one.264 Even though no recession ensued in the wake of the 1987 crash,265 it probably had a depressing effect on economic activity.2 664

Therefore, it is important that the price of securitized products be properly represented in markets, while at the same time being cognizant of the fact that these instruments present a level of complexity that is higher than the norm. In this situation, price accuracy is not an easy goal to achieve. The introduction of norms that seek to provide investors with detailed information on the pool of assets, the role of parties and the structure of the transaction, exactly serve this purpose.

1.1. Definition of Securitized Product

The introduction of the definition of “securitized products” is the first of the notable changes brought by the reform as it sets the universe of products that are subject to regulation. The wording of the draft seems to be very broad and includes “securities where the payments are derived from cash-generating financial assets… securities backed by assets that are themselves securities… and securities where the payments are derived from synthetic assets”.65 The definition was generally unwelcome in the comments filed to the CSA. In particular, concerns regarded the inclusion of specific types of products in

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64 Ibid [footnotes omitted].
65 34 OSCB 3811 (2011), at 3815.
the definition. Including asset-backed securities in its scope will cause a reduction of investor liquidity, thus impacting negatively market efficiency. Some have even pointed out that additional regulatory disclosure burden on issuers may incentivize them to find alternative sources of funding if transactional costs become excessive.

Although this solution has been subject to critics, in my view it remains necessary to keep a broad definition of securitized products because it allows adapting to the fast pace at which the financial industry develops new and complex products. If a list of every single product included in the definition is not the best solution to the problem as argued by Rumball, it is also true that a general definition that be broad but specific and clear at the same time is an utopian objective. The definition should be improved by using the list of products included as a means to satisfy the general wording and not to further expand it.

1.2. Structure of The Prospectus

Regarding the core elements of the prospectus, the Proposed Form 41-103F1 requires the issuers to disclose all the parties with significant functions and responsibilities in the securitization process (sponsor, arranger, depositor, originator, issuer, servicer, trustee and any other party with a material role). In fact, in the securitization process, the roles traditionally covered by the same bank are split into a number of specialized roles so to take advantage of expertise and economies of scale. Indicating roles and functions of parties in the transaction is extremely important. Research has shown that the healthier is the sponsor of the transaction, the lower the default rate of the product becomes.

69 Ibid.
70 Guettler, supra note 18.
finding seems due to the fact that banks with a longer term perspective are not interested in short term gains. In this case, it can be said that the reputational interest of the sponsor has an impact in the securitization process. Therefore, knowing whether the sponsor is a healthy one can give useful insights as to how strong the reputational interest is.

Along with this measure, issuers are required to identify significant obligors in the pool of assets and the pool of assets underlying the products. The elements to be disclosed are selection criteria, material pool characteristics, delinquent and non-performing assets, sources of pool cash-flow, reps and warranties regarding the pool assets, claims in pool assets, information on prefunding or revolving periods, transaction agreement terms governing the modification of pool asset terms. This is a very good example of how mandatory disclosure can make a significant difference on the amount of research that investors have to conduct. A full understanding of how products are structured can make a huge difference for investors in terms of research, and resources required.

Moreover the pool of assets is the core element of a securitized product as it determines directly its price. In order for the product to be accurately priced, it is paramount that the pool of assets be disclosed in the most organized and clear manner. The requirement to disclose the static pool information where it would be material is strictly correlated and in the case it is not provided, the issuer must explain why. Static pool information allows tracking the performance of a pool of assets over a period of time and getting a sense of what could be future developments in performance.

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An “obligor” is a person or company who is directly or indirectly committed by contract or other arrangement to make payments on all or part of the obligations on a pool asset. A “significant obligor” is any of the following: (a) An obligor or a group of affiliated obligors on any pool asset or group of pool assets that collateralizes one or more series or classes of securitized products, if such pool asset or group of pool assets represents 10% or more of the asset pool; (b) A single property or group of related properties securing a pool asset or a group of pool assets that collateralizes one or more series or classes of securitized products, if such pool asset or group of pool assets represents 10% or more of the asset pool; (c) A lessee or group of affiliated lessees if the related lease or group of leases represents 10% or more of an asset pool that collateralizes one or more series or classes of securitized products; 34 OSCB 3811 (2011), at 3841.

Contra, Osler, Hoskin & Harcourt LLP, “Re: Notice and Request for Comments on the Proposed Securitization Product Rules” (31 August 2011) at 5, online: [Osler];
Another element of concern for the CSA is the structure of the transaction. In other words, how and when the cash flow will occur and what are the underlying fees and expenses. In addition, credit enhancement is another novelty in the proposed legislation and requires describing internal and external credit enhancement and support, and derivative instrument used to alter the cash flow. The providers must be identified and the selected financial information and statements must be disclosed where it is material. Finally, credit ratings must be disclosed along with the modality of distribution of reports and all legal proceedings and regulatory actions that are being processed with respect to the parties with relevant functions and responsibilities in the process.\textsuperscript{74}

The first step to create a sense of confidence in investors is providing them with all the information they need to make their investment decisions. The Proposed NI 41-103 goes in this direction in my view. This includes the structure of the transaction, the role of the parties involved, the pool of assets underlying the securities and the use of derivatives to alter the cash flow, so to indicate the level of trust the originator has in its own products.

Most importantly, the form requires disclosing any transaction between those parties that would involve a conflict of interest in the past 12 months. This type of measure is in line with the theory of disclosure as an effective way to reduce agency conflicts. It would be quite relevant in fact for investors to know whether some of the parties involved in the transaction have previously been performing other transactions that could possibly misalign their interests and the ones of investors. Introducing a duty to disclose instead of simply prohibiting a transaction with a possible conflict of interest is in my view the best solution as it allows the investor to evaluate whether the transaction is still a good one despite of the conflict and therefore worthy of being brought forward.

1.2.1. Focus on conflict of interest rule

The introduction of rules that impose the disclosure of conflicts of interest and that actually require conflicted parties not to enter in further transactions for a period up to

\textsuperscript{74} 34 OSCB 3811 (2011), at 3852.
one year aims to strengthen mandatory disclosure by remedying where the market has failed in the US and may fail in the future in Canada. By having to retain part of the value of their own securities, issuers are compelled to give a message to the market as to the quality of those products, saving some time to investors and not relying anymore or at least to a lesser extent on the judgment of credit rating agencies.

The second request for comments on the subject draws again from the American regulations and concerns the practical conflicts of interests seen in Canada. They could be eliminated with the prohibition for sponsor and underwriters to engage in transactions that would involve or result in material conflicts of interest with respect to any investor in a sale. On this point, FAIR Canada comments are critical of this approach, maintaining that it would not make sense to introduce rules that eliminate only the present conflict of interest, but that regulation should try to prevent possible conflicts from arising, rather than just trying to fix those that already have arisen.

Of an opposite view are other experts who suggest the implementation of this measure only for those transactions where the issuer creates a Collateralized Debt Obligation to be sold and then engages in transactions that make profit from the failure of their own product. Both subjects for which the CSA is seeking comments are in my view very interesting because they are aimed to study measures that complement the disclosure rules. Only an integrated system of regulation that presents disclosure and interest alignment elements can be successful.

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75 The Canadian Foundation for Advancement of Investor Rights is an independent national non-profit organization whose goal is to be “a national voice for investors in securities regulation and a catalyst for enhancing the rights of Canadian shareholders and individual investors.”

76 FAIR Canada “Proposed Rules and Rule Amendments Relating to Securitized Products” (31 August 2011) at 11.

1.3. Possible negative consequences of extensive disclosure

Notwithstanding the fact that a high level of detail in the prospectus has the upside of making sure that everything important regarding a securitized product is reported, there are three arguments that could be formulated against such extensive disclosure. The first is that additional disclosure means higher costs for the issuers, the second that voluntary disclosure is the natural level of disclosure that the market needs and anything beyond that is simply not needed by the investor, the third is that excessive disclosure will trigger information overload.

1.3.1. Increased costs for issuers

The first argument is concerned with the fact that the more disclosure is required, the higher transactional costs will be for issuers. The issuer incurs costs because it must prepare and provide investors with more, better organized, information. This, however, should not represent a concern since I think that the issuer would provide most of those information anyhow in a hypothetical efficient market, therefore the extra marginal cost imposed by a system of mandatory disclosure cannot be too big. Secondly, it is in the interest of the issuer to provide this information for the very reason that it will help him attract more clients. It also makes sense from an efficiency point of view, because the costs of the issuer for providing this type of information is lower than it is for investors. Moreover, securities prices accuracy will be increased because investors will be induced to invest more by the fact that the informational costs just decreased. Interestingly, it has been found that higher quality financial reporting has a positive impact on firms as they suffer smaller stock prices decline during a crisis. Although a change in regulation of mandatory disclosure can cause additional adjusting costs, these costs are very limited compared to the great benefits that it will provide to irrational investors.

78 Easterbrook, supra note 6 at 684.
79 Gillen, supra note 52 at 27.
Another argument to be made is still related to information costs but tackles the problem from a different perspective. It holds that a change in regulation bears new costs in compliance deriving from the preparation of lawyers and the cost of enforcing and administering the new rules.\(^8^2\) This argument is the weakest of the three in my opinion. It is undeniable that a change in legislation is a burden that ultimately bears on those that are affected by it. However, the costs of compliance would probably overcome the benefits of regulation only where the latter is very frequently changed and is not able to address the issues raised by securitized products adequately. Although it is hard to quantify the potential loss that could arise from another financial crash due to the lack of proper regulation, past experience shows that it will likely be greater than the cost arising from the change of regulatory regime. It is not necessarily true that increased regulation automatically means higher transaction costs for market operators. Actually, mandatory disclosure reduces the cost of capital as we have previously mentioned.\(^8^3\)

1.3.2. Voluntary disclosure is the right level of disclosure the market needs

The second argument that has been advanced against a heightened mandatory disclosure regime is that empirical research shows that companies typically produce voluntarily information which contain, for great part, the same information mandated by law, as a sign of the fact that the market sufficiently provides incentives for disclosure.\(^8^4\) Despite the accuracy of these studies, they do not specifically refer to the field of securitized products, where the complexity of the products can really affect the asymmetrical information between the issuers and the investors. Where the investor has less ability to fully understand the quality of the disclosure made to him, issuers will be incentivized to select the information they want to provide, they will show the best and hide the worst of it. At this point, the market could be subject to a lemons problem or alternatively investors may engage in herd behaviour.

\(^{8^2}\) Gillen, supra note 52 at 33.
\(^{8^3}\) Allen.
\(^{8^4}\) Merkt, supra note 45 at 102.
1.3.3. Excessive disclosure may trigger informational overload

The third and most compelling argument against the new disclosure rules, is that excessive disclosure may result in information overload, which increases the cost for investors to select only those pieces of information that are relevant to their interest.\(^{85}\) As investors have “limited cognitive abilities to store, process and interpret information”\(^{86}\), disclosing more than it can be absorbed is therefore not only unnecessary but also detrimental to investors.

From a policy standpoint, this may turn out to be counter productive because an excessive statutory protection of the investor increases the costs of legal compliance for the financial operators. The operators have no intention to internalize the higher compliance costs and so they simply shift the burden on to the investor which will find increased costs for investing.

However, in this particular case, I believe that mandatory disclosure can make informational costs lower by standardizing the disclosure and thus making it easier for analysts in terms of time and preparation to identify an accurate stock price.\(^{87}\) Standardization is positive because “it facilitates comparative use of what is disclosed and helps to create an efficient disclosure language.”\(^{88}\) The new measures for securitized products do so by mandating the use of specifically designed forms to be completed when drafting the prospectus and then at specific times. The high level of specificity of these forms is very beneficial for issuers because it “reduces the cost of making disclosure and increase the comparative value of what is disclosed.”\(^{89}\)

\(^{85}\) Paredes, supra note 6.
\(^{87}\) Gillen, supra note 52 at 29.
\(^{88}\) Easterbrook, supra note 6 at 700.
\(^{89}\) Ibid at 701.
2. Continuous Disclosure

The new measures proposed by the CSA contain important novelties in the field of continuous disclosure. While NI 51-102 would remain in place, a whole new series of rules could be imposed on all securitized products except for “covered bonds” and non-debt securities of mortgage investment entities.

The first element to be introduced is the Payment and Performance Report for Securitized Products. This form must be filed at the latest 15 days after each payment date of every series or class of securitized products. The second element to be introduced is the Timely Disclosure of Significant Events. The events that will require such disclosure are the failure to make a payment, a change of servicer, the modification or termination of any material credit enhancement arrangement, bankruptcy, a change in credit rating and any other event that could result in the material modification of investors’ rights, payments or pool performance. The last requirement is the Annual Servicer Report that must be filed by each servicer whose servicing activities relate to more than 5% of the pool of assets.

Although these innovations substantially increase the requirements of continuous disclosure, I think they are a necessary addendum to securitized products regulation that is truly committed to the protection of investors. These provisions as a whole, give investors enough instruments to really understand the characteristics of a product and how these are evolving over time.

3. Exempt market

The subject of mandatory disclosure would not be complete without mentioning briefly the novelties of the exempt market. In fact, the exempt market introduces a major change

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90 A “servicer” is a person or company responsible for the management or collection of pool assets or making allocations or payments to a holder of a securitized product, but does not include a trustee of an issuer of securitized products or trustee for the securitized product that makes allocations or payments. 34 OSCB 3811 (2011), at 3838.
in the regulation that impacts directly the philosophy behind mandatory disclosure of securitized products.

The CSA intends to restrict the group of investors that can purchase these products without a prospectus.\textsuperscript{92} The “eligible securitized products investor” would be the new and only exemption provided by law under which securitized products can be sold without a prospectus. The CSA is eliminating the category of retail investors and some commentators, especially the banks, have unsurprisingly criticized this decision because it would excessively restrict the pool of eligible investors. Others instead do not see any issue with this measure. The American Securitization Forum actually stated:

\begin{quote}
ASF supports the view that complex securitized products offered without all of the protections of the prospectus delivery regime should be limited to investors who have the knowledge and experience to evaluate the securities they are considering for purchase and the ability to ascertain what disclosures, reports and other contractual features they require in connection with a prospective purchase.\textsuperscript{93}
\end{quote}

This new category is relevant to the analysis because it modifies significantly the universe of people that have access to the securitized products market without a prospectus.

It is possible to find some common perplexities in all the comments that were published on the exempt market. The first maintains that the elimination of these exemptions was clearly unnecessary because it aims at protecting investors from another ABCP crash (that is very unlikely to happen in their view.) Moreover, market operators maintain that these measures focus too much on the high-risk products such as the “originate-to-distribute” model, which no longer applies to Canada in the opinion of some of the market operators. Commentators also noted an unfair differentiation between securitized

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\textsuperscript{92} Proposed Amendments to NI 45-106 Prospectus and Registration Exemptions OSC, 34 OSCB 3811 (2011).
\end{flushright}
products and other high-risk products and wrongly approaches the traditional securitized products market in one single manner that applies to all.\textsuperscript{94}

In my view, it is true that the originate-to-distribute model\textsuperscript{95} carries higher risks than the standard securitization procedures. In fact, the originator bears no more risk in the moment in which the securities are sold and therefore it becomes a dumping game where the originator profits from the fees that it collects for the securitization. However, it is reasonable and completely in line with the rationale of the “closed system” of Canadian securities law that the general rule is to provide a prospectus and issuers should be exempted from doing so only where this is clearly and undoubtedly unnecessary. The exempt market has been created because it balances the protection of the investor and the convenience of raising capital.

I have mentioned how the complexity factor misled even the most sophisticated of investors to purchase instruments with high levels of risk. The first reason to welcome this new category is that “high net worth” has little to do with the direct ability to evaluate investments. The second reason is that these same categories that are being excluded will now be able to benefit from an enhanced disclosure system. All the extra information and the format in which they are being provided can only help them in making better investment choices.

A second proposal made by the CSA to solve informational asymmetry between issuers and investors is the change in the structure of the exempt market with the creation of a single category of investors. I think that although this measure could be restricted to a smaller category of higher risk products, the underlying idea is positive and overall the reform has been overly criticised by market operators. This may be perhaps due to the fact that the market for securitized products is more strictly regulated than it was before. A perception of overregulation may lead to think that the measures are negative for the

\textsuperscript{94}Michael Rumball, Overview on Comments on the CSA’s exempt market proposals (October 24, 2011) Canadian Structured Finance Law, online: <http://www.canadianstructuredfinancelaw.com/tags/securitization-general/>.

\textsuperscript{95}Issuer, securitizer and rater are only interested in the fees that they can obtain from the sale of the product and not by the profit that can be made by maintain some of the securities in their own portfolio.
liquidity of the market. However, this belief is incorrect. Markets liquidity can be watched and investors risk exposure decreased with the use of adequate mandatory disclosure.96

4. Risk retention rules

Having established that mandatory disclosure is a necessary element of the regulatory system,97 and that changes in the exempt market are a good measure to implement, it is possible to face another topic that has spurred some debate. Disclosure alone may not suffice and rules that align interests may be a necessary addition to a complete reform of securitized products regulation in order to reduce the risk of information overload and frame issuers’ behaviour.

In the draft, retention of a tranche or tranches of securitized products by the issuer must be disclosed, as it can be an indication of how parties involved in the issuance process value their own product. The requirement is therefore to disclose if there is retention. However, the CSA is seeking comments for a stricter rule that requires issuers to retain a portion of the credit risk for any asset that is sold or transferred to a third party.98 These rules are taken from the Dodd-Frank Act99 and are aimed at eliminating the originate-to-distribute model by mandating that issuers, sponsors and depositors keep their “skin in the game.”100

The risk retention rule is very controversial because it can have two opposite effects. By imposing risk retention, regulators would be introducing a rule that has the potential to align the interests of securitizers and investors. Research has shown that risk retention

96 Gillen, supra note 52 at 27.
98 34 OSCB 3811 (2011), at 3822.
99 Dodd-Frank Wall Street Reform and Consumer Protection Act Pub L No 111-203, HR 4173 at section 941.
100 These rules have also been implemented in the EU in article 122a of the EC, Capital Requirements Directive 2009/111/EC of 17 November 2009, [2009] OJ, L 302 at 97.
rule has a positive effect on mortgage loans. Between 2000 and 2006, banks had retained
the loans with a lower credit rating index but surprisingly these loans turned out to have a
20% lower default rate that the securitized loans.\footnote{John C Coffee Jr, “The Securitization Bubble” 30:27 The National Law Journal (March 17, 2008) [Coffee, “Securitization”].} This is due to the fact that the banks
did better research on the lower scoring loans using data that was not normally
considered or required by law in the securitization process.\footnote{Ibid at 14.}

Concerning the level of risk retention that should be imposed, the CSA has proposed 5%
in line with European regulations.\footnote{FAIR Canada “Proposed Rules and Rule Amendments Relating to Securitized Products” (31 August 2011) at 8 online: <http://www.osc.gov.on.ca/documents/en/Securities-Category4-Comments/comm_20110831_41-103_pascuttoe.pdf> [FAIR].} FAIR Canada notices that Canadian regulators must
introduce risk retention rules for an additional reason as well. Since the US and the EU
have already implemented it, there is the risk that if Canada does not, it will be targeted
as a dumping ground for poor quality assets.

I believe that the introduction of a risk retention rule can be beneficial only conditional
upon the fact that a good system of mandatory disclosure be implemented and that the
purchase threshold be no higher than 5%. In fact, the first reason why retained loans
performed better is that banks used a series of “softer data” not required or not easily
comparable into the analysis of securitized assets.\footnote{Coffee, “Securitization”, supra note 101 at 14.} The second reason to be sceptical
about risk retention rules is that it may incentivize issuers to drop out of the market. We
must bear in mind that high-risk products exist because they are requested by investors
that are risk prone such as hedge funds.

By mandating originators to hold a part of these products in their portfolio, the only
consequence will be to drive out this market. Originators may in fact not be as risk prone
as some of their clients and may not be willing to engage in high-risk transactions but
simply to reply to market demands as much as any other service provider does. In my
view, a risky product becomes bad only if its risk is not accurately reflected in its price or
rating. Therefore, it is necessary to make sure that all measures possible have been taken
to effectively inform investors of the level of risk that a product bears. Once the best level of disclosure has been implemented, risk retention rules can definitely be used as a complementary deterrent to opportunistic behaviour of issuers where the best level of disclosure is still not optimal.

Freedom should be given to structure a desired transaction and leave to the investor the decisions as to whether it is appropriate.105 Others maintain that risk retention was enacted in the US as a measure to specific industry conditions of originate-to-distribute, which do not characterize the Canadian market.106 Only the Commercial Mortgage-Backed Securities market in Canada has this structure, where Canadian commercial mortgages are sold to investors through multiple tranches.107

5. Mandatory disclosure and general principles of securities law

It is now possible to look at the proposed reform of regulation of securitized products from the more general perspective of the principles that guided the proposed rules drafting process and securities regulation. Overall, the draft is certainly a positive attempt to frame with specific measures these instruments. Regulation really puts the foot on investor protection, making the financial industry wary of possible consequences on market efficiency.

Critics have been directed towards most of the new elements proposed in the draft.108 However, the proposed rules seem to offer an enhanced level of disclosure that appropriately answers the specific problems posed by securitized problems while at the

same time seeking to introduce new rules, mainly drawn from the experience of the American market, to complement mandatory disclosure. In my opinion, the mix of the two, plus some modifications in the exempt market regulation, can be extremely beneficial to the Canadian market because they bring a change in a system that had not yet been subject to major modifications after the turmoil exposed the major issues that securitized products present.

A weighing factor in the considerations of the commentators is the limited impact that the crisis had on Canadian markets and the allegation of many operators that this reform is an answer to the measures taken in the United States where the situation was substantially worse. I understand but I disagree with this position. I think there is still plenty of space for improvement on the draft and the CSA will take advantage of all suggestions.

The CSA undeniably prepared these rules having in mind special securitized product, those originated to be distributed, credit default swaps and synthetized products that are the result of tranching different pools of assets. It is possible to narrow down the scope of the draft, to target specifically those products and to leave out those that, after a fair assessment, do not present significant elements of risk under the normal regulation.

**5.1. Is the new mandatory disclosure regime appropriate?**

Concern had been expressed in the US on whether derivatives disclosure is adequate.\(^{109}\) In hindsight it seems that these concerns were well founded. This question can be applied to the Canadian situation as well. Their complexity “heightens their ambiguity…allowing people to see what they are inclined to believe.”\(^{110}\) It is clear that, securitized products require deeper investment knowledge and therefore should not be disciplined in the same manner of more classical financial instruments.


\(^{110}\) Ibid at 15.
The regulatory system should be tailored around the differences in the instruments that are being traded and the level of sophistication the investor demonstrates. In the words of the Kimber Report, “it should be the function of securities legislation to ensure, so far as practicable, that financial information is presented in a form which is understandable to the investing public.”[111] Although enhanced disclosure is not the only solution for an improved regulation of securitized products, I believe that, as the founding stone of securities law, it is the best starting point for a review of the legislation.

5.2. New measures and information overload

In attempting to ameliorate mandatory disclosure requirements, one element of concern will be the phenomenon known as informational overload.[112] As it is important that investors be provided with all necessary information to make the best decision, it is equally important they not be submerged by an excessive amount of information, as this will cause them to make worse decisions than they would without all that information.[113] This consideration may be particularly true for securitized products where it is necessary to collect and study the market for the assets underlying the security. The huge amount of information may in some cases turn out to increase the complexity of the prospectus: “Because of information overload, in some cases, more disclosure can mean less effective disclosure.”[114]

In order to avoid this problem it is necessary to draft regulation that does not necessarily require more disclosure but better disclosure, meaning that the information should be organized, summarized and standardized in a better way. In this sense, it could be helpful to introduce in the prospectus a short summary with the key characteristics of the product offered, including a summary of the risk factors. I do not think that the new measures present an information overload problem. Rather I think that disclosure will be presented in a more efficient manner and will make investors the job a lot easier.

[113] Ibid at 418.
[114] Ibid at 446.
5.3. Complexity

Furthermore, a second problem with the securitized products market is that, given its complexity, it is subject, more than others, to strong agency costs. While forty years ago the idea was that the market would self regulate itself, reputational incentives for intermediaries have shown not to be a sufficient shield. These elements show on a factual basis how agency costs are an integral part of the market. A transparent and competent regulation seems the only appropriate solution particularly in times like these. It would be naïve to state otherwise.\footnote{John Coffee & Hillary Sale, “Redesigning the SEC: Does the Treasury Have a Better Idea?” (2009) 95 Va L Rev 707 at 711.}

Disclosure is the most powerful instrument that regulators have to avoid another meltdown. Even those who suggest instead the introduction of rules that require the elimination of agency conflicts, admit that these can only be effective if implemented along with a strong disclosure system.\footnote{See e.g. Schwarcz, “Rethinking Disclosure”, supra note 109.} In fact, it has been found that where product information is so hard to understand that only few buyers comprehend it, sellers do not have any incentive in making voluntary disclosure, as the gains may be lower than the costs of preparing appropriate disclosure.\footnote{See, Michael J Fishman & Kathleen M Hagerty, “Mandatory Versus Voluntary Disclosure in Markets with Informed and Uninformed Customers” (2003) 19 JLEO 45.}

According to Akerlof, a market that lacks transparency would disappear over time because of the inability of investors to distinguish good from bad securities.\footnote{Akerlof.} Recent studies of behavioural economics have shown that often investors lack the assumed rationality.\footnote{Ronald J Gilson & Reinier R Kraakman, “The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias” (2003) 28 J Corp L 715 at 731 [Gilson, “Market Efficiency”]; Camerer, supra note 81.} This means that in order to solve the market for lemons issue, quality of mandatory disclosure must be high enough to overcome the bounded rationality of investors. The new disclosure measures break down this complexity in many different items, allowing an investor that has limited rationality but sufficient education to avoid making the same choices that we all have witnessed in the 2008 realm.
5.4. Mandatory disclosure rules and confidence

Some authors have contested the correlation between healthier capital markets and confidence as the result of mandatory disclosure implementation.120 Their thesis is that although there have been periods in which market crashes have followed great outflows of capital, other can be reported in which this did not happen, therefore increase of confidence is not necessarily the result of mandatory disclosure.121

However, in my opinion, showing that there is not always a direct connection between the introduction of mandatory disclosure and market confidence is not sufficient to maintain that market confidence cannot benefit from regulators compelling disclosure. In fact, I think that the correlation exists as long as mandatory disclosure is implemented at the right level. Not all levels of mandatory disclosure can be effective. If the rules do not provide investors with the exact information that they expect, mandatory disclosure will reveal to be ineffective.

Informational asymmetry is a great element of disturbance for market confidence, especially in a highly specialized and technical field such as the securitized products market. In the best scenario they can drive wary investors away from capital markets. In the worst and more realistic hypothesis, they will not function as a deterrent to market confidence where investors are not sophisticated enough to pick up the warning signals. These products will attract investors, lured by quick profits, without being aware of what these instruments consist of.

Market confidence at this point is not based anymore on the knowledge of the market itself and the quality of the products but only on the unpredictable promise for profit. Like a house built on sand is not prepared to withstand strong solicitations, in the same fashion, the growth of capital markets based on the wrong reasons is not destined to last long. Market confidence should find its roots in good information dissemination and awareness. This will ultimately be the best protection that can be offered to investors and

120 Easterbrook, supra note 6 at 693.
121 Ibid at 693.
will allow realizing a market that is truly efficient. Recent history gives evidence of the consequences of a lack of trust for the economy. This is why proper and specific regulation is needed in the field of securitized products. One of the ways to maintain this trust is to enact regulations that lead investors to believe having and understanding what they are getting.

6. Mandatory disclosure measures can help the market where it fails

Although it makes sense for the legislator to intervene in the control of such a strategic area for the public interest, some authors have condemned this approach maintaining that disclosure should be left to the choice of securities issuers. Offerors of high quality securities are pushed by the market to disclose information about their product to distinguish themselves from the competition. Where this is not sufficient, high quality sellers will hire outsiders to review their books and records and express a judgment over the quality of their product. These outsiders will be driven by reputational interest in providing full true and plain disclosure about the firm.

However, we have seen how the market forces may reveal inadequate to respond to the solicitations that personal interest in the short term can exercise on market participants. So, rating agencies may inaccurately rate certain products to maintain a huge client. At the same time, without a rigid set of requirements that all offerors have to follow, firms may disclose information selectively, avoiding those information that may hurt them or publish them in a way that is misrepresentative of their true nature. After all, investors often do not engage in a thorough examination of all information relating to an issuing firm.

122 Stout, supra note 58.
123 See especially Easterbrook, supra note 6.
124 Ibid at 696.
If we want to expand the securities market to small and unsophisticated investor, it is necessary to provide them with the resources they lack or they are not willing to use to research on product and identify those that are more lucrative since their cost may surpass the potential gains. Market based arguments all fail, or at least pretend not to notice the fact that the market only reacts and protects investors in the medium and long term, but it does not offer any satisfactory solution to fraudulent behaviours. Evidence has shown that laws mandating disclosure benefit stock markets. Relying excessively on certification by third parties may decrease informational costs but will probably not increase the level of confidence of investors given the aforementioned weaknesses of the system.

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Conclusion

The recent market collapse has demonstrated the flaws of the theory of financial deregulation\textsuperscript{127} and indicated that regulation of financial markets is necessary to protect investors. Moreover, capital markets have demonstrated their natural inefficiency. The market for securitized products, among others, can be subject to problems of informational asymmetry that not to be solved in order to avoid the “market for lemons”.

Although many solutions have been suggested to counteract the effects of the market for lemons in securities market, they all present weaknesses that can be hardly bypassed. The use of third parties in order to certify or guarantee the quality of the information disclosed to the public presents evident flaws because reputational interests seem not to be as strong of an incentive as they were thought to be. The recent critics towards credit rating agencies after the 2008 financial crisis are evidence of these problems. On the other hand, the use of a voluntary disclosure regime is subject to self-interest behaviour on the side of the issuers. After all, the fact that a system of voluntary disclosure has never been enacted is indicative of the fact that it does not convince many experts.

The lack of a proper solution to a securitized products market where investor protection and market efficiency are both achieved has made me look towards mandatory disclosure as a possible solution. I have found that mandatory disclosure is powerful instrument to protect investors but that if used properly will not necessarily hurt market efficiency as people may think.

I have analyzed the CSA proposal for new disclosure of securitized products in light of securities regulation principles exactly to see whether the drafters had struck the much-sought balance between protection and efficiency. My conclusion is that the heightened level of disclosure required in the draft for securitized products can only benefit Canadian capital markets. Although striking the right balance between the basic principles of

securities regulation may seem a hard goal to achieve, the problem may be only apparent. The close connection between information dissemination, to render a market efficient, and efficiency, to make a market safe for investors, suggests that mandatory disclosure is the right path to follow because it can pursue both principles.

An improved system of mandatory disclosure will allow market to regain the loss of investor confidence by demonstrating (or at least claiming) that the same problems will not arise again. While the new regulation will make issuers incur in additional costs, I believe that the benefits that markets will obtain in terms of protection will affect in a positive way its liquidity and efficiency. Even though they can certainly still be ameliorated in some part to avoid unnecessary burdens on the issuers, the proposed rules for securitized products should be welcome positively by market operators. The requirement for a clear explanation of the pool of assets, of possible agency conflicts, and the change in the exempt market that I have outlined are appropriate measures to implement.

The recent increase on the pro capita debt of Canadians and the continuous growth of the housing market in the major Canadian centers could become a major concern for the securities possibly backed by those assets. For this reason the proposed reform of securitized products should not be seen as an excess of prudence, rather as advancement in the level of sophistication of Canadian securities regulation. Only time will tell how these measures will react to future market turmoil but at least it can be said that regulators have learnt from past errors. It does not matter whether these errors where committed by foreign regulators. What is noteworthy is the fact that the CSA has proved to be able to look forward and draft a proposal that not only tries to respond to the issues posed by the current Canadian securitized products market but it looks even further and tries to prevent problems that may arise should the market evolve in the same way and direction the American one did.
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