



Pension Investment
Association of Canada

Association canadienne des
gestionnaires de caisses de retraite

Submission to the Expert Panel on Securities Regulation in Canada

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Introduction

The Pension Investments Association of Canada (PIAC) appreciates the request by the Expert Panel on Securities Regulation in Canada for comments regarding the future structure of the regulatory regime in Canada.

PIAC has been the national voice for Canadian pension funds since 1977. Senior investment professionals employed by PIAC's member funds are responsible for the oversight and management of over \$940 billion in assets on behalf of millions of Canadians. PIAC's mission is to promote sound investment practices and good governance for the benefit of pension plan sponsors and beneficiaries.

The structure of the Canadian securities market regulatory regime has been the subject of considerable debate for many years with numerous reports, studies and committees established resulting in a number of proposals for reform. The most contentious issue has been the debate whether Canada needs a single securities regulator in place of the current structure.

PIAC's submission does not advocate for either a national regulator or the current regime rather, we concentrate on a number of issues that the Expert Panel may wish to consider in making its final recommendations. In the view of PIAC the key issue facing the Canadian securities markets is the lack of a credible enforcement regime and this is the issue on which the Expert Panel should focus its recommendations.

Objectives, Outcomes and Performance Measures

The Expert Panel has asked a number of questions regarding the objectives, outcomes and performance measures that could be incorporated into securities regulation. An important question is whether reduction of systemic risk should be one of those objectives and if so, how broadly it should be defined. In addition, the Expert Panel asked whether Canada should have objectives beyond those defined by the International Organization of Securities Commissions (IOSCO); and finally, how should securities regulation be evaluated in Canada.

In PIAC's view, all securities market regulators; whether at the national or provincial/territorial level, should have a common set of objectives and the three "core" objectives put forward by IOSCO encompass the issues that these should cover:

1. the protection of investors,
2. ensuring that markets are fair, efficient and transparent; and,
3. the reduction of systemic risk.¹

¹ International Organization of Securities Commissions Objectives and Principles of Securities Regulation February 2008.

IOSCO defines these as core objectives and notes that they are all closely related and overlap to a large degree. For example, investor protection is maximized when markets are fair, efficient and transparent; this in turn reduces systemic risk; which in turn protects investors.

Adoption of these core objectives will also assist in the integration of the Canadian security markets into the world market. This establishes a common “language” and makes the Canadian markets familiar and transparent for regulators and investors worldwide.

Concomitant with the adoption of the IOSCO objectives is the inclusion of the reduction of systemic risk as a core objective of securities market regulation. Pension funds have a particular interest in ensuring that systemic risk is addressed. Given the full range of exposures that pension funds have through their diversified investments, any crisis in the financial system has an impact. As we witnessed in the recent credit crisis, while some pension funds were exposed directly through subprime investments and experienced losses, many pension funds had no direct exposures but experienced losses in their investments. In today’s global financial system the impacts of one asset class can easily cross-over to other asset classes or across investors. In reality, pension funds have risk exposures to any investments that will impact the broader financial system and so it is in our interest that reduction of systemic risk be a key objective of securities market regulation.

Given these wide-ranging impacts it only makes sense to define systemic risk as broadly as possible and ensure that the regulatory regime possesses the comprehensive mandate required to deal with these issues.

Regulation should be evaluated in the context of the vital role that securities markets play in economic and social development, as well as providing for the needs of individuals throughout their investment lifecycle. This requires capital markets to be innovative and dynamic, encouraging both issuers and investors to participate, at the same time ensuring that the rights of both are protected. The members of PIAC recognize that it is important to balance the needs of both issuers and investors to ensure that the capital markets can play this vital role.

In this context then an effective regulatory regime should have two attributes:

1. It should promote the formation of capital – the regulatory regime should allow issuers to participate in a cost-effective, simple and innovative manner. This would attract and promote the formation of capital, enabling the raising of capital for new and existing businesses and provide a full range of investment opportunities for investors.
2. It should protect investors – an effective regulatory regime should protect investors. There are two elements to this. First, it must ensure that investors are

provided with the information they need to make informed decisions. Second, the enforcement model must be i) timely in identifying infractions, ii) swift in resolution of the allegation, and iii) substantial in the sanctions applied.

Principles-based Securities Regulation

The Expert Panel has asked a number of questions regarding principles-based regulation; are there specific areas of law or regulation that are overly prescriptive and could benefit from a principles-based approach; what core regulatory principles should constitute the foundation of securities law; what are the risks and challenges of a more principles-based approach to regulation.

One of the challenges with a principles-based approach will be to change the mindset of market participants. A problem in the investments industry is dealing with how market participants characterize or “frame” their behaviour. In effect, the wrong frame of reference can lead to ethical or legal violations.²

If people get up every morning thinking only about how to raise their company’s stock price, how to please their superiors, and how to make that bonus target and do not consciously keep ethical constraints in their decisional calculus, unethical conduct may ensue.³

This seems particularly relevant in a rules-based approach where the frame of reference has become adherence to the letter of the law. Three problems can result from this approach:

1. market participants are incentivized to find ways to comply with the rules without due reflection upon the ramifications of their actions;
2. regulators cannot make rules fast enough to keep up with market innovation and so if there are no rules in a particular situation some believe that any kind of behaviour is permissible; and,
3. detailed rules become a burden upon market participants and they spend a great deal of time trying to find ways around those rules.

One of the ways to change how market participants frame their actions is by articulating a public interest requirement. The substance of this public interest test could be drawn from the core objectives of market regulation: protecting investors; ensuring markets are fair, efficient, and transparent; and reducing systemic risks. Market participants would then be incentivized to consider the ramifications of their actions in a broader context.

² Robert A. Prentice “Ethical Decision Making: More Needed Than Good Intentions” Financial Analysts Journal November/December 2007.

³ Ibid.

While the challenges for companies are obvious, regulators will perhaps face as great a challenge.⁴ A more principles-based approach will require a higher level of skill and knowledge on the part of regulatory staff to make a proper judgment about the conduct of a market participant in a particular situation. Amongst the requirements will be a deep understanding of the principles involved and ethical standards; knowledge of the industry and company; and, knowledge of the people involved. Making judgments about the conduct of individuals in unique circumstances will require regulatory staff to have a great deal of experience and training.

Proportional Securities Regulation

The Expert Panel has requested comments on the need for proportionate regulation in Canada; what areas of securities regulation impose undue burdens and could benefit from proportionate regulation; should the economic characteristics of a company determine how it is regulated and if so what should these economic characteristics be; what role should risk analysis play in the regulation of a business.

Submissions to the Task Force to Modernize Securities Legislation in Canada have addressed this issue. The Bank of Canada proposed a “tiering” of the regulatory burden which could take into account the needs of issuers.⁵ Large, complex firms that are accessing international capital markets could be subject to higher level of regulation and reporting versus smaller firms that rely on domestic markets for capital.

While this approach has obvious merit, the primary thrust of the discussion centers on the costs to issuers of complying with detailed reporting requirements. The needs of investors should play an equal role in consideration of a tiered reporting requirement. Among the types of considerations that might be applied in assessing investor needs might be to focus on the risk attributes of companies and what kind of information investors need, and should expect, from a particular company. For example, it would be reasonable to expect that large-cap companies, which have multiple business lines, are widely held and comprise significant components of investor’s portfolios, would have more stringent reporting requirements. These are the kinds of companies that are integral to investors’ long-term investment portfolios and therefore investors may require a higher level of information.

Small companies, with limited business lines, limited ownership, or of a more speculative nature, may invite a different kind of investor. These types of investors are likely to be more active in their analysis and contact with the company and may not require detailed levels of reporting. While the reporting requirements would not be as high this would balance the costs to the company with the needs of investors in these companies.

⁴ Financial Services Authority “Principles-Based Regulation: Focusing on Outcomes That Matter” April 2007.

⁵ David Longworth and Donna Howard “Submission to the Task Force to Modernize Securities Legislation in Canada” January 2006.

Securities Regulatory Regime

The Expert Panel has requested comments on the securities regulatory structure; what are the strengths and weaknesses of the passport system, which structural model is best for Canada and which would best support the adoption of new regulatory approaches; what are the opportunities and risk of moving to a single securities regulator.

The appropriate structure of securities market regulation has been debated for many years in Canada. As mentioned at the outset of this submission; PIAC does not take a position on the appropriateness of one model versus another. However, for some guidance on our views one can refer to the debate in Europe over the same issue and the response of the U.K. Financial Services Authority (FSA).

The FSA strongly supports the creation of a single financial market in Europe with the view that this will provide investors with greater choice and create economies of scale and scope for companies. In order to improve the regulation of financial markets the European authorities have implemented a number initiatives such as establishing committees to deal with specific areas of the financial markets, implementation of a single rule book for financial services and, targeted improvements. While creation of a single regulator has been discussed it is not formally an agenda item.

The FSA's view on this issue is relevant for Canada; it is more important to focus on outcomes rather than structures. Quoting from the FSA: "Are member states implementing measures and undertaking their supervision in a way which is likely to minimize as far as possible the regulatory burden on firms and promote convergence of outcomes? The answer to this question may be "yes" even if the precise detail of implementation varies in some cases."⁶

If we substitute "provinces/territories" in place of "member states" this sums up the substance of the issue for Canada. The structure of the system is less important than the outcomes being right.

In this context the key issue for Canadian securities regulation today is weak enforcement. Submissions to previous efforts to review Canadian securities market regulation have highlighted the same issue. The submission by the Bank of Canada to the Task Force to Modernize Securities Legislation in Canada cited research which found large scale evidence of insider trading and reporting violations.⁷ The International Monetary Fund found that considerable improvement was needed on the enforcement side and noted that "Criminal enforcement appears to be particularly weak".⁸

⁶ Financial Services Authority "International Regulatory Outlook" April 2008.

⁷ Ibid, note 4.

⁸ IMF "Canada" Financial Sector Assessment Program – Detailed Assessment of the Level of Implementation of the IOSCO Principles and Objectives of Securities Regulation" February 2008.

Investors need only to compare recent headlines to determine the effectiveness of Canadian securities market enforcement. Frank Dunn, former CEO of Nortel was charged on June 19, 2008 with fraud; more than four years after being fired by the company. The principals of Livent began their trial in May of 2008; six years after being charged by Canadian authorities and nine years after being charged by U.S. authorities. This can be compared with recent actions by U.S. Federal authorities where they arrested and charged two former Bear Stearns hedge fund managers for fraud only months after the alleged infractions.

In the view of PIAC the key issue facing the Canadian securities markets is the lack of a credible enforcement regime. This is the issue on which the Expert Panel should focus its recommendations.

Conclusion

The members of PIAC would like to thank the Expert Panel for this opportunity to express our views on the critical issues that it has undertaken to address. The work of the Expert Panel is crucial to the long-term future of the Canadian economy, financial markets and the health of the pension industry.