

# CANADIAN SECURITIES REGULATION: SINGLE BODY OR DECENTRALIZATION?

In Canada, regulation of securities trading and related activities falls under 13 separate provincial and territorial bodies, most of them called securities commissions. The federal and Ontario governments argue that these should be replaced by a single national (or interprovincial) body. The other provincial and territorial governments oppose this and, since 2004, have created a mutual recognition process called the passport system.



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Under this system, a Canadian company, even if it conducts activities in several provinces, is regulated only by a principal regulator, usually in the province where its head office is located. Phase I of the system came into effect in September 2005. Phase II, set for completion in 2008, extends the regulatory requirements to come only under the principal regulator.<sup>1</sup> Alongside this process, the Canadian Securities Administrators, an association of the 13 regulatory bodies, has worked for several years to harmonize regulations.

This Economic Note presents the economic arguments in favour of both positions – that taken by supporters of a single body and that held by advocates of decentralization.

## Securities regulation

First let us examine the nature of the particular regulations affecting this area of activity and how they are justified. Securities commissions regulate the issuing of securities (when the issuers are not public administrations) as well as the information provided by issuers at the time of issue and, subsequently, certain aspects of securities trading. They also regulate the intermediaries and financial advisors involved

(especially brokers). Figure 1 shows annual spending by Canada's four main securities commissions.

Securities regulation is aimed at protecting investors and promoting efficiency in financial markets and at upholding fairness and integrity. Regulation is justified by the asymmetrical nature of market information: issuers have information they could easily

hide from investors. It is important to give investors a guarantee that adequate information is available and accessible to them, especially if related to securities traded on a stock exchange, and that this information is accurate. Otherwise, investors could not make well informed decisions and would lose confidence in

the financial markets, thereby reducing the efficiency of these markets.<sup>2</sup>

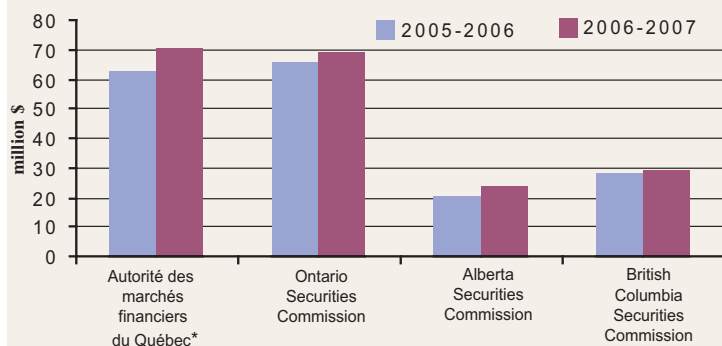
Not all economists share this position. The U.S. Securities and Exchange Commission, created in 1934 and serving as a model for bodies that regulate securities, has been heavily criticized, as has the Sarbanes-Oxley Act that it has administered since 2002 and that has made regulations significantly more strict. Some firms may choose to avoid U.S. listings in favour of markets in London.<sup>3</sup> Some people argue that the new legal risks



1. Under the system about to take effect, no province will be able to question decisions made in another province. Ontario does not accept the passport system, but the other provinces will respect its decisions as if it did.
2. See Gordon Boissonneault, "The Relationship between Financial Markets and Economic Growth: Implications for Canada", in Wise Persons' Committee, *Research Studies*, 2003, p. 70 and following.
3. Anna Fifield, "Tough Rules for Business Now 'Disturb' Greenspan", *Financial Post*, April 13, 2006, p. FP-3. See also Larry E. Ribstein, "Cross-Listing and Regulatory Competition", *Review of Law and Economics*, Vol. 1 (2005), No. 1, p. 128. This escape to London's Alternative Investment Market is not unanimous; see Craig Doidge, George A. Karolyi and René M. Stulz, "Has New York Become Less Competitive in Global Markets?: Evaluating Foreign Listing Choices over Time", Fisher College of Business Working Paper No. 2007-03-012.

FIGURE 1

## Annual spending by Canada's main securities commissions



\* The Autorité des marchés financiers assumes some regulatory functions that are not included in the typical functions of a securities commission.  
Sources: Annual reports of the commissions.

brought on by this heavier regulation, together with higher penalties for non-compliance and the risk of error in the law's application, may scare off executives who are most anxious to comply with the law and exert an anti-selective effect in favour of those who are less conscientious, thereby increasing the risk of fraud.<sup>4</sup>

Moreover, the aims of securities regulation are often ill-defined or contradictory (for example, investor protection as opposed to the flexibility needed for market efficiency).<sup>5</sup> If regulations were intended to inform investors, they would not need to impose compulsory standards on all issuers: it would suffice for investors to know who is regulated and who is not. Stock exchanges traditionally were private associations that offered the degree of regulation demanded by the market, without government intervention.<sup>6</sup> It is argued that competition between exchanges and their conversion from mutual to joint stock companies has led some of them to sacrifice their role and reputational capital in favour of income maximization.<sup>7</sup>

### The argument for a single regulator

If we accept the need for securities regulation, there are several arguments in favour of a single body. Only a single regulator,

enjoying substantial powers, can ensure that standards are uniform and are properly applied. As stated in a federal draft bill in 1979, "the Canadian financial market is pan-Canadian by nature," and regulation should be interprovincial or even international.<sup>8</sup> The Liberal government of the mid-1990s and today's Conservative government have agreed, moreover, on the need for a single national body.

This project was recently defended in two government reports: the report of the Wise Persons' Committee, created by the federal government in 2003,<sup>9</sup> and the report of the Crawford Panel, created by the Ontario government in 2005.<sup>10</sup>

The 13 securities commissions operate under different laws, impose different standards and requirements, and apply them differently. A company wishing to tap into public savings in more than one province must obtain the necessary authorizations in all these provinces. This produces inefficiency on the Canadian financial market, undermining investor confidence, creating high compliance costs and raising the cost of capital. The Wise Persons' Committee sums up the situation as follows: "Canada suffers from inadequate enforcement and inconsistent investor protection. Policy development is characterized by compromise and delay. Canada cannot respond as effectively or innovate as quickly as it should in the fast-changing global marketplace. The system is too costly, duplicative and inefficient. The regulatory burden impedes capital formation. Canada's international competitiveness is undermined by regulatory complexity."<sup>11</sup>

Without a national regulatory body, it is not possible to set the necessary "fine balance between ensuring efficient capital markets for issuers and maintaining adequate protection for investors."<sup>12</sup>

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4. Craig S. Lerner and Moin A. Yahya, "Left Behind" after Sarbanes-Oxley", *Regulation*, Vol. 30, No. 3 (Fall 2007), pp. 44-49.

5. A. Douglas Harris, *A Symposium on Canadian Securities Regulation – Harmonization or Nationalization?*, Capital Markets Institute and Canadian Foundation for Investor Education, 2002, pp. 47-48.

6. Ribstein, *op. cit.*, footnote 3, pp. 123-124. See also Roberta Romano, "A Market Approach to Securities Regulation", *Yale Law Journal*, Vol. 107, No. 8 (June 1998), p. 2399.

7. A. Douglas Harris, "The Impact of Hot Issue Markets and Noise Traders on Stock Exchange Listing Standards", *University of Toronto Law Review*, Vol. 56, No. 3 (Summer 2006), pp. 223-280.

8. Quoted by Harris, *op. cit.*, footnote 5, p. 24.

9. Wise Persons' Committee, *It's Time*, Department of Finance Canada, 2003.

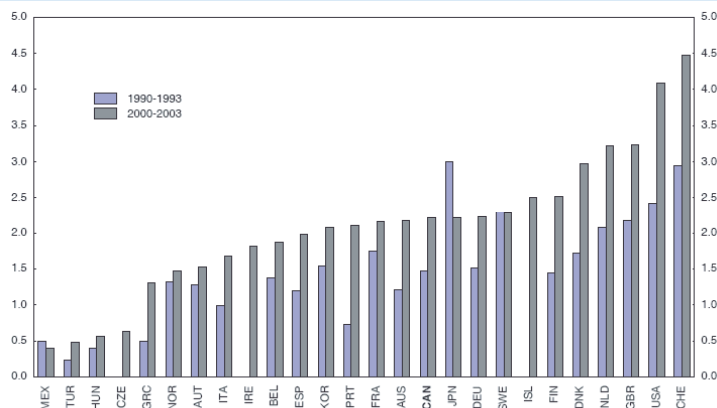
10. Crawford Panel on a Single Canadian Securities Regulator, *Blueprint for a Canadian Securities Regulator, Final Paper*, s. 1., 2006.

11. Wise Persons' Committee, *op. cit.*, footnote 9, p. viii.

12. *Ibid.*, p. 3.

FIGURE 2

Loans to the private sector and market capitalization of securities in OECD member countries



Source: OECD, OECD Economic Studies – Canada, 2006, p. 74.

Moreover, administering the current structure is costly. A single body would benefit from economies of scale. A consultant to the Wise Persons’ Committee estimates that 36.5% of the operating budget of the provincial regulatory bodies in 2002, which totalled \$127.8 million, could have been saved by turning to a single structure.<sup>13</sup>

Securities control is tighter and more highly respected in the United States, where the Securities and Exchange Commission regulates the entire market, although separate commissions coexist at the state level. In Canada, it is hard to develop new regulations along the lines of the U.S. Sarbanes-Oxley Act with the same speed.<sup>14</sup> It has been asserted that strict regulation is to thank for U.S. financial markets attracting issuers from around the world.<sup>15</sup>

Canada is the only advanced country that does not rely on a single body for securities regulation. An OECD study states that

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“securities regulation remains deficient” in Canada.<sup>16</sup> As for arguments on the advantages of competition among regulatory bodies, some people involved in the field feel this endangers the quality of regulation because of factors including a race to the bottom.<sup>17</sup> Although each company would be regulated by just one authority (that of its home province) under the passport system advocated by most provinces, standards and conditions would remain different.

The argument for decentralization and competition

The opposing argument holds that, if public regulation is necessary, it is preferable to have it subject to competition rather than entrusted to a monopoly. An example of this may be found in U.S. corporate law: each company can choose the legal rules that suit it best.<sup>18</sup> The advantages of competition between administrations form part of the justification for communal freedom and federalism, not to mention the existence of different governments around the world.

Capital markets are not just national but, in reality, are international. If arguments for a single body justify centralized regulation at the national level, they should provide even greater support for a single body at the international level. Competition generates incentives for efficiency, stimulates the discovery of more appropriate regulatory formulas, meets local conditions and gives companies some freedom of choice as to which regulator they will be subject to.<sup>19</sup>

Financial markets work quite well in Canada. The Toronto Stock Exchange is the world’s seventh biggest.<sup>20</sup> If loans to the private sector are included (see Figure 2), Canada falls to 11<sup>th</sup> rank, but this sector is not related to securities regulation. According to an index of the quality of securities regulation, Canada comes in second, after New Zealand but ahead of Norway and the United States.<sup>21</sup> Nothing indicates that investors truly lack confidence in Canadian financial markets. According to a study by the inter-

13. Charles River Associates, “Securities Enforcement in Canada: The Effect of Multiple Regulators”, in *Research Studies*, p. 511.  
 14. The Quebec government’s recent decision to modify the *Securities Act* so as to enable “an investor to sue for damages where an issuer publishes false or misleading information”, thereby ensuring harmonization with Ontario law, comes more than a year after this right was provided in Ontario (*Le Devoir*, November 13, 2007, p. B4). This delay may appear normal or too long, depending on the analyst’s standpoint.  
 15. Ribstein, *op. cit.*, footnote 3, pp. 97-148.  
 16. OECD, *OECD Economic Studies – Canada*, 2006.  
 17. The president of the Ontario Securities Commission was quoted as stating that “regulatory competition is demeaning to a regulator who is mandated to protect the public interest. I just think it’s not something that we should be talking about or thinking about at all.” (Richard Blackwell, “Regulatory Reform a “Political” Task”, *The Globe and Mail*, March 9, 2002, p. B3).  
 18. Roberta Romano, *Is Regulatory Competition a Problem or Irrelevant for Corporate Governance?*, Social Science Research Network, March 2005. See also Ribstein, *op. cit.*, footnote 3.  
 19. Harris, *op. cit.*, footnote 5, especially p. 78 and following.  
 20. Ralph Simmonds and Ray da Silva Rosa, “The Impact of Federalising Securities Regulation in Australia: A View from the Periphery”, in *Research Papers*, p. 180.  
 21. OECD, *Economic Policy Reforms: Going for Growth*, 2006, pp. 125-126. See also Luzi Hail and Christian Leuz, “International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?”, *Journal of Accounting Research*, Vol. 44, No. 3 (June 2006), pp. 485-531.



university research group CIRANO, “a majority of the arguments supporting this thesis of inefficiency in securities regulation are not well developed in terms of regulatory or finance theory and generally rely only on assertions.”<sup>22</sup>

A study sponsored by the Wise Persons’ Committee found that the single securities commission created in Australia, in its first fiscal year (1991-1992), spent 68% more than the bodies it replaced.<sup>23</sup> According to CIRANO researchers, the “direct costs of regulation per million dollars in capitalization are \$145.80 in Canada, \$293.10 in Australia and \$141.90 in the United States, not taking account of regulation at the state level.” The researchers add that “Texas alone levied fees and charges of C\$163 million, exceeding the income of all Canadian commissions.”<sup>24</sup> It is thus by no means clear that a single Canadian body would cost less. Moreover, issuance costs are substantially lower in Canada than in the United States for comparable amounts. Nor has it been proven that there exist significant differences in the cost of capital in the two countries.

In addition, the risk of over-regulation is greater with a regulatory monopoly that holds a captive client base.<sup>25</sup> And this monopoly could be headed by players that combine most banking and securities activity, including stock exchanges.

Competition can be expected to lead to harmonization to the extent the market demands this.<sup>26</sup> If decentralization creates undesirable obstacles to free trade, the principle of mutual recognition, already adopted in the European

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Union, has the advantages of promoting beneficial competition and of favouring harmonization. It is this type of system that the provincial governments (apart from Ontario’s) are now setting up. Some of the problems mentioned in the government reports are being resolved. The OECD admits that “progress has been made in harmonising standards.”<sup>27</sup>

Supporters of a regulatory monopoly warn against a race to the bottom. Advocates of regulatory competition say, on the contrary, that this favours a race to the top, especially in a field such as securities where participants’ level of expertise is relatively high; in other words, they know in advance the risks being incurred according to the rules in effect.

## Conclusion

Which system best enables investors and issuers (and, behind them, consumers) to express their preferences and to reconcile and balance them most effectively, at the lowest cost? In choosing between regulatory monopoly and competition, which process allows the most efficient form of regulation to be discovered?

In the end, the whole question comes down to knowing whether the fine balance between guaranteeing efficient financial markets for issuers and upholding adequate protection for investors is best ensured in Canada by centralized or decentralized institutions and processes.



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Printed in Canada

Illustration:  
Benoit Lafond

Graphic Design:  
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22. Jean-Marc Suret and Cécile Carpentier, *Enjeux et défis de la réglementation canadienne des valeurs mobilières*, CIRANO, 2003, p. 5.

23. Simmonds and da Silva Rosa, *op. cit.*, footnote 20, p. 184.

24. Suret and Carpentier, *op. cit.*, footnote 22, p. 12.

25. Harris, *op. cit.*, footnote 5, p. 78.

26. Regulation has been broadly standardized in Canada (a standardization project has begun in 2002), and it is estimated at present that more than 95% of elements are the same.

27. OECD, *op. cit.*, footnote 16, p. 51.