SUBMISSION TO THE EXPERT PANEL ON SECURITIES REGULATION

THE INVESTMENT INDUSTRY ASSOCIATION OF CANADA

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Introduction

The Investment Industry Association of Canada (IIAC) is the national association of the Canadian securities industry. The IIAC has 200 member firms registered as investment dealers with over 40,000 employees. These securities firms provide financial advice to individual and corporate clients, offer investment banking services to large and small Canadian companies, and engage in institutional and retail trading in cash and derivative products. These activities account for most of the trading and financing in Canada's capital markets.

The IIAC appreciates the opportunity to respond to the questions posed in the Public Consultation Paper issued by the Expert Panel on Securities Regulation (the "Panel"). We have placed our emphasis on what we see as the Panel's central task – the development of a realistic transition plan to create a common securities regulator for Canadian capital markets. The amount of work done on this topic in the past decade is voluminous (the Porter Royal Commission in 1964, the federally sponsored Anisman Report in 1979, the Wise Person's Report in 2003 and the Crawford Panel in 2004), and previous experts have described in considerable detail the structure and benefits of a common regulator. We believe a central focus of the Panel should be to build upon this work and take the process one step further by bringing forward recommendations on how to make a common securities regulator a reality. The Panel could also make a useful contribution by providing recommendations on how to move to a more principles-based securities rulebook and strengthen securities enforcement in Canada.

The Need for a Common Regulator in Canada

Despite the prodigious amounts of study and analysis that have been done on this subject, and the number of recommendations that have been made calling for some form of common securities regulation, the fundamental problem with the existing system remains; namely, that Canada has thirteen provincial and territorial jurisdictions overseeing securities regulation, each with its own legislation and rules. This creates a set of problems which undermine the competitiveness of the Canadian marketplace.

Costs

Market participants must deal with thirteen jurisdictions, creating significant costs both in terms of fees charged by regulators, and the administrative, legal and compliance costs of navigating multiple systems, often with differing regulatory requirements. These costs are ultimately paid by investors and issuers, a regulatory burden that imposes an adverse impact on capital market activities. These costs may discourage small companies from engaging in capital-raising efforts, and reduce investor participation in the capital markets.

A common regulator will provide relief by removing duplicate fees and the cumbersome multi-jurisdictional administrative structure that has developed, resulting in a more cost-

effective structure that will foster Canada's competitiveness in the global marketplace. While there will undoubtedly be costs associated with the transition to a common regulator, it is likely that, once the transition is completed, market participants will benefit from savings through the efficiency gains from rationalizing and streamlining the regulatory structure. Fees are likely to be lower.

Uncertainty

Market participants are required to understand the differing legislation and rules of the various regulatory jurisdictions if they choose to conduct business on a national basis – creating confusion and uncertainty among domestic participants, but also among foreign participants. This has become a more serious problem as domestic financial activity has become more national in scope. Not only do participants need to know multiple rules, they also need to understand how these rules will be interpreted in each jurisdiction, even where the rules appear substantially similar. A common securities regulator, applying a common securities act based upon an agreed-upon set of principles would promote simplicity and uniformity, and reduce the complexity caused by the multitude of rules and interpretations governing the current Canadian system.

Inefficiencies

The Canadian securities commissions have increasingly coordinated their policy-making and enforcement activities to project a national response to rule-making and enforcement. However, the need for consensus among a group of regulators (rather than simply creating one regulator speaking with one voice) may, in some instances, particularly policy-making and enforcement, slow down the regulatory process or actually result in issues not being addressed. Coordination may work for some administrative issues, or application of policies where clearly defined, but is less successful in areas where more subjective expertise, judgment and leadership is required.

Lack of Leadership

There is not a single consistent voice representing the Canadian marketplace at the international level, and no single consistent perspective on how the Canadian marketplace can be made more competitive. And, worse yet, there is a perception internationally this is the case, resulting in lost opportunities for Canada. The most recent example was the announcement of the SEC decision to begin formal discussions about mutual recognition with the Australian Securities and Investment Commission before similar discussions with the Canadian commissions, despite the much closer ties between the US and Canada in the areas of trade, commerce, culture, other formal agreements and even despite the ease of logistics due to characteristics such as common language and time zones.

This lack of a national perspective impairs Canada's ability to integrate quickly new products and market structures and related new rules into the Canadian marketplace to benefit retail and institutional investors. Approval of new products, rules and market structures is a drawn-out process because of the need for consensus, resulting in extensive

delays. Examples of this include the delays experienced with the development of rules associated with the introduction of alternative trading systems and institutional trade matching. This in turn impairs efficiency, adds to compliance costs and damages Canada's financial market competitiveness. A common regulator would enhance market competitiveness, but would also facilitate innovation when it comes to developing and marketing new financial products, and in responding to international developments.

Working Towards a Common Securities Regulator and Legislative/Rules Reform

The case for a common securities regulator has already been made by the Crawford Panel and the Wise Persons' Committee, among others. Regulatory reform can contribute importantly to the efficiency of capital markets that will in turn enhance Canada's productivity and competitiveness. The Panel should identify needed reforms, both in terms of structural modifications, such as a common securities regulator, and reform of securities content, notably moving towards more principles-based regulation. The Panel should also identify the process of achieving reform, enabling the transition to more cost-effective regulation.

Investment Industry Regulatory Organization of Canada (IIROC)

IIROC was created through the merger of the Investment Dealers Association of Canada (IDA) and Market Regulation Services Inc. (RS), bringing together the regulation of member firms and market regulation within a single national self-regulatory body for the securities industry. This merger will achieve efficiencies through the rationalization of internal processes, and realize synergies by bringing together complementary functions. However, self-regulation can make an even bigger contribution to overall regulatory efficiency in Canada by taking on responsibility for broker registration currently overseen by the provincial securities commissions.

The Passport Model

The Passport Model is a step in the right direction, but does not go far enough. Specifically, the Passport Model does not create the perception of a single market or voice for the Canadian investment industry, nor does it address the issue of duplicative or excessive regulatory costs. Further, it does not address uncertainty as it relates to compliance with multiple rules in multiple jurisdictions, and it does not ameliorate the consensus-building process at the CSA in the area of policy development.

The recent proposed reforms of NI 31-103 (*Registration Requirements*) and NI 45-106 (*Prospectus and Registration Exemptions*) have made considerable regulatory progress in the areas of prospectus approval and granting exemptions. However, the Passport Model still leaves too much discretion to local jurisdictions in the area of dealer registration. Furthermore, Ontario, the largest jurisdiction by far, has not agreed to participate in the Passport Model, complicating the approval process in the Canadian marketplace.

Alternative Models and Transition Options for a Common Regulator

The IIAC has identified three different structural models which have been proposed in the past.

The Federal Model

In this model the federal government assumes the entire sphere of responsibility for securities regulation, displacing the jurisdiction of the provinces in respect of securities regulation. In this model, federal legislation would be developed to create a federal securities act and federal securities commission. The federal act could pre-empt provincial legislation to avoid regulatory duplication, or alternatively, give issuers and investment advisors the option to register under either federal or provincial regulation.

However, this approach would introduce complexities, uncertainties and costs. While this approach could achieve a single regulator, the federal government would likely find itself engaged in constitutional battles with the provinces over regulatory authority. This debate could be disruptive to the Canadian capital markets.

The Provincial Model

The existing provincial model would formalize the cooperative national structure used to achieve consensus in rulemaking and enforcement. In this model, authority could be delegated to the CSA for policy-making, prospectus approvals and national enforcement matters. This model would depend on the provinces agreeing upon development of a common securities act, which might be based on the CSA's proposed Uniform Securities Act.

However, there are a number of drawbacks associated with this approach. It is overly complex, which could result in slow progress in achieving consensus on the design of the structure. Further, it is also not clear that authority can be legally delegated to the CSA. Finally, there is no evidence the provinces would be willing to delegate functions to the CSA and give up independent authority and autonomy to a common regulatory body.

The Crawford Model

The IIAC recommends that the Panel use this model as the starting point in developing a transition plan toward a common securities regulator, because it represents a realistic model relying on provincial jurisdiction; is sensitive to regional interests; and will improve the effectiveness and efficiency of the regulatory process.

To become a reality, the provinces, or several of the larger provinces, will have to agree to join the common securities regulator. The key building blocks would include a single commission, with participants chosen by and accountable to a Council of Ministers, and a single securities act. The Crawford Panel envisioned a voluntary incremental process of

entry, with individual provinces attracted by the incentive to have an equal say in the organizational structure and governance of the single regulator.

There are a number of advantages associated with the Crawford Model that make it a good starting point for the Panel. First, the Crawford Model is a national regulatory regime under the authority of participating provincial governments. Provincial jurisdiction over securities regulation therefore remains in place, avoiding constitutional debate associated with the federal model. Second, it is a cooperative approach, as the provinces have the option to participate. Third, the model has a good chance of becoming a reality, as it does not require unanimity. Other provinces may opt into the regime at a later date of their choosing, perhaps after their specific regional issues have been negotiated and settled.

One of the advantages of the Crawford Model is that it is largely silent on the governance and organizational structure, providing an incentive for participating provinces to influence the governance and organizational framework across the country. So far, no provinces other than Ontario have expressed an interest in this model. The Panel could contribute to this process by identifying needed incentives to attract other provincial participants.

Enhanced Enforcement

Securities enforcement in Canada has also been the focus of a great deal of study and analysis in recent years, as the perception grows domestically and internationally that enforcement in Canada is inadequate. A solution to Canada's enforcement problems would require a multi-faceted approach that goes beyond the jurisdiction of the provincial commissions, and would necessarily involve the federal authorities who have responsibility for criminal infractions.

At the provincial level, more fulsome coordination and information sharing between commissions in the area of investigation and consistent application of rules and punishment is required. At the federal level, the government must ensure that law enforcement agencies and the judiciary are equipped with the necessary resources and expertise to deal with serious offences in the capital markets. A common securities regulator could provide the necessary leverage and leadership to ensure that these infractions are investigated and prosecuted with vigor, and to make certain that penalties are adequate and consistently applied across the country.

Another issue that has been considered is the separation of the adjudication function of a common securities regulator from the rest of the enforcement function. The goal of the separation of the adjudication function is to remove the perception of conflict of interest in the enforcement and sanctioning process. The March 2004 Report of the Fairness Committee to the Ontario Securities Commission (OSC) recommended the OSC take this course of action.

On the other hand, the separation of the adjudication function could divorce the adjudicative process from the insights and knowledge of policy-making personnel. The Panel should look into the merits of the separation of the adjudication function, and, if significant, determine how to best deal with problems that have been identified, primarily those concerned with the loss of expertise on adjudicative panels.

While enforcement by a common regulator of common rules, carried out by regional offices that engage in effective investigatory and administrative coordination and have adequate resources, will be the most effective way of dealing with the real and perceived problems with Canada's securities enforcement. We believe the Panel should consider the benefits of a national enforcement agency as an interim step, if it concludes the process to achieve a common regulator will be lengthy. A national enforcement agency will provide better coordination between provincial regulators, federal law enforcement agencies, and the court system, and will likely increase resources allocated to investigating and prosecuting securities fraud in Canada. Such an enforcement agency could take advantage of these national benefits while maintaining strong regional involvement in the investigation of local crime.

Principles-Based Securities Regulation

The IIAC has been a proponent of a principles-based approach to securities regulation in Canada because of inherent advantages over the rules-based approach. The principles-based approach does not eliminate the need for rules, but identifies core rules that are backed by fundamental principles.

A principles-based approach is less prescriptive than a rules-based approach, requiring regulators to place greater focus on outcomes, such as the fair treatment of investors, and less focus on how outcomes are achieved. This gives securities firms greater flexibility in meeting outcomes.

The move toward a common securities regulator should be accompanied by a move to a common securities act that is principles-based. The principles should be based on a common set of objectives. We agree with the Panel that the current set of objectives in the various provinces should be used as a starting point for these objectives. A principles-based common securities act would be more cost-effective in both the primary and secondary markets, making Canada more competitive, and reduce uncertainty by ensuring common interpretation of rules. In addition, regulators will need to exercise discretion and good judgment to ensure participants are making reasonable efforts to achieve defined outcomes.

The existing system has done a good job assisting junior issuers obtain access to capital markets by relieving the regulatory burden and encouraging innovative financing techniques such as special warrants and expansion of the POP System to smaller issuers. However, to succeed in global capital markets, effective reform must extend well beyond the capital-raising process and embrace all market activity, including trading, distribution, product innovation and clearing and settlement.

The fragmented nature of the current regime acts as a deterrent to the development of a principles-based rulemaking system. It may be difficult to achieve agreement on the same principles and core rules, as well as ensure similar interpretation of compliance with principles and rules in a multi-jurisdictional system. This, in turn, can lead to inconsistent outcomes, undermining the goal of principles-based regulation. A common securities regulator and principles-based rulemaking go hand-in-hand, and will result in more consistent regulation across jurisdictions.

The recent success of the London marketplace, particularly the growth of the AIM market, can be traced to the adoption of a principles-based regulatory approach, along with the development of the FSA as a common regulator for all financial activities. Indeed, the Report of the Committee on Capital Markets Regulation "The Competitive Position of U.S. Public Equity Markets," recommended regulators rely on principles-based rules and guidance. The key to success in Canada will be in determining the core values and principles that will constitute the foundation of the reform of securities law in Canada, and while we do not propose to determine that in this paper, we think that this should form part of the Panel's recommendations. We urge the Panel to use the FSA's regulatory principles as a starting point in this regard.

Finally, while we agree the objective of reducing systemic risk as an objective of securities regulation should be an important goal, there is a substantial role for both the Bank of Canada and the Office of the Superintendent of Financial Institutions in reducing systemic risk. Ideally, there needs to be good coordination between the Bank of Canada, OSFI and securities regulators to address matters of potential systemic risk.

Performance Measures

The Panel should develop reasonable means to assess regulatory performance to measure regulatory effectiveness and demonstrate the integrity of our markets. It goes hand-in-hand with the need for metrics to monitor success in meeting the outcomes of principles-based regulation. In the event new rules are deemed necessary, regulators should rely on cost-benefit analysis, both prior to and after rule implementation. It will also be important to benchmark the cost of securities regulation in Canada with regulatory costs in other international jurisdictions.