PRB 05-28E

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REFORMING CANADIAN SECURITIES REGULATION

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19 September 2005

PARLIAMENTARY INFORMATION AND RESEARCH SERVICE
SERVICE D'INFORMATION ET DE RECHERCHE PARLEMENTAIRES

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INTRODUCTION

Each day, several billion dollars are traded on Canadian capital markets. In an era in which capital flows effortlessly across borders, the effective regulation of these markets is crucial to the country's economic well-being. Efficient capital markets allocate resources rationally, focussing investment on the most constructive uses possible. This paper provides a general overview of the regulation of Canadian securities markets, their evolution, the benefits and costs of the current system, and possible reforms that would improve market efficiency.

Securities law exists primarily to protect investors from being deceived or defrauded by the companies that issue capital and the brokers who trade on capital markets.(1) The protection offered under securities law is designed to create investor confidence in the markets. If the investing members of the public have faith in the integrity of capital markets, they will be more willing to invest. Shareholders who witness corporate scandals, or perceive that the only people who benefit are those with insider knowledge or connections, withdraw their money, depriving Canadian companies of much-needed capital.

While the regulation of securities in Canada has historically fallen under provincial jurisdiction, some legal opinions have found that the federal government has the constitutional authority to pass comprehensive legislation regulating capital market activity within Canada.(2) However, at present, the sale of securities is subject to the rules and regulations of 13 different provincial and territorial securities regulators. Navigating through

(1) Securities are broadly defined in Canadian law, and include not only debt and equity securities, but also investment funds, units and trusts, and other financial instruments such as derivatives and hedge funds. Many of these securities are traded on specialized markets by sophisticated investors. Securities regulators tend to delegate responsibility for overseeing these markets to self-governing organizations, or the markets themselves. In many instances the securities are traded on international markets, outside the reach of Canadian regulators. The regulation of these specialized markets is beyond the scope of this paper, which concerns itself with debt and equity securities. Many self-governing markets would not be affected by a move towards a single national regulator.

(2) The Canadian Constitution does not explicitly assign securities regulation to either level of government. See the section of this publication entitled "Jurisdiction Over Securities Regulation."

these regulations is often time-consuming and costly. It is argued, moreover, that over-regulated capital markets hamper foreign investment in Canada and limit the opportunities available to Canadian investors. Additional costs associated with excessive regulation hurt Canadian companies trying to raise money in Canada and reduce their international competitiveness.

The profusion of regulation has led many analysts to argue that the current structure of capital markets is unsustainable without the enactment of uniform securities laws across Canada. The debate is whether harmonization can be achieved through cooperation by provincial regulators or whether a more radical solution is necessary: the imposition of a single national securities regulator by the federal government. While this latter option is still under consideration, recent reform efforts have focused on working within the current system.

HISTORICAL BACKGROUND

In the early 19th century, deceitful eastern capitalists were increasingly defrauding people wishing to invest in America's frontier states. Unwitting investors were sold worthless stock in "fly-by-night concerns, visionary oil wells, distant gold mines and other like fraudulent exploitations."(3) It was stated that these speculative ventures were backed up by nothing but the blue skies of Kansas, and in 1911 that state became the first North American jurisdiction to enact a securities law,(4) later known as the "blue-sky law."

Canadian provinces began passing their own securities legislation shortly afterwards. Manitoba enacted its first securities law in 1912,(5) a modification of the Kansas law, and other Canadian provinces followed. Ontario overhauled its securities legislation in 1945, 1966, and again in 1978, introducing stiffer licensing requirements and new measures designed to prevent fraud.(6) After each reform, many Canadian provinces followed the Ontario legislation and enacted similar laws.(7)

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(3) *Hall* v. *Geiger-Jones Co.*, (1917), 242 U.S. 539 (USSC).

(4) Kans. Laws 1911, c. 133.

(5) *Sale of Shares Act*, S.M. 1912, c. 75.

(6) *Securities Act*, 1945, S.O. 1947, c-8.

(7) For a more complete history of Canadian securities regulation, see Mark Gillen, *Securities Regulation in Canada*, 2nd ed., Carswell, Scarborough, 1998.

The history of Canadian securities law has been one of sporadic legal consistency across most provinces, followed by gradual divergence. For brief periods, the provinces have tried to harmonize securities legislation. This limited uniformity has not persisted, as statutes are amended and the provincial commissions establish new procedures and regulations. Currently, the law in Canada seems to be again moving towards uniformity, but provincial jurisdictions nonetheless have competing visions of how securities markets are best regulated.

In marked contrast to the evolution of the Canadian regulatory system, the U.S. federal government established the Securities and Exchange Commission (SEC) in 1934, in response to calls for reform after the stock market crash of 1929. While U.S. states maintain some control over securities fraud in a criminal context, and may require licensing of traders in securities under their blue-sky laws, the lion's share of securities regulation in the United States now falls to the SEC.

CURRENT SECURITIES REGIME IN CANADA

Securities legislation in all provinces has a common purpose and the same underlying objectives: the twin goals of protecting investors and ensuring a fair, efficient, and transparent capital market. To this end, all provincial securities regulators share the following core responsibilities: prospectus review; continuous disclosure; regulation of traders; enforcement; and public education. The differences in securities laws across provinces are largely the result of divergent views on the degree of protection investors require and how best to maintain market efficiency.

Provincial and territorial regulators have made numerous attempts to simplify and standardize their laws and requirements, collaborating through the Canadian Securities Administrators (CSA). The CSA is a forum for the 13 securities regulators of Canada's provinces and territories to coordinate and harmonize regulation of the Canadian capital markets. Its mission is to give Canada a securities regulatory system that protects investors from unfair, improper or fraudulent practices and to foster fair, efficient and vibrant capital markets through developing a national system of harmonized securities regulation, policy and practice. Through the CSA, several initiatives have been introduced to reduce duplication and overlap between commissions and to minimize costs to market participants.

On 30 September 2004, ministers responsible for securities regulation from all provinces and territories, with the exception of Ontario, agreed to implement improvements to the current system, including:

- a "passport system" for securities regulation, resulting in a single window of access to capital markets in participating provinces and territories, which came into effect on 19 September 2005;(8)
- highly harmonized, streamlined and simplified securities laws, with the goal of having the laws implemented in all jurisdictions by the end of 2006;
- a Council of Ministers to facilitate change and ongoing cooperation;
- a review of regulatory fees charged; and
- a commitment to explore options for further reform.

At this point, it is unclear to what extent the implementation of this agreement will change the current securities regime in Canada.

It is worth noting that securities law forms only a part of the overall system of corporate governance in Canada. Corporate governance rules include not only laws imposed by securities commissions, but also corporate statutes and the listing requirements of stock exchanges if corporate securities are listed publicly. Corporations in Canada, for example, can be incorporated either federally or at the provincial level. The business corporation statutes of each province provide for disclosure, and allow disgruntled shareholders to sue companies and management that have engaged in certain unlawful business practices. The Toronto Stock Exchange, like other exchanges, has its own listing and continuous disclosure requirements for listed companies, which are designed to promote good corporate governance.

RAISING CAPITAL THROUGH THE SALE OF SECURITIES

In Canada, issuers can raise capital by selling securities privately via a private placement, or publicly via a listing on a capital market. Different regulations apply to each market, extending different levels of protection to investors. A small company often begins

(8) Under this system, each province and territory will continue to have its own regulator, enact its own laws and levy its own fees. However, capital market participants will be required to comply with the rules and decisions of only a single jurisdiction (the "primary regulator"), regardless of where they undertake capital market activity in Canada.

raising capital through a private placement of securities. As the company grows, it may consider graduating to a listing on a stock exchange, or through a bond issuance. Generally, the more widely the securities are sold, the more the company must comply with detailed securities regulations.

A. Private Placements

Private placements offer securities to a limited group of investors through an exempt distribution. In a private placement, the company is exempt from certain securities laws, such as the requirement to prepare a prospectus (see the section entitled "Initial Public Offering (IPO)," below), that would otherwise apply if the securities were being sold to the general public. The issuer can sell shares only to a limited group of "sophisticated" investors, such as banks, pension funds, and wealthy individuals, or to company insiders (i.e., a director, senior officer, or employee of the issuing company). The ability to re-sell the shares to anyone outside this group is similarly restricted.

Private placements are used by smaller companies because capital can be obtained more quickly, and less expensively, than through a public share offering.(9) Larger companies, too, may use a private placement when they want to sell securities to only a select group of investors.

In many instances, a private placement issuer is required to prepare an offering memorandum prior to offering the securities. This document provides detailed disclosure, similar to a prospectus, but is not reviewed by any regulatory agency and does not provide investors with the same legal protections as a prospectus. If the issuer was already a reporting issuer (i.e., was already listed on an exchange), it may also be subject to continuous disclosure requirements.

Prior to recent reforms, exemptions were not harmonized across jurisdictions. Previously, provincial regulators agreed on certain standards, published as "multilateral instruments," that were intended to provide common exemptions across Canada. Some provincial regulators, however, did not have the authority to change their own rules, and exemptions in those provinces were made on a case-by-case basis. Moreover, the multilateral

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(9) Many types of issuers use prospectus exemptions, which set out specific conditions under which securities may be lawfully sold without complying with the requirement for a prospectus. For example, governments use exemptions to sell savings bonds. Private companies use exemptions to sell common shares to their founders. Publicly traded companies use exemptions to raise capital from large institutional investors, like banks, pension funds or mutual funds. Limited partnerships use exemptions to raise capital from certain qualified investors.

instruments adopted by some regulators contained subtle differences to the uniform standards, effectively defeating the purpose of the harmonized rules.

These shortcomings will likely be addressed as provinces and territories progress towards harmonizing securities laws by the end of 2006. On 8 July 2005, Canada's securities regulators agreed to harmonize and consolidate prospectus and registration exemptions across Canada. New national instruments came into effect on 19 September 2005, replacing all significant existing exemptions found in securities legislation across Canada.

B. Initial Public Offering (IPO)

When an issuer decides to sell its securities to the public, it must prepare a preliminary prospectus and file that document with the securities regulators in each province in which its stock is to be sold. The prospectus is a document that provides detailed information about the securities to be sold, the issuer's business, its management and its financial condition. After a prospectus is reviewed and approved by a securities commission, the issuer can begin selling the securities described in the prospectus to members of the public.

Unlike private placements, regulations pertaining to public offerings have been largely harmonized. In an attempt to reduce duplicated effort, the provinces have adopted a Mutual Reliance Review System (MRRS). Under this system, one securities regulator is designated as the "principal regulator" so that other jurisdictions may rely on its analysis and review of filings. A company wishing to issue shares has to comply with the requirements of only one province. Shares that have been issued under the approved prospectus can then be sold across Canada.

Under the passport system that came into effect for all provinces and territories (except Ontario) in September 2005, this process will be further streamlined. Companies may register to sell securities in one province or territory, and all other provinces and territories will recognize their credentials. Each province and territory, however, will still have its own regulator, enact its own laws and levy its own fees.(10)

(10) Ontario has rejected the passport system on the basis that, if implemented, it would represent an incremental improvement only and would not go far enough to address the concerns of national and international issuers and registrants. Ontario supports the alternative approach of a single provincial-territorial regulator with uniform laws.

CONTINUOUS DISCLOSURE

In an efficient market, investors must have equal and simultaneous access to material information about the companies in which they invest. Securities laws attempt to achieve this result through continuous disclosure requirements. Continuous disclosure means that once stock is issued, and the company goes public with a listing on a stock exchange, it is required to submit information to its regulators and its shareholders periodically. In addition, if any new information becomes available, it is required to publicly disclose that information in a timely fashion.

Under Canadian law, publicly listed companies must disclose documents such as annual reports and financial statements. These documents are available to the public from securities regulators, stock exchanges, and on an Internet-based system called SEDAR.(11) Besides the issuer, company insiders must file regular reports about any trades they make in the issuer's securities. Insider reports are available for public viewing at the offices of the securities regulators and through an Internet-based system called SEDI.(12)

To protect investors, continuous disclosure documents are subject to many legal requirements and safeguards. Officers and audit committees must attest to the accuracy of certain documents, and the directors of the company must ensure that disclosure is timely and accurate.

Through the CSA, provincial securities regulators have harmonized their laws with respect to continuous disclosure. For example, under SEDAR, insiders need to file only one report to comply with the insider reporting obligations of all securities commissions. In addition, the periods for filing reports have been harmonized across Canada.

ENFORCEMENT

Securities regulators are given the power under provincial statutes to enforce securities regulation. For example, if a prospectus turns out to be misleading or deceitful, securities regulators can discipline the company that produced it. Penalties range from ordering the company to pay back its investors, to a suspension of trading in the company's shares. Under

(11) System for Electronic Document Analysis and Retrieval: www.sedar.com.

(12) System for Electronic Disclosure by Insiders: www.sedi.com.

the continuous disclosure requirements, failure to provide information or misuse of information before it is made public – i.e., insider trading – can result in disciplinary action by the securities commission.

REGULATION OF TRADERS

The securities legislation of each province requires annual registration of all individuals or companies whose business is trading, underwriting, or offering investment advice with respect to securities. The registration process is designed to protect investors by ensuring that only qualified and reputable individuals and firms are licensed. Individuals and companies must file an application and pay a fee in each jurisdiction in which they wish to be registered. Applicants must meet certain educational standards and capital requirements and must also fulfil detailed conduct, solvency and reporting obligations.

Registration requirements have in the past differed substantially across provinces. In 2005, however, all provincial securities regulators agreed to a streamlined national registration system, in which traders register with a principal regulator, whose decision will, except in exceptional circumstances, be respected by jurisdictions across Canada.(13) Harmonization will be achieved through the creation of a National Registration Database (NRD), an initiative of the CSA and the Investment Dealers Association of Canada (IDA). The NRD is a Web-based system that permits individual dealers and advisers to file registration forms electronically.

Regulators have, for the most part, delegated the responsibility for disciplining brokers and investment dealers to self-regulating professional bodies. The IDA regulates the activities of investment dealers in terms of both their capital adequacy and their conduct of business. The Mutual Fund Dealers Association of Canada is the recognized self-regulating organization for mutual fund dealers in Canada and is responsible for mandating, monitoring compliance with, and enforcing common rules and practices.

(13) See Canadian Securities Administrators, "Canadian Securities Regulators Implement National Registration System," 18 April 2005, available on-line at: http://www.csa-acvm.ca/html_CSA/news/05_09_implement_NRS.htm.

BENEFITS AND COSTS OF PROVINCIALLY REGULATED SECURITIES MARKETS

A. Benefits

The provincial regulation of securities markets is thought to have a number of strengths. Proponents believe the provincial system allows for more innovative ideas on how best to regulate markets. Provincial securities regulators introduce new laws and regulations. These laws are tested in one jurisdiction, and if they are an improvement upon existing law, they will gradually be introduced in other jurisdictions and become a standard across Canada. In this way, securities regulators compete against each other in introducing new policies and ideas, making the Canadian system of provincial regulation more innovative than a system where a central bureaucracy creates all securities policy and law.

Champions of provincial regulation also point to the system's ability to respond to regional demands. Different provinces have different corporate specializations and therefore unique needs in that market. The Alberta market, for example, focuses on oil and gas issues, while British Columbia is acknowledged as the leading jurisdiction for mining and mineral exploration companies. In contrast, Ontario has laws that are tailored towards larger and more established corporations. There is a concern that a federal securities agency might create laws and policies suitable for the dominant Ontario market, to the detriment of the unique requirements of Canada's regions.

Better enforcement of laws is a further purported strength of provincial regulation. Provincial commissions acquire expertise and experience in dealing with a limited number of companies. These companies often have a history of compliance or non-compliance. Regulators familiar with a specific company can better quantify the risk to the public, and act accordingly. A regulator familiar with local business is a more effective enforcer of securities regulations, since any proceedings by the regulator will not be hampered by geographical considerations.

Many provinces have an economic stake in local securities regulation, and would resent the loss of their securities infrastructures. Issuers that wish to sell shares across Canada usually hire local accountants, lawyers, underwriters, and other professionals. Provincial jurisdiction has created local clusters of securities professionals, primarily in Vancouver, Calgary, Toronto and Montréal. Many of these professionals feel that a national securities agency would further consolidate Toronto's dominance of corporate finance in Canada. The securities commissions themselves are likely to oppose the idea of a national regulator, since the national regulator might move policy jobs to Ontario, leaving only enforcement to the provincial offices.

Finally, supporters of provincial regulation say that the system is adaptable, and that uniform securities laws can be achieved through the previously mentioned "passport system." In contrast to the MRRS, which relies on voluntary mutual reliance, a passport system would be implemented through comprehensive inter-delegation of regulatory functions. The MRRS is limited primarily to prospectus clearance. The passport system, if fully implemented across all provinces and territories, would likely be much broader, entailing delegation of virtually all regulatory functions while leaving the existing infrastructure of 13 regulators intact. Capital market participants would be required to comply with the rules and decisions of only a single jurisdiction (the "primary regulator"), regardless of where they undertake capital market activity in Canada. This is the system that ministers from all provinces and territories, with the exception of Ontario, agreed to establish by 2005.

B. Costs

1. Compliance Costs for Issuers

Whatever the benefits of provincial regulation of securities, the system has a number of associated costs. Critics complain that it is expensive for companies trying to raise money in Canada to comply with all provincial laws. While provincial regulators have tried to harmonize their laws, subtle differences ensure that an issuer must consult with advisors and legal counsel in many jurisdictions in order to sell securities. Even when using the MRRS, issuers must pay filing fees to individual securities regulators. This is not likely to change under the proposed passport system.

Research has found that the incremental compliance costs associated with multiple jurisdictions are generally not material for large issuers.[(14)] Smaller firms, however, are less able to bear these costs and consequently are more likely to find them material. Thus, the existence of multiple securities regulators in Canada may impose a competitive disadvantage on smaller firms.

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(14) Charles River Associates, "Estimating the Incremental Costs of Multiple Securities Regulators in Canada," Submission to the Wise Persons' Committee to Review the Structure of Securities Regulation in Canada, 2003.

Many smaller companies also raise capital using prospectus exemptions. The differing treatment of exemptions across the provinces makes the process of raising capital more time-consuming and expensive for small and medium-sized businesses. The average potential savings per exempt distribution application under a single regulatory model has been estimated at $1,124.(15)

More important than direct costs, the current system may also entail significant "opportunity cost" risk. The ability to raise capital on favourable terms is often time-sensitive. Opportunity cost risk frequently arises due to delayed transactions that hold up the commencement of trading. Critics claim that these delays are inherent in the MRRS because, when a prospectus is filed, regulators are given a number of business days in which to comment or raise concerns.(16) Delays are even greater when an issuer is seeking an exemption from the prospectus requirement.

2. Compliance Costs for Dealers and Traders

It has been conservatively estimated that IDA members devote $4.2 million annually in internal labour resources to register firms and individuals.(17) While the new NRD will achieve some cost savings for dealers and advisors, registrants will still face the ongoing cost of paying annual fees in each province of operation.

3. Reduced Opportunities for Investors

Under the current system, investors in smaller provinces are often denied investment opportunities. Due to the costs of dealing with multiple regulators, some companies will sell shares only to investors in Canada's major securities jurisdictions (British Columbia, Alberta, Ontario, and Quebec) and not to those in smaller provinces and territories.

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(15) *Ibid.*

(16) When a long-form prospectus is filed under the MRRS, the principal regulator has 10 business days in which to provide comments. Once the comment letter is issued, a non-principal regulator has 5 business days in which to raise concerns with the principal regulator, or opt out of the system, or indicate that it is prepared to receive the final prospectus. A number of business days are then needed for the issuer to resolve any additional comments from non-principal regulators.

(17) Charles River Associates (2003).

4. Enforcement

One of the most frequent criticisms of the current system is that Canada does not enforce its securities laws effectively, particularly when compared to the United States. There has been little harmonization of enforcement activities across Canada. Small investors are particularly vulnerable; many believe that the system fails to protect their interests.

a. Resource Allocation and Enforcement

Provincial securities regulators typically spend between 13% and 19% of their budgets on enforcement, whereas in the United States enforcement accounts for approximately 29% of the SEC's budget.(18) Many studies have found more stringent enforcement in the United States, particularly with respect to insider trading. Critics argue that the rationalization of the regulatory structure in Canada would free up resources that could be directed towards improving enforcement performance and investor protection. Many have identified a growing need for more specialized staff as the complexity of securities violations increases.

b. Coordination of Enforcement

Each regulator is responsible for enforcing its own securities laws; enforcement issues, however, are often multi-jurisdictional. Regulators have made significant improvements in coordinating enforcement efforts. These efforts have included the appointment of a single regulator as lead investigator, partitioning of investigations, and undertaking joint investigations and hearings. However, coordination efforts are costly and can impede progress on investigations. Multiple investigations and enforcement proceedings by different regulators into the same issue are still common. In some cases, offenders may not be prosecuted because of poor communication between jurisdictions.

A further weakness of the system is the inconsistency among jurisdictions with respect to enforcement priorities and protections: investors receive different levels of protection depending on the province in which they live. Enforcement budgets and levels of expertise differ across regulators; penalties and sanctions for the contravention of securities laws also differ. Moreover, since the regulators have no power outside their own jurisdictions, offenders can simply move to another province and continue to operate as before.

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(18) Wise Persons' Committee, *It's Time*, Ottawa, December 2003, p. 27.

c. Policy Development and Enforcement

The current system is further criticized for its tendency to favour policy over enforcement. Each major securities commission has its own policy development branch. The duplication of effort means that resources are drained from enforcement. In addition, the system is criticized as being too inflexible to respond to new financial instruments in a timely fashion. Independent policy development and a divergence in regulatory philosophy inevitably lead to disagreements among the different jurisdictions. In turn, this slows the process of implementing and harmonizing laws. Critics point out that it takes the securities commissions up to three years to develop and achieve consensus on some of their multilateral instruments.

A criticism of the passport system is that it fails to address these concerns. Ontario feels that a passport system will not lead to improvements in the ability to respond to new market issues (i.e., more harmonized policy development), nor will it significantly improve investor protection and enforcement. Even if it is fully implemented by all jurisdictions, a passport system still has the potential to maintain excessive costs for market participants, and involve continuing legal uncertainty and inconsistent interpretation and enforcement.

GLOBAL COMPETITION

Strong regulation has an important role in ensuring Canada's ability to compete globally for investment capital. A goal of any reform of the financial regulatory system should be to foster a fair and efficient market that is attractive to both Canadian and foreign investors and issuers.

Today, more than half of the total market capitalization of companies listed on the Toronto Stock Exchange comprises companies that are interlisted in the United States. Canadian issuers have been able to take advantage of simplified access to U.S. capital markets provided through the multi-jurisdictional disclosure system (MJDS). The SEC adopted the MJDS in 1991 to eliminate duplicative regulation and facilitate cross-border securities offerings by Canadian reporting issuers in the U.S. capital markets (and U.S. reporting issuers in the Canadian capital markets). Under the MJDS, eligible Canadian issuers may offer securities to the U.S. public using a prospectus filed with and reviewed by the applicable Canadian securities regulator. These MJDS issuers may also fulfil their continuous reporting obligations under the SEC by filing or submitting their Canadian disclosure documents with the SEC. This system was established based upon U.S. confidence in Canadian capital market regulation.

Continued access depends in part on Canadian regulators' ability to maintain U.S. regulatory confidence by responding quickly to U.S. regulatory changes. Currently, there is no one Canadian regulator with the mandate to discuss evolving issues with the SEC. Under the passport system, Canada's status as the only advanced country without a national regulator will continue and each provincial regulator will need to determine how closely its reforms will mirror those of the United States. One example is current attempts by the CSA to bring Canadian requirements in line with those of the Sarbanes-Oxley Act of 2002 (SOX).[(19)] SOX introduced an extensive collection of corporate governance and disclosure reforms in the United States. Most of these new requirements will also apply to Canadian companies that have securities listed on a U.S. stock exchange.

While the regulatory burden imposed by SOX is high, the need to maintain investor confidence is forcing Canadian regulators to adopt similar principles. However, the CSA extended the deadline for changes, noting recently that the earliest date for the application of new instruments regarding reporting on internal controls is mid-2007. Fragmentation of the regulatory system may have had a role in extending this timeline. As an example, individual securities regulatory authorities in every Canadian jurisdiction (other than British Columbia) solicited comments on the proposed instruments.

The second force for greater reform flows from the globalization of capital markets. Canadian companies, to compete globally, need access to capital at a competitive price. It is possible that less efficient regulation of Canadian financial markets hampers capital market activity in Canada.[(20)] If regulatory fragmentation raises the cost of issuing in Canada to uncompetitive levels, Canadian companies, as well as foreigner issuers considering issuing in Canada, have a growing range of attractive alternatives.

Other smaller issuers, such as Australia, have recognized the need to maintain effective regulation faced with competitive commercial pressure from overseas markets. On 1 January 1991, the Australian Securities Commission, Australia's single national regulator,

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(19) The Sarbanes-Oxley Act of 2002 represents a major change to U.S. federal securities laws. Effective in 2004, it requires that all companies – both domestic and foreign – seeking to list on U.S. exchanges submit an annual assessment of the effectiveness of their internal financial auditing controls to the SEC. Section 404 requires that the Chief Executive Officer and the Chief Financial Officer of a public company certify its systems of internal control over financial reporting, and that an audit report attest to that certification.

(20) Charles Freedman and Walter Engert, "Financial Developments in Canada: Past Trends and Future Challenges," *Bank of Canada Review*, Summer 2003.

was established to replace the National Companies and Securities Commission and the Corporate Affairs offices of the states and territories. In 1998 it was renamed the Australian Securities and Investments Commission and its mandate was broadened to cover the regulation of market conduct for banking, insurance, and pension sectors. There is some evidence that moving to a single national regulator has helped Australian markets remain competitive. The 2004-2005 *Global Competitiveness Report*, compiled by the World Economic Forum, ranked Australia's regulation of securities exchanges number three in the world, ahead of major markets such as the United States, Germany and Japan (as well as Canada). The report measured market transparency, independence from excessive government influences, and the effectiveness of exchange rules within 104 countries.

THE WISE PERSONS' COMMITTEE AND RECOMMENDATIONS FOR REFORM

In December 2003, the Wise Persons' Committee (WPC), an independent body formed by the federal government and chaired by Michael Phelps and Harold MacKay, released its report on Canadian securities regulation. The WPC's mandate was to recommend a securities regulatory system that best supports competitiveness, innovation and growth in Canada's capital markets, responds to the requirements of regional capital markets and emerging public companies, and at the same time inspires and maintains investor confidence. The report, entitled *It's Time*, recommends that Canada adopt a single regulator administering a single code. This proposed new structure would be cooperatively created and overseen by the federal and provincial governments.

There appeared to be considerable support in the financial industry for a national securities commission. The presidents of the IDA and the Canadian Bankers Association both cited efficiency and a better match between markets and regulators as reasons for adopting a national body.

Provincial reaction to the idea of a national securities commission, however, was mixed. The Ontario Securities Commission supported it, but the Quebec Securities Commission opposed it. The Alberta and British Columbia commissions, for their part, had strong reservations, expressing fear that centralizing securities policy would impose uniform rules that ignore the varying needs of each provincial capital market.

A. Jurisdiction Over Securities Regulation

The Canadian Constitution does not explicitly assign securities regulation to either level of government. Regulation has traditionally fallen to the provinces under the "property and civil rights" power of the Constitution (subsection 92(13)). The federal government also has jurisdiction over capital markets pursuant to its power to legislate in respect of "trade and commerce" under subsection 91(2) of the *Constitution Act*.

In 2003, the WPC commissioned three legal opinions on this issue, all of which said that the federal government has the constitutional authority to pass comprehensive legislation regulating capital market activity within Canada. The WPC found that provincial cooperation would facilitate the process; but it also found that, in the absence of agreement, the federal government could impose a single national regulator to govern securities law in Canada, under the constitutional doctrine of federal paramountcy. It should be noted, however, that the jurisdiction of the federal government to override provincial securities law has never been tested in a court, and is not assured.

B. Recommendation for a Single National Securities Administrator

While the WPC report acknowledged that Canada's existing system of 13 provincial and territorial regulators has positive attributes, it claimed that the weaknesses of the system are serious and outweigh its strengths. According to the WPC, Canada suffers from inadequate enforcement and inconsistent investor protection. The Committee felt that the existing system also contributed to sluggish policy development, needless duplication, inefficiencies and costs, and regulatory complexities. The WPC concluded that these weaknesses make Canada less competitive than it must be at a time of increasing global competition.

The WPC also found the passport system was an inadequate solution to the weaknesses inherent in provincial regulation, for two reasons. First, the WPC claimed that the system would not improve the enforcement of laws. Provincial commissions would still have divergent enforcement priorities, with smaller provinces lacking the resources to properly enforce laws. Provincial commissions would also continue to have limited power to impose sanctions on breaches of the law in different jurisdictions. Second, the WPC believed that policy development under the passport system would continue to be sluggish and unresponsive, since it would continue to rely on the ability of provincial commissions to reach a consensus.

The WPC believed that a single securities commission, in which provincial governments electing to participate would pool some or all of their authority in a single regulator administering one set of rules, would be a considerable improvement on the existing system and would best achieve the objectives of an ideal securities regulatory structure. The Committee argued that the recommended national model would:

- significantly strengthen enforcement through more efficient allocation of resources, better coordination, and uniform investment protection across the country;
- facilitate better and, when needed, more timely policy innovation and development;
- address the disproportionate regulatory burden that the current system places on small and emerging companies;
- enhance the "brand" of Canada's securities regulation internationally;
- eliminate additional compliance costs resulting from multiple regulators;
- ensure responsiveness to local and regional needs through the participation of the provinces and capital market participants in its governance structure and regional offices;
- establish clear accountability and governance mechanisms; and
- simplify the current system by reducing the number of regulators from 13 to 1.

The report proposed that reform would begin through the enactment of a Canadian Securities Act that would provide a comprehensive scheme of capital markets regulation for Canada. The new legislation would be administered by a single Canadian Securities Commission consisting of nine full-time, regionally representative commissioners – two from each of Ontario and Quebec, one from each of British Columbia and Alberta, two from the remaining provinces and territories, and a ninth commissioner to be selected without regional restrictions. The federal Minister of Finance would be responsible for appointing the commissioners, based on nominees put forward by a Nominating Committee consisting of members from each province.

The report also proposed a Securities Policy Ministerial Committee made up of the federal Minister of Finance and provincial ministers responsible for securities regulation. This Ministerial Committee would provide a forum for policy and administrative input.

The new structure would ensure responsiveness to Canada's capital markets and regions by locating the Commission's head office in the National Capital Region and by establishing "strong, functionally empowered regional offices" in Vancouver, Calgary, Winnipeg, Toronto, Montréal, and Halifax. A Capital Markets Advisory Committee would allow issuers and investors (the "users" of the system) to provide their input, and would thus preserve regional representation.

CONCLUSION

Since the release of the WPC report, the provinces and territories (with the exception of Ontario) have endorsed a passport system that would keep the existing infrastructure of 13 securities regulators intact. Ontario has rejected the agreement and continues to strongly endorse a single securities commission, similar to that proposed by the WPC. The federal government, in the March 2004 Budget, also endorsed a single national securities regulator.

Without Ontario's support, it is unlikely that the passport system will lead to significant improvements in the regulatory environment. A major reform of Canada's securities regulation system may require stronger intervention at the federal level.