



British Columbia Securities Commission

## **Expert Panel on Securities Regulation Submission of the British Columbia Securities Commission July 15, 2008**

### **Introduction**

These are the views of the British Columbia Securities Commission on the questions posed in the Public Consultation Paper issued by the Expert Panel on Securities Regulation. They are not necessarily the views of the government of British Columbia.

Although we have dealt with most of the issues raised by the Public Consultation Paper, we have not organized them exactly around the questions asked in the Paper, as several issues are related and some of our responses relate to more than one question.

We are not responding to Consultation Item 3 – Proportionate Regulation. We note that it already exists to some extent, and so our only comment is that any consideration of whether to expand or limit proportionate regulation should be based on the experience with proportionate regulation where currently employed.

The Public Consultation Paper raises issues that are very important in the debate about the future direction of Canada's system of securities regulation. We urge the panel to analyze these issues carefully and thoroughly and to avoid making recommendations based on conventional wisdom or common misperceptions about securities regulation and enforcement.

### **Consultation Item 1 – Objectives, Outcomes, and Performance Measures**

#### **Objectives**

Canada should have a common set of objectives for securities regulation, and indeed already has one. The British Columbia Securities Commission's mission is to foster "a securities market that is fair and warrants public confidence" and "a dynamic and competitive securities industry." All Canadian Securities Administrators jurisdictions have similar objectives or regulate in a manner consistent with them.

These objectives reflect IOSCO principles and we see no need to go further. In particular, we think any objective to "enhance" competitiveness should be approached with caution. Our mission statement refers to competitiveness, but the verb is "foster". An objective to "enhance" competitiveness would be problematic if it were interpreted to mean regulators should develop and implement proactive policies.



The primary means through which regulators can foster competitiveness is to ensure that regulation is cost-effective. Cost-effective regulation is sometimes presented as a zero-sum trade-off against adequate investor protection. This is a false dichotomy: for example, replacing excessively prescriptive requirements with more outcomes-based requirements can both improve investor protection and lower the cost of regulation.

One of the best ways for a regulator to be cost-effective is to intervene only when demonstrably necessary and, when intervention is necessary, to design a regulatory response that will be most effective at the least cost. We discuss this further under Consultation Item 2.

### **Systemic risk as an objective**

Although IOSCO identifies systemic risk as one of its three high-level objectives, the principles that address systemic risk deal mostly with prudential standards for dealers and risk management standards for secondary markets and clearing and settlement systems. In Canada, we have interpreted the objective of fostering fair markets that warrant public confidence to include these long-standing aspects of securities regulation.

We do not think it is necessary to identify systemic risk as a separate objective of securities regulation in Canada. Within the objectives as we now describe them, we already focus on risks, systemic or not, that threaten investors or the integrity of the capital markets. Broader systemic risks to the financial system as a whole, although of interest to securities regulators, are primarily the responsibility of others, namely the Bank of Canada and the Office of the Superintendent of Financial Institutions. We coordinate with these agencies our collective efforts to identify and deal with risks to the financial system through the regular meetings the Heads of Agencies group.

### **Evaluation**

Securities regulation should be evaluated by measuring

- performance against high-level goals
- service against pre-established service standards
- the achievement of strategic milestones
- the cost-effectiveness of regulation
- the effectiveness of enforcement

This is easier said than done. Measuring the effectiveness of securities regulation is inherently difficult, because effectiveness is determined by the degree to which regulation is successful in changing the behaviours of the industry and investors so that desired outcomes are achieved. It is difficult to quantify those changes, and even more difficult to determine to what degree they were caused by regulatory intervention rather than the many other factors that influence the same target behaviours.



### ***Measuring performance against goals, service standards and strategic milestones***

The BCSC continues to develop our performance measurement system. If the panel wishes to see an example of how one regulator deals with this challenge, you can review our most recent strategic plan (called a “service plan”) and annual report.<sup>1</sup>

### ***Measuring cost-effectiveness***

Measuring the cost-effectiveness of regulation would include, we suggest, at least these two elements:

- post-implementation analysis of each regulatory intervention to determine whether it was effective in solving the problem it was designed to address and to estimate the costs and burdens actually incurred by industry
- benchmarking the cost of regulation in Canada against that in other countries

Other jurisdictions, such as the UK and Australia, also use independent groups to help them set priorities on how to make the system of regulation more efficient and aligned with market reality.

### ***Measuring the effectiveness of enforcement***

All kinds of enforcement agencies the world over have struggled to identify measurement criteria for enforcement activity. The measurement challenges are no less for securities regulation. For example, in our own efforts to establish a broader array of enforcement measures, we found many measures that, although appearing useful on the surface, were problematic:

- Measures that count enforcement results can lead to different conclusions depending on what is counted – cases, parties, or individuals.
- Measures that count inputs like budgets, FTEs or billed hours have more to do with cost-effectively executing the enforcement mandate than with quantifying outcomes.
- Measures of enforcement volumes can create an appearance of “enforcing to quota,” and carry the risk of turning that appearance into reality (what gets measured gets done).
- Measures that track enforcement time frames can discourage the prosecution of large or complex cases.
- Measures that count complaints will include complaints without merit and exclude hidden misconduct of which victims are unaware.

Ultimately, useful enforcement measures need to focus on outcomes. For example:

- measuring the timeliness of enforcement action, and the degree to which it disrupts market misconduct
- measuring the reduction of non-compliance in the market (perhaps like the FSA’s measure of “market cleanliness”)
- measuring the overall incidence of illegal distributions and fraud to help set enforcement priorities and evaluate the effectiveness of investor education initiatives

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<sup>1</sup> These are in the section “About the Commission” on our website: [www.bcsc.bc.ca](http://www.bcsc.bc.ca).



## **Consultation Item 2 – Principles-Based Securities Regulation**

We have learned that the phrase “principles-based regulation” is problematic. It is too often understood only as an alternative to “rules-based regulation,” setting up an unconstructive debate about whether principles or rules are better.

We are also concerned that many who now espouse principles-based regulation do so because it is trendy, and do not really understand the concept.

We have come to use the phrase “outcomes-based regulation” to describe an approach to regulation that can be more effective than a regime oriented to imposing prescriptive requirements and dictating the internal processes of market participants. A properly-designed outcomes-based regime uses both principles-based rules and prescriptive rules, and places a strong emphasis on using other regulatory tools.

These are our short answers to the first three questions in this Item

- A more outcomes-based approach would improve securities regulation in Canada.
- All areas of regulation would benefit – the benefits do not depend on which areas of regulation are too prescriptive and which are not, but by the best regulatory response to each investor protection and market issue.
- There is a misconception among those new to the idea of so-called principles-based regulation that the principles would operate at some different level than the rules. This is not so. The current securities act and rules contain a mix of principles-based and prescriptive requirements, all of which are legally binding. In a more outcomes-based regime, we would have fewer prescriptive requirements and place a greater reliance on principles-based requirements, but both types of requirements would still be legally binding rules.

### **Outcomes-based regulation**

Outcomes-based regulation is risk-based and applies carefully-chosen tools to bring about the desired results. This is the key to effective regulation. The effectiveness of a regulatory system, or of the regulator that administers it, is not measured by outputs – the number of prospectuses reviewed, registrants regulated, exemption applications processed, or enforcement actions concluded – but by outcomes.

These are the features of an effective outcomes-based system of regulation:

#### ***External focus***

The regulator’s primary focus is external, not internal. Its vigilance is directed toward the detection of “problems” – risks or threats to investors and markets – and it seeks to “fix” those problems by minimizing or eliminating the risks and threats it identifies.



Maintaining an external focus is harder than it sounds. The regulator must have the discipline to look for the source of a problem and analyze how it occurs and how it affects investors and markets. It is critical for the regulator to avoid the natural tendency to define a problem by reference to the regulator's own requirements and processes. This type of inwardly-focused analysis often leads to the conclusion that there is a "regulatory gap" and it can lead to solutions that are ill-suited to the nature of the problem.

An outwardly-focused regulator defines a problem by reference to the source of the problem and the market participants that are affected by it. The regulator then designs solutions tailored to fit the problem, using one or more of its regulatory tools.

For example, the BCSC applied an external focus to identify and define the abuses perpetrated from British Columbia in the US over-the-counter markets. We aimed to understand how the abusive activities are conducted and developed a multi-part solution consisting of enforcement, compliance reviews, education, and rule and policy initiatives. We will monitor how these initiatives affect the problem and, if necessary apply additional or different solutions.

### ***Targeted intervention***

The market forces at work in a competitive free market will usually be effective in promoting behaviours and conditions that will benefit the market, and in penalizing behaviours that harm the market. However, markets do not always do this effectively and, when they do not, the perception of the market's integrity can be put at risk.

The regulator's job is to intervene in situations where market forces fail to establish conditions favourable to a fair and efficient market. However, the regulator should intervene only if:

- regulatory intervention is the only means to restore or establish those conditions
- regulatory intervention can actually be successful in doing so

As Stephen Bland, then Director of the Small Firms Division at the FSA, said at the BCSC's Capital Ideas Conference in 2006, "it's really, really important that before introducing rules the regulators ask, 'Can the market actually solve this problem all on its own?'"

Again, this requires the regulator to have a disciplined approach, in this case to resist pressure to intervene prematurely, before assessing whether the market is finding a solution through competitive forces or self-regulation. All too often, commentators and even market participants label some activity as "unregulated," as if that were necessarily a bad thing, and demand that regulators do something. In many cases, the problem has self-corrected by the time the regulator has developed a new rule, but momentum carries the rule into place, resulting in an unnecessary regulatory burden.



### ***All regulatory options considered***

If the regulator finds it necessary to intervene, it should consider all regulatory tools in searching for outcomes-based solutions: compliance monitoring, enforcement, guidance, education, and rule-making. Rule-making is at the end of the list because rules are generally the most intrusive and expensive form of regulatory intervention, and can

- limit competition
- slow innovation
- increase cost
- encourage a loophole mentality
- create other unanticipated or undesired responses
- interfere unduly with normal market forces

For each potential solution, the regulator should consider

- its cost (both for the regulator to implement and for industry to comply)
- its effectiveness (how much of the problem it will address; likelihood of success)
- how easy it will be to implement
- the need and ability to monitor it
- its enforceability

### ***High expectations of market participants***

An outcomes-based system forces market participants to think about what is best for investors and markets in deciding how to comply, rather than looking to the regulator for instructions on what to do. The regulator's assessment of compliance is based on whether the market participant exercised reasonable judgment in fulfilling its compliance responsibilities so that the desired outcome would be achieved. Individuals in senior management are held accountable for non-compliance.

### ***Effective solutions***

Effective regulatory initiatives influence behaviour, and have a strong link to the desired outcome. For example, a rule or interpretation can impose a regulatory burden without yielding corresponding benefits to industry or investors if it merely prescribes how something must be done, rather than stating the outcome expected. Outcomes-based initiatives are also flexible, so that industry can design efficient processes to achieve the target outcomes.

Effective solutions also have longevity – by focusing on outcomes, they demand optimal behaviours, and are therefore much more likely, than narrow and prescriptive responses, to address new and unforeseen market developments.

Market participants sometimes employ outcomes-based systems on their own, regardless of regulatory requirements. For example, many dealers have already implemented internal requirements to mitigate risks to the markets (and therefore to themselves) because they consider the detailed requirements in the rules insufficient. In a survey we



conducted in 2004, one of the dealers indicated that it detected only 10% of compliance problems through the daily reviews that the SRO rules require. The firm found the rest of its compliance problems using its own proprietary, outcomes-based system that tracked patterns of behaviour.<sup>2</sup>

### ***Effective administration***

The most important factor for the success of an outcomes-based regime is how it is administered. For example, a principles-based rule can become a prescriptive requirement if regulatory staff interpret and apply it in a narrow and prescriptive way. This type of approach can create an excessive compliance burden and undermine the effectiveness of the system.

To establish effective administration, the regulator must have a problem-solving culture, disciplined leadership, and an adult-to-adult relationship with the regulated community. Those managing the regulatory system must hold market participants accountable for their decisions, rather than telling them how to run their businesses.

The system depends heavily on guidance issued by the regulator, so that guidance is transparent and accessible to all in the regulated community. Regulatory compliance staff also recognize that guidance is exactly that – a possible way to comply with the required outcome, not the only way. Guidance must not be used to turn principles-based rules into prescriptive requirements.

The outcomes-based regulator does not engage in “Gotcha” enforcement practices. If the regulator feels a policy change is required, it is made only after notice and consultation.

### **Risks and challenges**

There is no real risk to implementing an outcomes-based regime of regulation. The challenges to successful implementation of outcomes-based regulation are associated primarily with establishing the appropriate administrative culture, discussed above.

## **Consultation Item 4 – Enforcement**

### **Enforcing outcomes-based legislation**

Many enforcement proceedings today are based on the principles-based provisions of the current legislation – the prohibitions on misrepresentation, fraud, and market manipulation and the requirements for timely disclosure, fair dealing with clients, and recommending suitable investments.

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<sup>2</sup> See Strong and Efficient Investor Protection: Dealers and Advisers under the BC Model — A Regulatory Impact Analysis, November 2003, in the Publications section of our website.



In May 2004, we published a report that considered the enforcement implications of proposed new outcomes-based legislation.<sup>3</sup> The report analyzed Commission decisions and settlements in 2002 and 2003 to determine the provisions most commonly relied on during that period to enforce the current legislation. We then compared those provisions to the corresponding provisions in the then-proposed new legislation.

The report found, among other things, that the majority of findings would have been unaffected by the proposed new legislation – 92% of contraventions were in areas in which the requirements under the new legislation were identical or substantially similar to the current legislation, or had a similar “bright line” test. For example, the most common contraventions were

- illegal distributions (failure to register and to file a prospectus) – both bright line tests
- misrepresentation and fraud – principles-based prohibitions
- failure to act fairly, honestly and in the best interest of the client –principles-based requirement

The report also found that for other types of conduct, such as managing conflicts of interest, the proposed new legislation’s outcomes-based provisions provided a more specific basis for enforcement than the application of the general “public interest” power that had been relied on in past decisions.

The report also concluded that

- New requirements would be readily enforceable because they would require measurable outcomes, use objective tests that are familiar to adjudicators, or deal with areas in which there is a rich understanding of what constitutes acceptable and unacceptable conduct.
- New requirements would also be enforceable based on constantly-developing industry standards, assisted by jurisprudence on the new legislation.

Overall, the report said that it is reasonable to conclude that an outcomes-based regime would provide a solid foundation to take enforcement action against market misconduct – at least as solid as the current regime, and more so in some important areas.

Although British Columbia did not bring the 2004 legislation into force, as we have pursued greater harmonization instead, the BCSC has pursued a more outcomes-based approach in the development of new rules and in our compliance and enforcement processes. Our experience has reinforced our earlier conclusions that outcomes-based regulation is viable, enforceable, and provides better investor protection for less cost.

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<sup>3</sup> See Enforcement of Outcomes-Based Securities Legislation, May 2004, in the Publications section of our website.



### **Adjudication**

Separating the adjudication function from the rest of the regulatory agency functions is a possibility and perhaps could be made to work, although it is unlikely to provide any significant advantages over the current structure, and could entail significant risks. These are the issues that should be considered:

- The current structure is legal. The Supreme Court of Canada has ruled that it is a valid and appropriate way to structure a regulatory agency, and that the structure does not, in and of itself, violate the right to a fair hearing.<sup>4</sup>
- Although in some jurisdictions there is a perception among some (mostly defence counsel) that the structure is unfair, this constituency has provided no evidence of any miscarriages of justice that can be attributed to the structure. In fact, commissions take significant steps to insulate members of hearings panels to ensure fair and impartial adjudication.
- Under the current structure, those who adjudicate securities cases are involved closely with the development and implementation of securities law and policy, and so have an extensive background in securities regulation and its public interest implications.
- Because securities commission panels have that background, the courts recognize them as expert panels and accord them considerable deference. This is important, because enforcement decisions are a key part of the securities regulatory regime.
- If the adjudicative arm were separate, it is inevitable that a gap would develop between the policy objectives of the regulator and the enforcement outcomes of the adjudicative arm. Even a modest gap would damage the effectiveness of regulation. The risk is that the gap could become large. If that happened, the regulator's ability to regulate markets effectively in the public interest would be seriously impaired.
- In summary, there is no evidence to suggest that changing the structure of the adjudicative function would improve the effectiveness of enforcement. The contrary appears more likely.

It follows from the latter two points that a structure that separates the adjudicative function from the regulatory function would likely be less successful in implementing an outcomes-based regime, because that kind of regime depends heavily on a thorough understanding by the adjudicators of the principles and policies on which the regulatory regime is based.

Whatever merits there may be in separating the adjudicative function in a single securities regulator, establishing a "pan-Canadian" adjudicator in the current regulatory framework appears to make little sense. This structure would add the costs of a central bureaucracy. It would also involve the complication of one agency attempting to adjudicate under the laws of multiple jurisdictions. All of this would add cost and probably delay processing of cases, with no apparent offsetting enforcement benefits.

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<sup>4</sup> See Brosseau v. Alberta Securities Commission, [1989] 1 S.C.R. 301



### **National enforcement agency**

An even less sensible notion that has surfaced recently is the idea of a national enforcement agency, separate from the securities regulators. It is difficult to conceive of a strategy more likely to undermine regulatory effectiveness.

Enforcement is a vital component of securities regulation. Separating not only the adjudicative function, but the prosecution function as well, and combining administrative and criminal enforcement, would make enforcement worse, not better.

Although we have an enforcement division, and our formal enforcement processes are somewhat insulated to preserve fairness and confidentiality, there is no bright line separating enforcement from other compliance-related activities. We regularly refer matters back and forth between the enforcement division and the corporate finance and capital markets divisions. Increasingly we are integrating our investor education and enforcement activities, which is making both functions more effective.

Conducting enforcement also complements our rule- and policy-making activities. For example, in developing the requirements we are imposing on participants in the US over-the-counter markets, we relied significantly on the understanding gained by our investigators of the abusive activities in those markets. The close working relationships between divisions operating under the direction of executives responsible for both policy and enforcement enabled us to develop a multi-faceted approach to deal with the identified problem.

Enforcement is also most effective at the local level. Provincial regulatory enforcement is often criticized for having differing priorities. In fact, enforcement priorities vary significantly by region because the nature and pattern of misconduct varies. Enforcement is the ultimate on-the-ground regulatory function necessary to respond to localized threats to investors and markets. Experience in the US bears this out. The SEC's enforcement activities are carried out through regional offices and, indeed, most securities enforcement actions in the US — as many as 70% — are done by state, not federal, agencies.

A larger agency with national jurisdiction could deal with some types of cases that are national in scope, but these types of cases can be and are dealt with by the larger provincial securities commissions. There is also a demonstrated level of cooperation and assistance among regulators. Any efficiencies that could be gained by having a national enforcement agency would be far outweighed by the loss of effectiveness caused by separating enforcement from regulation.

The suggestion that one authority prosecute both regulatory and criminal cases ignores the relevant law.



The purpose of regulatory enforcement is the prevention of future harm; for criminal prosecution it is the punishment of past behaviour. Compelled testimony is admissible against the person who gave it in a regulatory hearing but in a criminal trial it is not. In a regulatory hearing, a contravention must be proven on a balance of probabilities. In a criminal trial, the offence must be proven beyond a reasonable doubt.

Most important, the courts have made clear that regulatory investigation powers may not be used for the purpose of advancing a criminal investigation. The threshold for compelling evidence for regulatory purposes is relatively low, reflecting the low expectation of privacy for those operating in a regulated sphere of activity. Before compelling evidence, criminal investigative authorities must have reasonable and probable grounds to believe an offence has been committed and must obtain judicial authorization.

Having regulatory and criminal enforcement combined in a single national agency would risk having the two processes intertwined and having the critical administrative enforcement tools (such as the power to compel testimony and documentary evidence) struck down.

## **Consultation Item 5 – Securities Regulatory Structure**

### **Structure of regulation**

The starting point for some appears to be that the *status quo* is so bad that any change would be an improvement. Perhaps that explains why expectations are so high for what a change to a single regulator would achieve. Those in favour of a national regulator seem to believe that it would solve every conceivable problem in the system. As a result, they significantly overstate its potential benefits, and ignore its risks.

As we point out below, Canada's decentralized regulatory structure has many strengths, and the implementation of the Passport system is improving it more. The consultation paper does not contain any compelling argument that explains why changing the structure is likely to improve securities regulation in Canada, never mind why it is necessary.

Furthermore, changing the structure carries significant risks. As far as we are aware, no one has yet seriously analyzed the risks of moving to a single regulator. No change of this magnitude should be considered until we are confident that the benefits of a new structure are so demonstrably superior to what we can achieve under the current structure that it is worth taking on the risk of change.



Only disciplined analysis will answer that question. The studies that we have seen simply assert that a single regulator would be more efficient, produce better policy more quickly, and conduct better enforcement. We hope that your panel, rather than simply repeating this type of assertion, will conduct a thorough analysis to assess what could realistically be achieved through a single regulator — a real world agency, not an imagined one without flaws — in comparison with a fully implemented Passport system that includes Ontario.

We suggest you consider the following factors in deciding whether to recommend a single regulator.

***Enforcement***

This has recently become the most often cited rationale for establishing a single regulator, although we are not aware that anyone has yet articulated exactly how a single regulator would improve enforcement. Most arguments simply cite the perceived weaknesses in the current enforcement regime.

In fact, enforcement in the current regime has the advantage of a local focus (discussed under Consultation Item 4) with extensive national cooperation. Enforcement is highly coordinated among CSA jurisdictions. Most provinces now have the power to make reciprocal enforcement orders, so that these orders can be based solely on decisions or settlements in another jurisdiction. Indeed, a national agency would find it difficult to implement a structure that met local enforcement challenges and achieved inter-office coordination as well as what is in place today in CSA.

There is also a tremendous amount of coordination and sharing of information internationally. Many cases are cross-border and involve not one but many agencies residing in different countries with different laws. There is no evidence that a single regulator would deal any more effectively with these cases than happens today.

Far from being a problem, “disparate priorities” is an advantage of the current structure. The profile of misconduct varies by region and jurisdiction. Too much centralized control of enforcement carries the risk of slow decision-making, less response to regional priorities, and the stifling of innovative solutions by head office staff too far from the field.

It is true that enforcement funding varies among jurisdictions (indeed, funding for all of securities regulation varies among jurisdictions). However, we have yet to see any study that correlates that fact with actual misconduct statistics, an essential starting point if one wants to make the case that uneven funding is resulting in market misconduct going unpunished.



### ***Governance***

The two single-regulatory models that have been suggested in recent years both carry risks.

The first structure, proposed by the Wise Persons Committee, would have the federal government play the dominant role for securities regulation. Regional interests would theoretically be protected by giving various provinces “seats” on the commission. Although this would simplify the structure for the administration of securities regulation, centralizing decision-making does not necessarily make it better. In contrast with a function like bank regulation, in which the regulator deals with a small number of industry participants located in a few major centres, securities regulators deal with thousands of public companies and more than 100,000 registered individuals, scattered across six time zones. The panel should seriously consider whether, in the Canadian context, a centralized agency could really provide the type of responsive, on the ground regulation this market needs. What other examples do we have in Canada of a centralized regulatory authority dealing effectively with a widely-dispersed field of activity?

The second structure, proposed by the Crawford Panel, exists in no other country and in no other field of regulation in Canada. The proposal relies on provincial legislatures to delegate the authority to make laws to an agency over which individual governments would have almost no influence. It is hard to imagine how timely decision-making could result from all jurisdictions, including the federal government, having “equal decision-making power”.

Compare this to the Passport system. Instead of an industrial-age command and control structure, we have an internet-age structure in which decisions are made locally by those who know the market, these decisions give access to markets in all participating jurisdictions, and regulation is coordinated through collaboration and consensus to provide reasonable consistency while reflecting local conditions.

### ***Compliance costs***

Many believe that compliance costs would decrease under a single regulator. This appears to be received wisdom. The reality, we suggest, is likely to be different.

The main drivers of compliance costs are

- 1) the nature of the regulatory requirements
- 2) the number of regulatory regimes involved

The first driver operates independently of structure. Costs for market participants to comply with regulatory requirements are what they are, regardless of the structure of the regulator. As we have argued, the best way to lower these costs while maintaining effective investor protection is through outcomes-based regulation, which can be done in any structure.



The second driver has been nearly completely addressed through the harmonization of regulatory requirements and the implementation of Passport (and would be completely addressed if Ontario would enable the OSC to adopt uniform rules and participate in Passport). That saving has already been, or soon will be, achieved under the decentralized structure so it will not accrue to a single regulator.

### ***Fees***

What fees would be under a single regulator is anyone's guess (another area where no credible study has been undertaken). On the one hand, the multiple fees now paid for a prospectus filing, registration, or a non-Passport exemption application would be replaced by a single fee. On the other hand, the fee structure for single regulator would have to cover its costs. Since no one knows what those costs would be, no one can know how the fee schedule under a single regulator structure would compare to the *status quo*.

Lately there have been media reports that quantify savings from a single regulator at \$59 million or as high as over \$100 million per year. It is not clear where these numbers come from but they seem wildly optimistic. Costs of a single regulator are likely to be the same as or higher than current costs, not lower.

For example, one of the stated benefits of a single regulator is that enforcement resources would be more uniform throughout the country. If that means that enforcement resources are to be augmented in the smaller jurisdictions, that is going to increase costs (we assume, given the stridency of enforcement-related arguments, that there would be no offsetting reduction of enforcement resources elsewhere). Furthermore, due to the nature of the enforcement function, there are few opportunities to capture economies of scale.

Some past reports made what appear to be inconsistent statements. The report of the Wise Persons committee proposed full service regional offices, but its cost analysis assumed only token offices. For example, it estimated expenses for the British Columbia office at about \$2 million. The BCSC's current budget is about \$31 million, of which about \$10 million is for enforcement.

Another source of increased costs would be professional salaries, which represent about 75% of expenses. Currently, the compensation for this group is governed by the local context. People who work at, say, the OSC make a lot more than those who work at, say, the MSC. However, in a single regulator, there would likely be one pay scale, as in other national agencies. That pay scale would likely be at or near the OSC pay scale, driving up costs in the other offices. As noted, that increment would affect about 75% of the cost structure.



Administration costs are often cited as an area for savings. Even if that were so, it is doubtful that those savings would offset higher enforcement costs and professional salaries. Although combining agencies could produce some savings in the executive and back office functions, there would be higher costs for the centralized management structure and the work of coordinating the regional offices. Combining information technology and human resources systems of 13 agencies might produce some efficiencies, but the transition would take several years and would be costly. The panel should recognize that many organizational mergers ultimately fail to meet their economic objectives because of the unanticipated costs of combining systems, policies and processes.

Most important, although regulatory fees are not insignificant and are a source of complaint, these direct costs represent only a very small fraction of the overall cost of regulation, so even if savings were achieved in this area, the benefit would likely be negligible.

### ***Efficiency***

The risk of less efficiency is far greater than the hope of greater efficiency in a single regulator structure, particularly since most of the advantages cited in the paper are achievable (and indeed have largely been achieved) through Passport.

Some say that even if the law is harmonized, it could be interpreted or applied inconsistently. This is a risk in any multi-office structure, whether it is the current decentralized structure or a centralized regulator with regional offices.

For example, consider the administration of federal legislation. The airport security clearance procedures mandated by the national air transport security agency are interpreted and applied differently at the nation's airports. Look at the Criminal Code, and see how the federally-appointed judges in different provinces develop different interpretations and sentencing standards. Having a single securities act and a single regulator will be no guarantee against inconsistency.

What matters is how the structure is managed to reduce the incidence of inconsistency. CSA has several mechanisms to prevent this today. They are largely successful, and are improving every year. How would a single regulator do that? We don't know – no one has addressed this issue in the context of a single regulator, even though it just as great a risk in that structure as in the *status quo*.

In the meantime, CSA has achieved, through Passport, a structure that gives a public company or an investment firm access to markets across Canada by dealing only with its principal regulator and complying only with one set of harmonized laws. The system has already been implemented for public companies and is imminent for investment firms.



Under Passport:

- each market participant has a principal regulator
- a market participant can clear a prospectus, register as a dealer, adviser or representative, or obtain an exemption across Canada through its principal regulator
- market participants are subject to only one set of harmonized prospectus, registration and continuous disclosure requirements across Canada

It is

- simple, because market participants require only one decision and need comply with only one set of harmonized laws,
- fast, because market participants deal with only one regulator, and
- cost effective, because the costs of dealing with multiple regulators and complying with different laws are eliminated.

### ***Policy development***

Proponents of a single regulator suggest that policy development would improve in that structure, yet we have not seen any explanation of how it would improve (that is, what does “improve” mean) nor how a single regulator structure would achieve it.

Current policy development and implementation does take time because of CSA’s consensus-building approach, but when the process is complete, what emerges is a national rule or policy, in force all across Canada. Despite this process, we are not convinced that development and implementation of effective policy takes any longer in the field of securities regulation than in many areas under Canadian federal jurisdiction, or at the SEC.

The current structure also has checks and balances that would be lost in a single regulator. Each CSA jurisdiction is sovereign in regulating securities in its own jurisdiction, so there is no central authority that can impose regulation on a jurisdiction that is unsuitable to the needs of that jurisdiction. Hence, the consensus-building process that CSA employs. The CSA process has a safety valve, through which an individual jurisdiction can opt out of a national consensus if necessary to deal with local differences. That opt-outs are increasingly rare is testimony to the strength of the consensus process.

Some have argued that differences in regional markets are not significant in an era of globalization, but that is not so. For example, each regional market has a very different profile of issuers, leading to different priorities and potentially different impacts from regulatory initiatives. It is often possible to develop regulation that works in all markets despite these differences, but it requires the involvement of people with knowledge of and sensitivity to each market to craft a rule that is appropriate across Canada.

A single regulator would have a hierarchy that could ignore regional concerns. So far, the only answer to this concern is the cumbersome governance structures mentioned above.



There is no evidence that a single regulator would be any faster or more effective in policy development than under the *status quo*.

One risk associated with a centralized policy structure is that many now engaged in this area may not stay with the new agency.

The professionals currently employed in securities regulation are accountable to the regulators in their own jurisdictions and are encouraged to think independently of those in other jurisdictions so that all the best ideas are put on the table for consideration. Most of these people have ready access to senior management in their organizations.

Working in a unified regulator with ultimate decision-making power residing in a far away city is a very different matter. The work would likely be less creative, involve less variety, and involve more submissions of papers to head office in hopes someone will read them and respond.

The people who would like this change the least are those who would be most important to the success of the new organization – the highly qualified and experienced ones. There is a substantial risk that they would seek other opportunities, starting a spiral of decline that would lead both industry and potential employees to view regional offices as second-class outposts.

#### ***International voice***

It may be that Canada's structure of regulation is confusing to some international constituencies. However, in international forums such as IOSCO, that does not appear to have impaired Canada's influence. Indeed, we think the record shows that Canada consistently punches above its weight in those forums. We also are well-represented and respected in NASAA.

In any event, to the extent our structure is not well-perceived internationally, that alone would not justify the establishment of a single regulator. Educating others about the efficiencies we have achieved through Passport, and the *de facto* national regulatory scheme we have through CSA, would be a better solution.

#### ***Competitiveness***

As for our competitiveness in attracting securities trading and listings, the myth of having to deal with "13 jurisdictions" can be readily dispelled by informing interested businesses about how Passport works (one decision, one set of rules). And, the opportunity remains to foster competitiveness by ensuring a low-cost regulatory environment, as we discussed under Consultation Item 1.



### ***Overall assessment***

A move to a single regulator entails great risk, yet the benefits are far from certain. It is not likely to improve enforcement. The governance structures proposed to date are unwieldy. It is likely to be more costly and no more (probably less) efficient. There has been no case made as to how policy development would improve. Competitiveness can be addressed by ensuring our system, no matter how structured, is cost-effective.

The only apparent benefit is that it would be easier to explain to those outside Canada, which seems a small star to shoot for, given the risks of change.

There might have been a better case in the past, but the major criticisms of a decentralized structure — multiple laws and regulatory approvals — have been addressed by Passport. All that keeps Passport from completely eliminating these duplications is Ontario's refusal to participate. Non-Ontario market participants have to rely on a set of protocols to clear a prospectus or obtain a discretionary exemption. Because the OSC makes a decision in each case, there is always the possibility of an opt-out or delays. If Ontario joined Passport, we would have all the benefits of a single regulator without facing the risk and disruption of a complex structural change.

### **Missing Consultation Item – The Real Problem**

The Public Consultation Paper fails to address the real problem in enforcement, which lies not with securities regulators but with the criminal justice system. It is no secret that Canada's overall track record in criminal enforcement of investment fraud is dismal.

Canadians agree. A recent CSA study "Understanding the Social Impact of Investment Fraud" involving over 5,000 Canadians told us that over 70% of Canadians believe fraud artists get away with their crimes and, even if caught, get off with a light sentence at most. Canadians have no illusions about the impact of investment fraud as 91% agree that the "impact of investment fraud can be just as serious as the impact of crimes like robbery and assault." Clearly, Canadians want the criminal justice system to deal more effectively with white-collar crime.

The federal government could make a significant contribution to securities enforcement by focusing efforts on improving how our criminal justice system deals with investment fraud. We need improvements in the way all aspects of that system — policing, prosecution, and courts — deal with securities-related offences. By taking a leadership role in seeking better criminal enforcement for this type of offence, the federal government could have a major impact.



The RCMP has recently garnered some publicity by laying charges in several high profile cases following multi-year investigations. This demonstrates important progress but much more remains to be done. Nick Le Pan's Report, published October 25, 2007, highlighted a whole range of initiatives that need to be implemented to make the IMETs effective in moving cases forward in a timely manner. A lot of time and effort also needs to be put into making securities prosecutions move more effectively through federal and provincial prosecution services and the judicial system.

Because we lack a timely and effective criminal-law deterrent for securities violators in Canada, we rely too heavily on regulatory enforcement to deal with serious fraud. This diverts regulatory resources from regulatory violations, for which our powers are best suited and towards serious fraud, for which they provide an inadequate deterrent.

## **Conclusion**

Canada has a system of securities regulation with common objectives. We have explained how we think the effectiveness of regulation should be measured, and the challenges in doing so. Of course, before any steps are taken to change the structure of our system of regulation, it would make sense to measure the effectiveness of the current system with the recent and impending improvements from harmonization and Passport. Otherwise, there will be no benchmark against which to measure the putative benefits of alternative structures.

We have outlined how outcomes-based regulation works. It is a cost-effective method of regulation that, if implemented more broadly, could contribute significantly to the competitiveness of our markets.

Enforcement is best done at the local level. Whether adjudication is separate or not, it makes no sense to separate the enforcement function from the rest of the regulatory agency.

A move to a single regulator is a leap into the unknown. The current structure works well. Granted, like all human creations, it has its flaws. Perhaps that is what seduces some to yearn for a fictitious alternative that has no faults and to ignore the certainty that any structure will have its flaws.

Are the flaws of the current structure really so serious that it is worth taking the risks of that leap into the unknown? Based on what we know today, a change in structure would be, at best, neutral in terms of benefits, and would carry serious risks.

Also, the market is just now adjusting to and preparing for the recent and impending changes in rules and processes. The panel should consider the effect of loading a further massive change onto market participants.



Canada needs to do a hard-nosed assessment of how the proposed alternatives would really work, based on facts, not myths, with a proper look at where the real problems lie in the current system. Then it must ask itself if the benefits are worth the risks and cost of what would likely be a very tricky transition of power.

Unfortunately, the Panel's last question appears to presume that Canada must have a single regulator and securities act to improve securities regulation and asks *how should the transition be managed and executed to minimize the disruption in Canada's capital markets?* We hope that the panel will impartially carry out its mandate to compare Passport to a single regulatory structure. For once, we would like to see a report on this subject that bases its recommendations on evidence and analysis.