IIAC ACCVM
INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

LETTER FROM THE PRESIDENT

Vol. 100

The cost-benefit thinking of the regulators needs to be more transparent

HIGHLIGHTS:

Regulators have refrained from formal quantitative cost-benefit analysis because of the complexities of the analysis, and fear of bogging down the rule-making process in endless debate about measured costs and benefits.

Regulators engage in extensive informal discussion about the qualitative impact of proposed rules at the formulation stage of the rule-making. This should be made much more transparent for market participants.

A detailed "walk-through" of regulators' thinking would give market participants a better idea of why a new rule is needed; the nature of the regulatory gap; the perceived risks in terms of excessive costs and unforeseeable consequences; and the reason for the particular rule rather than an alternative approach.

INTRODUCTION

Recent comments from the investment industry in response to Canadian Securities Administrators' (CSA) proposals to enhance the obligations of advisors and their firms through "targeted reforms", and impose a client best interest standard, have called for a formal cost-benefit analysis to be undertaken by the regulators before these reforms are implemented. This is not unlike many comment documents in the past when the industry has similarly recommended fundamental analysis on the impact of proposed rules.

Extensive consultations with key stakeholders, without accompanying rigorous analysis of the rule-making process, is not a sufficient condition to ensure sound feedback and vigorous debate—or the right rules. Fundamental analysis behind proposed rules is the best assurance that they will be as cost-efficient as possible and that unintended consequences are limited to the extent possible.

THE LEGACY OF AN INEFFICIENT REGULATORY PROCESS

Regulators have failed to carry out formal quantitative cost-benefit analysis in the post-2008 era of extensive and fast-moving rule reform. While regulators are obligated to provide a description of the costs and benefits of proposed rules, this typically takes the form of a cursory analysis. This has raised the risk of inefficient rules, contributing to a significant and unnecessary burden placed on the investment industry and dealer firms. A higher regulatory burden is acceptable if improvements to investor protection and market efficiency outweigh higher costs to investors and intermediaries. However, it is likely that recent reforms have resulted in unnecessary and duplicative rules, and an unfair cost burden. They have also contributed to unintended outcomes.

Particularly irritating for the investment industry has been the emergence of multiple equity markets and order protection rules to ensure best execution, which had the unintended result of ratcheting up trade execution costs, marketplace access costs and market data costs. The trade thresholds to restrict equity marketplaces that can enjoy 'protected market' status have been imposed far too slowly, resulting in an extended burden of excessive costs. These cost increases have squeezed operating margins and weakened profitability at boutique firms, and contributed to sweeping consolidation of small firms across the industry.

Further, the Exempt Market Dealer registration and its lower proficiency standards and patchy regulatory oversight have bequeathed these firms an edge when competing for the distribution of non-brokered private placement financings—an accelerating business in the small business sector. Unless regulators level the regulatory playing field through SRO-regulatory oversight of EMDs or a reduced burden on specialized IIROC-registered small dealers, the future of the small IIROC-registered dealer is imperilled, threatening harm to the small business capital-raising process, threatening harm to the small business capital-raising process. Finally, the successive layering on of rules in the financial advisory business has contributed to significant inefficiencies and excessive costs.

The reluctance of regulators to engage in formal cost-benefit analysis may reflect several factors. First, quantitative cost-benefit analysis is a complex and difficult process. Aside from measuring industry-wide compliance costs, and the extent these costs are passed on to clients, it is also difficult to measure in quantitative terms the benefits of proposed rules, to markets and to the investing public. While this argument cannot justify abandoning the rigors of cost-benefit analysis, it has sometimes been cited as a rationale. Second, regulators may fear triggering endless debate between regulators and market participants on the assessment of relative benefits and costs, leading to substantial delay in eventual rule formulation and implementation.

MAKING THE REGULATORS' THOUGHT PROCESS BEHIND RULE-MAKING MORE TRANSPARENT

While quantitative cost-benefit analysis is generally not part of the regulatory tool-box, we do know the regulators engage in a fairly detailed informal dialogue assessing the impacts of considered rules at the formulation stage, before proposed rules are released for public comment. Regulators should make this dialogue more transparent, in effect providing a detailed "walk-through" of the thinking behind rule formulation. A comprehensive outline of the qualitative factors considered by regulators in making rules would contribute to more constructive debate with market participants, and lead to better rules.

This information would give market participants a better idea of why a new rule is needed in the first place; the perceived risks in terms of excessive costs and unforeseen consequences; and the reasons for the particular rule rather than an alternative approach.

The regulators undoubtedly go through some of this process deciding on proposed rules and regulations. Indeed, the thinking is sometimes expressed in formal requests for comment on proposed rules. But the detailed issues considered by the regulators are not often made comprehensive, systematic and transparent. The details of this rule-making process should be marshalled in a formal framework, and the information made transparent to market participants commenting on rule proposals.

If regulators seek commentary on proposed rules, they should be able to answer the following questions:

- What are the reasons for proposing a new rule in the first place?
- What gap is the proposed rule intended to fill?
- Is the regulatory gap an actual compliance problem?
- Is it an anticipated concern?
- What are the broad trade-offs considered in bringing the rule forward?
- Why has the particular rule be chosen over alternatives?
- Have alternatives to the rule been considered?
- What are the perceived shortcomings of the rule in terms of costs on intermediaries and investors, or, at least, broad concerns that worry regulators?
- What is the initial assessment of the risks of unintended consequences?
- Why were alternative rules that were considered eventually rejected?

Such detailed qualitative analysis would shed light on what motivates the need for new rules, and the process examining various rule alternatives and reaching a final decision. This thinking would guide market participants framing their response to the proposals, and lead to more robust commentary, debate and feedback. The feedback would also provide a better indication of possible unintended consequences, and the priority for post-rule implementation review.

Moreover, the obligation to disclose the detailed background thinking on rule formulation and its impact on investors and the marketplace would foster a more disciplined approach to the rule-making process itself. It would encourage deeper and more systematic thinking on the market impact of proposed rules, and lead over time to more quantitative analysis. For example, the industry has argued in its response to the latest CSA Consultation Paper on advisor obligations that the proposed best interest standard is unnecessary, contributes to uncertainty among dealers and clients, and will lead to unintended consequences. The CSA Paper has disclosed the general reasons for the different positions among the regulators on the merits of a best interest rule, but greater transparency on the background debate would be helpful. For instance, what has prompted the need for a best interest standard for IIROC-registered dealers? What gap will the best interest standard actually address, particularly once the CRM rules, such as the conflict of interest rules governing compensation, are met? What alternatives were considered? Are the IIROC rules sufficient to meet the objectives of the targeted reforms? Does the problem rest with the rules themselves or with the compliance/enforcement process?

CONCLUSION

Based on recent experience it is difficult to be optimistic that the regulators will undertake full-blown quantitative cost-benefit analysis as part of the rule-making exercise, given apparent concerns over complexities of the exercise and fear of bogging down rule-making. However, we also know that regulators want the most cost-effective rules possible.

This detailed thinking and debate among the regulators should be made much more transparent to market participants. The regulators have an obligation to ensure consultations with stakeholders are as constructive as possible, and promoting a more transparent process would go a long way to contributing to vigorous and constructive debate on the merits of proposed rules, benefitting investors and the capital markets.

Yours sincerely,

Ian C. W. Russell, FCSI
President & CEO, IIAC
October 2016