ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

INVESTMENT INDUSTRY ASSOCIATION OF CANADA

A CAPITAL IDEA –

CLEAR, CONSISTENT, COMPETITIVE CANADIAN CAPITAL MARKET LEGISLATION AND REGULATION

A DISCUSSION PAPER

Submission to Finance Canada, November 23, 2007 (R. April 4, 2008)

The Investment Industry Association of Canada (IIAC) is a member-based, professional association that advances the growth and development of the Canadian investment industry. IIAC acts as a strong, proactive voice to represent the interests of the investment industry for all market participants. Our member firms range in size from small regional firms to large organizations that employ thousands of individuals across the country. Our members work with Canadians to help build prosperity and investment security for investors and their families.

The IIAC's aims are fourfold:

Advocacy: To be the voice of the investment dealer and brokerage industry, advocating on regulatory and public policy issues for an investment environment that is efficient for our members and that fosters savings and investment by Canadians

Industry profile: To build a better appreciation of the contribution that the securities industry makes to Canadians, to Canada's capital markets and to the Canadian economy

Member support: To offer operational support that contributes to the ongoing success of our members and to their ability to cost-effectively serve investors and issuers

Market advancement: To promote globally competitive capital markets for Canada.

PURPOSE

To initiate or continue discussion with federal and provincial governments regarding the need for practical, clear, internationally competitive and certain securities legislation and regulation, with a goal of agreeing to action to improve Canada's capital markets for all stakeholders.

> **"The burden of government is the intervention and interference of government in the operations of a business… It is the cost involved in complying with regulatory requirements, … and responding to information demands from government. And it is the administrative hurdles, the lack of customer service, the delays, the uncertainties and the frustration involved in dealing with public bureaucracy.**
>
> – *"Breaking through Barriers"*
> 1994 report of Industry Canada's Small Business Working Committee

SUMMARY

- Competition in global capital markets is growing rapidly. Technology is breaking the barriers of distance; English, the de facto language of business, is breaking communication barriers; and international regulatory and business convergence is helping to break the barriers caused by different practices. Canada has been able to tie its geography together for over 120 years through the national railroad; its securities settlement and payment systems have linked the country in a way that has been the envy of the world for the last quarter of a century. However, securities regulation remains far from unified, notwithstanding clear progress in recent years
- While the Canadian Securities Administrators has existed for more than 70 years, it has largely been in the past decade that the securities commissions have made measurable progress on harmonization and co-ordination, including:
  - Making many regulatory requirements governing the markets "virtually identical" in all provinces and planning to harmonize most of what is left
  - Implementing national systems for market participants to make and obtain regulatory filings and other information (for example, through SEDAR, SEDI, NRS, NRD and MRRS)
  - Defining operational processes to co-ordinate regulatory decisions (for example, allowing a public company to deal with only one regulator to quickly clear a national public offering) and enforcement proceedings (recognizing that regulatory, must not be confused with criminal, enforcement)
  - Putting in place a passport system, effective in the spring of 2008, that would, for example, give public companies, investment dealers and their registered representatives single-window access to the market across Canada based on a set of harmonized rules.
- However, in a world where the pace of change continues to accelerate, will this progress prove to be enough? The IIAC's paper, *Canadian Capital Markets Strong and Free: Support for a Canadian Capital Markets Strategy*, sets out why we believe that Canada's policymakers should promote Canada's capital markets from a macro-economic perspective. Here our focus is a more micro look at what impedes Canadian issuers and intermediaries from becoming more competitive and what effects this has on investors. Specifically, the current structure of securities legislation and regulation in Canada can be confusing to investors, may lead to uncertainties, often fails to provide a national market perspective, and results in significant direct and indirect compliance expenses, raising more

in aggregate than it costs to regulate. This imposes a net undisclosed tax on investors, issuers and intermediaries and has an economic cost borne in one way or another by Canadians and Canadian businesses.

Below, the IIAC considers what principles should guide decision-making; the specific problems we believe need to be solved; and proposed solutions consistent with expanding on Canada's current base to provide cost-effective regulation enabling investment dealers to most effectively serve their investor, issuer and government clients, as well as the overall economy.

PRINCIPLES

1. **Balance stakeholder interests/cost-benefit analysis:** The policy framework for the Canadian capital markets must balance investor protection, market stability, transparency, efficiency, innovation and market competitiveness. To this end, new regulations… and old ones… should be examined in terms of the benefits and costs associated with meeting and balancing the different interests.

2. **One-stop shopping/efficiency – cost-recover-based regulation :** Securities sector policy, as well as capital markets legislative and regulatory structures, must show Canada as "open for business:"
   - Issuers, intermediaries (such as investment dealers) and others must be able to act as if they are in – and the Canadian markets must be perceived to be – a uni-jurisdictional environment, reducing or eliminating costs of duplication or inconsistency that have little or no impact on the service that Canadian individuals and businesses expect.
   - Investors – Canadian retail and institutional clients – must be comfortable that they will be treated in the same way, wherever they are in the country, and that they will not be subject to the costs of inefficiency.
   - Intermediaries must be able to get the answers they need reasonably quickly to be able to react quickly to changing market conditions.
   - Investors, borrowers and intermediaries from foreign jurisdictions must have clarity as to what rules will apply to their transactions
   - Regulators, intermediaries, issuers and investors should work towards convergence of rules
   - Regulators must operate on a cost-recovery basis only, with any over-collection of fees used to reduce fees charged to issuers and intermediaries in the subsequent period.

3. **Principles- rather than rules-based regulation:** Regulation must be flexible to allow intermediaries and regulators to adjust rapidly to new situations. To allow for innovation and increased competition, regulation must recognize the reality of multiple business models in today's global environment.

4. **Competitiveness preserved or enhanced:** Current rules governing Canada's securities and capital markets must be generally consistent with the legislation and regulations across Canada and in key respected competing capital markets jurisdictions. Firms must be able to operate effectively on a level playing field with regulated and unregulated competitors.

5. **Certainty and confidence:** As confidence and certainty are critical in capital markets and financial markets generally, announcements from, or allowed to be published by the Canadian or provincial government bodies or regulators, or that appear to be endorsed by these entities, must be consistent with a nation that welcomes investment and has a flexible but strictly enforced regulatory framework.

6. **Single voice:** Canada must be in a position to show a unified front in the international arena and have a unified perspective domestically.

ISSUES

1. **Competing and conflicting demands:** Canada's investment dealers fully support the requirement for ***investor protection.*** They do not, however, believe that the current system meets certain investor requirements as it is confusing, overwhelms them with paper that they may not need or want, and treats investors in different ways in different provinces. Also, we believe that the increases in certain customer protection regulation is not justified by evidence – the number of investor complaints have remained remarkably flat despite increases in transaction numbers, values and information on how to carry forward complaints. From ***issuer and economic*** perspective, the balance is tilted away from meeting the needs of capital-raisers, where entities raising small amounts face prohibitive costs if they are to issue in each jurisdiction: a 2007 CBA survey using publicly available data from www.sedar.com concluded that a firm seeking to raise $1 million would see its regulatory-related costs double from eight per cent of the amount raised in one jurisdiction to 16 per cent of that amount if being raised in all Canadian jurisdictions." Furthermore, we think that regulation at present may not enable ***intermediaries*** to compete as effectively with less-regulated or unregulated entities and that discussions with the regulators on this point would be helpful.[1] Finally, at least one securities commission has ventured beyond investor protection and transparent efficient markets to development of regional economic interests – arguably, this responsibility lies more appropriately with provincial finance or development ministries and should be paid for by the broader taxpayer base, rather than by investors and issuers.

2. **Multiple jurisdictions lead to duplication, gaps and confusion:** Canada does not have a single securities regulator; it has at least 13 – but for some investment-related activities, it has none. Legislation governing securities is spread among provincial *Securities Acts* and *Business Corporations Acts*, as well as several federal and other provincial laws. While we agree that the introduction of a passport system to simplify regulation by provincial securities commissions is a positive step:

   - We have yet to hear from an ***investor*** who expects to be treated differently depending on where he or she lives and we believe that some would be more concerned if they knew they may not be able to keep their broker if they moved to a province where the advisor was not registered or if they were aware that regulation was preventing them from buying into an initial public offering (IPO) available only to residents of another Canadian province.

   - ***Issuers*** see little value in a multi-jurisidictional system – a 2004 Ipsos-Reid poll found that 75 per cent of 688 investor-relations officials and company directors in Canada supported the need for single, national securities regulator while the Prospectors and Developers Association of Canada in a fall 2007 survey by Angus Reid Strategies found that 88 per cent of those surveyed said they wanted a single national securities regulator.[2]

   While the prevalence of a problem that regulation is designed to address may vary across the country, we are not sure why investor protection, fair competition and other solutions should differ across the country. As an example, the B.C. Securities Commission has asked for comments on amending its policy position to ensure that persons seeking to trade in foreign exchange contracts register with the Investment Dealers Association of Canada (Pacific District) (IDA) as investment dealers given the risks related to trading foreign exchange positions on margin. This would also promote a level playing field between regulated and unregulated dealers in this area.[3]

Accommodations were made by the other provincial and territorial jurisdictions within the passport system for Ontario, a province that has not joined the passport system – this is viewed by some as a creative response by the other jurisdictions and, to others, as an unfair advantage for Ontario-based issuers and investors. Progress on the passport system is perceived as slow, less than fully effective (for example, it does not, as yet, extend to the policy-making process), yielding few cost efficiencies. There remains a concern about the limited provincial focus that will perpetuate differences between jurisdictions. Concerns include:

- ***Slow and cumbersome:*** With speed critical in markets where innovation and responsiveness help determine success, decision-making in the current multi-jurisdictional environment appears unreasonably slow in areas that seem to present little, manageable, or no risk:
  - National Instrument 24-101, Institutional Trade-Matching and Settlement Rule, took effect on October 1, 2007 but answers that were generally agreed to by early August and were to have been officially made available in mid-October, were released finally in mid-December – virtually the end of the first reporting period.
  - The participants of the Canadian Depository for Securities Limited have to wait a minimum of 78 days to get regulatory approval for a new file feed on dividend eligibility. By any practical standard, one would think this is at best a technical change, and, if anything, the delay increases the risk of participants who require the file feed as early as possible to be better prepared for tax reporting season effective January 1.
  - One Quebec broker reported a significant (two-month) backlog in approving registrations, meaning business for some parties was at a standstill until the situation was fixed. One explanation for the delay was that the provincial regulatory staff were at the time insufficiently trained on the National Registration Database (NRD) and that there was a "crunch" of registration filings.
  - There have been cases where registrations in smaller jurisdictions were delayed because the person responsible for the role was on vacation: businesses cannot wait, nor can the investors and issuers who rely on Canada's capital markets.

- ***Cost:*** Direct fees paid to regulators have been increasing – one small registrant reported a five-fold increase in fees between 1999 and 2007. Revenues raised by securities commissions almost always exceed costs of regulatory services.[4] This year, most if not all the provincial securities commissions will generate more revenue in fees charged to market participants than required to cover the costs of executing the commissions' mandates – one commission earned a 60 per cent "profit margin" ($over $6 million) that was turned over to the New Brunswick government for general purposes rather than to used to reduce costs for issuers and investors. These excess revenues, which can be interpreted as an undisclosed tax on issuers, investors and intermediaries, contrasts with the fee approaches of other regulators, such as the Office of the Superintendent of Financial Institutions (OSFI), which operates on a cost-recovery-only basis.

- ***Narrow focus:*** Decisions taken in Canada on securities legislation and regulation may have a very limited focus, which both is at odds with what is needed to compete effectively in global capital markets and contrasts with the approach that the U.S., U.K. and European Union are taking, namely progressing on regulatory convergence.

3. **"One-size-fits-all" does not "fit all":** The "tick-and-bob" checklist approach often associated with rules-based regulation means the application of rules in situations that may be inconsistent with common sense and good business practice. Applying solutions to

protect retail investors when there are no retail investors involved in an effort to appear even-handed is not, in fact, equitable and may distort effective decision-making. Applying solutions that regulators rightfully considered some years ago (for example, as regards the client relationship model and point-of-sale requirements) may make less sense now given advances in technology, Canadian investors' interest in opportunities around the globe following elimination of limits on foreign content in registered investments, and client preference.

4. **Unlevel playing field:** Rules governing securities and Canada's capital markets are in some cases not consistent with equivalent legislation and regulations in the U.S., European Union and other key competing capital markets jurisdictions and risk leaving Canadian firms at a disadvantage. In terms of the spot exchange market, a number of IIAC members point to the OSC not enforcing regulations preventing unfair competition in the province's jurisdiction from an estimated 10 non-regulated foreign entities that operate via internet and phone; Investment Dealers Association of Canada (IDA) capital rules place IDA firms facilitating spot FX transactions at a disadvantage to unregistered foreign and domestic non-IDA-regulated firms that that are subject to lower margin rates on the business (e.g., the U.S. National Futures Association's margin requirements are a third to a tenth of those in Canada for similar currency pairings and U.S. firms can mitigate the margin requirements by doubling the typical risk-adjusted capital requirement – essentially using their capital to reduce client requirements – the IDA believes their capital requirements are appropriate, however, combined with the ability for lesser and un-regulated firms to come into the Ontario market, this has the effect of making better-regulated IIAC members the higher-cost alternative – which is contrary to investor, intermediary and regulator interests).

   Also, the International Swaps and Derivatives Association has until late last year associated Canada with having an antiquated *Personal Property Security Act* regime (in the age of new ways of holding securities) with remaining uncertainties in netting. These shortcomings have been rectified in large part and the industry will approach provincial governments to make equivalent changes in the near future. The federal government is also considering leaving jurisdiction over securities transfers to the provinces, further supporting a competitive marketplace.

5. **Uncertainty:** As confidence and certainty are critical in capital markets, governments must work together, and with the industry, to ensure clarity. As clear examples highlighted by a late 2007 article in *Protégez-vous* on a survey funded by the Autorité des marchés financiers, and the news release and reporting on a Canadian-Securities-Administrators-sponsored survey on investment fraud (which did not define the term "financial advisors"), the understanding of those who provide investment advice across the country and those that regulate them is unclear at best and non-existent in many cases. Investment advice can be regulated by the federal or provincial governments… or not at all… which may lead to a lack of confidence in regulation and, as bad, the viewing of all in the industry on a par with the worst.

   Certainly, neither the *Protégez-vous* article nor the CSA survey nor material on commission websites clarified that IDA registered firms and IDA regulated investment advisors are subject to more stringent oversight and investment advisors are required to undertake continuing education courses and have the broadest scope of service offerings. In the U.S., the Financial Industry Regulatory Authority (FINRA) is looking at the proliferation of designations, particularly those requiring no meaningful training or specialised knowledge but that imply a knowledge that the individual may or may not have, and recommending statutory changes to harmonize the regulation of brokers and investment advisors offering similar products.

The multiple jurisdictions, as noted above, create uncertainties, in some cases dissuading Canadian and foreign issuers and investors from investments from which they and this country would benefit. As well, regulatory mandates in some cases appear to be expanding, leading to the potential for further confusion and duplication (for example, in the case of the Ombudsman for Banking Services and Investments (OBSI); refer IIAC's January 31, 2008 letter to the Chair of OBSI). Finally, announcements from or allowed to be published by the Canadian or provincial governments or their agencies so that they appear to be endorsed or accepted by these governments, have run contrary to the image of a country that welcomes investment; examples include a daily e-letter by a credible global investment analyst following the Alberta government's publication of the oil and gas royalty scheme, on top of the October 30, 2006 income trust change, was sufficient to push this advisor, and possibly others through him, into divesting from Canada due to the inability to obtain certainty.

6. **No national perspective; no accountability for a national perspective:** The passport system does not address two critical issues: dealing with international regulatory matters and providing a national market perspective on regulation. Arguably, these issues may have been factors in Australia being announced as the first jurisdiction with which the U.S. Securities and Exchange Commission (SEC), as announced on March 29, 2008, would engage in "formal discussions to develop a mutual recognition arrangement for the two nations' securities markets. The discussions are intended to enhance cross-border law enforcement cooperation, facilitate regulatory coordination, and increase investor access to well-regulated capital markets."… Australia, a country with a 14-hour time and 15,989-kilometre difference from the U.S. Securities and Exchange Commission (SEC), was chosen over a relatively similar-sized jurisdiction in the same time zone and a mere 897 kilometres away – Canada.

RECOMMENDATIONS

1. **Conduct meaningful fact-based cost-benefit analyses:** Before introducing new or amending existing rules, regulators and registrants must seek to come to a meeting of the minds through discussion on what the costs and benefits of a change may be and how they are to be measured against the benchmarks of investor protection, transparency, efficiency, innovation and market competitiveness. Old rules must be subject to review on a set timetable so that there is not an ever-increasing regulatory burden, particularly given capabilities of new technologies that also present new opportunities and efficiencies. B.C. in 1998 introduced a The purpose of this Act is to facilitate streamlining of the ways that businesses deal with the Provincial and local governments by "(a) simplifying the procedures for businesses to provide information, file reports, make applications and meet other administrative requirements under other Acts, (b) promoting co-ordination of licensing and reporting requirements under two or more Acts to reduce duplication of effort, inconvenience and delay for businesses, (c) and allowing businesses to use new technologies to reduce inconvenience and delay in making applications or reports required under other Acts." The federal government committed in 2006 to a reduction in regulatory burden by 20 per cent by November 2008; Ontario, in its 2008 budget, committed to aggressively limit new regulations, at least matching any new regulation with elimination of an existing regulation.

2. **Assess the passport system and common securities regulator dispassionately to identify how proponents of each model would address the flaws identified by those opposing them:** There are those who continue to press for a common securities regulator, assuming economies of scale and time – this is particularly true when they recognize that Canadian markets represent only three per cent of debt and equity markets. There are others who believe equally strongly that the goals of a common securities regulator can be

achieved better and more cost-effectively through the ongoing rule harmonization, process co-ordination and extension of the passport system.

The proponents of the passport system say it builds on what already works, will eliminate the remaining duplication of administrative tasks just as effectively as a single regulator, but faster, at a lower cost and without constitutional disputes to the provinces' jurisdiction over securities commissions.

Those that decry the passport model point to the length of time it takes to get decisions, especially as each jurisdiction may be at a different stage in its political cycle; the high costs that are borne by investors, issuers and intermediaries – effectively all Canadians; and the fact that the securities commissions have been slow to move other areas of responsibility into the passport model (e.g., development of policy, administrative decision-making processes, fee management and fee levels, etc.).

Both for and against sides have been able to find facts and figures, eminent authorities and persuasive arguments to make their case. The myths of one side are the realities of the other and vice versa. For this reason, and in an effort to help advance discussion, the IIAC – whose mandate is market efficiency and advancement, as well as operational and cost efficiency support for its members – is developing a series of questions to better understand how both the passport system and a common securities regulator would address key requirements of investors, issuers, intermediaries and efficient, competitive capital markets.

3. **Implement more principles-based regulation:** We urge Canada's governments and regulators to move the current rules-based regulation to a more principles-based model to allow firms to act more pro-actively and not just reactively. This should lead to a more innovative and responsive capital markets sector.

4. **Promote innovation and competitiveness:** Rules governing securities and Canada's capital markets must be consistent with similar legislation and regulations in the U.S., European Union and other key competing capital markets jurisdictions, or risk leaving Canadian firms at a disadvantage. The U.S. Treasury Department, responsible for the oversight and proper functioning of the largest capital markets in the world has recognized the need to remain competitive, evidenced by the publication in early April of its *Blueprint for a Stronger Regulatory Structure*, which, among other things, recognizes growing competition from other jurisdictions and recommends a merger of the U.S. Securities and Exchange Commission (SEC) and Commodities Futures and Trading Commission (CFTC) due to the distinction between these financial products continuing to blur. The EU-US Coalition on Financial Regulation is meeting with regulators and lawmakers throughout Europe and the U.S. to press for even greater convergence (IIAC joined this group in March 2008).

   We also believe that governments and regulators should ensure consistency with key markets as regards bankruptcy and insolvency legislation and securities transfer law, specifically, making rules governing securities within Canada's capital markets consistent with the legislation and regulations in the U.S., European Union and other key competing capital markets jurisdictions. Specifically:

   - The federal government should vacate the field of securities transfers as more appropriately provincial property law consistent with the uniform *Securities Transfer Acts* in the process of implementation across the country (refer IIAC-Finance September 14, 2007 letter on securities transfer legislation)
   - Provincial governments should align legislation governing provincial receivership proceedings in line with recent changes that brought federal bankruptcy and insolvency

legislation to international standards (refer June 26, 2006 and June 8, 2007 IIAC-Finance and Industry letters).

5. **Foster confidence through clarity:** We believe that the securities regulators in Canada have a responsibility for ensuring that investors understand the difference between different types of advisors in Canada in a simple, plain-language way. We believe that governments and regulators should provide clarity to investors regarding who regulates what firms and people in the investment business, as well as the differences between them and the differences between regulations in each province. As in the capital markets themselves, transparency is important – in this context as regards regulated and unregulated firms (and the difference between IDA, Mutual Fund Dealers Association of Canada and other forms of regulation), different types of advisors and instruments, and between investor rights and obligations is important. Having a clear understanding may have a material effect on investors' abilities to make the right choices for them.

   Also, firms must be able to get timely and responsive answers from regulators in order to have certainty in the execution of their business operations. Investors and issuers must be comfortable that the capital markets are transparent and efficient to promote further investment in Canada. Governments and securities commissions must not inadvertently undermine confidence in the marketplace in order to ensure that Canada's capital markets remain competitive.

6. **Develop a solution to the need for a national perspective:** Canada needs a single voice on international regulatory matters and a national market perspective on regulation. While Ontario and Quebec are working to develop a unified regulatory response from a securities perspective, a solution must be reached soon so that Canada can stay in the running for multijurisdictional free trade in securities.

[1] For example, in dealings with foreign third parties, we understand that there are differences between Canada and the U.S. under anti-money-laundering rules:

- The Canadian FINTRAC interpretation states that Canadian securities dealer must rely on an agent to make face-to-face identification. "The Canadian securities dealer must have a written contract with the agent, describing the agent's responsibilities, and the agent must accept the conditions of the contract. Where a Canadian securities dealer opts to enter into such an arrangement, the ultimate responsibility for ascertaining identity and making any third party determination remains with the Canadian securities dealer."
- In the U.S., the SEC provides that "… documentary and non-documentary verification methods set forth in the rule are not meant to be an exclusive list of the appropriate means of verification. Other reasonable methods may be available now or in the future. The purpose of making the rule flexible is to allow broker-dealers to select verification methods that are, as section 326 requires, reasonable and practicable. Methods that are appropriate for a smaller broker-dealer with a fairly localized customer base may not be sufficient for a larger firm with customers from many different countries. The proposed rule recognizes this and, therefore, allows broker-dealers to employ such verification methods as would be suitable to a given firm to form a reasonable belief that it knows the true identities of its customers."

[2] The Prospectors & Developers Association of Canada, in May 2005, stated: "There is growing support and momentum for Canada's securities regulatory system to be overhauled. The PDAC believes that the most effective way to do this is to:

A. institute a regulatory system administered by one regulator, applying one set of rules in a consistent manner across Canada. The single regulator does not need to be an agency of the federal government, nor based in Ottawa. However, it does need to be close to financial centres, removed from political influence, innovative and responsive to market needs, and cognizant of sector and regional interests.
B. develop securities laws which: provide junior issuers with access to capital on a timely, effective and cost efficient basis; restore and maintain public confidence in the capital markets; and include disclosure and reporting obligations that strike a balance between protection of the investing public and ensuring that the maximum amount of a company's financial and managerial resources are available for mineral exploration and development work.

[3] Also, the B.C. Securities Commission proposed a new rule for issuers quoted in the U.S. over-the-counter markets and new conditions of registration for investment dealers that trade in these markets in the case of entities with significant connections to B.C. that are not cross-listed on another, more senior exchange.

[4] In fiscal 2006, IIAC members incurred more than $120 million in direct regulatory costs, excluding compliance costs and $20 million in expenses related to tax reporting to clients. With only one known exception (the B.C. Securities Commission), all securities commissions continue to accumulate surpluses annually. On average over the past five years, surpluses at the Ontario, Quebec and Alberta regulators totalled $77 million – approaching 10 per cent of these regulators' total revenue. Despite its stated objectives of "generating fees that reflect the cost of providing services to market participants," the Ontario Securities Commission has generated fees that have continuously exceeded expenditures over the past decade.