Addressing the Burden of Regulation in Canada -
The Case for Proportionate Regulation

Submission to

The IDA Taskforce to Modernize Securities Legislation in Canada

By

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1. INTRODUCTION

In response to your open invitation to capital market stakeholders to submit comments, I wish to address directly, the issue of regulatory burden and indirectly, the issue of finding a balance in corporate governance. In this submission, I will outline for you my thought that the most practical way to address the issue of regulatory burden is to adopt proportionate regulation as an overarching regulatory principle.

Please note that, in this submission, I have expressed my personal views and do not purport to reflect the current views of the Alberta Securities Commission.

2. BACKGROUND

Over the past few years, securities regulators and capital market stakeholders in Canada have been embroiled in a series of debates over reform of securities regulation. These debates have dealt with either *regulatory structure* or *regulatory philosophy*.

(a) Regulatory Structure Debate

The most publicized debate topic has been regulatory structure, i.e., the formation of a single, national securities regulator vs. continued separate provincial regulation. Recently, all provinces and territories, other than Ontario, have agreed to establish a passport system. (Under the proposed passport system, a market participant will only need to deal with one securities regulator, typically the one in its home jurisdiction where it is located.) Earlier this year, the Ontario Government appointed a panel to draft a plan for a single regulator and announced that the creation of a single regulator is its top securities regulatory priority. And, in its last Budget, the Federal Government proposed the creation of a national securities commission on an "opt-in" basis. Obviously, the debate over regulatory structure is not yet over.

(b) Philosophical Debate

However, what has also been percolating over the same period of time – but overshadowed by the regulatory structure debate – is the debate over the regulatory philosophy that should be brought to bear on our regulation of the Canadian capital markets.

(i) Global Convergence/OSC View

We have had two different regulatory philosophies espoused in Canada. At one end of the spectrum is the "global convergence" view - or perhaps it might more aptly be described as the "U.S. convergence" view. Advocates of this position - of which Ontario is usually the most vocal - believe Canada needs a regulatory system that is highly harmonized with the

American system. They look to the U.S. - and to some extent, the emerging ideas being generated by IOSCO (the International Organization for Securities Commissions) - for their regulatory inspiration. Of course, the most recent examples of this inspiration are the investor confidence initiatives adopted in Canada: the rules respecting auditor oversight (MI 52-108), audit committees (MI 52-110), certification (MI 52-109) and, most recently, the proposed rule regarding internal control reporting or auditor attestation (proposed MI 52-111), all of which effectively mirror various provisions of the *Sarbanes-Oxley Act of 2002* (SOX).

Those supporting global convergence cite Canada's relatively small proportion of the global market as a rationale for harmonizing with the U.S. They fear that because of our small share of the international capital market - under 2% - any differences between the Canadian and U.S. regulatory system may be a deterrent to foreign - particularly U.S. - underwriters and investors. Advocates of U.S. convergence also cite MJDS as a rationale - concerned that failure to conform to the U.S. model may negatively impact continued US acceptance of MJDS.

(ii) Principles-Based / BCSC View

At the other end of the spectrum, are those advocating that Canada adopt a quite different regulatory perspective. The British Columbia Securities Commission (BCSC) is one of the strongest proponents of this position, which is embodied in the new BC *Securities Act* (Bill 38), which was passed last year but has not yet come into force. This approach moves away from regulation based on detailed, prescriptive rules and toward a flexible, results-based system. It is modeled on a principles-based approach containing more general principles and fewer prescriptive rules that basically leaves market participants to determine the details of the application of these general principles. It is very unlike the highly prescriptive U.S. style of regulation.

(iii) Alberta View

During my term as Chair of the Alberta Securities Commission (ASC), we sat right in the middle of these two competing philosophies. We didn't particularly have a problem with rules where necessary. We also felt that market participants wanted more than broad principles. However, rules should flow from some very specific general principles. Basically, we wanted regulation that was appropriate for the Canadian capital markets.

(c) Reason for Different Philosophies

In my opinion, the explanation for these differing regulatory philosophies – all of which are legitimate – rests with the perspectives of their advocates. I think that this becomes clear if we look at the differences in the capital markets which exist in Ontario, British Columbia and Alberta.

(i) Alberta Capital Market Study

At the ASC we did a study of the Alberta capital market, comparing it to the other provincial capital markets. We published our results in March of last year. Here are some of the findings from the Alberta Capital Market Study:

- The distribution of publicly listed issuers differs significantly from province to province. For instance, there are more publicly listed issuers headquartered in British Columbia than in any other province:
    - 1,265 (or 35%) compared to about,
    - 1,020 (28%) in Ontario, and
    - 720 (20%) in Alberta.
- However, if we rank the provinces according to aggregate market capitalization of the public issuers headquartered in the jurisdiction, we find that:
    - Ontario leads with $531 billion (45%),
    - Alberta has $210 billion (18%), and
    - BC follows with just $64 billion (5%).

In summary, the Ontario capital market is dominated by some of the largest issuers in Canada; in contrast, the BC capital market is dominated by a large number of very small issuers; and the Alberta capital market has a mixture of both.

Given this perspective, when the OSC is talking to its industry participants a number of those industry participants are some of the largest issuers in the country as well as some of the largest investors, like pension funds and mutual funds. Undoubtedly, this is the group that gets the ear and the attention of the OSC and this is the group that sees the prescriptive US approach as being the most appropriate for their own companies or for the issuers in which they invest. (It is interesting to note, however, that Ontario's capital market consists of a large number of small cap issuers as well. In fact, *43%* of Ontario-based public issuers are listed on the TSX Venture Exchange, trailing the number of Alberta-based Venture issuers by only 35 companies.)

The BCSC, on the other hand, hears from its numerous smaller issuers who feel over-burdened with rules and regulations. In its press release announcing its new principles-based approach, the BCSC quoted Bruce McLeod, the President of the Canadian Listed Company Association and the head of a number of public mining companies, as saying: "We used to spend most of our time growing our business. But, these days for small companies who don't have the benefit of expensive in-house experts and advisers, regulation can take up almost <u>70%</u> of management's time. This takes us away from what is really important for a company's growth". [Emphasis added.]

Again, the Alberta Securities Commission fell somewhere in the middle - we heard comments that supported both views from all sectors of our capital market.

(d) Which Approach is Right?

(i) OSC Approach

I suggest that the OSC approach is partly right in that it might be appropriate for the largest issuers in the country. However, it is important to understand that the Canadian capital market is not the same as the US capital market.

There are a number of significant differences between the Canadian and US capital markets. First, the majority of the companies participating in the Canadian capital markets are small cap, micro-cap or "nano-cap" issuers and, second, the majority of our large companies – relative to their US counterparts – are not that big. According to McKinsey & Company, US public companies tend to be more than 11 times larger than Canadian public companies when compared by market cap.

However, the allure of US financing means that, at some point in the growth cycle of any mature or maturing Canadian public company, they will be looking South and at least considering the prospect of accessing that capital market. In fact, last year Canadian corporations raised over $80 billion in the U.S. public capital markets. If we are to foster the growth of maturing Canadian companies – so that they can compete effectively on an international level – we must ensure our regulatory efforts are always cognizant of the interplay between the US securities regulatory system and our own.

However, this does not mean we must unquestioningly follow the lead of the Americans. We must also be cognizant of the fact that – no matter how integrated our two economies may be – our capital markets are distinct. Sometimes we seem reluctant to accept that but I believe we ignore these differences to the detriment of our capital markets.

(ii) BC Approach

In my opinion, the BC approach has equal merit because the BC capital market is dominated by a large number of very small companies that are all facing what they see as over-regulation.

(e) What is the Solution?

The challenge we face is how to avoid these dueling regulatory philosophies that make it difficult for us to have a uniform approach to regulation in Canada. One comment that I heard through intensive consultation on the Uniform Securities Legislation Project of CSA and as Chair of the ASC was the overwhelming demand that industry has for a *uniform* position. Industry does not want to be met with a rule in Ontario versus a rule that differs slightly in Alberta versus one that differs slightly again in BC. I agree entirely with that demand – we are

doing an enormous disservice to our capital markets by having anything other than uniform rules across the country.

However, uniformity does not mean "one size fits all" for every participant in the capital market. In my mind the solution to these philosophical differences is what the ASC promoted over the past five years – *proportionate* or *tiered regulation*.

3. Proportionate Regulation

(a) Top Tier Regulation

Many of our larger issuers are active in American and other foreign capital markets. Some have US exchange listings and register with the SEC. Even if they don't, large Canadian issuers typically have, or at least try to attract, foreign money and a foreign investor following. Issuers in this class are competing for capital internationally. Their investors – Canadian or foreign – can be expected to measure these companies against foreign peers. For these types of Canadian issuers, the case for global – specifically *SEC-comparable* – regulation is strong. Their investors, in comparing them to foreign peers, are likely to expect – and I'd say they are entitled to expect – comparable information to be available and comparable standards to apply. Increasingly, for the largest companies in the world, *global standards* are beginning to emerge.

The costs and other burdens of global standards are likely justified and offset by resulting investor confidence and enhanced access to investment capital for these largest issuers. Top-tier regulation of this sector makes sense.

Now let's look at the other end of the scale.

(b) Regulation of Less than Top Tier Issuers

Our smaller issuers tend not to have a foreign public investor following and not to seek capital abroad. A large proportion of the public companies in Canada are, by comparison to the US and other G7 economies, very small indeed – much smaller than issuers that would list on a US exchange or register securities with the SEC.

We have, in fact, something quite unique in Canada: a large and vibrant segment of the public capital market, focused on new or small, junior issuers. More than in any other developed country that I can think of, our capital market offers these junior issuers access to public capital, and offers the investing public the opportunity, as well as the risks, of investment in the junior sector.

In her last public address as CEO of TSX Group, Barb Stymiest spent some time extolling the value of the vibrant junior capital market we have here in Canada. These are her key points:

- TSX Venture is the best performing junior exchange in the world,

- together, TSX and TSX Venture have the *second* largest number of issuers among all the members of the World Federation of Exchanges (which is the primary industry association for equity exchanges) but they rank only *seventh* by aggregate market cap,

- US issuers and exchanges merge with, acquire or lure our largest Canadian companies to list in the US, effectively treating our issuers as what Barb Stymiest referred to as a "farm team",

- to continue Barb's baseball analogy, these "big league" issuers that have made it to "the Show" are quickly replaced through:

  - mergers and acquisitions between smaller companies, and

  - organic growth of smaller issuers

  both of which processes result in issuers moving from the "rookie league" of TSX Venture to the TSX where they are "one step from the majors".

Obviously, Canada has a real asset in our junior capital market and we need to protect and promote that asset. To do so, we need to recognize that some sectors of our capital markets – issuers as well as investors – have needs that are neither global nor applicable even to the top tier of our domestic market. As our smallest public companies grow and extend their capital raising endeavours beyond their home province, they have to deal with a system developed for our larger issuers, which may not always be appropriate for these smaller issuers. Because these small businesses can play a very important part in our regional economies, we need to be alive to the impact of our regulation on them. However, being alive to the issues facing them does <u>not</u> in any way mean we abdicate responsibility for regulating them. It means that we stop to consider the regulatory impact and, where appropriate, consider practical means of addressing their problems in ways that will still provide appropriate investor protection. This is proportionate regulation.

Differentiating between larger and smaller companies – proportionate regulation – is not radical or even novel. In the US, the SEC has an entire division dedicated to addressing the issues of small business. Furthermore, the US federal government has created an Office of Small Business Advocacy to champion these issues and has legislatively mandated that new regulatory initiatives specifically consider the impact on small business. Last year, the SEC established an advisory committee to examine the impact of SOX on smaller public companies. Among its various areas of inquiry are corporate disclosure and reporting requirements, "*including differing regulatory requirements based on market capitalization, other measurements of size or market characteristics*". SEC Chairman Donaldson stated that the SEC expects the committee to *provide recommendations as to where and how the SEC should draw lines to scale regulatory treatment for companies based on size.* [Emphasis added.]

There are other examples of proportionate regulation globally as well:

- companies listed on the Australian S&P/ASX All Ordinaries Index (the top 500 listed companies) must comply with the prescribed audit committee best practices rather than just disclose whether or not they comply,

- *Euronext* – the pan-European exchange – has two premier 'markets' or indices that companies can voluntarily enter – *NextEconomy* and *Next Prime*. A company that voluntarily enters this system agrees to abide by the most stringent (i.e., American) disclosure standards.

In Canada, the CSA is moving forward to formally recognize the concept and embed it in its rule-making process. Earlier this year, the Policy Coordination Committee, a committee of CSA Chairs and Vice-Chairs responsible for CSA policy development, approved amendments to the CSA Project Management Guidelines. These amendments "hardwire" a proportionate regulation analysis into the development of each new regulatory initiative. In each case, the regulators must first ask themselves whether they can develop a regulatory response that is appropriate to the entirety of the Canadian capital market. However, if they cannot, they will consider differential regulation - different requirements for different sizes of issuers.

One example of where CSA has put proportionate regulation to use is in the continuous disclosure rule - Venture Issuers have a slightly longer period to file their annual financial statements – 120 days instead of 90. This modest accommodation recognizes a very real resource problem – small cap issuers lack both the in-house expertise and the relative influence with external auditors that large cap issuers have. Giving Venture Issuers a bit more time to prepare and file their financial statements is a practical response which does not compromise investor protection.

To date, like the above example, most of CSA's *ad hoc* proportionate regulation has differentiated between the TSX and the TSX Venture Exchange. This has been a useful point of demarcation – it is very transparent. However, it may not always be the most appropriate dividing line. In many instances, the smaller issuers on the TSX have concerns very similar to those listed on the TSX Venture Exchange. Many of these issuers are small too. In fact, the Securities and Exchange Commission defines a business as "small" if it has less than US $25 million in market capitalization - which translates roughly into C$30 million. According to statistics provided by the Canadian exchanges, approximately 71% of all publicly listed issuers in Canada would be small by that standard and 29% of those listed on the TSX - Canada's senior market - would fit into that category. Furthermore, if you check investment guidelines for many of the funds and institutional investors, you will find them defining issuers with less than $200 million and even sometimes those with less than $500 million or $1 billion in market capitalization as "small-cap". Using those figures, the great majority of Canadian public companies would be considered small.

So again, proportionate regulation should not stop at the Venture Exchange – there has to be recognition that even on our senior market there is a vast diversity of issuers based on size.

4. Auditor Attestation - A Case for Proportionate Regulation

A recent example in which CSA has recognized that differential regulation requires considering more than differentiating between the TSX and the TSX Venture Exchange is proposed Multilateral Instrument 52-111 *Reporting Requirements for Internal Control over Financial Reporting*.

That proposed rule, which is largely based on the auditor attestation or internal control rules made by the SEC under section 404 of SOX, exempts out Venture issuers. But perhaps the real innovation in terms of proportionate regulation in Canada is the proposal to stagger the implementation for issuers listed on the TSX based on market cap. It proposes a four-year staged implementation schedule such that the largest issuers - those with over $500 million in market cap - are subject to the rule in the first year; those with over $250 million in market cap are caught in the second year; those with over $75 million market cap are caught the third year; and the balance of the TSX-listed issuers are not subject to the rule until year four.

Regardless of the merits of this proposed rule, the staged implementation is an example of this broader concept of proportionate regulation that recognizes that the Venture Exchange is not the exclusive home to Canada's smaller issuers. The staggering was designed to help address concerns about limited professional resources and give smaller companies the ability to learn from the experience of the larger companies.

The question regulators need to ask themselves with respect to any regulatory initiative is how can we best meet our objectives using the right regulatory balance. We need to think of *how* a particular rule or regulation affects each sector of the capital market. What is the right balance for the top-tier, global sector? What is most appropriate for the juniors? And what about those in the middle? This type of questioning and balancing of interests should be included in every instance of rule making in order to ensure that we arrive at a regulatory system that is appropriate for Canada's diverse capital markets.

5. Conclusion

To my thinking, the wide spectrum that makes up our Canadian capital market demands a special degree of regulatory flexibility, and a tailoring of regulatory measures, costs and outcomes that fits the needs and constraints of different market sectors. And, depending on the situation, there may be one, two, three or more such sectors or tiers.

Tiered or proportionate regulation is not new, it's not revolutionary, it is just common sense. And I suggest that it is the answer to our regulatory philosophy debate in Canada.