



# Two Cheers for Canada's Securities Regulatory System

A Presentation by Pierre Lortie  
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Note: The opinions expressed herein are solely those of the author and do not purport to represent those of the firm.



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# The Scope of Securities Regulation

- > Worldwide, the dual purpose of securities legislation is:
  - “to provide protection to investors from unfair, improper or fraudulent practices; and
  - to foster fair and efficient capital markets and confidence in capital markets” (1)

1. Ontario *Securities Act*, R.S.O. 1990, i.S.5



# The Performance of Canadian Securities Regulation

- > The international norms and standards with respect to the regulation of securities markets have been established by the International Organisation of Securities Commissions ("IOSCO")
- > The recent review of the Canadian financial sector by the IMF concluded that:

"The regulatory framework for the securities market in Canada in most respects implements the IOSCO Principles." <sup>(2)</sup>

"By and large there is agreement that the current structure has provided Canada with an effective system of regulation, although enforcement is in need of further improvement. This in fact has been a principal conclusion of the IOSCO Principles assessment. Arguably, the current system has responded to the specific characteristics of its capital market, such as allowing for a large presence of small issuers, and the concentration of certain industries in specific provinces." <sup>(3)</sup>



# The Performance of Canadian Securities Regulation

- > Canada obtained the second best score out of 40 countries in a comprehensive study of the efficiency of securities regulation: <sup>(4)</sup>
  - United States                    97%
  - Canada                            91%
  - Australia                        77%
  - United Kingdom                73%
  
- > In a recent study of the economic consequences of increased disclosure, the authors conclude:
  - "We find no significant post-listing change for Canadian firms....Canada is a particularly interesting case for study as its disclosure environment is very similar to that in the U.S., which implies that the factors involved in the cross-listing decisions of Canadian firms differ from those of firms in other countries." <sup>(5)</sup>

4. Hail and Levy, "What Works in Securities Law", Journal of Finance (2006)

5. Warren Bailey, G. Andrew Carolyi and Carolina Salva, "The Economic Consequences of Increased Disclosure: Evidence from International Cross-Listings", (2006) 81 Journal of Financial Economics 175

- > Protection of minority shareholders from controlling shareholders extracting benefits from the Company ranks amongst the best, at par with the United States

Estimated private Benefits of Control in Different Countries <sup>(6)</sup>

Country	Block Premium (%)	Voting Premium (%)
Australia	2	23
France	2	28
Germany	10	10
Switzerland	6	5
United Kingdom	2	10
United States	2	2
Canada	1	3

6. Randall Morck, Daniel Wolfenzon and Bernard Yeung, "Corporate Governance, Economic Entrenchment and Growth", (2005) 43 Journal of Economic Literature 655



# The Performance of Canadian Securities Regulation

- > The average cost of undertaking a small-sized issue is less than that of a comparably sized issue in the USA, while the cost for undertaking a large-scale issue is similar in both countries <sup>(7)</sup>
- > The cost of capital in the United States and in Canada is similar for comparable companies once you take into account the differences between the risk premium in the two countries, as reflected in government bond yields in the two countries <sup>(8)</sup>

7. J.-M. Suret and C. Carpentier, *Réglementation des valeurs mobilières au Canada*, Montréal, CIRANO (2003), note 23, pp. 35-36

8. Lorie Zorn, "Estimating and Comparing the Implied Cost of Equity for Canadian and U.S. Firms", *Bank of Canada Review*, Autumn 2007, p 29

- The decentralized Canadian system does not impose a cost burden greater than that of the US federal agencies...
  - > The empirical evidence shows that the direct costs of regulation per million dollars of capitalization was \$145.80 in Canada compared to \$141.90 for US Federal bodies only. <sup>(9)</sup> In the USA, the cost of securities regulations by the states needs to be added to those incurred by the Federal government
- And provincial jurisdiction does not preclude international agreements

9. J.M. Suret and C. Carpentier, *op. cit.*



- > In June 1991, the SEC and Canadian Securities Commissions adopted the Canada/US Multijurisdictional Disclosure System (MJDS). The MJDS:
  - Permits eligible issuers in Canada to effect offerings of securities in the United States based on disclosure documents prepared in accordance with Canadian requirements, and vice versa
  - Permits issuers to use Canadian continuous disclosure documentation and file Canadian-style insider reports in satisfaction of U.S. requirements and, conversely, allows U.S. issues to file their continuous disclosure and insider reports in satisfaction of the equivalent Canadian requirements
  - The MJDS extend to specific transactions such as cross-border rights offerings, takeover bids, and business combinations
- > No other country benefits from such a mutual recognition and harmonization agreement with the SEC



# The Acid Test of a Regulatory System Design

- > Any system of regulation must be flexible since markets change over time.
- > The Canadian securities regulatory system architecture is demonstratively characterised by:
  - Greater flexibility
  - A better capacity to adapt to changing circumstances
  - A greater responsiveness to particular industry or regional needs
  - Better assurances against the hasty adoption of disruptive and costly regulations
  - Better shield from the imposition of politically expedient or faddish requirements

Dynamic efficiency is the acid test of a regulatory system design



# The Acid Test of a Regulatory System Design

- > **A Pattern of Continuous Evolution and Adaptation to Changing Circumstances**
  - The judicious application of information technologies has created systems and practices which are truly national in scope:
    - > System for Electronic Document Analysis and Retrieval (SEDAR)
    - > System for Electronic Disclosure by Insider (SRDI)
    - > National Registration System (NRS) and the National Registration Database (NRD)
    - > Mutual Reliance Review System (MRRS)
  - Development and implementation of 25 National Instruments and 24 national policies covering key areas such as prospectus requirements, mutual fund regulation, rights of offering, take-over bids, prospectus and registration exemptions, continuous disclosure contents and market place operations
  - The *Principal Regulator System* (MI11-101) extended exemptions to participants when they deal with different securities jurisdictions (except Ontario)
  - The “passport system” allows participants to access capital markets across Canada by dealing only with the regulator in one jurisdiction (except Ontario)

- > A Record of Responsiveness to the needs of the Canadian Capital Markets:
  - Multi-jurisdictions does not prevent harmonization of regulatory requirements...
    - > In 2001, the Canadian Government eliminated the provisions of the Canada Business Corporations Act concerning going private transactions, take-over bids and insider reporting in order to avoid “the futility of maintaining a regulatory overlap” with Canadian securities regulations pertaining to these same matters <sup>(10)</sup>

10. Industry Canada, “Analysis of the Changes to the Canada Business Corporation Act”

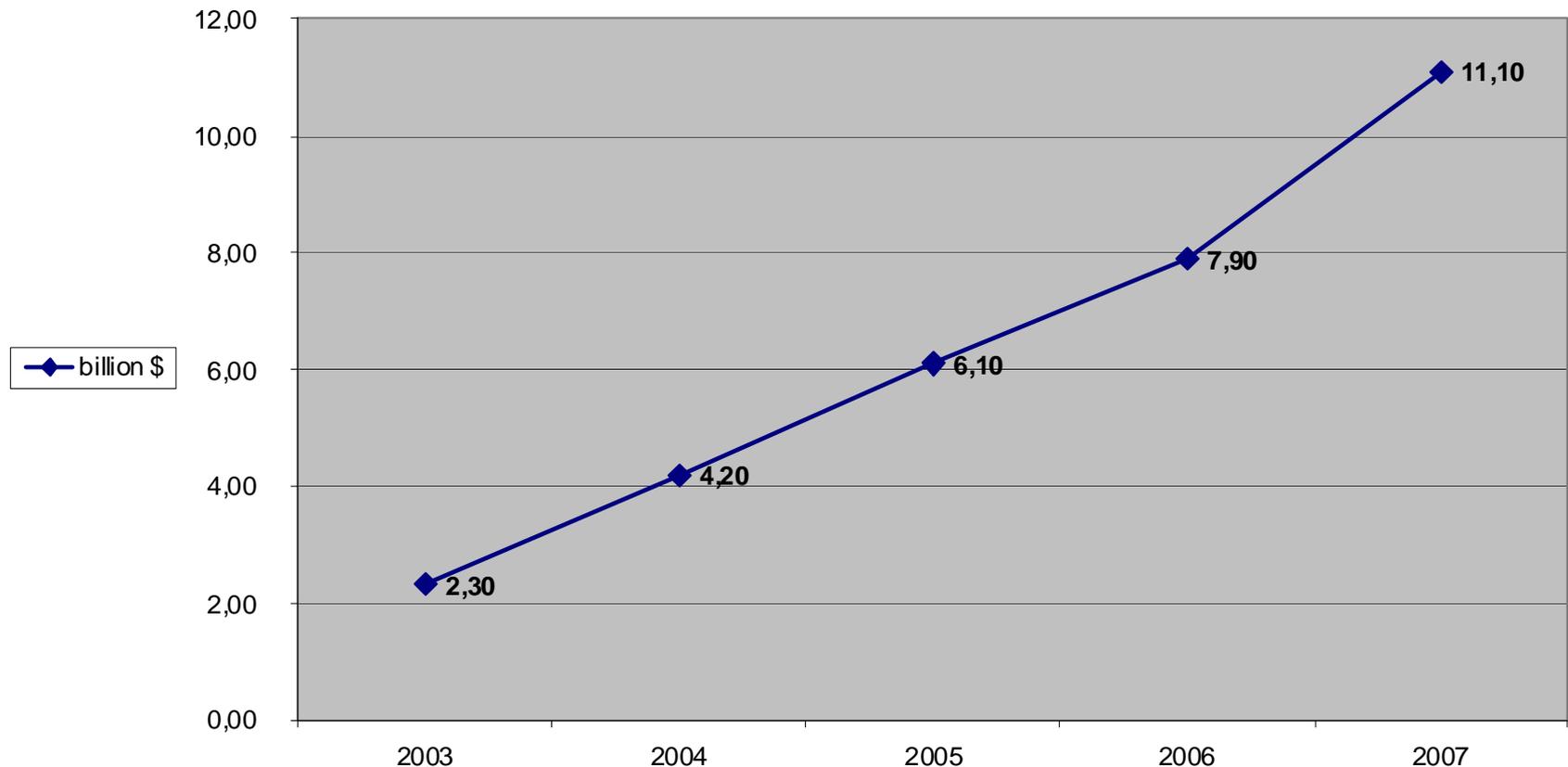


- > **The Dynamic Efficiency of the Canadian Securities System at Work**
  - The proportion of small-cap issuers is significantly larger in Canada than in the USA and other industrialized countries. 89% of issuers listed on TSX(V) have a market value of less than \$50 million
  - This avenue was facilitated by the focus of the Vancouver and Alberta stock exchanges and the responsiveness of the BC and Alberta Securities Commissions to the characteristics and specific needs of small-cap equity markets
  - To ensure the traditional tendency of the senior market to regulate-out small-cap markets, the acquisition of the Vancouver and Alberta Stock Exchanges by the TSX Group (TSE Venture) was accompanied by strong undertakings and guarantees to the Alberta Securities Commission aimed at ensuring that the development of this market will continue



# The Acid Test of a Regulatory System Design

- > Between 2003 and 2007, more than \$31.6 billion in equity has been raised by small issuers on the TSX(V)



- > Experience shows that centralization of a regulatory system does not equate with effectiveness and efficiency...
  - > An OECD study released in August 2007 rated Canada as 9th among OECD countries in terms of its antitrust framework and policies related to regulated industries <sup>(13)</sup>
- > ... whereas, the evaluation of investor protection and of the quality of securities regulation by international agencies is very favorable to Canada

	USA	UK	Australia	Canada
World Bank and Lex Mundi (2006)	7	9	-	5
OECD (2006)	4	5	7	2

13. Jens Hoj, "Competition Law and Policy Indicators for the OECD Countries", Working Paper No. 568, OECD, August 2007



# Setting our priorities to deal with emerging challenges

- > There exists mounting evidence that the SEC monopoly position has led to a regulatory regime which undermines the competitiveness of US capital markets. It is increasingly being challenged by the growth of financial centers abroad and the increasing mobility of investors, financial services firms and exchanges and alternate trading systems across global capital markets
- > The current domestic debate and the focus of the centralization initiatives fail to recognize that the main object of the debate over international securities markets has changed:
  - The emphasis is no longer on its traditional focus over cross-market listings and foreign issuer regulations but on the oversight of foreign financial service providers that want to establish facilities to provide investors with direct access to their markets
  - The paradigm has changed: the main issue is not how to regulate the foreign issuer seeking to list on a domestic exchange but how to facilitate direct access to foreign markets by investors while ensuring that they remain adequately protected



# Setting our priorities to deal with emerging challenges

- > “One of the objectives of these dialogues (with the US and other countries) is to promote our regulatory approach. We want to show the rest of the world that the way we regulate in Europe is conducive to a dynamic, healthy and sound financial services sector” <sup>(15)</sup>
- > In this new environment, the Canadian economy would be much better served by giving much more attention to the evolving regulatory approaches in the EC which are highly compatible with the present architecture of the Canadian system and to the **international competitiveness of the Canadian financial sector**

14. “Opportunities and challenges of the internationalisation of financial markets”, Charlie McCreevey, European Commission for International Market and Services, 29 January 2008.



# Setting our priorities to deal with emerging challenges

- > **The enforcement of securities laws and regulations is often considered to be lacking**
  - Criticisms concerning the quality of enforcement are common in all jurisdictions. In the USA, the GAO reports on this matter are revealing
  - One cannot judge the quality and efficiency of law enforcement in a country by the number of suits and jail sentences. There are 1.6 million adults incarcerated in the USA compared to 33,100 adults in Canada!
  - Efficiency in criminal enforcement requires a close, constructive and sustained cooperation between regulatory bodies and police forces. The restrictions placed by the Courts on the use for criminal investigations of evidence gathered during the course of regulatory investigations in Canada impose very serious constraints
  - The creation of the Integrated Market Enforcement Teams by the Federal Government in 2003 is an excellent initiative. Unfortunately, to date, the IMET program has not produced the anticipated results. The assessment of the RCMP program concluded that its management lacked the leadership, coordination, cohesion, flexibility and communications necessary to meet the task



# Setting our priorities to deal with emerging challenges

- > **With respect to the enforcement of our laws and regulations**
  - The governments of Canada and of the provinces should better join their efforts to:
    - > Implement the recommendations made by Nick Le Pan, Special Advisor to the RCMP Commissioner, in his October 25, 2007 report and eliminate, by adopting legislative measures if deemed necessary, the constraints and barriers to a genuine team effort between the securities commissions and police organisations
    - > Act on the proposal made by Mrs. Jérôme-Forget, Quebec Minister of Finance, to create a Canadian Securities Tribunal which would have jurisdiction to review decisions pertaining to all matters in which a decision by a securities commission or a self-regulatory organization involves a sanction against a person. Such an institution would:
      - ensure greater consistency in decisions across Canada
      - gradually anchor the highly harmonized Canadian regulatory framework



# Setting our priorities to deal with emerging challenges

- > The Federal Government has a legitimate claim with respect to prudential supervision, competition policy and Criminal Law (and enforcement):
  - It already supervises the financial position of:
    - > the Canadian banks (70% of the securities industry activity)
    - > CDS and the Canadian Derivatives Clearing Corporation (“CDDC”)
- > This, however, is not the case with respect to the regulation of the securities markets which pertains primarily to the protection of investors and the rules of conduct and business practices of the participants in the sector.



# Setting our priorities to deal with emerging challenges

- > An attempt by the Federal government to adopt a general securities act which would have paramountcy over provincial legislation will most likely lead to results contrary to what is sought. It will:
  - Give rise to a protracted constitutional battle the Federal Government will not win before the Supreme Court. Economic efficiency, even if proven, is not a sufficient reason to override the equilibrium and cooperative character of Canadian federalism
  - Undermine the efforts to pursue greater harmonization initiatives since the key resources will be diverted
  - In the end, it will most likely:
    - > result in the creation of a fourteenth Securities Commission with significant overlaps, redundancies, increased costs and the unavoidable turf battles
    - > increase the cost of compliance. For instance, a single, national commission should require that all documents filed on SEDAR be available in French. Today, this is not required when small cap stock issues are limited to their region and do not call upon Quebec investors

1. The empirical evidence demonstrates that Canada ranks amongst the best with respect to the quality of its securities regulations and protection of investors. Canada is ill served by sweeping statements to the effect that Canadian securities regulations are so deficient that nothing less than a profound structural reform is needed. A more positive assessment is clearly warranted
2. The Canadian regulatory machinery has adapted to the evolution of the structure of the industry. As a result of the very high concentration in certain segments such as exchanges, clearing houses, etc., it has become, de facto, national in scope, as an when warranted
3. As a result of the long tradition of cooperation between Canadian Securities Commissions, the degree of harmonization of securities laws and regulations that exists in Canada is so extensive as to create, in practice, a truly national system. The fact is that securities regulations in Canada are as uniform as the United States despite the fact that the Provinces have maintained their jurisdiction

4. Most of the criticisms about the current system point to shortcomings in enforcement activities in Canada. In this area, the federal government has an important role to play and a concerted effort is required
5. Dynamic efficiency is the acid test of a regulatory system design. It is the Achilles' heel of all centralized systems. The most likely result of the current centralization initiatives is the creation of an additional layer of regulation with its accompanying cost increases, rigidities and fertile terrain for conflicts and jurisdictional disputes
6. The structure of the Canadian financial sector has a profound influence on the workings and competitiveness of our capital markets. Its evolution toward a very concentrated industry has few parallels in industrialized countries. The implications for the efficiency and competitiveness of the Canadian capital markets are enormous and need to be given more weight in policy formulation