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November 15, 2002

The Honourable John Manley, P.C., M.P.
Deputy Prime Minister and Minister of Finance
House of Commons
Room 209-S, Centre Block
Ottawa, Ontario
K1A 0A6

Dear Minister:

On October 3, 2002 you asked me to recommend a process to determine the best securities regulatory system for Canada's needs and to identify the key issues to be addressed in that process. You asked, in particular, that I focus my attention on a process through which we can ensure a modern and efficient securities regulatory system that inspires investor confidence and supports [competitiveness](#), innovation and [growth](#) - one which is responsive to the important requirements of regional capital markets and emerging public companies. This is my response to your October 3 request.

My Consultations

In preparing these recommendations, I have discussed the underlying issues with many interested people in all parts of Canada. I have spoken with investor advocates, institutional shareholders, [investment](#) dealers and other market intermediaries (large and small), representatives of Canadian businesses (again large and small), industry associations, representatives of exchanges and regulatory organizations, professionals who advise both businesses and intermediaries, and interested academics. I have also spoken with the existing regulators. They, of course, know the strengths and weaknesses of the present system well and they have shared their views freely and candidly.

Consensus Views

You will not be surprised to learn that I have heard a wide variety of views. While my mandate from you was a relatively narrow one - focused on establishing a *process* to move these issues forward, not upon the merits of the various ideas for improvements I have heard - many to whom I spoke did outline their concerns with the present system and the solution for Canada from their perspective. While those views certainly differed, there is a consensus on some important fundamental points:

- Achieving a sound, efficient securities regulatory system is a matter of national importance. Vibrant and fair capital markets and their key components (including the securities regulatory apparatus) are essential to the health of Canada's economy and to the success of Canadian-based businesses. They are also essential to the personal lives of individual Canadians as underpinnings to their [employment](#) and their ability to

accumulate financial assets (in particular those counted upon for retirement).

- In an increasingly [competitive](#) world, Canada's regulatory structures have to be world-class, not run-of-the-mill. They should be designed to achieve [competitive](#) advantage for Canada and Canadians. This is especially true in respect of securities regulation because of the ongoing challenge to define the role of Canadian capital markets in achieving Canadian goals in the face of the powerful tug of the economy and capital markets of the United States.
- It is important to take regional interests fully into account in achieving improvements to the system and, in particular, to build on the expertise that exists among regulators across Canada.
- If one were to design a Canadian securities regulatory system in a greenfield context to achieve the objectives just noted, the system would undoubtedly differ significantly from the present one.
- The current system, as presently operated, must be improved significantly, and in a prompt fashion.

This extensive common ground, shared by most I consulted, should offer a platform for the necessary change.

This common ground also explains the public chorus for improvement from a growing constituency of market participants. Appendix A contains recent public comments on the subject from a remarkably diverse group of interested parties. While the solutions for change they proffer certainly differ, there is a remarkable consensus that the status quo will be inadequate for the future.

This consensus also provides an excellent backdrop for a productive process such as you envisioned in your charge to me. Unlike previous discussions of this topic (most recently in 1996-1997) when many market participants stayed on the sidelines in the discussions, they have indicated that they will not do so on this occasion. This augurs well for success.

The General Context

Before turning to the process I propose, it is useful to put Canada's capital markets, and the pressures upon them and those who regulate them, in context.

As I have said, well-developed, efficient capital markets are essential to the vitality of Canada's economy - to financial stability as well as to our long-term [economic growth](#). Fundamentally, capital markets are about the attraction of investor capital and the deployment of that capital to its most productive ends.

The attraction of capital on a consistent basis depends, among other things, on high standards of corporate governance. The latter subject, to which Canadian markets and regulators have devoted considerable attention in recent years, is again on the public agenda. Canada's response is under discussion in other forums and I will not deal with it here save to say that the effective governance of public companies depends in part upon capable, sensible and responsive regulation. My purpose is to focus on the regulatory system by which Canada achieves that goal as a component of a national capital markets strategy.

Canada's capital markets are well developed:

- Canada has over 4,000 publicly listed companies and a family of globally recognized equity indices. The domestic market in government and [investment](#) grade corporate debt is well developed.
- Canada is among a handful of countries with both a domestic equity and derivatives exchange. The TSX is the world's seventh largest equity exchange by market capitalization and has plans to build upon the TSX Venture Exchange to provide a world-class platform for venture capital financing. The Montreal Exchange and the Winnipeg Commodity Exchange offer specialized products and also have ambitious plans for the future.
- The combined market capitalization of publicly listed stocks in Canada was \$1.3 trillion at the end of 2001, with the value of trading reaching over \$700 billion. The over-the-counter markets in fixed income securities and derivatives are also well developed, with domestic dealers accounting for the bulk of market making and trading. Bond trading activity reached \$4 trillion in 2001.

At the same time, our capital markets are small in global terms. For example, our equity markets account for about 2.5% of global market capitalization and an even smaller fraction of trading activity. By way of contrast, the United States accounts for about half of global equity market capitalization.

From the perspective of businesses, large and small, capital markets occupy an important and growing role in company financing. Capital markets currently account for about 31% of the short-term financing and 80% of the long-term financing needs of Canadian firms. Although large Canadian businesses are able to access global as well as domestic capital pools, small and medium-sized enterprises do not have that choice. For them, the continued depth and vitality of the Canadian markets will be essential to [growth](#).

Canadians from all walks of life rely upon these capital markets to invest their savings and finance their goals - for their homes, their children's education, for retirement. Well-developed capital markets ensure that Canadians have access to a range of investment options according to their varying investment goals, time horizons and risk tolerance. Efficient markets help ensure their returns are maximized. Fair markets inspire investor confidence and participation, thus enhancing liquidity and efficiency.

Almost half of all Canadians own company shares, either directly or through mutual funds - double the proportion at the start of the 1990s. The number is higher still if one includes the indirect holdings of Canadians through employer-sponsored and public sector pension funds.

Capital markets in Canada have served the country well. Three observations in respect of those markets should be made in context of the present discussion of securities regulation.

First, indigenous Canadian markets will continue to be critical to the success of Canada's economy and the economy of every region and province. Canada's securities regulatory system, which regulates both market participants and the machinery of capital markets, has considerable influence on how efficiently capital markets function. At its best, securities regulation fosters investor participation through appropriate rules and supervision. In so doing, and by minimizing unnecessary impediments to transactions and market participation, it encourages innovation, growth and efficiency of capital markets. That in turn fuels economic activity and [jobs](#) and serves the public interest. Canada's securities regulatory

system should be designed to achieve these objectives in a world-class manner. Cost and time efficiency standards should be high. Most observers doubt that Canada's present system achieves these goals.

Secondly, the securities regulatory system must be structured so that it achieves, and is seen to achieve, effective investor protection. Typically this is done by screening those who can participate in capital markets, by providing disclosure standards for retail investor protection, and by providing an enforcement regime when there are violations of the prescribed norms. Fostering investor confidence fuels the willingness of investors to participate in markets, hence enhancing their liquidity and efficiency. The current discussions on investor confidence arising from the Enron and WorldCom fiascos have led many to wonder whether the Canadian regulatory system is properly equipped to address such a crisis of confidence.

Finally, as Canadians take stock of our securities regulatory system, we need to be sure not to view the regulatory needs of the future through a rear-view mirror.

Much is changing - very rapidly so. And regulatory structures, practices and principles will also have to change if they are to remain relevant and useful to the country and people they are supposed to serve.

A few examples show that landscape of commercial and regulatory change:

- In 1999 Canada had five member-owned stock exchanges. Today equity trading is carried on only in the exchanges of the TSX Group Inc.
- Until recently, the securities industry was carefully insulated in a policy and regulatory sense from the banking and insurance industries. These barriers began to fall in Canada in the 1980s and were swept away in the United States in 1999. Yet in both countries the regulatory structures for the most part are remnants of the famous "4 pillars".

Given that legacy and Canada's historical division of regulatory labour between federal and provincial governments, there are over 40 financial regulators, including self-regulatory organizations, in Canada. In contrast in Australia there are now two financial sector regulators (as of 1998) and in the United Kingdom one (as of 2001).

The Australian experience is particularly relevant to Canada - in 1991, after years of bruising debates about securities regulation somewhat similar to past Canadian discussions, eight Australian State and Commonwealth regulators were (for investor protection and efficiency reasons) restructured into a single securities regulator. Regional concerns were addressed as these changes were made. In 1998, again for reason of improving consumer protection and efficiency in an era of product convergence, the Australian securities regulator took on additional market conduct responsibilities and was renamed the Australian Securities and [Investments](#) Commission.

- [IOSCO](#), the [International Organization of Securities Commissions](#), is an international forum established to provide a venue to discuss common issues in securities regulation. Four Canadian securities commissions participate in this organization. Given the worldwide movement towards regulatory consolidation in respect of market conduct, it is interesting to note that more than half of the industrialized countries represented at [IOSCO](#) now have regulators with mandates extending beyond securities to other market conduct issues.

- Technology is continuing to change the face of capital markets for investors, intermediaries, issuers, exchanges and regulators alike. Computerized trading systems and new electronic platforms have created more choice and faster response time for market participants. New complex financial products have been created. Foreign and non-traditional competition is growing in capital markets. Regulators face many more demanding challenges.
- In the United States the Securities and Exchange Commission (SEC) is increasingly active in asserting its jurisdiction in respect of Canadian and other non-American participants in the United States capital markets.

I make these points not to suggest any outcome in the present Canadian debate, but merely to note the rapid changes in the capital marketplace, both domestically and internationally, and the trend around the world to focus on the best way to regulate in a modern context - and to make the necessary changes when required in the national interest.

My conclusion from all of this is that we, as Canadians, should be prepared to examine our regulatory structures, as well as our regulatory practices, in a zero-based process. We need to ask - what is best for Canada and for Canadians, from coast to coast. We need to do so in a fresh fashion, setting aside old bromides. We need to make progress. If we do not, we will be left behind, to the disadvantage of our businesses and those they [employ](#).

The Specific Context

You have requested me to identify a means to achieve that progress. To frame an appropriate process it is useful to first review briefly (a) the architecture of the present system, (b) the benefits of the present system and initiatives presently underway within it to effect improvement, and (c) concerns frequently expressed by those pressing for more substantial change.

As you know Canadian securities regulation is conducted on a geographic basis, with a separate regulator for securities laws in force in each of Canada's 13 provinces and territories. Five regulators are self-funded autonomous agencies; the remainder are structured within, or report to, government line departments. The 13 regulators come together to discuss common issues and to attempt to design consistent (and, if possible, harmonized and streamlined) solutions in an informal organization, the Canadian Securities Administrators (CSA). As noted earlier four commissions (Ontario, Quebec, British Columbia and Alberta) are IOSCO participants.

The benefits asserted for the present system include (a) the ability of provincially based regulators to respond effectively to local issues, particularly in respect of the financing needs of smaller businesses and in respect of enforcement, (b) the development of centres of regulatory expertise tailored to sectoral interests (for example, natural resource companies), (c) efficiency benefits for issuers and registrants in being able to deal on substantive issues on an "across-the-desk" basis, and (d) a framework within which regulatory innovation can take place in one jurisdiction and, if successful, be adopted elsewhere.

The regulators in the CSA have been conscious of the need for them to work together in the interests of investor protection and market efficiency. To that end they have implemented a number of harmonization and streamlining initiatives. Most market participants agree that these efforts have had some successes, particularly in the mutual reliance system of [prospectus](#) review and in a number of jointly

promulgated national policy [instruments](#).

The CSA is also working on a number of other harmonization and streamlining projects, two of which deserve particular mention: (1) the continuing effort to develop common rules and procedures to permit a mutual reliance system of intermediary registration, and (2) the drafting of uniform securities legislation and rules for consideration by provincial and territorial governments. These are important initiatives which should be encouraged. The question remains as to whether these steps and other CSA harmonizing and streamlining initiatives alone will be adequate to assure Canada of a sustainable, effective and efficient securities regulatory system in the decades ahead.

Those I have consulted point to a range of problems with the present system. They can be broadly grouped as follows:

1. There are important efficiency issues. Many issuers and registrants point to the excess cost and the time delays that flow from complying with often different laws, regulations, rules or policies (or different interpretations of the same laws, regulations, rules or policies) across Canada. They argue that these cost burden and time delays (a) create a barrier to entry for new investment dealers, brokers and other intermediaries, (b) prevent companies wishing to access public markets, particularly emerging growth companies, from doing so - and, for listed companies, impose unrealistic compliance burdens on an ongoing basis, and (c) prevent issuers and dealers from offering investment products to institutional and retail investors everywhere in Canada unless they navigate the rule complexity caused by the present system.

Issuers and registrants complain both of direct costs incurred in dealing with multiple regulators and indirect costs, including substantial incremental internal compliance costs. These cost and time delay concerns appear to have the greatest negative impact upon small and medium-sized businesses, who are least able to bear the consequences.

2. Others express concern with the cumbersome and sometimes slow pace (given the need to achieve CSA consensus) of developing national policy responses to important emerging regulatory issues. They question the ability of the present system to grapple promptly and effectively with market crises requiring regulatory intervention.
3. Still others point to the growing need, in fast-moving international capital markets, to ensure that Canada speaks with a strong unified voice internationally and, in particular, in bilateral dealings with the SEC in the United States. They argue that the lack of a single voice to represent Canada presents risk to Canadian market participants. They also express concern that the international image of Canada's capital markets suffers from the multiplicity of regulatory regimes, with a resulting loss of international investor confidence and participation in Canadian markets.
4. Some argue that the present structure makes it difficult to effectively involve securities regulators in Canadian financial sector policy development and in developing national responses to market crises, with the probability of less-than-optimal outcomes.
5. Finally there is a widely held view that there has been ineffective enforcement of securities laws in Canada and that strong enforcement standards and practices, available on a consistent basis everywhere in the

country, will be difficult to achieve without [structural changes](#).

It was not my task to recommend specific changes to the securities regulatory system, and I have not done so. I have, however, concluded that the current system, as presently operated, is inadequate to meet the challenges of today and tomorrow. While not broken, it must be improved significantly, and in a prompt manner.

A careful, independent review of the system, free from preconceptions, is therefore both warranted and of importance. Canada must not lag behind other countries in its regulatory practices. To the contrary, the securities regulatory system must be made a source of competitive strength, not weakness. Objective assessments and recommendations are required so that policy makers may make sound judgments.

Recommendations

It is clear from my consultations that the nature of the process is important if we have any hope of making real progress. The interested parties were extremely frustrated by the inability in past discussions of these issues to come to any clear plan of action. Many people put the blame on the framework within which the discussions were held.

The people leading any new process must be, and be seen to be, impartial and open-minded, and their terms of reference unbiased in favour of any outcome. In short, the process will have to be such as to command respect.

My recommendations follow:

1. I recommend that you work with your provincial and territorial colleagues to establish a Wise Persons' Committee to conduct the necessary review and to make recommendations to policy makers (including both the federal government and the provincial and territorial governments) in a timely manner. The project is of importance; it should be initiated without delay. It will require clear focus and efficient execution.

Some observers have suggested that the best way to proceed would be for the federal government unilaterally to exercise its jurisdiction to the fullest extent to resolve the concerns with the present system mentioned earlier. I do not agree. The problems which exist can best be solved by a collaborative process. There should be active participation from the provinces, who have much to offer and gain.

I would hope that the project would proceed with the support of all governments. If, however, some choose not to participate, the others should go forward. If for some reason provincial governments do not wish to help choose the Committee I recommend that the federal government do so after consultations with representatives of market participants.

2. The Committee should consist of respected Canadians, a maximum of six in number, with an interest in Canada's economy and whose commitment to the best interests of Canada and its citizens is beyond question. While the group should be broadly representative in geographic terms, I do not recommend the representation of sectoral interests; the views of such interests can be obtained in other ways as an input to the Committee. Similarly I do not recommend that expertise in securities regulation be a major factor in choosing the members of the Committee; they should be persons with demonstrated sound judgment with the skill of drawing on expert advice as

needed, assessing various points of view and identifying policy solutions to problems involving the balance of complex interests.

3. The mandate of the Committee should be to identify the appropriate model for securities regulation in Canada, including the underlying philosophy of regulation that should be adopted. The goal of the review should be a system that:

- (a) provides sound protection for investors in Canada's capital markets and provides those investors with confidence that our markets are regulated with the highest standards and that these standards are rigorously enforced;

- (b) provides Canada with efficient capital markets for Canadian businesses, large and small, and that do not place an undue burden on firms seeking to raise capital or on registrants seeking market participation;

- (c) adopts an approach to regulation, monitoring and enforcement that ensures that market participants, including investors, everywhere in Canada have equal protection;

- (d) encourages dynamic and innovative capital markets across the country and encourages local innovations to respond to particular local needs and opportunities; and

- (e) presents international investors, governments and regulators with a positive image and perspective on securities regulation in Canada and with a sense that Canada is able to speak with one voice in international securities regulation discussions.

4. It is important that the Committee's work should have focus. While there should be no effort to constrain the Committee in its recommendations, I suggest that it should assess the respective merits of two specific models against the goals described in recommendation 3, namely:

- (a) An enhanced version of the present system, with such practical and achievable improvements as the Committee might propose so that there is a greater sense of common purpose and more efficiency. Those enhancements could include the adoption of the single passport model advocated by some market participants, which builds upon the existing mutual reliance mechanisms of the CSA.

- (b) A single commission model in which governments electing to participate would pool their authorities in a single regulator administering one set of rules.

In developing its recommendations, the Committee should (i) identify any difficult or challenging issues to be encountered in achieving the model it recommends and (ii) propose ways to resolve these issues. It should, in particular, recommend a governance model and describe an accountability framework. It should also address any significant implementation issues, including transition costs, should major institutional changes be proposed. It should weigh the costs and benefits of its recommendations.

5. The Committee will require competent staff to assist in its consultations and

to undertake or organize research studies relevant to its work. Most knowledgeable persons agree that further data on the costs and benefits of various structures will be useful but they also caution against a research-intensive agenda and urge a businesslike approach to garner the data which will be most helpful to the Committee and to policy makers. Because this is a project of national interest I suggest that the federal government should provide the necessary funding.

6. The project should go forward expeditiously and with well-identified milestones. I suggest that the Committee be appointed as soon as possible and that it be asked to report by September 30, 2003. Governments should then deal promptly with the Committee's conclusions.
7. Market participants, academics and regulators should be encouraged to participate fully in the Committee's work in such manner as the Committee may determine. My consultations in recent weeks demonstrate a keen interest in doing so. I would anticipate that there would be an opportunity for submissions by interested persons.

Finally, although I make no recommendation on this point, I want to draw your attention to a number of searching, fundamental questions raised by some of those I consulted about broader, but related, issues in relation to the future of Canada's capital markets. As I mentioned earlier those markets are extremely important to Canada's economy. Some people believe they may be significantly challenged in the years ahead. Others say that they have some significant opportunities. We, as Canadians, should be prepared to ask and answer some important questions.

For example, in a [globalizing](#) world, is there a risk that Canada's markets could become marginalized and, if so, what policy steps can be taken to address that problem? How do we best position Canadian markets in a North American context to take advantage of emerging opportunities? Will the SEC in Washington become the effective regulator of Canada's capital markets, with little heed to any special requirements of those markets? Has the reorganization of the Canadian exchanges adversely affected the public microcap market in Canada? Is there an excessive focus in the underwriting community on large issues that is undermining the financing of emerging public companies and, if so, how should it be remedied? Should we attempt to sponsor better access in Canada to private venture capital and high yield debt, and if so how?

These are important questions. They merit attention by Canadian policy-makers so that there is a vision for Canada's capital markets in the global marketplace of the future.

Conclusion

I conclude by emphasizing once again my conviction that the issues described in this report are of major concern to Canada and its future economic direction. They touch on the redefinition of the exercise of Canadian sovereignty in the 21st century in this important area. The project I have described is of national importance.

I very much hope that everyone concerned can approach this much-needed process of review with an open mind and a solutions-minded approach. As Canadians we very much need the will to make progress on issues of this sort if our nation is to realize its potential.

Yours very truly,

Harold MacKay

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