THE CASE FOR A NATIONAL SECURITIES REGULATOR IN CANADA

by

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I. INTRODUCTION

In the most general sense, securities markets exist in order to channel savings to investments. In order for a securities market to function perfectly, every market participant would need to act completely rationally and with full information and there could be no transaction costs. If these conditions were met, welfare would be maximized, no regulations would be needed, and markets would clear without delay. It is because this ideal is not possible that securities regulation is needed. The basic purpose of securities regulation, therefore, is to push the securities market as close as possible to the ideal. In pursuing this goal, regulators must work within the constraints imposed by their jurisdictions legal system. Largely due to its federalist structure, in Canada, securities are regulated in a decentralized manner whereby each of Canada's 13 provinces and territories is responsible for securities regulation within their respective jurisdiction. In 2010, Parliament proposed the *Canadian Securities Act*, which would have implemented a national securities regulatory system; however, the Supreme Court of Canada, who ruled that the proposed Act unconstitutionally infringed on the legislative authority of the provinces, quashed this legislation. Since this decision, the federal government has continued working on ways to implement a national regulatory system, and has recently released new draft legislation (collectively the *Cooperative Capital Markets Regulatory System* or *CCMRS*) to that end. In this paper I will discuss the costs and benefits of implementing a centralized securities regulatory regime, such as is contemplated in the *CCMRS*, in Canada and propose alterations to the draft legislation that utilize the constitutional constraints to produce the best regulatory outcome.

I begin the paper with an overview of Canada's current regulatory system, the 2010 *Canadian Securities Act* and the proposed changes found in the *CCMRS* draft legislation. I

then provide an overview of the literature discussing the objectives of securities regulations and conclude that the goals of securities regulation in Canada are to balance fostering fair and efficient capital markets and protecting investors, and to manage systemic risk. Using these objectives as an evaluative framework, I compare Canada's current regulatory regime against the proposed *CCMRS* to determine the merits of the proposed legislation. I move next to an assessment of the constraints in pursing the ideal regulatory system imposed by the Canadian Constitution. I do this by exploring the 2010 Supreme Court decision that prevented the full implementation of the *Canadian Securities Act* and assessing whether the *CCMRS* would likely withstand a Supreme Court challenge. Lastly, I recommend a few changes to the draft *Cooperative Capital Markets Regulatory System* legislation that I believe would ensure its constitutionality, increase provincial buy-in, and address the main criticisms of a centralized regulatory system that arise in the literature.

II. LEGISLATIVE DETAILS AND HISTORY

The Evolution of Canada's Current Regulatory System

Currently in Canada each province and territory has its own 'Securities Act' and securities regulator, which administers the Act and manages provincial regulations. Though provincial and territorial regulators currently delegate certain responsibilities to national self-regulated organizations such as the Investment Industry Regulatory Organization of Canada (IIROC) and the Mutual Fund Dealers Association (MFDA), the bulk of securities regulation exists as unique legislation within the 13 jurisdictions (Expert Panel, 2009). Prior to 1999, there was relatively little regulatory coordination between jurisdictions and each of Canada's provinces and territories claimed overlapping jurisdiction to regulate any inter-provincial transaction that had a connection to their region (Trebilcock, 2010). Under this

system, companies that wanted to list nationally were forced to seek approval individually from each provincial and territorial regulatory agency. In 1999, recognizing the need for some amount of coordination and harmonization, Canadian securities regulators got together to develop the Mutual Reliance Review System (MMRS), which coordinated regulatory review across participating jurisdictions. Under this system, firms applying to list in multiple provinces/territories were generally reviewed by a single jurisdiction, which would then coordinate the review with the other relevant and participating jurisdictions. Applicants would receive a single decision covering all participating jurisdictions in which they applied (Trebilcock, 2010).

In 2004, a memorandum of understanding was signed by provincial ministers that created the "passport system" that has remained in place as part of the Canadian regulatory system ever since. Under this system, jurisdictions have increased the harmonization of regulations and now allow for approval in one jurisdiction to qualify as approval in all participating jurisdictions. Currently, the only province that has chosen not to partake in the passport system is Ontario (Expert Panel, 2009). For many years successive federal governments have commissioned studies and drafted legislation in hopes of increasing harmonization through the creation of a centralized federal regulator, but for a variety of reasons have never successfully implemented national legislation to this effect (Puri 2010).

In 2009, the Expert Panel on Securities Regulation released a report that recommended the implementation of a national securities regulator. The report highlighted that Canada is the only major industrialized nation that does not have a national regulator and noted concerns about the duplication and overlap of provincial regulations. Specifically the report emphasised that the current decentralized system limits Canada's ability to: ensure efficiency in domestic capital markets, manage systemic risk, and present a strong and

unified voice in international discussions regarding financial regulations. The report concluded that although the passport system has addressed some of the issues of decentralized regulation, it does not go far enough. The findings of this report, along with several other reports with similar conclusions, led to the federal government proposing the *Canadian Securities Act* in 2010.

The Proposed 2010 *Canadian Securities Act*

In the spring of 2010, the federal government released draft legislation, the *Canadian Securities Act*, to begin the process of creating a national securities regulatory system for Canada. According to Finance Canada, the purpose of the Act was to: better protect investors, improve regulatory and criminal enforcement, provide new tools to support financial stability, improve regulatory responsiveness, simplify processes for businesses, and increase Canada's international regulatory-influence. The Act was developed with representation from 10 out of 13 of the provinces and territories of Canada, with Alberta, Manitoba and Quebec opting not to participate in the process (Finance Minister Takes…2010). Some key features of the Act included: a regulatory mandate and guiding principles (including promoting financial stability), strengthened criminal and regulatory enforcement mechanisms, a governance framework, and harmonized regulatory requirements across participating jurisdictions (Backgrounder: A new…2010). The *Canadian Securities Act* set out the core principles that were to guide the specific regulations, but left out specific details, which were to be drafted as regulations after the Act was passed by Parliament. At the time, the federal government indicated that the regulations would be largely based off of the harmonized regulations already in place, which were created by provincial/territorial authorities. The legislation proposed creating a Canadian Securities

Regulatory Authority comprised of two divisions: a Regulatory Authority, responsible for administering the proposed Act, and a Canadian Securities Tribunal, which would be independent of the Regulatory Authority and would provide adjudicative functions. The Act also created Deputy Chief Regulators, appointed for each region, which were to provide local expertise in policy decisions.

The *Canadian Securities Act* used an opt-in model, whereby provinces and territories would have the choice of being governed by the new federal regulations, through providing written consent, or maintaining their current provincial/territorial regulatory structure. However, the Act also contained some criminal prohibitions, such as a prohibition on fraud, market manipulation, and insider trading that, upon the passing of the Act, would have been in full force in every jurisdiction within Canada. The Act also gave the Regulatory Authority broad investigatory powers to verify compliance with the legislation through search and seizure provisions. After Quebec and Alberta challenged the constitutionality of the legislation in their respective provincial courts, the federal government submitted the proposed Act to the Supreme Court to assess whether the federal government had competence and authority to introduce such legislation. As discussed in greater detail later on, the Supreme Court ultimately found that the *Canadian Securities Act* unconstitutionally infringed on provincial regulatory powers, and thus was not valid legislation.

The Proposed *Cooperative Capital Markets Regulatory System*

Immediately following the 2010 Supreme Court's decision, discussions regarding a national securities regulator were fairly quiet; however, in their 2013 Budget Release the federal government once again announced their intention to create a national securities regulatory scheme. In the same announcement the government further indicated that they

would attempt a negotiated agreement with the provinces, but would push forward with unilateral legislation should negotiations fail. In the fall of 2013, the federal government, along with the provincial governments of British Columbia and Ontario, announced the signing of a memorandum of agreement in principle to establish a unified regulatory system among participating jurisdictions (Ministers of Finance of…2014). Since then, Saskatchewan, New Brunswick, Prince Edward Island, and Yukon have all also signed on to what is now the proposed *Cooperative Capital Markets Regulatory System* (Memorandum, 2015). Though the agreement highlights that provinces and territories will maintain the capacity to weigh and consider local perspectives in the regulations, some provinces, such as Quebec and Alberta, remain skeptical of the proposal. Quebec has already indicated its intention to challenge the proposed legislation in court once again (Canadian Press, 2015).

The proposed legislation is quite similar in principle to the 2010 *Canadian Securities Act* with changes largely targeted at ensuring compliance with the Supreme Court ruling through the implementation process. Unlike the *Canadian Securities Act*, the relevant legislation will be enacted by each participating province/territory, instead of the federal government, and will delegate authority to a single national regulator. Similar to the *Canadian Securities Act*, the proposed *Cooperative Capital Markets Regulatory System* is based on an opt-in model and creates a Capital Markets Regulatory Authority, which will administer a uniform regulatory scheme and will "protect investors, foster efficient capital markets, and manage systemic risk" (Backgrounder: cooperative…2014). The Authority will be broadly overseen by a council of financial ministers from participating jurisdictions and will be directed by an expert board of directors appointed by this council. Again, similar to the 2010 legislation, the Authority will have both a regulatory and independent tribunal component, and will have a regulatory office located in every participating province/territory (Memorandum, 2015).

According to Finance Canada, these local offices will be guided by common principles, but will "deliver consistent regulation in a way that is responsive to the interests and sensitivities of Canada's regions and market sectors" (Backgrounder: cooperative…2014). The federal government has committed to providing transitional funding to provinces and territories but once in place, the regulatory authority is to be self-sufficient.

The *Cooperative Capital Markets Regulatory System* consists of two types of legislation: the provincial *Capital Markets Act* (*PCMA*), and the federal *Capital Markets Stability Act* (*CMSA*). The *PCMA* will be proposed as legislation to be enacted by each participating provincial/territorial legislature and will replace local securities regulation to create a uniform framework across all participating jurisdictions (Draft Provincial…2014). The provisions of the *PCMA* borrow heavily from the language of provincial legislation in British Columbia and Ontario but also incorporate language from the Acts of other participating jurisdictions (Commentary….2014). In many of its provisions, the *PCMA* takes a minimalist, platform approach, outlining broad principles that will inform more specific regulations to be created and administered by the new Regulatory Authority. The *CMSA* will be enacted by Parliament and will address criminal matters and matters related to systemic risk in capital markets and national data collection (Draft Capital…2014). The Regulatory Authority will administer both the *PCMA* and *CMSA*, and a single set of regulations, which will be created through delegated authority from Parliament and participating provincial/territorial legislatures. Some other key points of the *Cooperative Capital Markets Regulatory System* include: a single fee structure for issuers listing in multiple jurisdictions, the introduction of tools to address issues of systemic risk, increased enforcement tools, more reliance rules created by an administrative body (the Regulatory Authority) and increased and updated criminal laws. The *CCMRS* also attempts greater integration of the regulation between different financial

sectors (e.g., banking, securities, and insurance) through data collection and sharing mechanisms and the reduction of federal/provincial jurisdictional issues (Commentary….2014). Drafts of the *PCMA* and *CMSA* have been presented for consultation recently and are currently being reviewed in the context of the feedback provided. The intention is to implement the *Cooperative Capital Markets Regulatory System* in the summer or fall of 2016 though the upcoming federal election makes the implementation timeline somewhat hard to predict.

III. THE OBJECTIVES OF SECURITIES REGULATION

Though the broad purpose of securities regulation is to push the securities market as close as possible to the ideal, Milne (2010 at para 2.2) suggests that:

> "[s]ecurities markets have two basic functions in the process of channelling savings to investments: to allow demanders of investment capital ("issuers") to receive investment capital from suppliers of capital ("investors") in exchange for a security, and to allow investors to trade securities with other investors."

Milne notes that the first function occurs in the primary market, where investors and issuers interact directly, whereas the second function occurs primarily in the secondary market in which investors interact either in an organized public market, such as a stock exchange, or in a similar but less formal (and generally less regulated) "over-the-counter" market where investors trade among themselves. In the primary market, the main concern of regulation is setting timelines, ensuring completeness of information and disclosure, and ensuring integrity in the sales transactions between investors and intermediaries. In the secondary market, the main concern of regulation is ensuring the integrity of the "trading process, and the integrity of the advice that intermediaries provide to investors" (Milne, 2010 at para 2.5). Puri (2010) defines the purpose of capital markets regulation as to promote fair and efficient

capital markets, protect investors, and maintain investor confidence in capital markets. She borrows largely from the *Ontario Securities Act* (1990 at s 1.1) which states its purpose as "(a) to provide protection to investors from unfair, improper or fraudulent practices; and (b) to foster fair and efficient capital markets and confidence in capital markets".

When describing the *Canadian Securities Act* in 2010, Finance Canada stated that "[s]ecurities regulation must protect investors and promote market integrity and stability, without imposing unnecessary compliance burdens" (Backgrounder: A new…2010). The document describes the mandate of the 2010 proposed national securities regulator as having three core objectives: (i) to protect investors from unfair, fraudulent or improper practices; (ii) to foster fair, efficient, and competitive capital markets which maintain public confidence; and (iii) to contribute to the stability of the financial system. In a 2013 press release, Finance Canada highlighted that "[t]he cooperative securities regulator [as proposed in the the *Cooperative Capital Markets Regulatory System*] will better protect investors, enhance Canada's financial services sector, support efficient capital markets and manage systemic risk" (Ministers of Finance of…2014). These stated goals coincide exactly with the language describing the purpose of the *PCMA* in the most recent draft.

Though the literature varies in the exact words used to describe the overall goals of securities regulation in Canada, Trebilcock (2010) offers a summary that appears to reflect the general consensus on this matter. He suggests that in Canada the objectives of securities regulation have generally been to strike a balance between promoting efficient capital markets and investor protection. This balance must be struck because one often comes at the cost of the other. He highlights that the expression of these goals originally came out of the very influential 1965 'Kimber Report' and are now present in provincial and territorial securities regulations across Canada. However, Trebilcock also notes that, since the 2007

financial crisis, groups such as the G20 and the International Organization of Securities Commissions (IOSCO) have more recently identified monitoring systemic risk as a third policy objective. I will now explore how Canada's current regulatory system compares to the *Cooperative Capital Markets Regulatory System* in terms of ability to strike a balance between promoting efficient capital markets and investor protection, and to manage systemic risk.

IV. ASSESSMENT OF THE *COOPERATIVE CAPITAL MARKETS REGULATORY SYSTEM*

In this section I will provide an analysis of Canada's current securities regulatory framework and the changes proposed to it through the *Cooperative Capital Markets Regulatory System*. I will do this through evaluating Canada's current securities regulatory framework against the *Cooperative Capital Markets Regulatory System* in terms of ability to pursue the objectives identified in the previous section.

Striking a Balance Between Fostering Fair and Efficient Capital Markets and Protecting Investors

Generally speaking, the more local the regulation and the regulator, the better tailored to local needs it can be and, thus, the better it can both promote efficient capital markets and protect local investors from improper or fraudulent activity.[1] Such a decentralized system may also foster jurisdictional experimentation and competition, pushing regulation to continually evolve and become more effective. Therefore, complete provincial

[1] For example, regulators in Alberta may be more familiar with the financial reporting techniques of oil & gas companies than regulators in Ontario. Alberta regulators, through enforcement expertise and/or specific regulations could, therefore, more effectively ensure regional oil & gas companies report diligently on the value of their owned-but-unexploited resources. An example of an existing locally tailored regulation is Saskatchewan's Local Policy 45-601 *Community Venture Exemption*, which exempts issuers raising money for community ventures from certain reporting and prospectus requirements within the province (Puri, 2003).

autonomy on regulations may be the ideal system if all aspects of securities transactions took place within a single jurisdiction (Trebilcock, 2010). However, largely due to technological progress, in Canada, transactions in securities markets today are largely national in scope. Approximately two-thirds of all reporting issuers in Canada report in more than one province/territory (Puri, 2012), and 30% of the issuers listed on the Toronto Stock Exchange report in all ten provincial jurisdictions (Puri, 2010). From April 1, 2009 to March 31, 2010 there were approximately 50 newly-listed issuers on the TSX and all but 3 of them were reporting issuers in multiple jurisdictions (Milne 2010). "In Canada [t]here are more than 3,000 active firms registered under the National Registration Database; of these, approximately 80% are registered in more than one provincial or territorial jurisdiction" (Milne, 2010 at para 3.6). Further, out of 298 small and medium-sized Canadian firms that raised capital through public offerings between 2002 and 2006, only 7 raised capital in their home province alone (Milne, 2010). Canadian stock exchanges have also become more national through their continued process of merging since 1999, with the previous 5 regional stock exchanges (i.e., the Vancouver Stock Exchange, the Alberta Stock Exchange, the Toronto Stock Exchange, the Montreal Stock Exchange, and the Winnipeg Stock Exchange) joining into what is now the TSX (Puri, 2003). With the majority of securities transactions occurring over multiple jurisdictions, complete provincial autonomy incurs jurisdictional externalities and additional transaction, coordination, and enforcement costs.

The high level of inter-jurisdictional transactions means that some level of coordination between provinces/territories is required for an effective regulatory system. In order to assess the ideal level of coordination in terms of balancing the promotion of fair and efficient capital markets with protecting investors, I will explore four considerations: (i)

costs of raising capital; (ii) compliance and enforcement; (iii) market distortions; and (iv) policy experimentation and innovation.

Costs of raising capital

Studies have shown that the cost of capital in Canada is over 25 basis points higher than it is in the United States (Hail and Leuz, 2006) and Puri (2010) attributes this to Canada's decentralized regulatory regime. In their paper "International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?" (2010) Luzi Hail and Christian Leuz conduct an empirical study examining the relationship between a country's securities regulation and legal institutions and the cost of equity capital within that country. The study compares data from 40 countries between 1992 and 2001 and estimates the cost of equity capital within the countries through the use of multi-year, multi-firm data, including stock prices and earnings forecasts. This data is imputed into four permutations of financial models that estimate the cost of equity capital, "as the internal rate of return that equates current stock price with the expected future sequence of residual incomes or abnormal earnings"(Hail and Leuz, 2006 at page 491). The authors use an index from 0 (weakest) to 1 (strongest) to categorize the quality and strength of each country's disclosure regulations, securities regulations, and legal environment and institutions. They borrow the index measures from previous research that built the indices through data obtained from a questionnaire issued to securities law attorneys in 49 countries. The study found that the cost of capital in Canada is 10.53%, well below the average of 12.97% and higher but comparable to the U.S.A. (10.24%).[2] The authors estimate Canada's index for securities regulation to be

[2] It is, however, important to note that the data from this study was taken prior to the implementation of the current passport system, and it is possible that the implementation of this system has since reduced the cost equity capital within Canada.

0.91, substantially higher than the average (0.56) but lower than that of the U.S.A. (0.97). The study runs a series of regressions to estimate the correlation between the cost of capital and the strength of each country's disclosure regulation, securities regulations, and legal environment and institutions. They find that each of these variables is negatively correlated with the cost of equity capital and "[t]ogether, these variables explain about 60% of the country-level and close to 40% of the firm-level variation in the implied cost of equity capital around the world" (Hail and Leuz, 2006 at page 524). These results hold even with sensitivity checks and even after factoring in control variables for firm and country risk.

Aside from facing higher costs of capital, King and Segal (2003) have shown that Canadian companies also suffer from a "Canadian discount" in that they are valued lower than their American counterparts all else equal. This lower valuation holds "even when variables such as cost of equity, secondary market liquidity, and the risk-adjusted return of the overall stock market [are] controlled for" (King and Segal, 2003). Puri (2010) attributes this phenomenon, at least partially, to Canada's decentralized securities regulatory regime, since Hail and Leuz's, 2006 study found that strong capital market regulation, and strong enforcement of this regulation, is positively correlated with efficient pricing, high liquidity and low costs of raising capital. A related phenomenon to the Canadian Discount can be seen through foreign investment trends. Though Canadian companies are increasingly cross listing on international exchanges, Canadian exchanges do not do nearly as well in attracting foreign listings (Puri, 2010). Similarly, Canadian investments and pension fund holdings are continually substituting away from Canadian investments and towards foreign investments, but Canada has had difficulty attracting foreign investment in return (Puri, 2010). Though Canada has attracted a higher level of foreign investment recently, in 2014 Canadians still invested over $96 billion more abroad than was invested by foreigners in Canada (Statistics

Canada, *Table 376-0051)*. Since foreign investors tend to invest more in countries with perceived stronger overall financial governance mechanisms, Canada could likely attract more foreign investment through the implementation of a national regulator.

Puri (2010) suggests that the existence of regional markets means that current regulations are tailored to best allow for regional specialization, which helps local industries raise capital. In her 2003 paper, "Local and Regional Interests in the Debate on Optimal Securities Regulatory Structure", Poonam Puri explores (i) whether distinct, regionally-specialized capital markets exist in Canada and, (ii) if so, whether jurisdictions that host these markets have tailored their securities regulations to the specific needs of these markets. The author labels these regional markets as local infrastructures for capital raising (LICR), and defines an LICR as "a geographic region where there is a critical mass of issuers of a certain industry type or level of market capitalization; this allows local securities regulators and professionals (such as investment bankers, lawyers and accountants) to develop an expertise and respond to the needs of such issuers" (Puri, 2003 at page 209) In determining whether an LICR exists, the author uses data from the TSX and TSX Venture Exchange (TSXVE) to determine where companies are headquartered. Puri finds that there is strong evidence that LICRs exist in Canada,[3] with

- Alberta hosting an oil and gas LICR;
- BC and Ontario each hosting both mining and technology LICRs;
- Ontario hosting a financial services LICR;
- BC hosting an LICR for micro-cap issuers;
- BC, Ontario, Quebec, and Alberta hosting LICRs in communications and media; Ontario and Quebec hosting an LICR in life sciences; and
- Ontario, BC, and Alberta each hosting an LICR for small-cap issuers.

[3] For example 92% of the oil and gas issuers on the TSX and 61% of the oil and gas issuers on the TSXVE have their headquarters in Alberta (Puri, 2003 at page 216–217).

However, after examining provincial GDP-by-sector data, the author concludes the following:

> Even though the infrastructure for capital raising for these industries may be clustered in certain regions of the country, the…GDP data suggest that the economic significance of these industries transcends regional boundaries, and that many provinces are interested in fostering policies and programs that encourage such industries. As a result, it is not improper to conclude that these industries are national in character (Puri, 2003 at page 228).

Puri then moves onto an analysis of whether regional regulators have in fact developed regulatory products tailored to the LICR(s) that their province hosts. To do this, the author examines the circumstances surrounding the implementation of five separate regulatory policies that are argued to be examples of regional responses to local needs.[4] Specifically, Puri considers factors such as whether the creation of the local policy inspired similar regulatory changes in other Canadian jurisdictions, whether it was created with the stated purpose of supporting a local industry, and whether it is actually a local policy in that it is limited in application to transactions occurring within the province. After a long analysis, Puri finds that, for the most part, these regional policies cannot be attributed to regional regulators developing regulatory products tailored to the LICR(s) that their province hosts. The paper concludes that:

> [o]verall, the analysis in this study finds that most local regulatory responsiveness is not the product of local and regional distinctiveness. As a result, the main conclusion to be drawn from the study is that existing local and regional differences can be accommodated under different regulatory models without appreciable differences in regulatory outcomes" (Puri, 2003 at page 249).

[4] (a) Alberta's Junior Capital Pool Programs; (b) BC and Alberta's System for Shorter Hold Periods with an Annual Information Form and Multilateral Instrument 45-102 *Resale of Securities*; (c) National Instrument 51-101 *Standards of Disclosure for Oil & Gas Activities* (developed by Alberta); (d) Ontario's Accredited Investor Exemption and Multilateral Instrument 45-103 *Capital Raising Exemptions*; and (e) Saskatchewan's Local Policy 45-601 *Community Venture Exemption*.

Based on the above analysis, I conclude that overall Canadian firms would likely face lower costs of raising capital if Canada were to move to a national regulatory system.

Compliance and enforcement

Anand and Klein (2005) argue that the Canadian securities regime is "burdened by four types of cost inefficiencies: lack of harmonization, duplication, opportunity cost risk and uncertainty" (Anand and Klein, 2005 at page 1). They also note that dynamic efficiency, which looks at the ability of a system to respond and adapt to market pressures, is an important tool to assess the regulatory impacts on capital market efficiency. The authors suggest that the lack of harmonization of regulations across Canada's 13 jurisdictions creates duplication and incurs additional compliance costs for firms who must research and ensure compliance with the individual regulations for each jurisdiction in which they list. The paper also highlights that requiring approval from multiple regulatory authorities can cause delays and lead to opportunity costs through missed market windows; this is particularly relevant for inter-jurisdictional transactions involving Ontario (as the only non-participant in the current passport system). As amending the regulatory regime has been discussed for many years, the authors also note that uncertainty in Canada's regulatory system has not inspired confidence in the marketplace and has likely led to other inefficiencies as well. Lastly, the authors discuss dynamic efficiency of the Canadian regulatory regime and note that, although a centralized system would be able to implement policy changes more quickly than the current decentralized system, a national regulator may lose out on dynamic efficiencies currently realized through locally tailored regulations and enforcement. However, given Puri's 2003 study discussed earlier, decentralized securities regulations currently in place are rarely tied to the unique regional needs of a specific province/territory and, thus, efficiency losses from centralization in this regard would likely be minimal.

From the perspective of reporting issuers listed on multiple Canadian exchanges, a single national regulatory framework will almost certainly lower compliance costs. Though the passport system achieves a great deal in terms of improving the ease by which companies can operate in multiple jurisdictions, "its application is limited and it still falls short of what is required in today's global marketplace" (Expert Panel, 2009 at page 2). Further, under the passport system, a firm must still pay registration fees in each jurisdiction it decides to list in, and Ontario does not currently participate in the passport program, which adds a layer of regulatory burden for companies seeking to cross-list in Ontario. Thus, for Canadian companies, a single national regulator would likely lower the administrative costs of complying with regulation.

A study conducted by the Canadian Bankers Association (CBA) found that, in Canada, additional costs associated with an offering increase by approximately 7% for each additional jurisdiction a firm lists in (Canadian Bankers Association, 2008). The CBA also found that offering expenses are subject to economies of scale in that they tend to decrease relative to the size of the offering as the offering size increases. This suggests that small and medium-sized businesses are disproportionately burdened by the current regulatory system. The study estimated that firms seeking to raise capital in all 13 of Canada's jurisdictions, as opposed to just one, face double the regulatory costs. Firms listing nationally and seeking to raise $1 million pay approximately 16% of their capital in regulatory costs whereas firms listing nationally and seeking to raise $10 million pay approximately 4% of their capital in regulatory costs (Canadian Bankers Association, 2008). From a regulatory perspective, having 13 regulators performing similar jobs also leads to inefficiencies. One study estimated that "consolidating 13 regulators into a single national regulator with one head office and five regional offices would save 37 per cent of the total regulatory operating budget" (Puri,

2010). Although the current proposal plans a local regulatory office in each participating jurisdiction, potential efficiency gains still exist in terms of enforcement through central information gathering and investigative resources.

Though decentralization capitalizes on the investigative and enforcement expertise of local regulators who are most familiar with the jurisdictions common industries (and more importantly those industry's accounting and financial practices), it suffers from a few major issues. Firstly, with regulatory enforcement occurring more-or-less autonomously within each of Canada's 13 jurisdictions, high levels of coordination are required to share and produce accurate information and to make that information public (Trebilcock, 2010). This is especially true with a large proportion of securities transactions occurring inter-provincially. Coordination issues and unequal enforcement resources across jurisdictions also means that there is room for investors to avoid prosecution (Trebilcock, 2010, Puri, 2005). For example, if information from multiple regulatory authorities is required to discover improper activities undertaken by an issuer, that information may take a long time to put together or never get put together at all. It is probable that this is known to individuals looking to take advantage of the system and thus likely lowers both enforcement and voluntary compliance. The current system also lacks an overall authoritative governing and/or enforcing body, which means that enforcement priorities and interpretation of harmonized rules differ across jurisdictions (Trebilcock, 2010, Puri, 2005). Lastly, the current system makes coordination of regulations between the different financial industries (i.e., insurance, banking, and credit and securities) more difficult. This means that investors often lack full information and are, without their knowledge, inadequately protected from risk (Milne, 2010) which may be irresponsibly taken on by financial intermediaries that hold their money.

Through technological progress and advances in finance theory, financial transactions have become incredibly complex over the past few decades (Milne, 2010). The application of electronic platforms capable of facilitating transactions nearly instantaneously and computers with the ability to gather and analyze huge data sets to develop financial models "implies a degree of sophistication unheard of four decades ago" (Milne, 2010 at para 2.8). Innovations in finance theory have led to complex forms of hedging and derivatives, and have driven the development and popularization of the process of securitization, whereby debt is packaged and sold in the securities markets (Milne, 2010). As transactions become more complex, the likelihood that market participants have adequate information and understanding to make the most rational decisions becomes less likely, which increases the need for effective regulations (for example around disclosure). However, the rapidly changing environment in which securities transactions take place also means that implementing effective regulations requires increasing the expertise and responsiveness of regulators. The proposed *CCMRS* creates broad principles that will guide the Regulatory Authority in making specific regulations, but leaves the details of those regulations largely in the Regulatory Authority's, hands. This approach puts more reliance on experts, rather than politicians, to draft regulations and also allow for quick regulatory implementation. According to the Canadian Bankers Association, this creates "a more flexible regulatory system that can help competitiveness by enhancing the ability of firms to be responsive to changing market opportunities and by reducing the drag of regulatory complexity on firms' efficiency (Canadian Bankers Association, 2008 at page 11)." The *CCMRS* also continues to capitalize on local enforcement expertise through the use of regional offices as enforcement centers. Additionally the CCMRS also allows for the utilization of national enforcement

tools, such as criminal law jurisdiction and federally-coordinated information sharing systems.

Market distortions

Similar to barriers to the trade of goods, barriers to the flow of capital (such as ineffective regulations) can cause welfare losses through the distortion of comparative advantage-based resource allocation (Trebilcock, 2010). Due to the higher costs of operating in multiple jurisdictions, it is plausible that many Canadian firms choose to list in fewer or different locations than they would under a harmonized regulatory model. Firms that wish to be national issuers are faced with the choice of complying with the regulations of the strictest jurisdiction or with avoiding that jurisdiction entirely, which may lead to distorted allocations of firm headquarters based on convenient regulations rather than pure market considerations. Another distortion from decentralization is the creation of jurisdictional externalities that may arise and not be adequately addressed by regional regulatory regimes. For example, a province may ignore consumer abuses that occur in other jurisdictions from companies located within its jurisdiction, or an individual province may discount the negative impacts of national monopolies or cartels operating in their jurisdictions because of the limited impacts on their own residents (Trebilcock, 2010). These externalities are perpetuated through regulatory arbitrage, whereby financial actors 'shop around' for the jurisdiction whose regulatory regime will be most advantageous to them. Milne (2010) argues that modern market participants practice this type of arbitrage regularly and that this has created the need for coordination between jurisdictions and regulators of financial services of all types. Though harmonization may come at the cost of restricting the policy preference choices of firms and citizens of individual regions, harmonization would limit the prevalent

market distortions in Canada's current regulatory regime and would therefore likely improve market efficiency and investor protection.

Policy experimentation and innovation

Trebilcock (2010) suggests that a decentralized regulatory system has the advantage of fostering jurisdictional competition, which may help create better regulations by pushing jurisdictions to offer "better" regulations than their neighbours to attract firms and investors.[5] Similarly, decentralization may also allow policy experimentation and innovation without risking major systemic issues; Trebilcock (2010) uses Medicare in Saskatchewan as an example of the type of policy experimentation that decentralization allows.

In her 2006 paper, "The States as a Laboratory: Legal Innovations and State Competition for Corporate Charters", Roberta Romano tracks the evolution of corporate law in the United States to show that states act as regulatory laboratories and that the best state corporate laws tend to diffuse across the country. Romano begins by explaining that corporate law is under state jurisdiction and that the jurisdiction (state) that a corporation chooses as its *statutory domicile* maintains exclusive jurisdiction over the corporate law affecting that corporation. Firms can therefore select the legal regime that best suits their needs by choosing their domicile. Romano notes that there are three empirical indicators that states are regulatory competitors: first, the proportion of states who copy 'successful' regulatory provisions increases over time; second, franchise revenue within states is positively related to the responsiveness of that state's legal system to firm demands; and lastly, that firms tend to move from states with low levels of responsiveness to states with

[5] It is important to note that the definition of "better" can be problematic in this analysis. For example, if better is determined by the number of issuers within a jurisdiction, this may be indicative of a jurisdictions greater responsiveness to current issues (arguably a good thing) or it may be indicative of a jurisdiction implementing lax legislation that is relatively inexpensive to comply with in order to attract more issuers (probably not a good thing).

high levels of responsiveness. She postulates that this system has spurred state regulatory competition (as states vie for incorporations–a source of revenue–within their jurisdiction) that has made state regulation responsive and effective for firms and their investors. Romano further asserts that the pattern of evolution of corporate law in the United States is such that first there is jurisdictional experimentation to solve a particular problem and then, after a successful formulation is found, the formulation spreads and uniform regulation is made across the country.

In order to offer evidence of her arguments, Romano uses Delaware, the state most successful at attracting corporations, as a case study. She notes that Delaware is consistently responsive to firm demands in their corporate laws and is frequently among the first states to enact or amend new corporate provisions. She tracks a series of provisions that spread across the continent, and notes that Delaware was often the first, or among the first, to enact each particular provision.

> The tracked provisions were selected from commentary on the code identifying the major improvements and from survey responses of firms that had changed domicile, which indicated what types of code provisions affected their re-incorporation-location-decision. These tended to be provisions that increased organizational flexibility, and in particular, provisions reducing the cost of acquisitions (Romano, 2006 at page 216).

Romano analyzes the evolution and spread of each of these provisions to demonstrate that they were developed by states in reaction to new legal decisions and evolving financial problems, and borrowed and refined other jurisdictions' provisions until the right combination was found. Only after a provision had been left unaltered for some time within a state, an indication that it was working well within the jurisdiction, did the provision start to spread across the continent. Romano concludes that this type of regulatory competition

leads to higher levels of innovation and responsiveness then a single regulatory jurisdiction would and is, therefore, an important ingredient to regulatory success.

Though it is tempting to project these results onto Canadian securities regulation, inter-jurisdictional regulatory competition has not played nearly as big of a role in Canada (Nicholls, 2012). In "The role of inter-jurisdictional competition in shaping Canadian corporate law" (2000), Douglas J. Cumming and Jeffrey G. MacIntosh explore both the supply and demand side of the Canadian incorporation market in order to assess the role that inter-jurisdictional competition has played in the development and spread of Canadian corporate laws. After the *Canadian Business and Corporations Act* (*CBCA*) was implemented in 1975, many of its key provisions were adopted by the provinces and the authors study the spread of these provisions throughout Canada using data from 1976 to 1986. From the supply-side, the study seeks to determine whether the spread of these provisions was motivated by attempts to attract incorporation revenues. Specifically, the authors run a series of regressions to determine whether incorporation revenues had an effect on the responsiveness of the province to adopt *CBCA* provisions (a passive supply-side response), or whether the relationship moves in the opposite direction with incorporation revenue acting as a function of responsiveness (a proactive supply-side response). The study found no evidence of either a passive or proactive supply-side response, with relevant coefficients being either insignificant or having the opposite sign as predicted. With regards to the supply-side, the authors conclude, "[i]n sum, there is no empirical support for financially motivated competitive corporate law reform in Canada" (Cumming and MacIntosh, 2000 at page 165).

From the demand-side, the study uses data from 1975 to 1997 to determine whether firms or their legal advisors participate in *jurisdiction shopping*, by comparing either different

law regimes (*law shopping hypothesis*) and/or incorporation fees (*fee shopping hypothesis*), before deciding where to incorporate. To test the *fee shopping hypothesis*, the authors run regressions that test whether the number of incorporations within a province is correlated with incorporation related fees in that province. To test the *law shopping hypothesis*, the authors use dummy variables to test whether the number of incorporations within a province increases in the years corporate law reforms were implemented or the years immediately following. The results did find some support for both the *fee* and *law shopping hypotheses.* In regards to the *fee shopping hypothesis*, only coefficients for 2 provinces were found to have the right sign and be significant at the 0.05 level of significance. In regards to the *law shopping hypothesis*, results were a bit stronger with the coefficients on 5 provinces having the right sign and being significant at the 0.05 level of significance. The authors emphasize, however, that:

> "[i]t is important to stress that evidence of jurisdiction shopping on the basis of differential laws is not strong evidence in favor of the competition hypothesis [as]…jurisdiction shopping is compatible with a variety of underlying supply-side motivations....At best, the existence of jurisdiction shopping is a necessary (not sufficient) condition of the existence of a charter market." (Cumming and MacIntosh, 2000 at page 166).

Further, the study found that the most significant factor driving incorporation activity was real gross domestic product within each jurisdiction. The authors ultimately conclude that, if there is a jurisdictional incorporation market in Canada, it is quite limited and not nearly as prevalent as in the United States.

Nichols (2012) has suggested that, instead of spurring effective innovation, regulatory competition can create a *race to the bottom* whereby jurisdictions implement legislation that overly caters to firms at the expense of investors and the province in order to compete in the incorporation market. Since inter-jurisdictional competition has quite limited application in Canada, however, it does not seem likely that jurisdictional competition (for

better or for worse) would be significantly effected through the implementation of a centralized regulatory regime. Further, although there is a move towards harmonization under the current passport system, harmonized regulations are necessarily agreed to through consensus, which likely means that first-best options are sacrificed for a compromise which is difficult to change or update (Trebilcock, 2010). This consensus-based approach also means that jurisdictions can opt-out of the consensus at any point, implementing whatever regulations they like, making the level of harmonization unpredictable and unstable (Trebilcock, 2010). A centralized regulatory system would therefore improve policy innovation and responsiveness through a more streamlined decision-making process, such as that in the proposed *Cooperative Capital Markets Regulatory System* draft legislation (which generally makes decisions on a majority vote basis). Thus, the proposed *Cooperative Capital Markets Regulatory System* will better balance promoting fair and efficient capital markets and protecting investors than Canada's current regulatory regime.

Managing Systemic Risk

Trebilcock (2010) describes systemic risks as "risks that occasion a 'domino effect' whereby the risk of default by one market participant will impact the ability of others to fulfil their legal obligations, setting off a chain of negative economic consequences that pervade an entire financial system" (Trebilcock, 2010 at para 26). One reason why this domino effect is particularly difficult to regulate today is that the traditionally distinct financial sectors (i.e., insurance, banking, and credit and securities) have become progressively integrated over the past few decades and can no longer be effectively regulated independent of one another (Milne, 2010; Anand, 2012). This blurring has largely occurred through the growth in popularity of securitization (Milne, 2010). Over the past two decades, the selling of risk by

Canadian banks in the form of securitized debt has become more common and Canadian savers have largely moved away from bank deposits towards securitized debt, often through pension and/or mutual funds. This phenomenon means that today, if we include investments in mutual and pension funds, the majority of Canadians are capital market participants (Puri, 2010).

To illustrate the regulatory issues presented by the integration of the different financial sectors, Milne (2010) uses two case studies, the 2007 financial crisis and the Canadian non-bank asset-backed commercial paper (ABCP[6]) crisis. In terms of the 2007 financial crisis, Milne attributes the crisis at least partially to the growth of the (generally) unregulated and complex securitized credit system that, as noted above, has largely taken over the traditional bank-deposit system. He notes that this system, coupled with insufficient risk management practices, was a root cause of the crisis and led to reckless lending and irresponsible risk transfers around the world. Though the bank-sponsored ABCP market in Canada managed to avoid failure during the financial crisis, in 2007, the Canadian non-bank-sponsored ABCP market failed concurrently with the USA credit market. Milne attributes the non-bank-sponsored ABCP market failure largely to the fact that this market was part of the "shadow banking system" (financial institutions that essentially perform banking functions, but are not governed by banking regulations). This meant that the non-bank-sponsored ABCP market did not have the same level of capitalization as the bank-sponsored ABCP market, which had a regulated minimum capitalization that helped it remain solvent. Trebilcock (2010) and Anand (2012) both argue that these events are strong evidence that a

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[6] Milne (2010 at para 11.1) describes Asset Backed Commercial Paper as "an unsecured debt obligation, typically with a maturity of 30 to 180 days, issued by issuers that hold underlying assets (such as credit card receivables, car leases and loans, and residential mortgages) as collateral security for the repayment of the ABCP."

centralized securities regulator in Canada would greatly improve the country's ability to manage systemic risk.

Another issue with managing systemic risk that Canada's current system faces is the ability to take action quickly. When responding to a crisis, the ability to respond quickly can make all the difference. Within the existing framework, regulatory responses to financial crises in Canada can be severely delayed by the need for 13 legislatures to approve changes. The 2009 Expert Panel on Securities Regulation report noted that this delay specifically caused problems in September 2008 when, in the eye of the financial crisis, jurisdictions globally were implementing a ban on short-selling certain stocks as a temporary stability measure. Canada's response lagged behind that of the USA and the United Kingdom and was not implemented uniformly across provinces. The delay, though only 24-hours long, created unnecessary volatility and uncertainty for financial institutions within the country, as many were cross-listed across jurisdictions. As another example, the 2009 report also noted that the fragmented Canadian regulatory system likely led to significant negative effects on market stability in Canada in August 2007, with the delay it caused in freezing the non-bank ABCP market in a time of high volatility. In contrast, the Canadian bank-sponsored ABCP market, which was under federal regulation and the control of a single federal regulator, was able to act quickly and responsively to market turbulence and survived the crisis relatively well (Milne, 2010). Ultimately, the 2009 Expert Panel concluded that the Canadian regulatory scheme is not adequately prepared to deal with issues of systemic risk as "[a] delayed response, which is poorly managed by any one of the securities regulators, could have a detrimental impact on the integrity of Canada's capital markets as a whole" (Expert Panel, 2009 at page 40).

To properly manage systemic risk domestically, Canada must be aware of risks internationally because Canadian firms commonly raise capital abroad. "At the end of 2008, there were 193 issuers inter-listed on a USA exchange including most of the 60 largest issuers listed on the TSX" (Milne, 2010 at para 3.9). As of 2010 there were 178 Canadian companies (12%) cross listed on a New York Exchange and in 2004 the USA securities and Exchange Commission reported that 40% of foreign firms reporting with them were Canadian, more than four-times higher than any other foreign jurisdiction (Puri, 2010). Canadian issuers are also commonly cross-listing in London. "As of June 30, 2005, Canadian companies accounted for about 20% of the foreign-based companies listed on AIM [London's Alternative Investment Market]. Of the thirty-one Canadian companies listed on London's AIM, twenty-three were inter-listed with the TSX and five with the TSXV" (Rousseau, 2006). Canadian investors are also increasingly holding foreign securities with foreign holdings by Canadian pension funds increasing from 4.9% of total holdings in 1988 to over 30% in 2006 (Puri and Vasudev, 2010) and Canadian investors purchasing over $56 billion worth of foreign securities in 2014 (Statistics Canada, Table 376-0131). As international markets clearly have an impact on market participants within Canada, managing systemic risk domestically requires some level of international cooperation.

Although Canadian capital markets are progressively impacted and affected by global competition and international regulations, Canada's potential international influence in this regard is severely hindered by its lack of a uniform body to represent Canadian interests. For example, Canada participates in the International Organization of Securities Commissions (IOSCO), which is an international body aimed at protecting investors, controlling systemic risk and increasing information exchange and enforcement of financial misconduct (Puri, 2010). Of the 109 IOSCO members, Canada is the only one to lack a national securities

regulator and is currently represented by Ontario and Quebec with Alberta and British Columbia accorded observer status (Trebilcock, 2010). This hurts Canada's ability to advocate for its own interests as the economic size of each province is much smaller than Canada as a whole and any disagreements between provincial IOSCO members greatly reduce each members influence. Further,

> "[w]hat other leading regulators think about the Canadian securities regulatory system is important. For example, in 2008, the SEC started negotiating a free trade in securities agreement with Australia but did not do so with Canada on the basis that our securities structure was too fragmented" (Puri, 2010).

Canada currently represents only about 4% of global capital markets and, if it wants to have any hope of meaningful international influence, it needs to present a unified voice (Trebilcock, 2010).

Although Puri (2012) contends that a national systemic risk regulator would add another layer of regulatory burden to Canada's already patchwork system of capital markets regulation, this criticism does not hold in the face of a complete regulatory overhaul as is contemplated by the *Cooperative Capital Markets Regulatory System.* Under the *CCMRS*, a single regulatory authority has broad jurisdiction over day-to-day regulation (under the *PCMA*) and over managing systemic risk (under the *CMSA*). Canada's currently decentralized system (decentralized both in terms of being non-national and having separate legislation and regulators for the different financial sectors) can make responding to crises slow and cumbersome.

> To the extent that securities markets are prone to systemic risks, and that securities regulation is able to address these risks, these risks are the strongest examples of jurisdictional externalities and underline a need for national, if not international regulation, and enhanced cooperation amongst domestic and international regulators of the various segments of domestic and international capital markets. The 2007 financial crisis originating in the U.S. sub-prime mortgages market and then cascading across financial markets around the

> world underscores the extent of these jurisdictional externalities (Trebilcock, 2010 at para 30).

Not all authors, however, agree that harmonization is the best approach to promoting financial stability and managing systemic risk. In her paper, "For Diversity in the International Regulation of Financial Institutions: Critiquing and Recalibrating the Basel Architecture" (2014), Roberta Romano challenges the idea that harmonized international financial regulation will decrease systemic risk. Romano contends that we still do not understand what regulatory policies actually reduce systemic risk and that financial markets are moving so quickly that, even if we did know, our knowledge could not keep up with the changing markets. This reality means that our attempts at harmonization may actually increase systemic risk if bad policies, that is policies which promote rather than hinder systemic risk, become the harmonized policies. Romano notes that, overwhelmingly, current international discussions on systemic risk are concerned with the goal of harmonizing international securities regulations and suggests that this may have been a contributing factor to the 2008 financial crisis. Examining the Basel Accords, the international agreements harmonizing certain financial regulations, she demonstrates that these agreements promoted the holding of securitized mortgages, and in particular securitized subprime mortgages by financial institutions internationally prior to the financial crisis. This was accomplished through allowing for preferentially-low capital requirements on these assets. Romano also notes that the Basel Accords encouraged treating sovereign debt as having zero-risk, which overly encouraged its holding as an asset. This has likely protracted the EU debt crisis and diverted investor activity away from nations that need access to liquidity the most as worries around a Greek default casts doubts on the solvency of other nations that are heavily invested in Greek debt.

Romano suggests creating an international agreement framework that would produce harmonized model regulations, but would also allow for justified divergence subject to international review and approval. She puts forward that this system will mitigate systemic risk by diversifying risk-management strategies and tailoring them to address regional problems. She also notes that this system will lead to more innovation and regulatory experimentation, which will ultimately produce better regulations globally. As a way to prevent jurisdictional arbitrage, Romano suggests requiring companies that operate within any jurisdiction to incorporate in that jurisdiction. Romano's critique is applicable to Canada both domestically, in terms of harmonizing provincial regulations, and internationally in terms of participating in international harmonization discussions.

Although there is some disagreement as to the optimal level of regulatory harmonization, ultimately the evidence suggests that, in regards to addressing issues of market stability and systemic risk, a national regulatory system would better serve Canada.

V. CONSTRAINTS IMPOSED BY CANADA'S LEGAL SYSTEM

In this section I will explore the constraints imposed on securities regulation in Canada by the constitution and, specifically, by the Supreme Court's interpretation of the constitution in the *Reference Re Securities Act*. I will then assess the likelihood of the *CCMRS* withstanding a constitutional challenge based on the current drafts. I will use this legal framework in the next section to suggest improvements to the *CCMRS* that would both better ensure its constitutionality and address the main criticisms of a centralized regulatory system from the previous section.

The Supreme Court's *Reference Re Securities Act*

The question of the constitutionality of the authority of Parliament to implement the *Canadian Securities Act* was based on the question of whether or not the legislation fell under Parliament's power over "trade and commerce" or the province's power over "property and civil rights" (Reference…2011).[7] The test for determining this question was established in *General Motors of Canada Ltd v City National Leasing*. In *General Motors*, the court held that in order for a legislative scheme to fall within the federal government's general trade and commerce power, five criteria must be met: (i) the law must be a part of a general regulatory regime; (ii) the scheme must be overseen by a regulatory agency; (iii) the legislation must be concerned with trade in general, not a particular industry; (iv) the scheme must be of such a nature that the provinces would be constitutionally incapable of enacting it either alone or in concert; and (v) the failure to include one or more of the provinces in the scheme would jeopardize its success in other parts of Canada.

In a unanimous decision, the Supreme Court held that much of the *Canadian Securities Act* fell under the provinces exclusive jurisdiction and thus was unconstitutional. Specifically they found that the legislative scheme failed to meet the third, fourth and fifth criteria of the *General Motors* test noted above. Though the proposed legislation was built on an opt-in structure, whereby provinces could choose whether to be governed by the legislation, the Supreme Court did not find this to be sufficient to save the legislation. They noted that if the Court ruled that the general regulation of securities falls under the federal power over trade and commerce, all existing and concurrent provincial jurisdiction over these matters would

[7] Section 91(2) of the *Constitution Act, 1867* provides that Parliament has legislative authority over "The Regulation of Trade and Commerce" whereas section 92(13) of the Act provides that the provinces have exclusive legislative authority over "Property and Civil Rights in the Province". *Constitution Act, 1867* (UK), 30 & 31 Vict, c 3 reprinted in RSC 1985, Appendix II, No 5.

essentially be eviscerated through the paramountcy doctrine.[8] The court did find that there were parts to the proposed legislation that were of a sufficiently general nature, such as regulation over systemic risk and market stability, and noted that Parliament may be able enact separate legislation dealing with these matters exclusively. However, in general the Court found that the legislation was overly broad and contained many aspects that would infringe on the provinces' ability to regulate the day-to-day aspects of their markets. The Supreme Court's decision has been highly criticized (see e.g., Puri, 2012; Hogg, 2012, Trebilcock, 2012) for not adequately considering the economic evidence that capital markets could no longer be effectively regulated on a regional basis.

The Legality of the *Cooperative Capital Markets Regulatory System*

On its face, the *Cooperative Capital Markets Regulatory System* does appear to address the issues that caused the Supreme Court to characterize the *Canadian Securities Act* as unconstitutional. Most notably, the provinces, not Parliament, will now enact a large part of the legislation, specifically the component that deals with the day-to-day aspects of securities regulation (i.e., the *PCMA*). This legislation will be drafted in coordination with the federal government, and the participating provinces/territories will explicitly delegate some authority to a national regulator, but ultimately it will be provincial legislation enacted with the authority of the participating province/territory. In this way, the provinces maintain their ultimate jurisdiction over the regulatory aspects which fall under their power over property and civil rights and, since there will be no overlapping federal legislation, the paramountcy doctrine will not be triggered. The current Memorandum of Agreement between participating provinces/territories and the federal government specifies that,

[8] The paramountcy doctrine dictates that where there is inconsistency between validly enacted provincial and federal legislation, the federal legislation prevails (Rothmans…2005)).

> "[i]n entering into this MOA and participating in the Cooperative System, each of the Participating Jurisdictions is addressing matters within its constitutional jurisdiction and is neither surrendering nor impairing any of its jurisdiction, with respect to which it remains sovereign" (Memorandum, 2015 at section 2.2.).

In their decision, the Supreme Court also noted that: "[w]hile the proposed Act must be found *ultra vires* Parliament's general trade and commerce power, a cooperative approach that permits a scheme that recognizes the essentially provincial nature of securities regulation while allowing Parliament to deal with genuinely national concerns remains available" (Reference…2011 at para 130). Exactly what this means is not clear and the Court was explicitly cautious not to provide a roadmap for federal regulation which would prejudice a reference to them in the future. The Court did, however, explicitly acknowledge that criminal prohibitions, market stability, and systemic risk fit under the federal government's authority over trade and commerce and these are exactly the elements that the federal legislation (the *CMSA*) addresses. In the wake of the *Securities Act Reference*, Poonam Puri (2012) has suggested putting forward federal legislation on these matters and taking a cooperative federalist approach on day-to-day securities regulation as a constitutionally sound option. This is exactly the approach taken by the *Cooperative Capital Markets Regulatory System*. Though Rousseau (2012) has contended that managing systemic risk has both provincial and national jurisdictional elements and, therefore, that federal legislation on this matter is still somewhat restricted, he stops short of suggesting that this would prevent Parliament from enacting any legislation on the matter. Rousseau simply notes that Parliament will be unable to use the guise of managing systemic risk as a way to reintroduce federal legislation managing the day-to-day operations of securities transactions. The *Cooperative Capital Markets Regulatory System* introduces federal legislation narrowly addressed at managing systemic risk and implementing criminal laws and leaves the implementation of harmonized day-to-day

regulations of securities to the provinces legislatures through the *PCMA*. Similar to the *Canadian Securities Act*, The *PCMA*, delegates authority to a federal Regulatory Authority but, unlike the *Canadian Securities Act*, the *PCMA* maintains core substantive legislation in the provincial legislature. Further, under the *PCMA*, provincial ministers have oversight over the Regulatory Authority through the Council of Ministers. Based on the Supreme Court's language in the *Securities Act Reference* and the commentary by legal academics, it seems unlikely that the new proposed *CCMRS* would be deemed unconstitutional if challenged, however, uncertainties around what a "cooperative approach" means makes a hard conclusion difficult to make.

VI. WORKING WITHIN CANADA'S LEGAL FRAMEWORK TO ACHIEVE THE BEST REGULATORY OUTCOME

Though, overall, the *Cooperative Capital Markets Regulatory System* would better serve Canada than the current regulatory regime, there are still a few issues with the proposal. Firstly, as discussed in the previous section, though the constitutionality of the *CCMRS* is likely, it is not a sure thing and, if it is found to be unconstitutional, we are back to square one. Another major issue with the current proposal is that only six of Canada's 13 jurisdictions have agreed to it. How the *CCMRS* will interact with non-participating jurisdictions remains unclear and is highlighted by critics of the proposal as a major uncertainty. Although, based on provincial/territorial participation in the 2010 *Canadian Securities Act*, it is likely that more jurisdictions will sign on before its implementation, some provinces have indicated their outright opposition to the *Cooperative Capital Markets Regulatory System* (Canadian Press, 2015). As more provinces and territories sign onto the draft, and particularly after it is enacted, compromises and amendments geared at enticing skeptical

jurisdictions to sign on become more complicated and, therefore, less likely. Many of the benefits highlighted in this paper with regard to implementing the *Cooperative Capital Markets Regulatory System* will be reduced or eliminated if the legislation is enacted without the participation of all of Canada's jurisdictions. It is, therefore, very important that complete provincial/territorial participation is sought over the next 12 months. Although I have generally argued that, with regard to regulating securities in Canada, centralization is preferable to decentralization, and although the barriers to moving towards centralization are mainly due to Canada's constitutional structure, in this section I will argue that the best regulatory outcome can still be achieved under Canada's constitutional structure. Specifically, I will argue that the draft *Cooperative Capital Markets Regulatory System* would both attract more participation and increase its effectiveness by implementing a model such as Romano's (2014) framework for international regulatory cooperation (hereafter referred to as the "Romano Framework").

Without the constitutional barriers contemplated in the *Securities Act Reference*, implementing a single, national securities regulator in Canada would be relatively simple. The federal government could simply pass legislation that harmonized regulation across the jurisdictions under the authority of a single federal regulatory body. This legislation would apply to all provinces/territories regardless of whether they desired it or not. Though somewhat speculative, based on the federal government's persistence in pursuing a centralized regulatory system, the fact that a truly cooperative approach was only seriously pursued after the *Securities Act Reference*, and given its general statements on the subject, it can be safely assumed that this is the path it would have pursued if feasible. This would likely have led to a centralized regulatory regime years ago, accruing some benefits for Canada; however, it would not have captured several significant benefits that the cooperative

approach makes possible. For example, the *CCMRS* includes a regulatory office in each participating jurisdiction, which will utilize local expertise to guide enforcement and to advocate nationally for regulations that meet the specific needs of their individual region. This balances the benefits of centralization and decentralization and likely represents a compromise of the federal/provincial governments required for the implementation of the *CCMRS*.[9] Though the *Cooperative Capital Markets Regulatory System* comes close to the best regulatory approach, the Romano Framework presents a model that could elevate the *CCMRS* proposal from good to great. Further, it would likely attract the participation of more jurisdictions and would further solidify the constitutional legality of the proposal. This, I will argue, is the best regulatory outcome for Canada. Further, obtaining this outcome is only possible through a level of cooperation and compromise between the federal and provincial/territorial governments that would not have happened without the Canadian constitutional structure. Thus, the Canadian legal structure can be used to serve as a conduit to achieve the best regulatory outcome.

As described previously, in "For Diversity in the International Regulation of Financial Institutions: Critiquing and Recalibrating the Basel Architecture", Roberta Romano outlines, in great detail, a securities regulatory model that she argues is optimal for the international coordination of securities regulation. Romano suggests creating an international agreement framework that would produce model regulations while allowing for justified divergence subject to international review and approval. Under this system, model regulations are drafted and implemented, but divergence on specific regulations is permitted sparingly. In order to implement divergent rules, three steps must be followed: (i) the

[9] This assumption is based on the fact that offices in each region represent an additional cost to the federal regulator. For example: One study estimated that, "consolidating 13 regulators into a single national regulator with one head office and five regional offices would save 37 per cent of the total regulatory operating budget" (Puri, 2010).

departing jurisdiction must submit a plan outlining the divergence and economic analysis and justification to the umbrella regulatory authority; (ii) the proposal must be assessed by a committee of peers; and (iii) if implemented, the divergent regulations must be monitored and periodically reassessed. This system, Romano argues, has many benefits including jurisdictional experimentation leading to greater policy innovation, the ability to tailor regulation to regional needs, better data collection abilities through diverse data sets, and better management of systemic risk.

Although Romano proposes this model as an international framework, it is a perfect fit for a centralized Canadian regulatory system. As noted earlier, the *Cooperative Capital Markets Regulatory System* takes a minimalist or platform approach, setting out broad rules and regulations and delegating authority to make specific regulations to the Regulatory Authority. Implementing the Romano Framework, the *CCMRS* could be enacted in substantially the same format as is currently written and draft model specific regulations could still be created and implemented across the country by the Regulatory Authority. However, according to the Romano Framework, regional offices should be given the ability to submit regional-specific divergences to the harmonized regulations to the Regulatory Authority, or the Council of Ministers, which would allow divergence through a process similar to that as laid out above. Though this may reduce some of the compliance-based benefits allowed by complete harmonization, regulations would still be substantially harmonized across the country with only a small number of divergences permitted. Indeed, divergence from the harmonized regulations should only be allowed if the jurisdiction can demonstrate a specific regional need that is not being met by the harmonized regulations. As noted earlier, there is some evidence of regional specialization in Canada, and, even if current provincial regulations largely do not reflect customization implemented to fit these specializations, that does not

mean that they could not in the future. The Romano Framework may even encourage more studies on regional specialization by jurisdictions interested in divergence which could lead to better regional-tailoring than is in existence currently. Further, if no beneficial regional customization can be imagined or justified, than the default of complete harmonization would remain along with all its stated benefits. Aside from the benefits noted by Romano, this model would also likely increase participation in the system by holdout provinces who wish to maintain some amount of regional specialization and authority.[10] From the perspective of provinces, this is a much smaller step from the current passport system then the *CCMRS*, and this small allowance for regional specialization would thus likely go a long way in attaining provincial support from currently non-participating jurisdictions.

Although Trebilcock (2010) suggests that a system with a national regulator complemented by provincial-level regulation resembles the model used in the USA, which has been far from problem-free, there are several important differences between the American model and the Romano Framework proposed here. Firstly, under the Romano Framework, Canadian regulations would be substantially more harmonized than is the case across American states; divergences from harmonization would only be permitted through a strict review process. Further, the American model is complicated by seven federal regulators responsible for different aspects of regulation of financial services markets; this makes coordination cumbersome and difficult (Trebilcock, 2010). Not only would implementing the Romano framework improve the proposal substantially and potentially attract the participation of more jurisdictions, it would also solidify the constitutionality of the proposal. By allowing for the possibility of provincial/territorial divergence and customization, the

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[10] For example, in a statement Quebec's Finance Minister Carlos Leitao stated that he opposes the *Cooperative Capital Markets Regulatory System* because "[t]his plan would adversely affect the maintenance of Quebec's expertise in securities, a key sector of our economy." (The Canadian Press, 2015).

Romano Framework more clearly "recognizes the essentially provincial nature of securities regulation" (Reference…2011 at para 130) than does the *CCMRS*. Further this approach is also likely be seen as more "cooperative" as it would attract more participation and would shift the balance between provincial and federal jurisdiction slightly more towards the provinces than does the *CCMRS*. This model would thus capitalize on the requirements of the Canadian federal legal system to achieve the best regulatory outcome for Canada.

VII. CONCLUSION

The largest overall conclusion of this paper is that the Canadian regulatory system for securities would benefit from centralization. Although the current passport system has been a move in the right direction, it still suffers from a few major issues. Firstly, harmonized regulations are necessarily agreed to through consensus, which reflect unstable compromises which are difficult to change or update. The system also lacks an overall authoritative governing and/or enforcing body, which means that enforcement costs are duplicated and enforcement and interpretation of harmonized rules is inconsistent across jurisdictions. Further, this system still requires registration fees to be paid to each jurisdiction in which the market participant is active. Lastly, the current regime does not allow Canada to present a unified voice for international discussions on securities regulations or effectively integrate the regulation of different financial sectors. A single national regulatory system would be beneficial for Canada as it would reduce compliance costs, allow for the realization of economies of scale for the single regulator, and reduce enforcement problems associated with the multi-jurisdictional approach. The national regulator would also have the authority to utilize federal criminal law jurisdiction and would be able to make decisions more quickly and effectively, addressing issues of systemic risk. Though studies have shown that current

provincial regulations minimally reflect unique regional circumstances, by establishing regional representatives and offices, a national regulator could mitigate any forgone benefits that do currently exist from the local, tailored provincial approach. Further, centralization would improve the transparency of decision-making by having a single point of accountability. This approach would also reduce issues of jurisdictional arbitrage and would allow Canada to present a unified voice in international regulatory discussions.

Although the *Cooperative Capital Markets Regulatory System* presents many benefits over Canada's current regulatory system and is likely to withstand a constitutional challenge at the Supreme Court, it could be improved through the allowance of some regional regulatory divergence. Specifically, the proposed *CCMRS* should be amended according to Roberta Romano's suggested framework for international regulatory-cooperation. Under this system, regional offices would be allowed to diverge from the harmonized regulations, subject to the review and approval of the Regulatory Authority, if the jurisdiction can demonstrate a specific regional need that is not being met by the harmonized regulations. By implementing the Romano Framework, Canada could improve the *Cooperative Capital Markets Regulatory System* proposal substantially, solidify its constitutionality, and attract the participation of more jurisdictions. This approach would, thus, utilize the Canadian federal legal system to achieve the best possible regulatory outcome.

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