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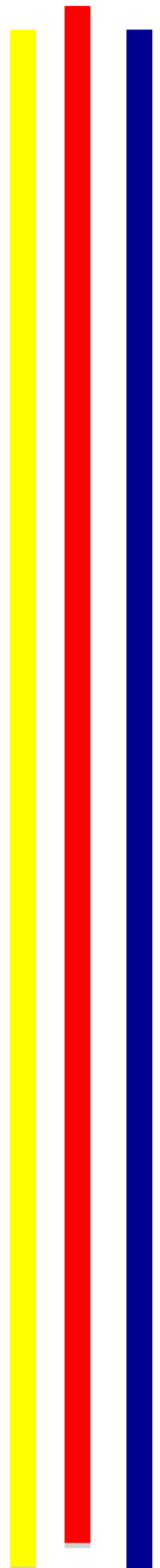
Federalism and Securities Regulation in Canada

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INTRODUCTION

The 2011 constitutional references dealing with the proposed federal securities legislation were “not only about securities regulation [but] also about the very essence of Canadian federalism” (Grammond 2011). The securities references were the latest battle between two radically-different visions of federalism – centralist vs. decentralist – that have been warring in Canada since Confederation. The next battle, in the form of another constitutional reference triggered by anticipated federal systemic-risk legislation, already looms on the horizon. Because the division of powers “remains ‘the primary textual expression of the principle of federalism in our Constitution’” (*Reference SCC 2011*, para. 54), the courts’ constitutional conclusions in the securities references also reflect their view on the competing visions of federalism.

This paper examines in detail the factual context of the securities references and the “legislative facts” underlying the courts’ constitutional conclusions in order to illustrate the competing visions of federalism. Legislative facts “are those which establish the purpose and background of legislation, including its social, economic and cultural context” (*Danson 1990*, 1099). Legislative facts inform the “pith and substance” analysis which “looks at the *purpose* and *effects* of the law to identify its ‘main thrust’” (*Reference SCC 2011*, para. 63). When eighteen of nineteen justices (including all nine at the Supreme Court) reach essentially the same conclusions on legislative facts, rejecting the federal government’s core constitutional argument because it was not supported by the “legislative facts adduced by Canada” (*Reference SCC 2011*, para. 116), those facts are important.

Because the proposed federal securities legislation replicated existing provincial legislation, the legislative facts consisted mainly of descriptions of our existing securities regulatory system. Over 5,000 pages of evidence were filed in the references, most of it narrative descriptions of a system itself composed of over 5,000 pages of legislation, regulations, rules, policies and regulated contracts. This paper focuses on the enormous contradictions between the descriptions presented by the federal government and the provinces¹ which illustrate the two competing visions of federalism in the securities references.

My perspective is that of a veteran observer of federalism from the front lines of securities regulation. I wrote four reports filed in evidence in the securities references, describing our regulatory system based on my experience as a former Director of Enforcement, Member and Vice Chair of the Alberta Securities Commission, and as an official with Alberta Finance during the development and implementation of the so-called “passport system” of securities regulation. In this paper, I go further in describing my personal observations about the inner workings of our system and how it evolved to meet the functional policy objectives of securities regulation. It will be apparent that I agree with the courts’ constitutional conclusions, although the focus of this paper is not so

¹ For convenience, most references in this paper to “provinces” mean those provinces that argued against the proposed federal legislation at the Supreme Court: Québec, Alberta, New Brunswick, Manitoba, British Columbia and Saskatchewan. References to “provincial” arguments or evidence have a corresponding meaning and do not include arguments or evidence from Ontario (the only province to argue in favor of the federal legislation).

much on those conclusions as it is with how the rejection of the federal government's evidence reflects upon the corresponding vision of Canadian federalism.

The first substantive section of the paper outlines the decisions in the securities references and their treatment of the contradictory evidence. It explains the rejected federal evidence as “constitutional rhetoric” – inaccurate assertions, assumptions, descriptions and criticisms of our existing regulatory system intended to support a federal constitutional claim of provincial incapacity. It describes how that rhetoric dominated the public debate for decades and became conventional wisdom in Canada, how the adoption of that rhetoric by the International Monetary Fund finally prompted the provinces to respond, and how the evidence in the securities references then unfolded as a contest between myths and facts. Ironically, the facts showed that our much-maligned decentralized system is probably the best in the world in terms of meeting the functional policy objectives of securities regulation.

The second section shifts the analysis to why our decentralized system seems to excel, describing the system as an example of successful federalism. It examines what constitutes good securities regulatory policy and the processes used to make good policy at a granular level, addressing several misconceptions about securities regulatory policy. It examines the failure of proposals for a federal securities regulator in the mid-90s, how the policy-making process then evolved into our current passport system, and the political considerations underlying Ontario's refusal to join the passport system.

The final section examines the securities references as an example of “constitutional risk” – the risk that a constitutional agenda may generate incentives for retrograde policy that override functional policy considerations. It describes other examples of how this kind of constitutional turf war can be toxic from a policy perspective. It then examines the impact of the reference decisions on the federal government going forward, describing other federal legislation that now appears *ultra vires* and recent suggestions that the federal government may introduce legislation related to systemic risk, triggering a sequel to the securities references. It concludes with a call for a more transparent process to deal with proposed constitutional changes that will reduce constitutional risk in the future.

THE SECURITIES REFERENCES

2011 ended with a landmark decision from the Supreme Court of Canada striking down proposed federal securities legislation as *ultra vires*. The decision was unanimous and consistent with the previous reference decisions of the Alberta and Québec Courts of Appeal. These decisions revisit the most-contested constitutional question in Canada's history – the scope of provincial jurisdiction over property and civil rights vs. federal jurisdiction over trade and commerce – which has always reflected centralist vs. decentralist views of Canadian federalism. The decisions essentially re-affirmed the constitutional *status quo* by characterizing existing securities legislation as property and civil rights, not trade and commerce.

Although the federal government consistently portrayed its securities legislation as a policy initiative, it was widely recognized to be, as Alberta's then-Finance Minister

described it, an “unprecedented federal power grab”.² The theme of the 2011 State of the Federation conference – “rebalancing” – scarcely describes the scale and aggressiveness of the federal constitutional claim. This point is crucial to any understanding of the securities references and their aftermath.

If valid, the federal government’s arguments in the securities references would have produced a seismic shift of jurisdiction in other areas by effectively overturning the seminal decision in *Citizens Insurance Company v. Parsons*, 1881. The Alberta Court of Appeal compared this with the federal government’s earlier campaign to assume the national regulation of the insurance industry and described the reference as “an attempt to overturn all those earlier cases [including *Parsons*], and to rewrite Canadian constitutional history” (*Reference ABCA* 2011, para. 42; Armstrong 1976). At the Supreme Court, British Columbia’s counsel described the proposed Act as a constitutional Trojan horse that would result in the complete evisceration of provincial power over securities regulation and other areas. MacIntosh (2012b, 232-8) lists over a hundred Ontario statutes that might be construed as falling within the trade and commerce power, if federal securities legislation had been valid.

FAILING ON THE FACTS – THE MYTH OF TRANSFORMATION AND OTHER CONTRADICTIONS

The Supreme Court rejected the federal government’s core argument that “securities markets have undergone significant transformation in recent decades, evolving from local markets to markets that are increasingly national, indeed international [which] has given rise to systemic risks and other concerns that can only be dealt with on the national level” (*Reference SCC* 2011, para. 33). The Supreme Court said:

This argument requires not mere conjecture, but evidentiary support. The legislative facts adduced by Canada in this reference do not establish the asserted transformation. On the contrary, the fact that the structure and terms of the proposed Act largely replicate the existing provincial schemes belies the suggestion that the securities market has been wholly transformed over the years. (*Reference SCC* 2011, para. 116)

Some commentators (collected in Anand 2012a) have severely criticized the Supreme Court’s decision, particularly the Court’s rejection of the asserted transformation. For example, Puri (2012a) argues that the decision “fails to demonstrate an understanding of Canadian capital markets” and suggests that the Court “ignored” or “turned a blind eye” to the federal evidence of transformation (Puri 2012b, 15, 18). While Trebilcock (2012, 42) suggests that “the facts – along with their policy relevance – appeared not to matter”. However, those criticisms do not address, or even acknowledge the existence of, the contradictory evidence presented by the provinces. As described below, a review of the contradictory evidence shows that the courts did not ignore the federal evidence but rather rejected it in favor of the provincial evidence, and were correct to do so.

² H. Curry, J. McFarland, and R. Seguin 2010. “Securities watchdog plan allows provinces to opt out” May 26, 2010. At <http://m.theglobeandmail.com/globe-investor/securities-watchdog-plan-allows-provinces-to-opt-out/article1581470/?service=mobile>.

The Supreme Court euphemistically described the federal government's failure to present "a factual matrix that supports its assertion of a constitutionally significant transformation" (*Reference SCC 2011*, para. 115). The majority decisions at the Courts of Appeal were also restrained, but pointed more specifically to facts contradicting fundamental elements of the claimed transformation:

- Securities markets were international before Confederation (*Reference ABCA 2011*, para. 20; *QCCA Reference 2011*, paras. 288, 413-4).
- While technology has speeded up modern trading, and markets are larger and more complex, these factors do not serve to transform the pith and substance of the matter from property and civil rights into the regulation of trade and commerce because the regime still regulates individual contractual and property rights, as sophisticated, complex and fast as they may now be (*Reference ABCA 2011*, para. 20).
- No securities legislation regulates or manages capital flows (*Reference ABCA 2011*, para. 25) and so does not regulate interprovincial or international trade (*QCCA Reference 2011*, para. 289).
- Systemic risk is not a constitutional head of power and the proposed Act does nothing not already being done by the provinces with respect to the reduction of systemic risk which, in any event, is a matter of property and civil rights in the context of securities regulation (*Reference ABCA 2011*, paras. 23-4). The federal government failed to show that provincial legislation was unable to reasonably prevent systemic risks (*QCCA Reference 2011*, paras. 205-10).
- Our existing securities regulatory system is a world leader, including in the area of systemic risk prevention or management (*QCCA Reference 2011*, para. 368). The federal government's assertions "regarding the fragmentation of the system, the duplication and complexity of procedures, the high system costs and the general inability of the provinces to manage ... systemic risk are contradicted by this reality" (*QCCA Reference 2011*, para. 369).

Those findings were more than enough to sink the transformation claim but they were only the tip of the iceberg of contradictory evidence. The courts properly avoided commenting on "the policy question of whether a single national securities scheme is preferable to multiple provincial regimes" (*Reference SCC 2011*, para. 10) because that question was not relevant to the constitutional issues as a matter of law. Of course, that policy question remains crucial to any federalism analysis and it is especially interesting here because it highlights the biggest contradictions in the evidence:

- The most credible assessments available rank the performance of our decentralized system among the best in the world, if not the best, in terms of meeting the functional policy objectives of securities regulation (Spink 2010b, paras 3-20).
- Canada's obsession with regulatory structure is unique. The rest of the world seems to recognize that: structure is not necessarily relevant to functional performance; there is no ideal structure; and there need not be a single regulator (IOSCO 2003b, 9; IOSCO 2008, 9; IOSCO 2011b, 21; Corcoran 2010; Spink 2010b, paras. 3-10, 17-8).
- To the extent that structure may be relevant to functional performance it appears that decentralization has been a strength, not a weakness, of our system (Courchene 1986;

– 2010a; – 2010b; Spink 2010b; – 2010c; – 2010d, Rousseau 2010a; Suret and Carpentier 2010; Choi 2010; Macey 2010a). Centralization “effectively abandons the diversity and dynamic-efficiency features of [decentralization]” replacing it with “an entirely different approach, one with new players, new politics and no history” (Courchene 2010b, 10), so centralization would appear to be a retrograde step from a functional policy perspective.

That evidence radically contradicted conventional wisdom in Canada, which had been shaped by a series of reports from Royal Commissions and federally-constituted panels in 1935, 1964, 1979, 2003 and 2009. Those reports portrayed our existing system as inefficient and dysfunctional due to its decentralized structure, which was described using pejorative terms like fragmented, balkanized, patchwork and hodgepodge. What explains such extreme contradictions?

There is a rhetorical pattern evident in those reports and similar opinions: each is based on an underlying assumption that a single-regulator structure is inherently superior to a decentralized system as a matter of policy (Spink 2010b, paras. 11, 38-40). As soon as we question that assumption it appears, like “transformation” and “fragmentation”, to be unsupported by empirical evidence and, moreover, a rhetorical device constructed to support federal constitutional claims – constitutional rhetoric. The constitutional agenda therefore explains the strategic origins of the rhetoric and the contradictory evidence describing our existing system.

THE CONSTITUTIONAL AGENDA – PROVINCIAL INCAPACITY

One of the federal government’s primary constitutional objectives in the securities references was meeting the “provincial incapacity” test stated in *General Motors* 1989, where the court found that “competition cannot be effectively regulated unless it is regulated nationally” (*General Motors* 1989, 680). A similar finding in the securities references was necessary in order for federal securities legislation to be valid under the “general” or “second branch” of the trade and commerce power.

The provincial incapacity test was immediately recognized as being crucial to the future of Canadian federalism generally, and particularly to the constitutionality of federal securities legislation (Swinton 1990; Swinton 1992). The test has also been criticized for its vagueness and the low evidentiary threshold applied in *General Motors* 1989 (Leclair (2003; 2010); Karazivan and Gaudreault-DesBiens, 2010; Lee 2011). Leclair (2010, 570-2) believes that Chief Justice Dickson had both competition and securities regulation in mind when formulating the test and that it is “a purely rhetorical device” (590) which took “normative statements founded on the belief of the provinces’ ontological incapacity to work for the economic good of Canada as a whole” and “morphed [them] into empirical truths” (595). He describes Chief Justice Dickson’s approach as founded on the premises that “effectiveness can only be achieved by the federal polity and efficiency is reducible to uniformity [which are] normative statements that do not appear to be validated by empirical reality” (591-2).

The federal government's evidence and arguments in the securities references were focused on the provincial incapacity test. The asserted transformation from local to global markets was needed to claim that securities markets had outgrown provincial jurisdiction, making federal legislation necessary to address what would otherwise be a "constitutional gap" (*Reference SCC 2011*, para. 83). The transformation theory suggested such a gap by pointing to the provinces' constitutional inability to regulate interprovincial and international trade and emphasizing the increasingly national and international dimensions of securities markets (Canada 2010, paras 109-10). Pejorative descriptions like "fragmented" and "balkanized" suggested provincial incapacity by asserting that structural and substantive uniformity are necessary for the system to be "effective" (Expert Panel 2009, 41; Anand 2005; Anand and Klein 2005; Puri 2010, 2012a).

Provincial incapacity is therefore more than just a constitutional test; it also reflects the two competing visions of Canadian federalism. The federal government's vision of federalism is evident in the constitutional rhetoric leading up to the securities references, as summarized below.

OVERVIEW OF CONSTITUTIONAL RHETORIC ABOUT SECURITIES REGULATION

The origins of the transformation and fragmentation rhetoric can be traced back to broader constitutional rhetoric about provincial incapacity in the 1930s. The 1935 *Royal Commission on Price Spreads* asserted that the provinces were incapable of performing a number of functions important to the national economy (including securities regulation) and that a unitary approach was essential going forward as a matter of policy – all in support of proposals to amend the constitution to give the federal government jurisdiction over those functions (Canada 1935, 39, 274, 286-7; Spink 2010b, paras 38-40; Wilbur 1969, 18). The leading constitutional scholars of the day shared that centralist view, urging, for example, repeal of the *British North America Act* and a complete rewrite of the constitution (Kennedy 1937, 399) to give the federal government legislative authority over matters of national economic importance (Kennedy 1937; MacDonald 1937; Scott 1937).

The opposing – essentially decentralist – vision of federalism can be traced back to Oliver Mowat and Ontario's constitutional struggles with Sir John A. Macdonald over "provincial rights" in the late nineteenth century. The best-known illustration of that vision in the 1930s was the broad provincial opposition to federal "New Deal" legislation that resulted in the legislation being largely struck down by Supreme Court of Canada in 1936 and the Privy Council in 1937. Less-well-known are the constitutional battles fought alone by Alberta's Social Credit government, elected in 1935, against the federal government and the banks. Those battles were remarkably fierce: in 1936 Alberta became the only province in Canada ever to default on its sovereign debt obligations, the result of being the only province to resist a constitutional amendment to create a Loan Council that would control provincial borrowing (Ascah 1999, 62; Mallory 1954, 129-35); in the winter of 1936-37, the banks prepared a proposal to pay lower interest rates on Albertans' deposits and charge higher rates on Albertans' loans as retribution for Social Credit initiatives (Ascah 1999, 70-1); and Alberta refused to participate in the (Rowell-Sirois)

Royal Commission on Dominion-Provincial Relations appointed in 1937, addressing *The Case for Alberta* 1938 to “the Sovereign People of Canada and their Governments”. The *Case for Alberta* opposed any transfer of powers to the federal government and supported decentralization on the basis of what we would now refer to as subsidiarity, saying that provincial jurisdiction “conform[s] to the principle that the responsibility for any function should be left [to] that Government which can most readily perform that function” (Alberta 1938, 9).

Because the 1930s rhetoric was aimed at supporting constitutional amendments, it focused simply on asserting a policy need for uniformity, uniformity being synonymous with federal jurisdiction (Canada 1935, p. 39). The 1964 Porter Report (Canada 1964) took the provincial-incapacity rhetoric a step further by implying that the federal government already had the constitutional authority to enact securities legislation under the “first branch” of the trade and commerce power dealing with the regulation of interprovincial and international trade. It suggested “a national agency under federal legislation which would take over the major responsibility in this area from the provinces” and that the “federal regulatory agency...might at first require only registration of issues being distributed interprovincially and internationally” (Canada 1964, 348). The rhetoric about the policy need for a unitary approach also escalated with references to the “hodgepodge of [provincial] legislation” and “fragmentation of administration”, suggesting that “the job [will] be accomplished most effectively if a federal agency takes the lead in setting high and uniform national standards” (Canada 1964, p. 344-9).

The Proposals for a Securities Market Law for Canada (Canada 1979) were the first explicit assertions of federal constitutional jurisdiction over securities regulation. The Proposals included a Draft Act which purported to apply to all but “intraprovincial transactions” (Anisman 1981, 365-7) and a constitutional opinion almost identical with the federal government’s position in the securities references (Anisman and Hogg 1979).

The rhetoric intensified with the 2003 report of the Wise Persons’ Committee (WPC 2003), which claimed the transformation from local to international markets “made it increasingly difficult for the provinces to regulate effectively” (WPC 2003, 12). It used “fragmented” as synonymous with decentralized, and claimed:

Policy development is slow and inflexible. The need for consensus often results in a lack of uniformity, overregulation or policy paralysis. The system is too costly, duplicative and inefficient. The regulatory burden impedes capital formation. Canada’s international competitiveness is undermined by regulatory complexity. (WPC 2003, 25)

The 2009 report of the Expert Panel on Securities Regulation (EP 2009) said markets were more international than ever before and described transformation in terms of systemic risk (EP 2009, 1, 11). The report said “[w]e do not believe that multiple securities regulators will be able to work effectively as part of a national systemic risk management team, as structural challenges will likely compromise its ability to be proactive, collaborative, and generally effective in helping to address larger capital

market issues on a timely basis” and “we believe that the current structure fundamentally misallocates resources, causing securities regulation to be less efficient and effective” (EP 2009, 40). Our existing structure was described as balkanized or fragmented, never as “decentralized”. In what was perhaps the pinnacle of the constitutional rhetoric, only the proposed federal securities regulator was described as “decentralized” (EP 2009, 3, 47).

These assumptions about a single-regulator structure being inherently superior as a matter of policy were questioned by some (Schultz and Alexandroff 1985; Pidruchny 1985; Courchene 1986; Roy 1986; Swinton 1992; Daniels 1992; MacIntosh 1996; Fluker 2009; Lortie 2010; Lortie 2011; Lee 2011). However, most media reports and academic commentary repeated the assumptions (Banwell 1968; Anisman 1981; Tse 1994; Leckey and Ward 1999; Lehman 1999), and the accompanying rhetoric intensified in the decade preceding the securities references: uniformity became synonymous with effectiveness and efficiency; moving to a single-regulator structure became synonymous with “reform”; and the focus of discussion shifted to why any province would resist “reform” and why the move to a single regulator was taking so long (Harris 2002; Harris 2003; Harris 2005; Anand 2005; Anand and Green 2005; Anand and Klein 2005; Anand and Green 2010; Puri 2010; Anand and Green 2011).

The provinces did not challenge the constitutional rhetoric until shortly before the securities references and by then it had been repeated for so long that it had become conventional wisdom. Most Canadians believed, and still believe, the constitutional rhetoric because it continues to be repeated, not just by the federal government and supportive academics, but also by international bodies such as the Financial Stability Board (FSB 2012) and the International Monetary Fund (IMF). The federal government’s representatives have influence with these bodies – the federal Department of Finance, the Office of the Superintendent of Financial Institutions, and the Bank of Canada are members of the Financial Stability Board, and the current Executive Director of the IMF representing Canada is Thomas Hockin (former Chair of the Expert Panel on Securities Regulation). As described in the next section, it was the repetition of constitutional rhetoric by the IMF that finally prompted the provinces to challenge the rhetoric, previewing the evidence and arguments in the securities references.

CHALLENGING CONVENTIONAL WISDOM – MYTHS VS. FACTS

In 2007, the IMF conducted a Financial Sector Assessment Program – Detailed Assessment of the Level of Implementation of the IOSCO Principles and Objectives of Securities Regulation in Canada (FSAP). Because it uses the assessment methodology developed by the International Organization of Securities Commissions (IOSCO 2003b) – the most comprehensive and rigorous by far – the FSAP is the most credible available measurement of the functional performance of securities regulatory systems (Spink 2010b, para. 11).

The 2007 FSAP assessment of Canada was conducted in a highly-charged atmosphere. The IMF examined two provincial regulators (Québec and Ontario) with

diametrically-opposed perspectives on a single regulator. Ontario was allied on that issue with the federal government and was the only province refusing to join the passport system. Québec essentially represented the “passport jurisdictions”, which looked forward to the FSAP results because they expected a positive assessment but were concerned that the IMF would go beyond IOSCO’s assessment methodology and repeat the constitutional rhetoric about a single regulator structure, which was particularly intense in Canada at the time. That prompted the Council of Ministers of Securities Regulation (representing all provinces except Ontario) to respond publicly to “intense negative rhetoric from those who advocate creating a single securities regulator”, describing criticisms of the existing system as “myths” and “misinformation”, and pointing to functional assessments by the OECD and World Bank which ranked Canada’s securities regulatory system as one of the best in the world (Selinger 2007). The rhetoric was also described as “fiction”, “untrue” and “irresponsible” by the British Columbia Securities Commission, which said it “neither supports nor opposes creating a single regulator ... What we do oppose is advocating a single regulator, or any other type of reform, on the basis of mythology.” (Hyndman 2007).

That was the first time the provinces challenged the constitutional rhetoric and, although the “myths vs. facts” approach proved extremely effective in the securities references, it had no appreciable impact on public opinion or the IMF. When the IMF published Canada’s (stellar) FSAP results early in 2008, it also published a Financial System Stability Assessment–Update (FSSA 2008) recommending a single-regulator structure for Canada on the basis of those same myths. The IMF seems poised to do something similar when it publishes the results of Canada’s 2013 FSAP (Spink 2013). Whatever the IMF does or says, it will be important to recognize the distinction between the IMF’s functional vs. structural opinions on Canadian securities regulation.

FUNCTIONAL VS. STRUCTURAL OPINIONS – METHODOLOGY MATTERS

The contrast between the FSAP 2008 and FSSA 2008 illustrated the distinction between *functional* and *structural* opinions, which is crucial to understanding the contradictory evidence in the securities references (Spink 2010b). The FSAP was a *functional* opinion, measuring performance in terms of implementing functional policy objectives according to a stated methodology. The FSSA was a *structural* opinion, asserting that a single-regulator structure would be functionally superior to our existing system, without disclosing a methodology.

The following chart compares the aggregate grading from the FSAP assessments of Canada (2008), the United States (2010), Australia (2006), UK (2011), France (2005) and Germany (2011).³

³ The chart shows results of FSAP Detailed Assessments of the Level of Implementation of the IOSCO Principles and Objectives of Securities Regulation for each country available at: <http://www.imf.org/external/np/fsap/fssa.aspx>.

Number of IOSCO principles:	Canada⁴	United States	Australia	UK	France	Germany
Implemented/Fully implemented (FI)	24	16	21	19	18	21
Broadly implemented (BI)	4	8	5	10	7	4
Partly implemented (PI)	1	5	2	0	2	2
Not implemented (NI)	0	0	1	0	0	0
Not applicable (NA)	1	1	1	1	3	3
Total	30	30	30	30	30	30

IOSCO's assessment methodologies were designed primarily as tools for identifying areas of potential improvement for each regulator being assessed (IOSCO 2003b, 5; IOSCO 2008, 5; IOSCO 2011b, 16), not to rank the relative performance of regulatory systems in different jurisdictions, but the FSAP results obviously invite comparison. Canada's high performance contradicted the rhetorical assumptions underlying the FSSA structural opinion, highlighting its lack of methodology and relative credibility. It was the first time that constitutional rhetoric (represented by the FSSA 2008 structural opinion) and a methodological assessment of functional performance (the FSAP 2008 functional opinion) were presented side-by-side allowing comparison of myths vs. facts.

The evidence in the securities references included other functional opinions published by the World Bank, OECD and the Milken Institute, ranking Canada's securities regulatory system against others around the world. The World Bank's annual "Doing Business" reports' chapters on "Protecting investors" ranked Canada fifth in the world from 2007-11 and fourth in 2012 and 2013.⁵ Two OECD publications ranked the Canadian securities regulatory system second among 21 countries in terms of "overall securities market regulation".⁶ The Milken Institute's "Capital Access Index" ranked Canada first in the world in 2009 and 2010.⁷ Together with the FSAP, these are the only functional opinions based on disclosed methodologies.

The methodology used by the World Bank and OECD has been criticized (Siems 2005) and the resulting rankings were described as a "flimsy foundation" for arguments that our system performed well, and "not particularly relevant to actual performance"

⁴ These are the gradings resulting from the implementation in Canada of National Instrument 31-103 and National Instrument 41-104, which were pending in 2008; gradings prior to implementation were: FI - 22; BI - 4; PI - 3; NI - 0; NA - 1. See IMF FSAP 2008 at pp. 20-1; 35-6; and 49.

⁵ Available at <http://www.doingbusiness.org/>.

⁶ *Going for Growth* 2006 and *Economics Department Working Paper* No. 506. Available at http://www.oecd.org/document/24/0,3343,en_2649_34117_41665624_1_1_1_1,00.html.

⁷ Available at <http://www.milkeninstitute.org/research/research.taf?cat=indexes>.

(Anand 2010b). While I agree that every assessment methodology should be scrutinized because some are better than others, the much more crucial distinction is between functional opinions that use a methodology and structural opinions that do not use a methodology. Scrutinizing the methodology and empirical foundation enables us to consider what level of credibility to afford the resulting opinion, while no methodology means no measurable credibility. We may choose to attach less weight to the World Bank/OECD assessments opinions than to the Milken Institute and FSAP assessments. The fact remains that, of all the methodological assessments available, Canada's securities regulatory system ranks no worse than fourth in the world and, according to the better methodologies, Canada is first in terms of functional performance.

These methodological assessments allow us to see past the constitutional rhetoric in historic portrayals of our system and focus instead on what Canada has been doing right. The next section examines Canadian securities regulation as an example of successful federalism.

SECURITIES REGULATION AS AN EXAMPLE OF SUCCESSFUL FEDERALISM

Before examining why our existing system seems to excel, it is useful to put Canada's high performance rankings in perspective and clarify what is meant by good securities regulatory policy.

KEEPING RANKINGS IN PERSPECTIVE

The high performance rankings of our existing system are consistent with my personal experiences in Canadian securities regulation since 1988. They are a tribute to the many regulators and government officials who worked hard to develop better regulatory policy and better processes for developing that policy across Canada, and who were historically under-appreciated, over-criticized, and even impeded by constitutional rhetoric. However, we must heed IOSCO's caution that their assessment "is not an end in itself" (IOSCO 2003b, 5; IOSCO 2008, 5; IOSCO 2011b, 16) and resist any tendency to rely too much upon performance measurements or rankings, especially when they are favorable.

Canada's high rankings do not mean that our system cannot be improved. Rather, they mean that our existing system is at or near the front of the continuous-improvement process in which every securities regulatory system is engaged. Every system must continuously adapt and evolve in order to achieve its functional policy objectives in a dynamic environment. It is prudent to use the rankings to recognize that Canada produces good securities regulators and good securities regulatory policy, and has consistently done so for a long time. Recognizing that allows us to understand what we have been doing right from a functional policy perspective.

WHAT IS GOOD SECURITIES REGULATORY POLICY?

IOSCO's objectives and principles of securities regulation (IOSCO 2003a; IOSCO 2010) and assessment methodology (IOSCO 2003b; IOSCO 2008; IOSCO 2011b) describe the global consensus on good securities regulatory policy in considerable detail, including examples of current practices. IOSCO recognizes, however, that best practices will and should change to keep up with market developments (Corcoran 2010) and that there is often no single correct approach to a regulatory issue, so making good regulatory policy is as much an art as a science.

To understand how Canada makes good policy, it is first necessary to debunk two myths about securities regulatory policy: 1) that faster policy-making is necessarily better; and 2) that uniformity is a necessity. These myths pervade the constitutional rhetoric and are evident in descriptions of our consensus-based policy-making process as “duplicative”, “cumbersome”, “protracted” (EP 2009, 2) and resulting in “a lack of uniformity” (WPC 2003, 25).

FASTER POLICY IS NOT NECESSARILY BETTER

Faster policy-making is not necessarily better – indeed, the opposite is often true. The Chair of the British Columbia Securities Commission recently observed that “investors and markets should be able to look to a regulator that is seasoned and keeps a steady hand on the tiller – a regulator that knows when to act quickly, and when to wait for better information” (Leong 2012, 9-10).

The first job of a regulator is to do no harm and there is an unfortunate history of fast policy responses doing harm. Policy can be made quickly but doing so increases the risk of error. Regulatory errors tend to have more significant impact than regulatory successes (which are typically incremental functional improvements) because errors divert the evolutionary process towards a dead-end in terms of policy, which remains damaging until reversed. An error-avoidance mentality is therefore crucial in an environment where it is normal for stakeholders to exert pressure on regulators or elected officials to, in effect, err in favor of that stakeholder (the risk of regulatory capture). The greatest danger has been when political pressures force regulatory responses that, in hindsight at least, were ill-considered and damaging.

In the evidence in the securities references, the most prominent example of this was how Canada's slower response to the issues addressed by the U.S. *Sarbanes-Oxley Act* in 2002 was qualitatively superior to the faster U.S. response (Rousseau 2010a, 117-21; Rice 2010, para. 172(a); Choi 2010, paras. 88-94; Macey 2010a, 28-30). In summary, the evidence regarding the *Sarbanes-Oxley Act* demonstrated: the need to distinguish between speed and quality in policy-making; how quality is significantly more important than speed; how speed in policy-making is only good if it produces the right policy; and how very bad speed can be when it produces the wrong policy. The myth that faster is always better thus ignores the most significant factor determining the impact of any particular regulatory policy – quality (Spink 2010d, para. 3).

Once we recognize the predominant value of quality it becomes apparent that focusing on the speed of policy development can be an artificial exercise (Rousseau 2010b). For example, some of the evidence criticized our policy-making process for taking too long to make new rules governing alternative trading systems (ATS), which have been a policy issue in Canada since 1990 (Russell 2010). I respectfully disagreed with those opinions (Spink 2010d) because, in my experience, the consensus-building process is precisely what produces quality regulation. Complaints about the speed or efficiency of the process obscure the functional mechanisms that determine quality, underestimating both the volume and value of the work involved (Spink 2010d, para. 9).

The ATS rules illustrate how consensus-based regulation should work in situations where there is strong consensus on the regulatory objectives and principles, but uncertainty about how best to implement them in a particular context (Spink 2010d, para. 10). These situations are common, and bringing multiple, expert perspectives to bear on such policy issues is not duplicative – it is additive and often highly productive. Consensus therefore tends to produce better-quality regulation than a single perspective. So-called delays should be recognized as maximizing quality and preventing error – postponing decisions on changes because more time or information is required to make the right policy decision and the current situation is not urgent enough to warrant the risk of an immediate-but-regrettable decision (Spink 2010d, par. 8). There are often no clear starting or endpoints in regulatory policy that can be used to start and stop the clock, so regulation is more appropriately viewed as a dynamic and continuous process (Spink 2010d, para. 5). The most important thing is not the speed of the process but whether it is moving in the right direction.

UNIFORMITY IS NOT NECESSARY

The second myth is that uniformity is necessary to achieve efficiency and effectiveness. The purported need for uniformity has always been the primary argument for a federal regulator so the provinces introduced a great deal of evidence intended to show that forced uniformity was unnecessary and undesirable.

The most prominent examples in evidence were the differences in exempt-market regulation – the rules governing sales of securities without a prospectus. In Alberta, the vast majority of new capital is raised in the exempt market (Spink 2010c, para. 32). Historically, exempt-market rules in Alberta and British Columbia have allowed investors to accept more risk than similar rules in Ontario.

Exempt-market regulation deals with local investors and typically, local issuers and enterprises. Local market conditions differ significantly across Canada, so regulatory philosophies naturally differ based on those conditions (Rousseau 2010a, 115-7, 122-5; Suret and Carpentier 2010, 15-41). The history of resource exploration and development in Alberta and British Columbia explains their different regulatory philosophy regarding the capacity of investors to accept risk in the exempt market (Rice 2010, paras. 156-8, 175-6; Suret and Carpentier 2010, 23-41; MacIntosh 2012b, 257-8).

These philosophical differences are subtle – a slightly different view of the balance between regulatory costs and benefits in the local exempt market – but subtle differences in regulatory policy can make a significant difference. Alberta (among others) revised its exempt-market regulation in 2002 and subsequently observed a dramatic increase in activity (ASC 2004; Spink 2010c, para. 32; Robinson and Cottrell 2007).

While it is possible to criticize the policy decisions made by each provincial regulator, the different approaches reflect real competition among regulators to find the best form of exempt-market regulation for their particular market. It is therefore wrong to view these differences as a lack of consistency or efficiency – they demonstrate how policy differences among jurisdictions may (and apparently do) increase efficiency. Arguably, the different approaches to exempt-market regulation are the most sophisticated examples of regulatory policy development in Canada and are the jewels of our system.

The fact that regulators sometimes agree to harmonize their rules, and that harmonization sometimes extends to the point of complete uniformity, does not mean that uniformity is necessary or always desirable. The reality is that some things can't be harmonized, some shouldn't be harmonized, and that regulatory competition is healthy even when rules are harmonized (Spink 2010c, para. 21). Healthy regulatory competition exists “when different regulators share the same overarching regulatory objectives, but, in implementing comparable regimes, compete with each other to develop the most effective and least costly ways to achieve these goals” (Tafara and Peterson 2007, 52).

Internationally, uniformity has always been practically impossible so systems have evolved towards harmonization and the mutual recognition of other jurisdictions' regulatory standards. In 2007, the U.S. Securities and Exchange Commission (SEC) signaled a change from its long-standing strategy of seeking “regulatory convergence” among jurisdictions towards a new framework founded on “bilateral substituted compliance” and mutual recognition, in part because it “has the benefit of not discouraging regulatory experimentation (a risk with a regulatory convergence approach), but without encouraging regulatory arbitrage” (Tafara and Peterson 2007, 55). Tafara and Peterson said:

Despite its undeniable theoretical advantages, *complete* regulatory convergence has proven difficult to achieve over any short-to-intermediate time frame. The reasons for this are many, but the magnitude of the task stands out: the entire complement of individual regulations and standards that need to be “converged” to allow for full market integration are quite numerous. Another reason, less frequently mentioned in the convergence dialogue but perhaps just as important, is that some jurisdictions simply have fundamentally different regulatory philosophies. When these differences are significant, complete convergence may not be possible and, indeed, may not even be desirable, if eliminating these philosophical differences results in less regulatory experimentation and a rigid one-size-fits-all approach to market oversight. (Tafara and Peterson 2007, 50)

The policy objective is “to build a framework that facilitates international access and rejects protectionist tendencies but, at the same time, protects investors and market integrity” (Jenah 2007, 83). Our current passport system is an example of such a process and framework. Before examining the passport system in more detail, it is useful to describe how our existing system evolved as an example of “federalism as process” (Courchene 2010b, 5-6).

FEDERALISM AS PROCESS

Securities regulation can be viewed as performing three basic functions: 1) making the rules (policy development and implementation); 2) enforcing the rules (encouraging compliance, investigating and prosecuting violators); and 3) adjudication (the quasi-judicial function). I will focus here on the first function because it most clearly illustrates securities regulation as process, and how that process has evolved in Canada.

DELEGATED LEGISLATION AND THE EXPANDING RULEBOOK

When I started working in securities regulation in 1988, the Alberta *Securities Act*, Regulation and policies totaled about 300 pages. Today the consolidated version is about 3,000 pages, and would be more than twice that size if it included all the rules imposed by self-regulatory organizations and the approved contracts used by regulated entities such as exchanges and clearing agencies. The Act and traditional Regulations have actually shrunk in size and the growth has been in the rules made by securities regulators (delegated legislation). What explains this phenomenal expansion of delegated legislation?

In my experience the expansion of rules is primarily the result of burgeoning demand for new rules, primarily from the securities industry but also from governments and regulators, to deal with evolving market practices and events. There is a continuous demand for new rules because, when done properly, rules are good for everybody. Sound rules reduce risk and cost, and facilitate transactions. Ronald Coase described this from the economic perspective, observing how securities exchanges originally used private law rules to enable two people who wiggle their fingers at each other across a room to create a sophisticated contract that would automatically and reliably complete within a few days (Spink 2010a, para. 24).

Modern rules reflect basically the same functional policy objectives, principles and regulatory mechanisms used by the London and New York stock exchanges in 1882 (Spink 2010a, paras. 3(d), 22, 84). They remain principles-based, but over time those principles have become increasingly codified and detailed in response to the continuous demand for clearer articulations of exactly how the principles apply to particular products or transactions, and changing conditions. The need to update existing rules means the demand is not only continuous, but continuously increasing. Securities regulation is

therefore essentially a continuous law-reform process that applies basic policy principles to a rapidly-evolving securities industry.

The next section will focus more specifically on how Canadian securities regulators met this growing demand for policy and law reform as an example of “federalism as process”. It examines how the process evolved in response to the demand for more and better securities regulation by improving the system’s dynamic efficiency.

DYNAMIC EFFICIENCY AND RULE-MAKING

Dynamic efficiency is basically the ability of a system to innovate, adapt and respond appropriately to market developments. It has been aptly described as “the acid test of a good regulatory regime” (Lortie 2010, 22). There are many examples of the dynamic efficiency of the existing system (Anand and Klein, 2005; Lortie 2010; Courchene 2010a; Courchene 2010b) but here I will focus on how the rule-making process evolved to become more dynamically efficient.

In 1988, every securities commission in Canada was basically a department of government, each responsible for its respective act and regulations. It was already obvious that conventional processes for amending legislation or making regulations were ill-suited to the demands of securities regulation because elected officials, however well-intended, could not be expected to deal with the volume, rapidity and complexity of issues arising in this area. Regulators tried to meet the demand for new rules by issuing policy statements in ever-increasing numbers but policy statements did not have the force of law and, eventually, one was struck down (*Ainsley* 1993). That triggered major changes to give securities regulators:

- more authority – the power to make rules (legally equivalent to regulations passed by government);
- more autonomy – several major commissions (starting with the Alberta Securities Commission in 1995) were removed from government and converted to provincial corporations managed by a CEO and directors appointed by government; and
- more resources – major commissions became self-funding, using regulatory fees to fund their operations.

These changes gave securities regulators significantly more responsibility and capacity, and deliberately insulated them from elected officials. They recognized the risks associated with politically-motivated regulatory decisions and attempted to reduce those risks by having most decisions made by expert regulators instead of elected officials. The precise balance and accountability mechanisms were different in each jurisdiction; the only constant was that every regulator reported to a minister who reported to a legislative body.

There was earnest debate about the merits of rule-making (MacIntosh 1994) and the models continue to evolve, but the overarching functional purpose has always been the

same: to provide a more responsive, transparent, consultative and non-partisan policy-development process. Rule-making processes were designed to facilitate more rigorous and better-informed debate on technical or specialized issues than was possible with conventional legislative processes. They enabled the use of explanatory “companion policies”, which do not have the force of law but promote better understanding and compliance with the rules. The objective was to produce better-quality policy.

Rule-making enabled policy development and implementation to move either faster or slower than was possible with conventional legislation. Faster action is sometimes useful, but the more significant advantage of rule-making is that it enabled the policy-development process to be sustained over much longer periods than were possible with conventional legislative processes. That longer attention span is a necessity for dealing with the complex issues that abound in securities regulation.

Rule-making facilitated harmonization in some areas and regulatory competition in others. The volume of change and consultation increased so that securities regulators now hear complaints of “regulatory fatigue” from stakeholders struggling to keep up with requests for comments on proposed new rules. That seems a necessary and small price to pay for a more rigorous, transparent consultation process and resulting dynamic efficiency. It belies suggestions that our policy-making processes are too slow and reminds us again that the critical objective is not speed but quality.

COMPETITIVE FEDERALISM AND INNOVATION

Securities regulation provides many concrete examples of the “theory of competitive federalism” described by Breton 1986. Competitive federalism “brings to the operations of governments some of the innovation and dynamic efficiency associated with the operation of decentralized markets in the private sector” (Courchene 2010b, 6). A colorful example was described in a 2007 speech by the then-Chair of the British Columbia Securities Commission:

A few months ago, I attended a presentation by an eminent professor from Columbia University, who told the audience that the SEC has ramped up the pace of its policy processes. As an example, he pointed out that the SEC had concluded that rapid dissemination of corporate disclosure through the internet meant the traditional one-year hold period for private placements was unnecessarily long. As a result, the SEC had published a proposal to reduce the hold period to six months. If Canada’s regulators can’t keep up with this kind of innovation, he thundered, Canadian markets will become even more uncompetitive.

It might surprise the good professor to learn that Canadian regulators actually noticed the internet some years ago, and that we came to the same conclusion. As a result, we reduced our hold period from 12 months to 4 months. That was in 2001. We aren’t too worried about falling behind our US colleagues on this one!

Indeed, Alberta and British Columbia pioneered this change in 1998. Demonstrating one of the strengths of our decentralized system — innovation — our successful implementation in the west led to national adoption a few years later. (Hyndman 2007, 8-9)

The evidence filed in the securities references included other examples of how decentralization and competitive federalism foster dynamic efficiency and innovation (which centralization sacrifices for uniformity), and how the SEC's recent failures may be seen as the result of "excessive centralization" (Macey 2010a, 61; Courchene 2010b, 18-9) facilitating regulatory capture, complacency and error (Courchene 2010b, 21; Suret and Carpentier 2010, 96-105; Choi 2010, paras. 75-8). The evidence also described how the risk of regulatory capture for a single regulator in Canada would be particularly high because our financial sector is so concentrated (Suret and Carpentier 2010, 96-105; Choi 2010, paras. 75-8).

MacIntosh (2012b, 259) describes how decentralized policy-making produces superior policy outcomes in securities regulation because it is a process of Bayesian updating where "making good legislation is essentially a never-ending iterative process" in which "regulation experiences rapid and essentially continuous evolution". Before considering some specific examples of such evolution, it is useful to examine the incentives for securities regulators and the concern about a "race to the bottom".

WHY THERE IS NO RACE TO THE BOTTOM

Concerns about provincial autonomy resulting in a race to the bottom reflect certain misconceptions about the incentives facing securities regulators. For example, there was evidence in the references suggesting that:

- securities regulators have incentives to impose "negative jurisdictional externalities" such as: allowing a local factory to pollute rivers flowing into other provinces; ignoring or discounting the effects of consumer fraud perpetrated by local firms against consumers in other provinces; and preserving a local monopoly (Trebilcock 2010, para. 22);
- provinces are largely powerless against such externalities because it is difficult to negotiate interprovincial cooperation and coordination to "avoid these kinds of beggar-thy-neighbour effects" and avoid "some form of 'race to the bottom' where all provinces choose to ignore jurisdictional externalities" (Trebilcock 2010, para. 24);
- "[a] principle of decision-making by consensus or unanimity means that 'hold-out' provinces can credibly threaten to undermine efforts at coordinated responses to inter-jurisdictional externalities" (Trebilcock 2010, para. 24); and
- jurisdictional externalities from a decentralized system of provincial securities regulation are pervasive and lead to dysfunctional, costly and inefficient regulatory regimes (Trebilcock 2010, para. 7).

Although a regulatory “race to the bottom” is hypothetically possible, the evidence demonstrated quite the opposite. Securities markets have always been international, inherently receptive to free trade and relatively borderless by comparison with markets in tangible goods (Spink 2010c, para. 11). It has long been understood that “the larger the pool of investors bidding on a company’s securities, the more efficiently the price of those securities will be set and the more liquid the market for them will be” (Tafara and Peterson 2007, 46). The normal incentives for regulators are to pursue the most efficient market possible while maintaining a primary focus on investor protection, thereby maximizing the benefits for investors and issuers both locally and outside the jurisdiction (Spink 2010c, para. 11). These incentives drive securities regulators to produce positive externalities through continuous improvement and innovations that respond to local conditions (Spink 2010c, paras. 12-6; Macey 2010a, 30-4; Macey 2010b, 2-3; Choi 2010, paras. 65-80).

Canada has of course experienced its share of regulatory errors and failures. Armstrong (1997; 2001) examines the history of securities regulation from 1870 to 1980 including fascinating details about regulatory failures such as the epic struggle to control Toronto boiler rooms. Those details reveal no race to the bottom but rather a steady inclination towards better regulatory policy in which failure normally consisted of not advancing quickly enough or in exactly the right direction. This pursuit of better regulatory policy was the reason interprovincial cooperation was formalized in 1937 through the Canadian Securities Administrators (CSA) and is evident in every CSA harmonization initiative and every example of innovation, experimentation or diversity ever since (Rousseau 2010a, 90-8, 115-48).

Experimentation enables individual jurisdictions to maximize their positive externalities (by exporting successful innovations) while limiting the risks associated with unsuccessful experiments. For example, Alberta’s Junior Capital Pool (JCP) program was initially problematic. The very first JCP in 1986 generated a massive scandal and the bankruptcy of a brokerage firm, resulting in many regulatory and criminal proceedings, and my first job as a securities regulator was largely occupied by taking enforcement action against violators of the original JCP Policy. Those problems pointed regulators in the direction of reform. The policy was modified several times and since 2002 has operated across Canada as the Capital Pool Company program with considerable success (TSX 2012, 3). The crucial point is that the process that created the JCP Policy and modified it until it became a success was dynamically efficient.

JCPs illustrate why it is simplistic to suggest that federal legislation might usefully set “minimum standards”. Sometimes it makes sense to reduce regulatory requirements, or do away with them altogether (Aitken 2005). So-called minimum standards would actually just ossify a single standard, preventing innovations or improvements by individual jurisdictions such as JCPs (Suret and Carpentier 2010, 41-2; Choi 2010 paras. 22-4; Rice 2010, para. 172e).

JCPs were also a pivotal factor in the failure of the federal government’s proposals for a single securities regulator in the mid-1990s – the MOU proposals, named after numerous draft memoranda of understanding (MOUs) between the federal government

and provinces. Parallels between the failure of the MOU proposals and the federal government's failure in the securities references are described in the next section.

WHY THE MOU PROPOSALS FAILED

The MOU proposals started in 1994 (Canada 1994), collapsed, were revived in 1996, and collapsed again in early 1997 (MacIntosh 1997; Harris 2002, 27-36; MacIntosh 2012a, 179-80; MacIntosh 2012b, 265). They were presented as a constitutionally-neutral initiative focused on improving the efficiency of the system by reducing costs and eliminating duplication (Sawiak 1996). Alberta was initially open to the proposals and considered them seriously. The MOU proposals generated intense critical scrutiny of our existing system (CSA 1995a).

Similar to what occurred in the securities references, scrutiny revealed that the system was already quite efficient. It became evident that a single regulator was going to cost more than our existing system because transition costs would be significant and a single regulator (in whatever form) would inevitably be bigger than the existing system. Although presented as reducing overlap and duplication, the MOU proposals were recognized as a source of overlap and duplication (CSA 1995a, para. 2.1.6). Since no other policy goals had been articulated for the MOU proposals (CSA 1995a, paras. 2.3.3, 6.2.3), their inability to improve efficiency may, alone, have been enough to cause their failure.

Alberta's paramount concern, however, was that a single regulator would eliminate the most valuable feature of our existing system – innovative regional initiatives such as JCPs.⁸ Although the federal government agreed in principle that regional innovation should be accommodated it was impossible to envision how JCPs, or any other significant regional innovations, could be achieved under a single regulator. This crystallized Alberta's opposition and other provinces had similar concerns about forced uniformity.

The MOU initiative was never formally pronounced dead but discussions ended early in 1997 after Ontario agreed to a federal securities commission on the understanding that a majority of the commissioners would be selected from Ontario.⁹ From today's perspective it seems astonishing that such a significant issue with the governance of the proposed federal regulator would surface so late in the process, but it reflects how the initiative had, until then, been focused narrowly on the possibility of improved efficiency.

The parallels between the MOU proposals and the securities references seem significant: functional improvements were claimed but not supported by empirical evidence; scrutiny of the existing system revealed strengths that a single regulator could not replicate; and at the end, only Ontario supported the federal proposals. The next

⁸ Alberta Hansard, August 20, 1996, p. 2244.

⁹ G. McIntosh, "National securities agency gets Ont. nod" *Edmonton Journal*, February 13, 2007, p. G8.

section examines how our regulatory system evolved in the aftermath of the MOU proposals and considers whether that evolutionary trajectory will continue in the aftermath of the securities references.

THE PASSPORT SYSTEM – THE EVOLUTION OF PROCESS

We can trace the evolutionary trajectory of today’s passport system directly back to the failure of the MOU proposals (CSA 1995b, 18). While the MOU proposals foundered, the Alberta and British Columbia securities commissions signed a regulatory accord designed to increase coordination and cooperation on regulatory initiatives, policy development, and securities enforcement (ASC/BCSC 1996). That accord was the next step in refining the prospectus-review process which then evolved into the Mutual Reliance Review System (MRRS) in 1999 (Rousseau 2010a, 93-7). Each of these incremental functional improvements was an evolutionary step towards our current passport system.

The passport system is a mutual-recognition process functionally similar to the Multijurisdictional Disclosure System adopted by the SEC and Canadian jurisdictions in 1991. Mutual recognition basically means that: each jurisdiction accepts the others’ disclosure and approvals; nobody gives up jurisdiction; and everyone’s anti-fraud provisions continue to apply. Mutual recognition enables practically-free trade in securities without compromising each jurisdiction’s overarching objective of investor protection. It is the most obvious functional model for globalized free trade in securities (Spink 2010c, para. 23, Selinger 2007).

The term “passport system” is simply the label attached to the most recent set of functional improvements to regulatory process that have been evolving constantly since the 1930s (Spink 2010c, para. 24). The key innovation enabling mutual recognition (dubbed “operation of law”) is quite narrow and technical, applying to only certain portions of our securities regulatory system (Spink 2010c, para. 23; Rousseau 2010a, 112-4), but has resulted in significant functional improvements.

FUNCTIONAL IMPROVEMENTS

It is important to recognize that the passport system, like the vast bulk of policy initiatives throughout the history of securities regulation, focused strictly upon making incremental functional improvements to the existing system. It is therefore incorrect to refer to our entire securities regulatory system as the “passport model”, or to view the passport system as a structural model or evolutionary endpoint. The passport initiative deliberately expressed no conclusion on regulatory structure and was neutral to the significant structural differences among regulators in the passport jurisdictions.

Constitutional rhetoric portrayed the passport system as a “virtual single regulator”, implying that it was an inadequate attempt to emulate the functional superiority of a

single regulator (Spink 2010b, paras. 46-8). In fact, the passport system was conceived as potentially superior to a single regulator (CSA 1995a; CSA 1995b). It was designed to provide a “single window of access to market participants” with respect to areas where securities law is highly harmonized – as a single regulator would – but to outperform a single regulator by preserving the essential elements of consensus-based policy making and the ability of jurisdictions “to innovate and test new and unique initiatives” (Alberta 2004, paras. 5.1, 5.10).

ACCOUNTABILITY

The passport system illustrates how accountability mechanisms have evolved and how relatively subtle changes can have significant effects. It changed the dynamics of policy-making by creating the Council of Ministers of Securities Regulation (Council) and giving it a role in the existing consensus-building process. This produced “unprecedented levels of co-ordination and consensus among provincial and territorial governments and the Canadian Securities Administrators to streamline and improve securities regulation”, and a large volume of National Instruments and complementary legislative reforms including entirely new and harmonized *Securities Acts* in several jurisdictions (Selinger 2007).

The Council was perhaps the most successful innovation of the passport system in terms of improving the quality and pace of policy development. In each jurisdiction there are three distinct policy inputs on securities regulatory issues: 1) the securities regulator; 2) Ministry officials; and 3) the Minister. Basically, the Council improved the process by which those inputs were coordinated so that, when consensus is possible it is reached more quickly and, when there is no consensus the reasons are clearer and discussions are better-informed. Better coordination of policy and legislative timetables at the ministerial level, together with a shift towards “platform legislation” (retaining fundamental principles in the Act but removing detailed provisions to be addressed through rule-making) makes the continuous-reform process more efficient for everyone. It is easier for smaller jurisdictions to develop and maintain harmonized securities legislation and to actively participate in policy discussions. Jurisdictions choosing to simply monitor policy discussions and harmonize their legislation obtain all the benefits of the process at low cost. Each jurisdiction remains locally accountable and free to innovate. The Council continues to allow each province to customize its internal accountability and policy arrangements with its securities regulator. These vary significantly across Canada and are another form of regulatory competition reflecting:

- fundamentally different public policy or regulatory philosophies, such as Québec’s “communitarian capitalism” versus Anglo-American “individualist capitalism” (Courchene 2010a, paras. 34-40);
- more nuanced policy differences such as exempt market regulation; and
- even more nuanced structural/substantive/policy differences such as the independent securities tribunals in Québec and New Brunswick (Rousseau 2010a, 178-85; Spink 2010b, para. 8, n.7).

These changes to the accountability mechanisms are subtle – although they give elected officials an increased role in managing the process by which regulatory decisions are made, they remain intended to reduce the possibility of unwise political regulatory decisions by making political influences more transparent and subjecting them to more rigorous policy scrutiny. Although not perfect, the Council appears to provide the most productive level of political accountability for securities regulation that has evolved to date in Canada.

THE PASSPORT SYSTEM IN PERSPECTIVE

Although the passport system has been a significant functional improvement, it is just the latest innovation in our continuously-evolving securities regulatory system and would have gone largely unnoticed except for Ontario's refusal to participate and the ensuing constitutional references. Thrusting it into the spotlight revealed in extraordinary detail how the passport system evolved and why it seems to work so well. Looking back along that evolutionary trajectory, the following points seem evident:

- the objectives and principles of securities regulation have not changed significantly over time – what has changed continuously are technology and products in the securities industry and the details of securities legislation;
- the process for continuous reform of securities legislation evolved primarily in pursuit of better-quality regulatory policy and dynamic efficiency;
- regulatory competition, experimentation, innovation and diverse perspectives tend to produce better-quality regulatory policy and dynamic efficiency, whether or not the result is harmonization;
- securities markets have always been international, so harmonization (as distinct from uniformity) and mutual recognition are the most promising bases for enabling international free trade in securities while preserving healthy regulatory competition;
- our current passport system is a world leader in terms of the achieving the functional policy objectives of securities regulation, illustrating what Courchene has described more broadly as Canadians being “masters of the art of federalism” (Courchene 2010a, para. 11) and excelling at “federalism as process” (Courchene 2010b, 6); and
- regulators can never rest on their laurels but must continually innovate and pursue functional improvements – the most important regulatory challenge is always the next one.

ONTARIO AND THE PASSPORT SYSTEM

From a functional perspective it has always been clear that Ontario should join the passport system and harmonize its securities legislation with the other provinces (Selinger 2008). In 2003, Ontario supported consulting on a passport system based on the view that, if implemented, it would represent an incremental improvement to the current

securities regulatory framework, but it refused to sign the Passport Memorandum of Understanding in 2004 because “[f]or Ontario, the passport system was not an end unto itself, but rather a step towards the creation of a national securities regulatory system” (Rousseau 2010a, 107-8). Ontario officials were then concerned that joining the passport system would “not do anything for Ontario” but result in the loss of political momentum for a single regulator.¹⁰

After the Supreme Court’s decision, Ontario’s Finance Minister was quoted as saying: “The passport system itself does not serve the interests of the Ontario market, particularly”.¹¹ A new political consideration is that joining the passport system now may be seen as final capitulation by Ontario (MacIntosh 2011), the federal government’s only provincial ally in the securities references. Since Ontario and the federal government have been aligned politically on this subject for some time, Ontario’s position on the passport system seems unlikely to change except in tandem with the position of the federal government.

Ontario’s refusal to join the passport system raises interesting questions about its particular vision of federalism and about the capacity of a single province to alter the course of federalism. The functional superiority of the passport system was always the most plausible explanation for Ontario’s refusal to participate (Spink 2010b, para. 48) and it is extremely unusual in my experience for political considerations to prevail over functional considerations in this way (Spink 2010c, para. 13). The fact that political considerations have prevailed in Ontario illustrates what I will refer to as “constitutional risk” – the risk that a constitutional agenda may generate incentives for retrograde policy that override normal functional policy considerations.

TURF WARS AND CONSTITUTIONAL RISK

The realization that the long struggle over securities regulation has always been a constitutional turf war is sobering. One wonders how history may have been written if Canada had replaced its world-leading securities regulatory system with an inferior model based on constitutional rhetoric. The securities references illustrate how toxic this kind of constitutional turf war can be to functional policy development and implementation, and how preposterous the supportive myths can be – an extreme example of constitutional risk.

My first exposure to constitutional risk was in the 1990s when I described how a constitutional turf war and agenda impeded the process of modernizing our securities transfer legislation (Spink 1997). It still does. That particular constitutional agenda (and supportive myth that securities transfer legislation is a matter of corporate law, not

¹⁰ Ontario Hansard, August 18, 2004, p. F-908. At http://www.ontla.on.ca/committee-proceedings/transcripts/files_pdf/2004-08-18_pdfF024.pdf.

¹¹ K. Howlett, 2011. “Ontario to push for reforms to fragmented securities system” December 22, 2011. At <http://www.theglobeandmail.com/globe-investor/ontario-to-push-for-reforms-to-fragmented-securities-system/article2281169/>.

property and civil rights) significantly obstructed the reform process and frustrated functional policy objectives – including the reduction of systemic risk – by clinging to obsolete concepts deliberately rejected by other jurisdictions (Spink 2007, 194-5; Spink 2010a, paras. 66-8; Gray and Scavone 2012). Although the proper constitutional characterization of securities transfer legislation seems clear (Geva 2004), these toxic policies were necessary to hold a line in the constitutional turf war by delaying action on securities transfers pending the federal government’s anticipated victory in the securities references, whereupon securities transfers could be subsumed under the trade and commerce power as a matter of “economic efficiency” (Puri and Lan 2007, 30). This history of retrograde policy and the artificiality of the supporting myths epitomize constitutional risk.

Another example of constitutional risk has been chattel-security law. Ziegel (2012) described this as an area “where federal-provincial co-operation has failed conspicuously”. The federal government has resisted almost-unanimous calls for elimination of *Bank Act* security provisions with “a very short and unpersuasive explanation” (Wood 2012, 256), producing outcomes that “are not commercially sensible” and an approach which “undermines several foundational features of modern secured transactions law and makes it necessary for secured parties to adopt more costly practices” (Wood 2012, 270). Because the federal government evidently has constitutional jurisdiction over *Bank Act* security this is a slightly different type of turf war and constitutional risk – the risk that federal jurisdiction may be used to prevent provincial law from reaching its policy objectives, perpetuating a “tortured and dysfunctional relationship” between the federal and provincial regimes (Wood 2012, 248).

A striking example of constitutional risk invoked by the securities references was the epic constitutional turf war where “[f]or many years the federal government mounted a repeated campaign to assume the national regulation of the insurance industry [and the] federal efforts were rejected on every occasion” (*Reference ABCA*, 2011, para. 42; Armstrong 1976; Armstrong 1981, 100-13). There are many important parallels between securities and insurance regulation. Perhaps the most significant fact concerning the war over insurance regulation is how that war was conducted not by the federal government but by federal bureaucrats. Gray (1946, 483) observed that parliament had not understood the policy of the failed legislation because that policy:

...was made in the offices of the Dominion Insurance Department on Rideau Street, Ottawa, irrespective of the party or the minister for the time being nominally responsible for Dominion legislative policy. This fact is the key to what is regarded as a series of unfortunate judicial defeats for Dominion jurisdiction by those who persistently seek to establish at Ottawa a centralized control of Canada’s business economy.

In retrospect it seems axiomatic that decades-long, strategic, constitutional turf wars must be conducted by bureaucrats, or not conducted at all. Cooper observed that “senior bureaucrats in the [federal] Department of Finance have for generations sought to control and regulate securities [and] still harbor secret (or not-so-secret) desires in that direction” (Cooper 2012, 16). As discussed in the next section, the turf war over securities

regulation has continued and seems almost certain to produce a sequel to the securities references and perhaps even a series of constitutional battles like those over insurance regulation.

THE WAY FORWARD

Elsewhere I observed that the “victorious” provinces did not seek this battle and gained nothing from the securities references except affirmation of the constitutional *status quo* (Spink 2012, 185). On the other hand, the reference decisions were a crushing blow to the federal government because obtaining jurisdiction over securities regulation was evidently part of a larger constitutional agenda, which began to unravel after the references.

For example, there have long been questions about constitutional validity of Part 1 of the federal *Personal Information Protection and Electronic Documents Act* (PIPEDA), which “sprang from an ambitious – some have said cynical and aggressive – attempt to stake out expanded jurisdiction for federal policy-makers” (Chester 2004, 52). The federal government’s constitutional arguments in support of PIPEDA (*State Farm* 2010, para. 42) were practically identical to those in the securities references. After the references former Supreme Court Justice Michel Bastarache described “compelling reasons to believe that PIPEDA, as enacted, would not be upheld as constitutional” (Bastarache 2012, 17). The references also cast doubt on the constitutionality of certain federal copyright provisions (Geist 2012; Crowne-Mohammed and Rozenszajn 2009).

Recent amendments to the *Payment Clearing and Settlement Act* (PCSA) are remarkable because they purported to shift reliance from banking to the first branch of the trade and commerce power, asserting jurisdiction based on the mere fact of cross-border activity (Canada 2011, 8:33). This subtle change arguably represents an even bolder and more aggressive expansion of the trade and commerce power than was attempted in the securities references. It clearly anticipated a federal victory in the securities references and might have succeeded in that event, completing the categorical transfer of jurisdiction from the provinces to the federal government under the banner of trade and commerce. Now conspicuously *ultra vires*, these amendments reopen longstanding concerns over the constitutionality of portions of the PCSA (Rousseau 2010a, 72-6).

A SYSTEMIC-RISK REFERENCE?

With so much at stake, the federal government was naturally reluctant to accept the results of the securities references as a defeat. Instead, it decided to “forge ahead” towards “the goal of establishing a national securities regulator” (Fraiberg 2012b) based upon *obiter* comments in the Supreme Court’s decision regarding systemic risks.

The current argument is essentially that “the federal side did not lose” because the decision “recognizes, for the first time, a significant role for the federal government in securities regulation, particularly in regulating systemic risk” (Jamal 2012, 96-7). Partisans of federal regulation urged the federal government not to “throw in the towel” but to “address a glaring regulatory gap with respect to systemic risk” (Anand and Bishop 2012) by creating a new federal systemic-risk regulator (Fraiberg 2012a, 178; Puri 2012a, 195-6; Sarra 2012; Ford and Gill 2012; Anand 2012b). The Canadian Bankers’ Association (2013) objected to proposed securities regulation intended to reduce systemic risk in derivatives markets on the basis that the Supreme Court “confirmed the federal government’s exclusive jurisdiction to regulate systemic risk in Canada, including systemic risk as it relates to OTC derivatives transactions”.

The 2013 Federal Budget threatened to unilaterally propose federal systemic-risk legislation unless a “timely agreement” could be reached with the provinces on a “cooperatively established common securities regulator” (Canada 2013a, 143). In September 2013 an “Agreement in Principle to Create a Cooperative Capital Markets Regulatory System” (AIP) was signed by representatives of the governments of Canada, Ontario and British Columbia. The AIP contemplates as-yet-unseen uniform provincial securities legislation and complementary federal legislation asserting authority to “make regulations of national application (including in non-participating jurisdictions) related to systemic risk in national capital markets” (Canada 2013b, s. 4). The government of Québec immediately indicated that it would challenge the constitutional validity of such federal legislation so, assuming such legislation sees the light of day, there will presumably be a “systemic-risk reference”.¹²

Some of the weaknesses in the federal systemic-risk arguments have been discussed elsewhere (Spink 2012; Rousseau 2012a; Rousseau 2012b; Cooper 2012; MacIntosh 2012b) and I agree with MacIntosh that “[t]he argument about systemic risk was never more than an adventitiously concocted flying buttress cooked up in the wake of the credit meltdown to support an inherently unsupportable case” and “[t]o the extent the feds actually believe their argument about systemic risk, it is a triumph of ideology over reason” (MacIntosh 2011). This paper focuses narrowly on how the federal systemic-risk arguments reflect traditional constitutional rhetoric and false assumptions about systemic risks that are, essentially, extensions of the transformation rhetoric that failed in the securities references.

Systemic risk was an integral part of the argument that “this area of economic activity has been so transformed that it now falls to be regulated under a different head of power” (*Reference SCC*, para. 116). The federal government asserted that systemic risk is a relatively new phenomenon that only became relevant to securities regulators in 1998, and requires “national, if not international, regulation” (Canada 2010, paras. 27-9, 82, 84, 119). These and similar assertions that “securities regulation has not historically included concerns relating to systemic risk” (Anand 2010a, 7) are unfounded. In fact, systemic risks are as old as the markets themselves and have been regulated in the securities industry since the 1800’s using the same property-and-civil-rights mechanisms now being

¹² S. Mas and J. Fitz-Morris, 2013. “Securities regulator deal opposed by Quebec, Alberta”, September 19, 2013. At <http://www.cbc.ca/news/politics/securities-regulator-deal-opposed-by-quebec-alberta-1.1860472>.

applied to reduce systemic risk arising from over-the-counter derivatives and other sources (Spink 2010a, paras. 84-5; Spink 2012, 184; IOSCO 2011a; IOSCO 2013). Reducing systemic risk has always been one of the core objectives of securities regulation because it overlaps, and is often practically synonymous, with protecting investors and ensuring that markets are fair, efficient and transparent (IOSCO 2003a, 5-7; Spink 2010a, paras. 5-12; IOSCO 2011a, 6). What that means, of course, is that if “systemic-risk regulation” was a constitutional head of power, and it was federal, then federal systemic-risk regulation could replicate and subsume provincial securities regulation.

The securities references make clear, however, that federal legislation cannot validly replicate existing securities legislation because it is impossible to show a new or different constitutional purpose for such duplicative law. There has been no transformation – the thousands of pages of existing securities regulation are properly characterized as property and civil rights (Rousseau 2012b), as future generations of such regulation will be. Although federal trade-and-commerce legislation related to systemic risk is hypothetically possible, it remains abstract because, until we see such legislation, all we can say about it is that it must be qualitatively different from valid provincial legislation and of a type that the provinces could not effectively achieve – unlike existing securities regulation.

It is significant that, despite the strong incentives to do so, the federal government presented no new approach to systemic risk in the securities references, nor in connection with the AIP. It is not surprising that the federal government has been unable to devise qualitatively different legislation. The Supreme Court described a hypothetical “constitutional gap” that could only be filled by qualitatively different federal legislation, which is a correct statement of constitutional law but not a description of specific legislation nor a policy suggestion. Until qualitatively different federal legislation is presented, there is no reason to assume it will ever exist. The evolution of our regulatory system to date strongly suggests that future measures to reduce systemic risks will not be qualitatively different from existing law, but take the form of incremental policy initiatives developed within the existing legal framework (Spink 2012, 184).

In the absence of qualitatively different legislation, we should heed Lederman’s (1965, 94) admonitions that “when classifying to distribute legislative powers, we approach the facts of life only through their legal aspects, that is, only to the extent that such facts have been incorporated in rules of law as the typical fact-situations contemplated by those rules” and “vague general questions about legislative jurisdiction cannot be answered with any real clarity or precision”. Lederman (1953, 246) emphasized the importance of understanding the division of powers in terms of “classes of laws, not classes of facts” and seemed to foresee the current discussion of systemic risks when he said:

It is impossible for instance to look at a set of economic facts and say that the activity is trade and commerce within section 91(2) and therefore any law concerning it must be federal law. Rather, one must take a specific law... which is relevant to those facts and then ask if that rule is classifiable as a trade or commercial law.

Lederman's points are illustrated by existing federal and provincial laws related to systemic risks. Some (such as prudential regulation of banks, or the enforcement of close-out netting of derivatives) are properly characterized as matters of banking or bankruptcy and insolvency, while others (such as securities regulation or securities transfer laws) are properly characterized as matters of property and civil rights. It is therefore naïve, even dangerous, to discuss "systemic risk" as though it were a constitutional head of power. The same can be said of "derivatives".

The dangers of vague general discussions about legislative jurisdiction were highlighted in the securities references when Saskatchewan and British Columbia (which had previously expressed some political support for the federal initiative before seeing the proposed legislation) eventually joined with the other provinces in condemning the proposed legislation, leaving Ontario as the sole provincial supporter. Many intriguing questions arise from those events: what was Ontario's understanding with the federal government; what was the misunderstanding with Saskatchewan and British Columbia; and would the federal government have acted differently if it had known it would eventually stand alone with Ontario against six other provinces? The fundamental lessons seem clear – specific legislation is necessary to any meaningful discussion of jurisdiction; political agreements about jurisdiction made without reference to specific legislation are meaningless; and provinces cannot agree to proposals that would amend the division of powers except by constitutional amendment. As the Supreme Court said, "notwithstanding the Court's promotion of cooperative and flexible federalism the constitutional boundaries that underlie the division of powers must be respected" and "[t]he backbone of these [cooperative] schemes is the respect that each level of government has for each other's own sphere of jurisdiction" (*Reference SCC 2011*, paras. 62, 133).

IOSCO's (2013) review of the implementation of new principles relating to systemic risk and the perimeter of securities regulation suggests that Canada has relatively advanced regulatory mechanisms for addressing systemic risk, including cooperation and coordination systems between the relevant federal and provincial regulators. The AIP appears to be another constitutionally-driven structural initiative disguised as a policy initiative, destined to fail for essentially the same reasons that federal securities legislation failed in the securities references (Spink 2012, 184-5): lack of evidence supporting the asserted transformation; inability to present a qualitatively different approach; and inability to demonstrate provincial incapacity.

THE NEED FOR A MORE TRANSPARENT PROCESS

It is depressing to think of how many resources have been spent over the decades on artificial criticisms of our securities regulatory system, confusing the public and tarnishing Canada's reputation globally – all in order to advance a constitutional agenda. These wasted resources and the constitutional risks illustrated by the securities references and ongoing campaign for a federal securities regulator demonstrate the need for a more transparent process to deal with proposed constitutional changes.

When a constitutional paradigm shift is proposed it seems reasonable that the public ought to know what constitutional chips are on the table, where all those chips might go

and what is being exchanged for what. I knew none of that in the securities references, even though I was a relative insider. It was clear that many constitutional chips were on the table but, except for securities regulation, no one knew exactly what other chips were in the pile. There were political arrangements between the federal government and some of the provinces but the details of those arrangements were unclear, even to the governments involved. Such confusion about a constitutional paradigm shift seems like an unacceptable risk, and increased transparency the best way to prevent it.

The reference process worked perfectly in this instance and was a credit to our judiciary. However, the reference process was forced to overcome the lack of transparency in the larger process for dealing with constitutional change. For example, the first official statement of the federal government's constitutional position on its proposed securities legislation was its November 1, 2010 factum filed with the Québec Court of Appeal – released only 11 weeks before the Québec hearing and less than six months before the Supreme Court hearing. Litigation strategy is understandable but it seems unwise to have such a short fuse on such a potent constitutional device.

A more transparent process would reduce constitutional risk by ensuring that constitutional proposals are clearly identified and assessed as such – not disguised as policy proposals as they were in the securities references and in the brewing systemic-risk reference. We should be encouraged by the courts' skepticism about conjecture, insistence on evidence, and rejection of constitutional rhetoric in the securities references. We should anticipate a similar result in the systemic-risk reference and hope that will cause future constitutional initiatives to be scrutinized even more carefully.

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