Canada Steps Up
Canada Steps Up
Canada Steps Up

Chapter 3

Approaches to Securities Regulation and General Principles

3.1 The regulatory response to a market failure is dictated by the way in which the market failure is viewed by a regulator – it is the product of the "prism" through which a regulator views the job of regulating. During the course of the Task Force's deliberations, we have been presented with the opportunity to consider whether the prism through which Canadian securities regulators view the capital markets can be modernized. As is evident in the observations and recommendations which follow in subsequent chapters, we do not regard the perspective from which Canadian securities regulators operate as being fundamentally flawed or objectionable. Rather, we see an opportunity to make some improvements around the edges. The most important element of such improvement is simply outlining what are, and what should be, the characteristics that shape the securities regulatory model.

3.2 In the paragraphs that follow, we will outline what we regard to be the key characteristics of the Canadian securities regulatory model:

- The goals of securities legislation.
- The "when" and "how" securities regulators should intervene in the capital markets.
- The unique features of Canada's capital markets and the concomitant need for a unique regulatory approach.

The Goals of Securities Legislation

3.3 Securities legislation in Canada generally espouses two purposes: to provide protection to investors and to foster fair, efficient capital markets as well as confidence in these markets.[1] We regard these purposes as appropriate. However, as was similarly outlined in the final report of the Five Year Review Committee[2] established to review securities legislation in Ontario, we consider it necessary for the purposes of securities legislation to be broadened. We endorse the recommendation of the Five Year Review Committee that securities regulation take into account other considerations, such as:

- promoting the informed participation of investors in Canada's capital markets;
- maintaining the competitiveness position of Canada's capital markets;

[1]See, for example, *The Securities Act, 1988* (Saskatchewan) at s. 3.1; *Securities Act* (Nova Scotia) at s. 2; *Securities Act* (Ontario) at s. 1.1.

[2]*Five Year Review Committee Final Report – Reviewing the Securities Act (Ontario)* at 66.

- facilitating innovation in connection with regulated activities; and
- facilitating competition among regulated participants in Canada's capital markets.[3]

3.4 As we reported in Chapter 1, the vitality of Canada's capital markets is of paramount importance to the economic well-being of all Canadians. Such vitality is fostered by ensuring that the regulation of the Canadian capital markets not only protects investors and fosters fairness and efficiency, but also ensures that Canada's capital markets are competitive with their global counterparts. Accordingly, we recommend that Canada's securities regulators be guided by securities legislation which makes explicit as one of its purposes the enhancement of the competitiveness of Canada's capital markets. As a result, the effect of regulation on the competitiveness of Canada's capital markets would need to be considered prior to the introduction of regulation. We are conscious of the fact that the competitiveness of Canada's capital markets already undoubtedly factors into the regulatory calculus, but regard it appropriate to elevate it to the status of a guiding purpose of securities regulation.

Recommendation: *The Task Force recommends that Canadian securities legislation include as one of its purposes the enhancement of the competitiveness of Canada's capital markets.*

When and How Regulators Should Intervene in the Canadian Capital Markets[4]

3.5 Regulators should only intervene in the capital markets to address existing market failures or to address anticipated market failures. Market forces in a competitive market are usually effective in promoting behaviours and conditions that will benefit the market and penalize behaviours that harm the market. It is the role of the regulator to step in where market forces do not function perfectly and put the market's integrity at risk.

"The effect is our cost of being a public company has probably quadrupled in the last 10 years, and that's our corporate governance, our auditors, our legal and the rest."

– Bruce MacLeod, Canadian Listed Company Association and BC and Yukon Chamber of Mines (oral submission to the Task Force)

3.6 The Task Force is of the view that market forces work best when unencumbered, so regulatory intervention should be limited to the least degree necessary to solve a market problem. There is little that securities regulators can do in a proactive sense to foster competitiveness in the capital markets, but if regulators are not careful, there is much that can be done to hinder it – *it is our view that regulators successfully enhance competitiveness by staying out of the way as much as possible*.

[3] *Ibid*.

[4] We acknowledge the role that presentations and written submissions (see Volume VII) by the British Columbia Securities Commission played in shaping our thoughts in this area.

3.7 There will undoubtedly be instances where anticipatory regulation is warranted. Regulators should not be obliged always to be in a reactive mode. However, as with reactive regulatory intervention, anticipatory regulation must be revisited regularly to determine whether market forces continue to be unable to address the market failure in the absence of regulatory intervention.

Recommendation: *The Task Force recommends that rules that are enacted in anticipation of a market failure should be revisited on a regular basis to determine whether market forces continue to be unable to address the issue in the absence of regulatory intervention.*

3.8 In most cases, regulatory intervention should be undertaken after careful study of the present or anticipated market failure that is to be addressed. Such study should include the following components.

A Review of What is Already "On the Books"

3.9 It almost goes without saying that prior to enacting new rules, a thorough and systematic review of existing rules should be undertaken to ensure that a market failure cannot be addressed by more vigorous enforcement of a rule that is already in the regulator's "toolkit". This, in turn, requires that the regulator clearly define the failure that is to be addressed and the outcome which the rule is intended to produce, including identifying measurements to be used to determine whether it has been addressed effectively.

Recommendation: *The Task Force recommends that prior to enacting new rules to address a market failure, a thorough and systematic review of existing rules should be undertaken to determine whether, if enforced, existing rules are adequate. This requires that the regulator clearly define the failure that is to be addressed and the outcome which the rule is intended to produce, including identifying measurements to be used to determine whether the failure has been addressed effectively.*

Cost-Benefit Analysis

3.10 The Task Force is of the view that no new significant securities rule should be imposed upon participants in the Canadian capital markets without there first being an empirical cost-benefit analysis conducted in connection with that rule. A cost-benefit analysis imposes a form of discipline on the regulator – it forces the regulator to identify clearly each of the components of the competing demands of efficiency, competitiveness of the markets and investor protection.

Recommendation: *The Task Force recommends that all securities regulators in Canada undertake empirical cost-benefit analyses prior to the introduction of a significant new rule.*

3.11 We endorse initiatives undertaken by the Ontario Securities Commission to ensure that regulatory interventions are not undertaken without regard to the costs to capital markets participants. For example, in its 2002 announcement of the establishment of the Regulatory Burden Task Force, the Ontario Securities Commission stated:

Canada Steps Up
Canada Steps Up
Canada Steps Up

> Reducing the regulatory burden also includes finding ways to reduce excess costs to our stakeholders, and this begins with our internal processes. Now, before initiating any regulatory activity, the OSC conducts a comprehensive cost benefit analysis…in order to evaluate the merits of projects, justify the allocation of resources and, ultimately, produce the most effective regulation.[5]

3.12 The statutory underpinnings for cost-benefit analyses by the Ontario Securities Commission are contained in section 143.2 of the *Securities Act* (Ontario), which requires, in connection with every proposed rule by the Ontario Securities Commission, the publication of a "description of the anticipated costs and benefits of the proposed rule." The description need not be the result of analysis undertaken by the Ontario Securities Commission itself, nor is the Ontario Securities Commission precluded from adopting a rule for which the costs exceed the benefits.

3.13 A recent and extensive cost-benefit analysis undertaken in connection with a proposed rule was the cost-benefit analysis undertaken in respect of National Instrument 81-107 – *Independent Review Committee for Mutual Funds.*[6] In addition, the British Columbia Securities Commission undertook a detailed cost-benefit analysis in advance of proposing new securities legislation for British Columbia.[7]

3.14 We encourage the other members of the Canadian Securities Administrators to adopt similar requirements for cost-benefit analyses in connection with new rules. We note that the Task Force has not undertaken cost-benefit analyses in connection with the recommendations presented in this Report and in recognition of that fact, we have specifically cautioned as to the need for such an analysis.

3.15 While the current situation in Ontario and the efforts by the British Columbia Securities Commission are commendable, we do recommend that mandatory provision of cost-benefit analyses be augmented with the following requirements:

- To the extent possible, a uniform set of published guidelines should be established outlining the methodology to be used in cost-benefit analyses.
- All cost-benefit analyses should include a clear description of the uncertainties (i.e., the predictions, assumptions, forecasts, etc.) that are associated with the analysis.
- Third-parties affected by a proposed rule should be encouraged to undertake their own cost-benefit analysis for consideration by securities regulators.
- Where a rule is adopted despite evidence that the expected benefits of a new rule are less than the expected costs, the securities regulators should be required to explain why they have adopted the rule. Moreover, there should be a mandatory re-evaluation of any such rule after a set period of time to ensure that the objectives of the rule are still being met.

[5]Ontario Securities Commission, *Annual Report 2002* available on-line at www.osc.gov.on.ca/About/AnnualRpt/2002/en/index.html

[6]The cost-benefit analysis was included as part of the request for comments in respect of the proposed text of the National Instrument and is available on-line at www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part8/rule_20040109_81-107_req-com-mutual.jsp

[7]Please see Chapter 2 for a brief discussion of British Columbia's proposed securities legislation.

Recommendation: *The Task Force recommends that a uniform set of published guidelines be established outlining the methodology to be used in cost-benefit analyses.*

Recommendation: *The Task Force recommends that each cost-benefit analysis include a clear description of the uncertainties (i.e., the predictions, assumptions, forecasts, etc. that have been applied) that are associated with the analysis.*

Recommendation: *The Task Force recommends that third-parties affected by a proposed rule be encouraged to undertake their own cost-benefit analysis for consideration by securities regulators.*

Recommendation: *The Task Force recommends that where regulations are adopted despite evidence that their expected benefits are less than the expected costs, securities regulators be required to explain why they have adopted the rule. Moreover, there should be a mandatory re-evaluation of any such rule after a set period of time to ensure that the objectives of the rule are still being met.*

3.16 We also believe that it would be a healthy addition to the Canadian regulatory model for ex post cost-benefit analyses to be conducted by a body other than the body which imposed the regulation in the first place. Periodic reviews would be mandatory and could, for example, be conducted in conjunction with the work of Five Year Review Committees or similar initiatives.

3.17 We recommend that an independent body be established for the specific purpose of conducting, at defined intervals, a systematic cost-benefit analysis of every significant regulatory intervention into capital market activity. The independent body would be staffed by capital markets experts from all stakeholder groups. In any case, where the cost-benefit analysis did not indicate that the regulatory intervention was justified, the securities commission would be entitled to preserve the regulation, but only by providing an explanation to the public for its disagreement with the independent body.

Recommendation: *The Task Force recommends that an independent body, staffed by capital markets experts from all stakeholder groups, be established for the specific purpose of conducting, at defined intervals, a systematic cost-benefit analysis of every significant regulatory intervention into capital market activity.*

Canada Steps Up
Canada Steps Up
Canada Steps Up

Rules vs. Principles?

"A shift towards a more principles-based approach will take time to implement, as much care will be needed to ensure that we retain rules that clearly add value in maintaining efficient orderly and fair markets or helping consumers secure a fair deal. Ultimately, though, this approach will produce better outcomes for both consumers and the financial services industry."

– John Tiner, Chief Executive of the FSA (UK) (December 2, 2005 – www.fsa.gov.uk/pages/library/communication)

3.18 Over the course of our deliberations, we have become acutely aware of the debate surrounding the question whether securities regulation should take the form of a prescriptive set of defined rules or a set of guiding principles. At the risk of creating an over-simplified dichotomy, securities regulation in the United States is regarded as the epitome of the former, while securities regulation in the United Kingdom is often pointed to as the best example of the latter. Canadian securities regulation – as with many components of Canada's legal frameworks – reflects elements of both. We are of the view that such a blending of rules and principles has been shown to be appropriate (although, as noted in Chapter 7 in our discussion regarding the enforcement of securities laws, we believe the principle of "contrary to the public interest" risks being a blunt and unfair enforcement weapon).

3.19 We emerge from our discussions regarding the "rules versus principles" debate with the view that this distinction is unnecessarily arbitrary. Rules must be based on underlying principles. And principles must find their expression, in the interest of a basic modicum of clarity, in rules.

3.20 Nonetheless, it is our view that when either system tilts too far toward its label, the system becomes unbalanced and suffers. We have all witnessed the reaction of issuers to avoid, where possible, the costs associated with compliance with the *Sarbanes-Oxley Act* in the United States. We have observed that stock exchanges in the United States have a high level of concern regarding the impact of this extensive regulatory framework on the attractiveness of U.S. capital markets. At the same time other markets where capital is in adequate supply are distinguished by "toned down" regulation, by outsourcing to gatekeepers who have reputational capital at risk if they perform their task inadequately.

"What was the impetus to move to a principles-based and outcomes-focused model at the FSA? There was strong support from HM Treasury and the Prime Minister in the UK for a reduction of regulatory burden and greater senior management responsibility and accountability as a means of maintaining the UK's competitive position generally. There is a strong view held across party lines that lighter regulation, firm but fair, with education, will be most effective both to protect UK consumers and to maintain London's position as world leading financial centre."

– Robin Ford, Commissioner of the British Columbia Securities Commission (oral submission to the Task Force)

3.21 How will Canada distinguish itself in this "beauty contest" for capital? Certainly not by inadequate or lax regulation – that is never the answer to attract capital. However, Canada can distinguish itself by focusing its regulation, at every available opportunity on clearly enunciated regulatory principles which do not need a detailed set of interventionist rules for sound implementation.

Recommendation: *The Task Force recommends that Canadian securities regulation be based on clearly enunciated regulatory principles which do not need a detailed set of interventionist rules for sound implementation.*

Recognizing the Unique Features of Canada's Capital Markets

3.22 In order to form a basis for our consideration of means by which to enhance the competitiveness of Canada's capital markets, the Task Force commissioned research to identify the unique features of Canada's capital markets.[8] The features of Canada's capital markets can be delineated based on the size of the capital markets and the size (by market capitalization) and industry sector of those companies publicly traded within those markets.

3.23 Professor Christopher Nicholls characterized the size of the Canadian capital markets as follows:

> Canadian capital markets (specifically, Canada's equity markets) represent a very small fraction of world equity markets (although, given the size of Canada's economy, Canada's share of world equity markets is not disproportionately small.) According to figures published by the World Federation of Exchanges, in 2004 the total market capitalization of Canada's stock exchanges was about U.S. $1.178 trillion. Total market capitalization for all WFE exchanges was about U.S. $37.168 trillion. Thus, Canada's markets constituted about 3.17% of total market capitalization worldwide. To put this number in perspective, the NYSE's market capitalization as of 2004 was U.S. $12.708 trillion (34.19%), the American Stock Exchange's market capitalization was U.S. $83.302 billion (0.22%), NASDAQ's market capitalization was U.S. $3.533 trillion (9.51%), the London Stock Exchange's market capitalization was U.S. $2.865 trillion (7.71%), and the Deutsche Borse's market capitalization was U.S. $1.195 trillion (3.22%).[9]

3.24 Professor Nicholls has reported that although the market capitalization of Canadian public companies is small on a global scale, the actual number of publicly-listed Canadian companies is relatively large:

> The number of publicly-traded corporations in Canada is approximately 3,500-4,000. (The total number of exchange-listed issuers for which data is available as of December 31, 2005, is 3,516.) The total number of Canadian corporations (both public and private) is approximately 2 million, of which the overwhelming majority are, not surprisingly, private (that is, not publicly-traded) corporations.[10]

3.25 Moreover, Professor Nicholls notes that the number of Canadian companies listed on the three recognized stock exchanges in Canada (the Toronto Stock Exchange (TSX), the TSX Venture Exchange and the Canadian Trading and Quotation System, Inc.) is 130.13 per million people. This figure is more than double the figure cited for Australia and, surprisingly, four times that cited for the United States (28.88 per million people) and the United Kingdom (31.11).[11]

3.26 There is, however, a distinct bifurcation among this large number of Canadian public companies; there are a modest number of companies with very high market capitalizations and a much higher number with very low market capitalizations. It is well understood that those with the highest market capitalizations are found on the TSX, while those with smaller market capitalizations are found on the TSX Venture Exchange and the

[8] C. Nicholls, "The Characteristics of Canada's Capital Markets and the Illustrative Case of Canada's Legislative and Regulatory Response to *Sarbanes-Oxley*" in Volume IV.

[9] *Ibid*. at 149.

[10] *Ibid*.

[11] *Ibid*. at 153.

Canada Steps Up
Canada Steps Up
Canada Steps Up

Canadian Trading and Quotation System, Inc. That being said, the marked bifurcation between high and low market capitalization repeats itself within the ranks of the companies listed on the TSX: the 100 largest companies (by market capitalization) listed on the TSX account for over 70 percent of the market capitalization of all TSX listed companies and fewer than 20 percent of the largest TSX listed companies account for almost 85 percent of the total market capitalization of the TSX. By contrast, the 1,000 smallest companies (by market capitalization) listed on the TSX account for less than five percent of the total market capitalization of all TSX listed companies.[12]

3.27 Putting these figures into perspective, all but the largest 245 companies listed on the TSX, and all companies listed on the TSX Venture Exchange, would be considered to be "small cap" (or smaller) companies in the United States (i.e., having market capitalizations in the US$128.2 to US$787.1 million range).[13]

3.28 Other key features of Canada's capital markets include the following:

- The distribution of companies with high and low market capitalizations is not uniform across all of Canada's provinces. We note anecdotal evidence which suggests that there is a disproportionate number of companies with high market capitalizations with their headquarters in Ontario and, conversely, a disproportionate number of companies with low market capitalizations with their headquarters in British Columbia and, to a lesser extent, Alberta.[14]
- A significant number of Canadian public companies with high market capitalizations are listed on major stock exchanges in the United States.[15]
- A significant percentage of Canada's public companies operate in a handful of key sectors: mining, oil and gas, and financial services. These three sectors collectively account for just over 65 percent of the market capitalization of the TSX.[16]
- The rising relative importance of trusts (income trusts, royalty trusts, real estate investment trusts) compared to corporations as the form of organization for listed issuers on Canada's stock exchanges.[17]

Unique Capital Markets Require Unique Regulation

3.29 The unique features of Canada's capital markets vis-à-vis the capital markets in the United States or the United Kingdom dictate that the regulation of Canada's capital markets should be different. As Professor Nicholls has pointed out:

[12] *Ibid*. at 154.
[13] *Ibid*. at 159 using the capitalization cut-offs established in the *Final Report of the Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission* available on-line at www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf
[14] See the written submission to the Task Force of Stephen Sibold in Volume VII; Ibid. at 5.
[15] Nicholls, *supra* note 8 at 134.
[16] *Ibid*. at 5 and 165.
[17] *Ibid*. at 163.

> The Canadian capital markets pose twin regulatory challenges for regulators: first, there is a need to ease certain formal requirements for the largest public companies—for which adequate investor protection already exists (as in the U.S. [Well-Known Seasoned Issuer] proposals); yet, regulators must also recognize that the relative cost of complying with regulatory burdens is much higher for the smallest companies, and may impede their competitiveness. In short, there is less need in principle to stringently regulate the largest companies, and less room, in practice, to stringently regulate the smallest companies.[18]

3.30 Some have suggested[19] that the appropriate response to such challenges should be "tiered" regulation. Tiered regulation entails the application of different rules to different companies based on pre-defined characteristics. The current approach by Canadian securities regulators is tiered regulation based on the location of their listing - for example, less stringent continuous disclosure obligations are applied to issuers listed on the TSX Venture Exchange (so-called "venture issuers") than to issuers listed on the TSX.[20]

3.31 We endorse the principle behind applying different levels of regulation to different issuers. However, as has been noted above, differentiating issuers based on the location of their listing may be overly cumbersome – there are many issuers with low market capitalizations on the TSX which should benefit from less stringent regulation. It is our recommendation that regulation should be "scaled" – scaled regulation does not necessarily mean less regulation in our view, but more *appropriate* regulation – based on the size of the issuer's market capitalization and other considerations, such as the complexity of the issuer's business.

3.32 Without necessarily prescribing how such a system of regulation would look, we would imagine that at one end of the scale will be issuers with the lowest market capitalizations that should be required to comply with regulations that are appropriate and consistent with their size, the complexity of their business and their resources. Of course, investors should be duly warned of the risks associated with issuers at this end of the scale. At the other end of the scale will be issuers with the highest market capitalizations – "C-WKSIs" as we call them in Chapter 5 – that should be afforded less formal regulatory oversight by virtue of their size and resulting analyst and media following. The middle of the scale, where the vast majority of issuers will reside, will be subject to the full set of regulation.

"I think we have a very unique Canadian capital market and let's keep it Canadian. We can find a 'made in Canada solution', we don't have to go to a Sarbanes-Oxley type of solution. But the one thing that we really want to stress is in all our issuer surveys, the number one priority and especially for small companies, is efficient access to capital. The cost of capital is higher than it's ever been."

– Bruce MacLeod, Canadian Listed Company Association and BC and Yukon Chamber of Mines (oral submission to the Task Force)

[18] *Ibid*. at 141.

[19] See the submissions of the Prospectors and Developers Association of Canada and The Canadian Listed Company Association/ the BC & Yukon Chamber of Mines in Volume VII.

[20] See National Instrument 51-20 – *Continuous Disclosure*.

3.33 We recognize the difficulty in determining the different market capitalizations and other considerations that will make up the scale and admit that there may be a degree of arbitrariness in such a determination. Nonetheless, we regard the appropriate level of regulation for an issuer should be based on something more than the venue of the issuer's listing.

Recommendation: *The Task Force recommends that regulation be scaled according to the size of an issuer's market capitalization and other issuer specific considerations in order to ensure that regulation is appropriately balancing the cost to the issuer against the benefit to investors.*