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Chapter 2

An Overview of Recent Canadian Securities Law Reform Initiatives

2.1 The Task Force acknowledges the work of others who have put forward recommendations or undertaken initiatives to reform the Canadian securities law landscape. As will become apparent in the chapters that follow, we have, in many instances, been influenced by the work of those who have come before us. Where our recommendations over-lap with those made by others, we hope that the addition of our voice to the recommendation will help make the case for implementation.

2.2 What follows is a high-level select overview of some recent Canadian securities law reform initiatives. We direct readers to Appendix D, which contains similar discussions regarding reform initiatives in the United States and the United Kingdom.

Five Year Review Committee of the Securities Act (Ontario)

2.3 Section 142.12 of the *Securities Act* (Ontario) (the "Act") requires that the Minister of Finance for Ontario establish an advisory review committee every five years to review the legislation, regulations and rules relating to matters dealt with by the Ontario Securities Commission (the "OSC") and the legislative needs of the OSC. The first Five Year Review Committee to review the Act (the "Committee") was appointed in 2000 under the chairmanship of Purdy Crawford and tabled its draft report for comments in May 2002. The final report of the Committee (the "Crawford Report") was tabled in the Ontario provincial legislature on May 29, 2003. This was followed by public hearings on the Crawford Report held by the Standing Committee on Finance and Economic Affairs in August 2004, culminating in the Standing Committee publishing its own report in October 2004. As at the date of its report, the Standing Committee advised that 20 of the 95 recommendations made in the Crawford Report had been implemented by the OSC or the Ontario legislature or required no further action.

2.4 The Crawford Report made significant recommendations relating to all aspects of securities regulation. The Crawford Report singled out the need for a single securities regulator in Canada as the most pressing issue for the securities market today. As a corollary, the Crawford Report recommended that regulators across the country continue to work towards increased harmonization of securities regulation both nationally and internationally to ensure that Canadian capital markets are competitive with other jurisdictions. The Committee notes in its cover letter to the Minister of Finance accompanying the Crawford Report that "…a nation that commands only two per cent of the global economy suffers daily from a regulatory regime which is comprised of 13 separate regulators".

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2.5 In addition to the need for a single, co-ordinated approach to securities regulation in Canada, several other themes were reflected in the Crawford Report and the recommendations of the Committee:

- The Committee noted that securities regulation should support clearly identified public policy objectives and must also be proportionate to the objective. Compliance costs must be outweighed by the benefits of regulation.
- The securities regulatory regime in Canada must be part of its competitive advantage in the global competition for capital and investors. While public policy objectives must be achieved it is also imperative that securities regulators operate efficiently and that the requirements of compliance be no more onerous than those existing in other jurisdictions, particularly the United States. Market participants must also have confidence in the enforcement powers of securities regulators in Canada, which requires that regulators have the resources necessary to exercise those powers.
- Securities regulation must be sensitive to the characteristics of those it is intended to regulate; for example, the large number of small cap issuers and the many public companies in Canada with controlling shareholders should be taken into account in designing the regulatory regime. As the Committee points out "a one size fits all approach may not work in all instances in Canada".

2.6 While the Crawford Report canvassed a wide range of securities law issues, the following four issues were identified by former OSC Chair, David Brown, in his presentation to the Standing Committee on Finance and Economic Affairs on August 18, 2004 as falling within the OSC's top priorities for legislative amendment or reform:

Civil Liability for Secondary Market Disclosure

2.7 The Committee strongly recommended enhancing the rights of investors through greater accountability for disclosure by market participants. This has been reflected to a large degree in Bill 198, *The Keeping the Promise for a Strong Economy Act (Budget Measures), 2002*, which amended the Act effective December 31, 2005 to, among other things, provide investors with a statutory right of action against persons or companies responsible for misrepresentations (written or oral) in various types of disclosure or for failure to make timely disclosure of material changes. Liability for all types of disclosure, including disclosure made in public oral statements, attempts to put investors purchasing in the secondary market on an equal footing with those purchasing under a prospectus. The Crawford Report also recommended the inclusion in the Act of an express prohibition against fraud and market manipulation and making misleading or untrue statements, thereby giving the OSC more powerful means to combat these problems. These provisions also came into effect on December 31, 2005.

Delegation and Mutual Recognition

2.8 The OSC endorsed the Committee's recommendation for a single Canadian securities regulator and, in the interim, inter-provincial delegation and mutual recognition of securities regulation. These proposed reforms would see securities legislation across the provinces and territories amended to give each regulator the authority to delegate powers to another securities regulator in Canada, and provide mutual recognition of rules of a neighbouring jurisdiction.

2.9 Since the publication of the Crawford Report two other notable initiatives relating to national harmonization of securities regulation have emerged. Related to the goal of inter-provincial delegation and mutual recognition, ministers responsible for securities regulation from all provinces and territories, other than Ontario, became party to a memorandum of understanding during 2004 and 2005 with a view to implementing a single window of access for prospectus review, prospectus discretionary relief, continuous disclosure and registration through the "passport system". The passport system was implemented in these jurisdictions on September 18, 2005 through Multilateral Instrument 11-101 – *Principal Regulator System* ("MI 11-101"). Although Ontario is not a party to MI 11-101 the OSC was part of the comment and review process and has implemented some consequential amendments to facilitate its operation. Various jurisdictions participating in the passport system have also introduced or implemented consequential amendments to their local securities legislation to give effect to the passport system. Related to the goal of national harmony, but from a different approach, Ontario's Minister of Government services appointed Purdy Crawford to chair a panel whose mandate was to produce a discussion paper outlining a model for a securities regulatory framework featuring one common securities regulator with a common body of securities law and a single fee structure. This panel produced a blueprint of its proposal for a single regulator in December 2005, conducted six regional public roundtable discussions throughout 2006, tabled its summary report on the roundtable process in April 2006 and released its final report entitled "A Blueprint for a Canadian Securities Commission" in June 2006.

Reduced Regulatory Burden through Blanket Exemptions

2.10 The Crawford Report recognized that the current prescriptive regulatory framework had failed to adapt to the needs of an increasingly complex and evolving market. Specifically, it noted that market participants were often required to apply for exemptions from existing rules that were based on a dated regulatory framework. Accordingly, the OSC supported the Crawford Report's recommendation that burdensome procedures requiring market participants to obtain the same exemptions over and over again be reduced and that the legislation be amended to provide better efficiency for both market participants and the securities regulators through the use of "blanket" regulatory exemptions.

Modernize Ontario's Commercial Law

2.11 The Committee recognized the need to nationally harmonize the existing commercial property law framework in order to more efficiently deal with the transfer and pledging of securities. The Crawford Report noted that Canada had fallen quite far behind its international counterpart jurisdictions in this area, resulting in increased transaction costs and a perception of reduced legal certainty in securities transfer and pledging transactions in Canada. The Committee noted that the Uniform Law Conference of Canada approved the *Uniform Securities Transfer Act* on August 26, 2004 and encouraged its adoption as soon as possible. In Ontario, Bill 41, an act to create a comprehensive system of rules for the transfer of securities that is consistent with such rules across North America and to make consequential amendments to various Acts (Securities Transfer Act, 2006) has passed third reading and is scheduled to be proclaimed in force in January, 2007. Similar legislation has also been introduced in Alberta and is being considered in British Columbia and Quebec.

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The "New" British Columbia Securities Act

2.12 The British Columbia Securities Commission (the "BCSC") began a consultation process in 2002 in order to determine the best options for streamlining and simplifying its securities regulatory regime. The BCSC published a series of proposals starting in 2002, engaged in a variety of public consultation activities and eventually published its final proposal in October 2004. The final proposal was scheduled to come into effect on November 15, 2004, however, on November 18, 2004 the BCSC advised that implementation of the new regime had been delayed. The government of British Columbia reportedly initially delayed implementing the proposal to give the industry more time to prepare for the changes. Since then, citing the progress of, and in order to devote greater attention to the harmonized and streamlined legislation represented by, the passport system (discussed above), in February 2006 the BCSC recommended a further deferral until at least December 31, 2007.

2.13 The proposal consists of (i) a new Securities Act for British Columbia, (ii) a set of securities rules governing key areas such as registration, public offerings and continuous and timely disclosure, supplemented by two regulatory instruments (BC Instrument 65-502 – *Takeover Bids* and BC Instrument 81-509 – *Mutual Fund Requirements*) and, (iii) comprehensive and plain language guides, one for issuers and one for dealers and advisers.

2.14 The review and consultation process for the British Columbia proposal also included a number of impact analyses on matters relating to enforcement, remedies, firm-only registration, investor protection and disclosure. These studies can be found at www.bcsc.bc.ca/policy (select "Regulatory Impact Analyses").

2.15 The new legislation is designed to be more responsive to a dynamic and changing securities environment and is purported to be less rigid than the current legislation. One of the objectives of the new legislation is to lower costs incurred by market participants by streamlining regulations and simplifying the language used in the statute. The new legislation is also intended to affect major substantive changes in the following areas:

Enforcement

2.16 The new legislation maintains prohibitions against misrepresentations, fraud, market manipulation, unfair practices, and unregistered trading and confers broader powers on the BCSC to ban market participants markets and order disgorgement and increases the limits of administrative penalties. In addition, any person who believes that another person has contravened the legislation can ask the BCSC to hold a hearing in the matter. These amendments are aimed at providing stronger deterrence against misconduct by giving the BCSC more tools to take decisive action against illegal market activity.

Investor Protection

2.17 The new legislation gives investors the ability to sue market participants for damages resulting from misrepresentations in offering, bid and continuous disclosure documents or in oral statements by a company's officials, failure to disclose material changes, illegal insider trading and "front running".

Continuous Market Access

2.18 The new legislation proposes to increase access to capital markets by replacing the current prospectus or prospectus exemption requirements with a continuous market access model. Under this model, an issuer would initially file a prospectus to enter the market and would then be required to keep its public record updated through mandated continuous disclosure filings. It would then be able to raise subsequent capital by filing a news release with material information about the offering. As modern laws and technology give investors real-time access to the issuer's continuous disclosure record, all material information about the issuer would be available to investors at all times. The proper functioning of the continuous access model is reliant on the inclusion of a civil liability regime for secondary market disclosure.

Code of Conduct

2.19 In regulating registrants the new legislation shifts away from a rules based approach and towards a principles based approach by proposing to replace intricate rules governing securities dealers and advisers with a code of conduct. The code is comprised of 25 rules organized under eight principles based on the purpose of, and reasons behind, current regulatory standards. The purpose of the code is to allow market participants to comply with regulatory requirements according to the size and nature of their businesses.

Ontario Securities Commission "Fair Dealing Model" and the Registration Reform Project

2.20 The OSC released its concept paper on the "Fair Dealing Model" in January 2004. The concept paper includes a description of how the fair dealing model will work as well as a number of technical and practical appendices, including model documents and the results of a stakeholder survey on the project.

2.21 The fair dealing model is described by the OSC as a proposal to "significantly reform the way the retail investment industry is regulated". The impetus for the project is said to be the Canadian Securities Administrators' (the "CSA") identification of conflicts of interest as a more significant concern than proficiency in the financial planning sector and a determination that regulations governing the delivery of financial advice to retail investors should emphasize relationships over products.

2.22 The fair dealing model is the OSC's approach to revamping the regulation of securities dealers (and advisers). Recognizing that retail consumers (outside the discount broker environment) generally seek advice, rather than products, the fair dealing model seeks to adopt a regulatory approach that stresses advice, in contrast to the present approach, where advice is viewed as "incidental" to securities transactions.

2.23 The fair dealing model is aimed at streamlining registration and registrant governance aspects of securities regulation and consists of two components:

- one license for all financial services providers (including conglomerates, businesses and firms); and
- a set of business conduct standards for these services providers.

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2.24 Self-regulatory organizations ("SROs"), who have historically enjoyed flexibility in setting their own policies, are expected to play an important role in the implementation of the fair dealing model. The fair dealing model is based on three core principles:

- a clear allocation of roles and responsibilities among the investor, the firm and the representative of the firm;
- maintenance of transparency in all dealings with the investor through understandable, meaningful and timely disclosure; and
- appropriate management of any conflicts of interest and avoidance of self-serving outcomes.

2.25 Under this model, every new accountholder will need to choose among one of three relationships with its adviser:

- the self-managed ("do-it-yourself") relationship, in which the investor seeks only transaction execution services (similar to a discount broker client), but allowing for some recommendations, including with respect to proprietary products (described as the "buyer beware" model);
- the advisory relationship, where the client looks for objective and expert advice and may be entitled to fiduciary protection; and
- the "managed-for-you" relationship, in which the service provider has full discretion on which the client relies completely.

2.26 Applicable standards and requirements will vary based on the type of relationship that is chosen, with standards becoming increasingly rigorous in proportion to the level of reliance placed on the advice of the adviser. Each new account holder will also be a party to a "Fair Dealing Document" that emphasizes the three core principles. Both parties will be expected to keep the contract updated with respect to any relevant changes to their relationship and representatives and firms will have a greater responsibility for educating their clients. With respect to transparency, the goal is not to require more disclosure but to replace existing burdensome disclosure requirements with disclosure documents that are relevant and easily understood by accountholders. Account statements and summaries of transactions are also intended to be enhanced by requiring more information for the investor, including personalized performance information.

2.27 The four phases of the fair dealing model initiative include implementation of a National Registration Database; implementation of the core principles of the fair dealing model; development and implementation of a harmonized national registration rule; and changes to the National Registration Database. Both the Mutual Fund Dealers Association and the Investment Dealers Association are also expected to implement new by-laws regarding transparency of the nature of relationships between investors and advisers, performance reporting, costs and conflicts.

2.28 With respect to achieving progress on the various phases of the fair dealing model, the CSA initiated the "CSA Registration Reform Project" whose purpose is to implement the National Registration Database (which was implemented in April 2005), draft a national registration rule and implement the core client relationships principles set out in the fair dealing model through SRO rules. The project's working group prepared an initial proposal in January 2006 recommending, among other things, the move towards a business trigger for registration requirement and a harmonized set of registration exemptions. The initial proposal was presented to the project's steering committee and to the chairs of the CSA, who substantially approved of the proposal and recommended the drafting of a national registration requirement rule on its basis. Further details on the objectives and contents of the proposed rule were released in the "Proposal on Registration Reform – Part II" in July 2006. These include implementation of a business trigger for registration requirement, availability of limited registration exemptions where there is other appropriate regulation only and streamlined and harmonized categories of registration.

2.29 The registration reform project is currently actively working on the drafting phase of the proposed registration rule and plans to publish the proposed rule along with related consequential amendments for comment by December 2006.

Uniform Securities Legislation

2.30 The Canadian Securities Administrators launched a uniform securities legislation project in March 2002 with the stated objective of developing uniform legislation by 2004. The proposed uniform legislation consists of a Uniform Securities Act ("USA") and a Model Administration Act ("MAA"). The USA is intended to provide national consensus on the fundamental principles of securities regulation while the MAA proposes a model for procedural aspects of securities laws.

2.31 The USA, as proposed, sets out the core principles of securities law only. The intention is that specific technical requirements necessary to implement these principles will be set out elsewhere by relevant provincial authorities. The USA streamlines regulations for issuers and registrants and includes proposals such as the provision of a right of action for misrepresentation in continuous disclosure documents and an objective test for determining "material change" and "material fact". The enforcement powers of the commissioners of the various securities authorities are also intended to be enhanced. Lastly, common heads of rule-making authority to facilitate the "platform" structure of the USA will be introduced.

2.32 Drafts of the USA and the MAA were published for comment in December 2003 with the comment period expiring on March 16, 2004. According to the Notice and Request for Comments published on January 2, 2004, the CSA expected to have draft legislation ready to be tabled in the provincial legislatures in 2005. To date, no further information has been provided on the status of this project.

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Bill C-13: An Act to Amend the Criminal Code (Capital Markets Fraud and Evidence-Gathering)

2.33 Bill C-13, which was passed by the House of Commons on February 12, 2005, amends the Criminal Code to create a new offence of prohibited insider trading and providing whistleblower protection to employees who report unlawful conduct. The Bill also amends the Criminal Code to increase the maximum prison sentences for the existing offences of fraud and fraud affecting the public market from 10 to 14 years and gives the Attorney General of Canada concurrent jurisdiction with the provincial Attorneys General to prosecute capital markets fraud offences.

2.34 As a sentencing tool for the courts, the Bill codifies a list of four aggravating circumstances that can be considered when imposing a sentence for market fraud offences: (i) whether the amount involved in the fraud exceeded $1 million; (ii) whether the offence adversely affected the stability of the Canadian financial system or investor confidence in the system; (iii) the number of victims involved; and (iv) whether the perpetrator took advantage of his or her elevated status or reputation in committing the offence.

2.35 The Bill also amends the Criminal Code to allow investigators to obtain "production orders" to compel persons not under investigation to produce data or documents relevant to the commission of an alleged offence under any federal law.

RCMP Integrated Market Enforcement Teams

2.36 Beginning in 2003, and continuing for an initial 5-year term, the RCMP and certain federal partners began receiving up to $30 million a year to create Integrated Market Enforcement Teams ("IMETs") with the objective of strengthening law enforcement capabilities to detect, investigate and deter capital market fraud and illegalities. The IMET initiative is designed to promote compliance with the law and promote confidence in the Canadian capital markets by focusing on what IMET calls the "four pillars" for the effective deterrence of capital market fraud:

- a strong legal framework providing appropriate sanctions and necessary tools for investigators and prosecutors to take enforcement action against illegal activities;
- dedicated investigative teams with specialized knowledge of the capital markets;
- resources for timely prosecution of alleged offences; and
- appropriate sentencing of perpetrators of corporate fraud.

2.37 In addition to the establishment of IMETs, the federal government's proposed strategy to strengthen enforcement and legislation against serious capital markets fraud includes providing additional resources to support prosecutions of capital market fraud offences under the Criminal Code (Canada) and proposing legislative amendments to the Criminal Code to, among other things, create new offences and establish concurrent jurisdiction with the provinces in the prosecution of serious cases of capital market fraud.

2.38 The IMETs are composed of police, lawyers and other investigative experts in Toronto, Vancouver, Montreal and Calgary. The first two IMETs were launched in Toronto on November 28, 2003. IMETs receive cases for investigation from referrals made by the RCMP's Commercial Crime sections, from other police forces, through the RCMP's web-based Economic Crime reporting system www.RECOL.ca, and through the provincial securities commissions.

Regulatory Analysis of Hedge Funds

2.39 On May 18, 2005 the Investment Dealers Association of Canada released a report entitled "Regulatory Analysis of Hedge Funds" (the "IDA Report"), the purpose of which, among other things, was to "identify any regulatory arbitrage or 'soft spots' in securities legislation and regulations" governing hedge funds.

2.40 The IDA Report focused on the lack of regulatory oversight of the hedge fund industry, noting that while the industry claims that "unshackling" the hedge fund manager from regulatory oversight is advantageous for investors, the broad license afforded to managers may also pose a significant risk.

2.41 The IDA Report noted that a large proportion of hedge fund investments in Canada are concentrated in principal protected notes ("PPNs") since they are exempt securities under relevant securities legislation and as exempt securities PPNs can be "sold to any investor for any amount by any entity (whether registered as a dealer or not)". Nonetheless, the IDA Report pointed out that there are a number of risks associated with an investment in PPNs which should prompt securities regulators to consider enhanced regulation for such products.

2.42 The IDA Report also pointed to the inherent conflict of interest arising from the multiple roles associated with hedge fund activities as a reason for reviewing the need for regulatory oversight for hedge funds. In particular, the IDA Report noted that many hedge fund managers are not securities registrants. To the extent that fund management activities are conducted by a company separate from the fund adviser the conflict of interest risk increases as there may be no direct regulatory oversight of the functions performed by the fund manager. Without proper internal controls, there is a natural bias to overvalue securities held in the fund and thereby overstate the fund's net asset value, which is the basis on which compensation is determined for both the fund manager and adviser. The IDA Report concluded that "because of the inherent conflict of interest arising from multiple roles associated with hedge fund activities through entities under common ownership and management, regulatory jurisdiction and oversight of non-registered fund managers is an issue that needs to be addressed in Canada as it recently was by the SEC in the United States".

2.43 The IDA Report recommended a review of provincial securities laws and regulations and the development of amendments that will bring hedge fund products fully within the regulatory system. This would include a review of the exempt status afforded to PPNs, the distribution of hedge funds and other exempt products to non-accredited retail investors and the conflicts of interest of hedge fund managers and advisers. The IDA Report also recommended that the review include examining the registration of hedge funds and their managers and the oversight of their activities generally.