



31 July 2008

Honourable Tom Hockin
Chair
Expert Panel on Securities Regulation
c/o David Murchison, Executive Director
Ottawa, Ontario
K1A 0G5

Re: Submission to the Expert Panel on Securities Regulation

Dear Panel Chair, *Tom*

The Bank of Canada welcomes this opportunity to provide its views on selected issues under examination by the Expert Panel on Securities Regulation.

As set out in the Bank of Canada Act, the Bank's mandate as Canada's central bank is to contribute to the economic well-being of Canadians. A critical element of our mandate is the role of promoting a stable and efficient financial system in Canada. More specifically, the Bank aims to achieve this by providing essential central banking services and by influencing public sector agencies and private sector behaviour to improve the safety and efficiency of the financial system.

Principles of Regulation

The Bank believes that any regulatory initiative should meet three conditions. First, it should correct a market failure. Second, it must be effective. Even when a market failure is recognized, regulators should act only if there is a reasonable chance that they will actually address the failure in question. Third, the benefits of a particular rule must be greater than the cost of complying. Regulation should thus encourage proper behavior without imposing an unnecessary burden on participants through unduly high compliance costs. In addition, market failures should be addressed within a risk-based framework that allocates regulatory resources to firms, markets or instruments in proportion to their perceived risks for the financial system.

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The Bank Supports Principles-Based Regulation

Given the rapid pace of financial innovation and the increasing complexity of markets, our regulatory framework should be based, to the greatest extent possible, on principles that do not require prescriptive rules for sound implementation. It is not desirable for regulators to rely on a framework where they need to introduce - or amend - detailed rules every time a new product is created. As examples ranging from ABCP to PPNs demonstrate, product innovation, even if it occurs within the boundaries of existing rules, can violate the spirit of regulation and have adverse consequences for consumer protection and potentially financial stability.

Principles-based regulation not only facilitates timely regulatory actions, but also means that firms, in striving to meet the spirit of the regulation, have to look more carefully at how they meet the desired regulatory outcome than if they were simply complying with prescriptive rules. However, for principles-based regulation to be effective, there needs to be sufficient and up-to-date guidance about how registrants and issuers are expected to comply with the regulator's policy goals.

Canada should have uniform securities laws and regulations that apply to all. In some instances rules should be applied in a tiered manner to take into account differences in the size or complexity of firms. There is, however, no need for rules to be applied based on other factors that are not economically significant, such as the province or territory of the issuer or investor.

While regulation should take the unique characteristics of Canadian markets and institutions into account, our regulatory framework needs to follow global best practices in order to support the competitiveness of our financial system. Regulation should also foster competition within Canada as it provides incentives for market participants to innovate and become more efficient.

Disclosure Requirements Need Strengthening

One of the objectives of regulation should be to reduce information asymmetries, until the benefits of additional disclosure no longer outweigh the cost of compliance. The recent disruption in markets for structured financial products has revealed deficiencies in this regard as the lack of transparency and inadequate disclosure that characterized many of these instruments prevented investors from conducting thorough due diligence, a necessary process for achieving stable and efficient markets.

A lesson from recent events surrounding the turmoil in credit markets may be that blanket disclosure exemptions for money market instruments have been too broad. The current practice of exempting certain instruments from the requirement of issuing a prospectus, or other form of information disclosure, should be revisited to ensure that the appropriate information is disseminated, and that it is communicated in a timely way and in a manner that is easy to understand for the average investor. The disclosure regime for issuers should provide incentives for them to ensure that the amount and the nature of the information they disclose is adequate.

Better Enforcement Must Be a Priority

It is imperative that we not only have, but also be perceived to have, rigorous enforcement in Canada. In order to enhance the efficiency of our regulatory framework, weaknesses in enforcement that were identified by various stakeholders, most notably by the Task Force to Modernize Securities Legislation in Canada, need to be addressed. There must be more effective and timely compliance monitoring and prosecution of offenders. Moreover, sanctions resulting from a guilty verdict need to better reflect the harm, both economic and social, posed by financial market crimes. Since many corporations are registered in several jurisdictions - and because of the presence of various authorities with an enforcement mandate in any given jurisdiction – mechanisms should be put in place for better cooperation and coordination between securities regulators and self-regulatory organizations, law enforcement agencies and other actors in the legal system at a provincial, national, and international level.

Regulation Must Take Into Account Macro-prudential Considerations

One of the early lessons of the current financial crisis has been that a host of regulations and standards - for example fair value accounting, credit ratings and capital adequacy requirements – can have unintended pro-cyclical consequences. That is, they can amplify fluctuations in asset prices and, potentially, in macro-economic outcomes, including economic growth.

In order to reinforce safeguards against financial instability, regulation should take into account, in addition to firm-specific issues, the risks of episodes of financial turmoil with significant losses in terms of the real output for the economy as a whole. Regulators, legislators and standard-setters should be encouraged to “see the forest” rather than the trees and weigh macro-prudential considerations when designing regulation.

This may be better achieved with a principles-based regulatory framework. The development of macro-prudential regulation can also be facilitated by better coordination and cooperation between public sector agencies, both across geographical borders – within Canada and internationally – and between regulators that oversee complementary segments of the financial system, for example securities markets and the banking, insurance and pension sectors. Better cooperation would allow regulators to achieve a more integrated view of emerging issues and to respond more effectively to them, thereby reinforcing the safeguards against financial instability. This may require some statutory mechanisms to facilitate cooperation between regulators, for example to formalize roles and responsibilities surrounding the exchange of sensitive information.

The Expert Panel Should Consider the Oversight of Derivatives Markets

Regulation based on core principles would also allow for a more rapid adaptation to changing business structures as well as the introduction of new products and other market developments. It is generally recognized that, in many countries, regulation of derivatives markets has failed for some time to take into account new types of product and trading practices.

Moreover, derivatives markets are regulated separately from cash markets given the belief by regulators that while derivatives markets are linked to that of their underlying instruments, the financial system would be best served by regulation that emphasizes the different risks inherent to these instruments. While this view may be valid, the interrelationships between these markets should be considered in the regulatory framework.

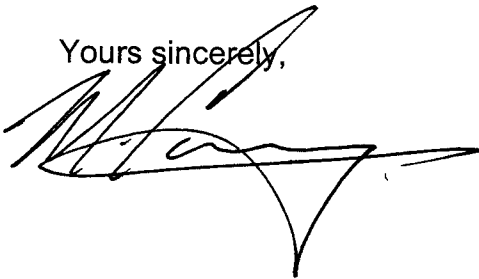
Finally, the recent report of the Financial Stability Forum on enhancing market and institutional resilience identified the lack of a sound settlement, legal and operational infrastructure for over-the-counter derivatives markets as a source of weakness.

Given that derivatives markets have become a vital component of the financial system, the Bank believes that the Expert Panel should consider the regulation of these markets. The recently adopted Quebec Derivatives Act, which follows best practices for the oversight of both exchange-traded and OTC derivatives, is a constructive step in strengthening the regulatory framework for these markets.

In concluding, I would note that the Bank continues to endorse the recommendations made in its 2006 submission to the Task Force to Modernize Securities Legislation in Canada (attached).

Thank you again for this opportunity to share our views with the Expert Panel. We look forward to discussing progress on this initiative in the future.

Yours sincerely,

A handwritten signature in black ink, appearing to be a stylized name, possibly "M. H. ...".

Enclosure: Bank of Canada's Submission to the Task Force to Modernize Securities Legislation in Canada