

Notes for a speech by Monique Jérôme-Forget

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The Passport Securities System

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CHECK AGAINST DELIVERY

I am particularly happy to be here today to speak about the passport system for the Canadian securities industry.

But before turning to this matter I feel strongly about, I want to say a few words on Québec's economic and financial situation, and the turnaround my government has achieved since 2003.

### **Sound Public Finances Promote Economic Growth**

Our Government has taken very seriously the promotion of economic growth based on healthy public finances since we took office in 2003.

We have undertaken a number of initiatives since 2003 to encourage job creation and stimulate wealth creation.

- We have tightly controlled government expenditure. The annual rate of expenditure growth for government programs between 2003 and 2007 has remained on average at 4.2% in Québec compared to an average of 6.7% for the provinces as a whole (7.9% in Ontario and 9.9% in Alberta). Apart from British Columbia, Québec is the province with the lowest average rate of increase of public spending in the country.
- We have reduced income taxes for individuals. Québec no longer ranks as the province that imposes the heaviest tax burden on its citizens. Five other provinces have a heavier tax burden than Quebec.
- We have relieved the tax burden on businesses. The tax on capital will be gradually eliminated by the end 2010. In addition, thanks to the capital tax credit, manufacturing companies that invest currently do not have to pay this tax.
- We have put a new energy policy in place. It puts emphasis on re-launching major works and exporting electricity. Over the next ten years, we expect to invest \$31 billion leading to the creation of roughly 70 000 jobs. Our Government has mandated Hydro-Québec to emphasize electricity exports. The Premier's visit to New York, last week, is part of our Government's determination to develop new markets.
- We have doubled investment in our public infrastructures. Despite this gigantic effort, it has become clear that more still needs to be done. Accordingly, I announced last week, together

with the Premier of Québec, the launching of one of the largest economic projects in Québec's history. Over the last 30 years, successive governments, from all parties, have neglected to maintain public infrastructures. By investing \$30 billion over five years, we are initiating the first phase of a huge undertaking that, over a period of 15 years, will renew all of our public infrastructures. This plan affects schools and hospitals, roads, bridges, cultural facilities and water systems. To secure the longevity of our infrastructures, I want to have a law on good infrastructure management passed. Why such a law? It would impose discipline and rigor and would force politicians to be accountable to the National Assembly.

- Lastly, recognizing the intrinsic value of our hydro resources, we created the "Generations Fund", which is our "Heritage Fund". The purpose of the Fund is to collect hydroelectric royalties and pay down the public debt in accordance with specific targets set by law. By 2026, the Fund will have raised \$42 billion, all of which will be used to pay down the debt. Our debt level will then be only 25% of GDP, with, keep in mind, renovated public infrastructures.

The Government's actions have produced results:

- The unemployment rate has dropped from 9.3 % to 6.9 %, its lowest level in 33 years;
- The employment rate has reached an historical peak of 61.1 %. Never before have there been so many Quebecers at work;
- There are 57,000 fewer people on the welfare rolls;
- We received a strong vote of confidence from international rating agencies which have raised Québec's credit ratings to its highest level in more than 30 years.

In short, I think that these are results we can be proud of.

### **Passport System versus a Single securities Regulator**

As you know, my topic today is the passport system.

We all too often overlook that the financial sector is a major job creator. According to a recent survey by the Institut de la statistique du Québec,

the financial sector employs close to 150 000 people in Québec. In addition to these employees, a large number of people in the sector are self-employed.

The financial industry accounts for about 6.2% of Québec's total gross domestic product, and as such is a major wealth generator.

I cannot speak of the importance of the financial sector in Québec without mentioning the Montréal Exchange. In recent years, it has experienced exceptional growth – compound annual growth of roughly 26% over the last five years – and its influence extends beyond Canada's borders.

As you doubtless know, the exclusivity agreement on derivatives transactions extended to the Montréal Exchange will end in March 2009. For a number of months, the Toronto Stock Exchange has on many occasions indicated that it intends to resume trading in derivatives. Recently, Richard Nadeau, Senior Vice-President at the Toronto Stock Exchange, confirmed this on television.

Let's be clear: Montréal must keep its financial exchange and its expertise in the derivatives sector. I firmly believe that we must rely on the huge potential of the derivatives market to continue Montréal's development as a financial centre. I would hope that the Toronto Stock Exchange will abide not only by the letter but also by the spirit of the exclusivity agreement reached in 1999 regarding derivatives trading in Canada.

Having said that, let's now turn to the passport.

Several proposals have been made in recent years to overhaul the Canadian securities regulation system. They embody either one of two competing views of a preferable securities regime.

The first model is advocated by Ontario and federal Finance Minister Jim Flaherty. It consists in setting up a single regulator. The second is the "passport" system, i.e. the harmonization of provincial regulation to create an efficient pan-Canadian system. It involves building on what already works well.

The provinces have already made tremendous strides to improve the efficiency of Canada's regulatory system.

Thanks to information technologies, systems and practices of a truly pan-Canadian nature have been implemented. This already eliminates

many functions previously performed on a local basis by individual securities commissions. As a result, we now have:

- SEDAR, an electronic system for data, analysis and research;
- SEDI, a system for electronic disclosure by insiders;
- NRS, the National Registration System;
- NRD, the National Registration Database;
- MRRS, the Mutual Reliance Review System;
- The adoption and implementation of 25 national general instructions and 24 national policies regarding key aspects, such as prospectus requirements, regulation of mutual funds, rights issues, regulation of buy offers, registration and prospectus exemptions, requirements relating to continuous disclosures, and so on.

But we must do better. All the provinces have already agreed to implement the passport system. However, Ontario, which initially promoted the passport, has decided to go it alone. I sincerely regret their decision. Accordingly, with the exception of Ontario, all the other provinces have agreed to implement Phase II off the passport by the end of 2008. The pan-Canadian passport will provide each issuer, dealer and registered participant with one-stop access to the Canadian market. The reform, with its imminent implementation, is no trivial matter.

- The passport system will give issuers access to the capital market across Canada while dealing solely with the securities regulator of their home jurisdiction.
- Similarly, dealers or representatives who wish to do business anywhere in Canada need only register with their home jurisdiction.

It is obvious to practitioners and observers that the passport system initiative is causing a profound transformation of our securities regulation system.

The passport system builds on what already works. It will eliminate the remaining duplication of administrative tasks just as effectively as a single regulator. It will do it faster, at a lower cost, and all without the kind of constitutional disputes that nobody wants because of the challenge to the provinces' jurisdiction over securities commissions.

To show our good faith, even though Ontario has not joined the passport system, an issuer registered with the Ontario Securities

Commission will be recognized by the commissions of all other provinces. For the good of Canada, shouldn't Ontario do the same?

A majority of the market participants that the Crawford Panel consulted mentioned that Ontario should join the passport system. This simple action would deliver additional economies to issuers across Canada in a very short time without closing the door to further improvements. One would have hoped that the Minister of Finance of Canada would use his influence to encourage Ontario to listen to this sound advice.

Unfortunately, Mr. Harper's government insists on backing a single securities commission. Some even indicate that it could ask the Supreme Court of Canada to rule on the federal government's constitutional authority regarding securities. Yet the provinces' jurisdiction in this field has always been acknowledged. Rather than asking the Supreme Court for its opinion, would it not be wiser for the federal government to consult with the provinces on this matter? This show of force by the federal government will leave more than a bitter taste. The Prime Minister of Canada should practice the federalism of openness that he preaches rather than referring the issue to the courts.

On that subject, I gave a speech in Toronto last October 3 to the Investment Funds Institute of Canada. I reiterated our position on the passport system and I called on the Ontario government once again to join the passport.

I agree completely with the Premier of Alberta, Ed Stelmach, who mentioned in a speech to the Empire Club in Toronto two weeks ago:

"I want to make my position very clear. The passport system is a model provinces can quickly implement to create a national system – so let's accept the passport and move on to other matters."

One of the prime objectives of regulating the securities industry is to ensure that investors are protected and that markets work efficiently. It is important to point out that the current system compared favourably with what exists in other jurisdictions.

- In 2006, a study by the World Bank and Lex Mundi ranked Canada 3rd in the world out of 155 countries for investor protection. The United States ranked 7th, and the United Kingdom 9th.
- In its 2006 report, the OECD ranked Canada 2nd in the world out of 29 countries for securities regulation quality, ahead of the

United States (4th), the United Kingdom (5th), and Australia (7th).

With these results, it's surprising that the federal government continues to denigrate the Canadian regulatory system from both inside and outside our country. That's what I call shooting yourself in the foot.

Moreover, I was very surprised to learn of a preliminary report by the International Monetary Fund that clearly and specifically suggests creating a single securities commission in Canada. How can the IMF's intervention be explained when the World Bank and the OECD rank Canada among the leaders when it comes to the quality of securities regulation?

How does one explain the IMF's interference in an issue that is the focus of a political debate in Canada? The close link between the federal Department of Finance and the IMF is certainly one reason. Pressure has certainly been brought to bear by the federal government to encourage such an intrusion by the IMF in our internal discussion. One need only skim through the IMF's studies on the securities systems of France, Germany and Italy, to name but a few, to understand that the IMF rarely reaches such definite conclusions in its research.

### **Three myths about the competitiveness of the Canadian market**

Today, I want to dispel three of the principal myths trotted out by the promoters of a single securities commission.

These three myths are as follows:

- Our regulatory system is more cumbersome and costly;
- Our regulatory system comes with higher financing costs for businesses;
- A single commission would reduce transaction costs on the secondary market.

I will respond to each of these myths.

### **First myth: higher cost of our regulatory system**

In a recent speech, the federal Minister of Finance stated:

“The benefits of moving to a Common Securities Regulator will save money and give all regions a real say. A Common Securities Regulator would better serve our common interest by having a structure that would allow all regions of the country to participate in market regulation in a more meaningful and constructive way. By having a structure that would ensure broad and equal participation by all provinces and territories (13 commissions), with a strong on-the-ground presence in all regions with local expertise that would respond to regional needs.”

But what are the facts? In 2002, the direct costs of regulation per million dollars of capitalization were \$145.80 in Canada compared to \$141.90 just for the *federal* regulatory bodies in the United States. Add to that the costs of regulatory bodies in each state, and the situation is strongly in Canada's favour. It is wrong to believe that in the US one deals with only one securities regulator. The reality is that often they must also deal with state regulators in addition to the SEC.

How can one seriously suggest that a structure supported by a strong organization in each province, in addition to a head office in Toronto or Ottawa responsible for directing and coordinating 13 regional offices, will result in a cost structure that is less onerous than the existing decentralized system?

### **Second myth: higher financing costs in Canada**

The main factors determining the costs of financing are of three kinds. First, remuneration of dealers; second, costs associated with legal services, fees, and prospectus preparation; and third, initial undervaluation of share price.

The results of empirical studies speak volumes. Findings reveal that the average total direct cost of a Canadian small-cap share issue (1 to 10 million dollars) is less (15.98%) than an American one (17.99%). The direct cost for larger-cap issues (over 100 million dollars) is similar in both countries.

Once again, the facts contradict the promoters of a single securities commission.



### **Third myth: a single commission would reduce transaction costs on the secondary market**

The liquidity of the secondary market for corporate shares is a determining factor in the cost of capital stock. This aspect is extremely important because investment decisions are affected by the cost of capital.

The empirical data paints a worrisome picture for anyone interested in the competitiveness of the Canadian capital market. For example, a recent study compared transaction costs for shares of a company listed on the TSX and an American stock exchange. The results indicate that transaction costs in Canada were 52.4 basis points, compared to 38.1 in the United States.

However, this disadvantageous situation for the Canadian market does not arise from the present regulatory system. The odds are that a centralized agency would instead tend to exacerbate the problem as a result of a more cumbersome bureaucracy.

The real problem is the low level of competition in the Canadian market. It is worth pointing out that the big Canadian banks alone control the bulk of the securities industry in Canada.

Moreover, it's interesting to note that it took the threat of competitive alternative markets in Canada (Pure Trading, Instinet, and Alpha) for the TSX to announce a reduction of its fees and the development of Quantum, a faster transaction system. Here as elsewhere, the answer to many inadequacies of the Canadian capital market is not found in upheavals of the securities regulating system architecture, but rather in greater competition within the industry.

I can already hear some people retort, "yes, but a single securities commission would be so much more rational, more coherent, like in the United States." I can't say whether this is ignorance or bad faith. However, the reality is this:

- In the United States, contrary to a widely-accepted myth, the states have their own securities regulating agency. The American system is a lot more decentralized than it appears.
- On several occasions, state authorities reacted more quickly and more effectively than the central agency, the Securities and Exchange Commission (SEC)—for example to correct abuses by financial analysts or to put a halt to questionable practices by

mutual funds. One of the big scandals of the 1980s, the fraudulent schemes of the managers of Prudential-Bache, was brought to light as a result of the tenacity of securities commissions in some American states, and there are more examples.

- The SEC didn't save Americans and other investors from the disasters of Enron, Global Crossing, Tyco, and more recently, the "sub-prime" crisis.

In fact, a detailed comparison of Canadian and American securities regulating systems reflects this paradox: the present Canadian system, even without any federal or national commission, is as uniform and harmonized as the American system.

A single, lone Canadian securities commission is not the panacea it is touted to be, and is not what we need.

### **Elements of an Action Plan**

To increase the efficiency of our regulatory system, I propose a two-point action plan:

- The first point is the quick implementation of the passport, which will take place in 2008.
- The second point is to strengthen the means for punishing violations of the securities laws in order to effectively combat white-collar crime.

This point is very important. Many practitioners and observers believe that the regulatory bodies in Canada have fallen short in this area. They are correct. However, bear in mind that it is not the proper role of regulatory bodies to lead criminal prosecutions.

As Doug Hyndman, Chair of the British Columbia Securities Commission, said:

"Canadians do not feel that the authorities treat investment fraud as seriously as other crimes. They think that people who defraud others "generally get away with it". Unfortunately, they're right. Canada will have to work hard to fix this problem. Our focus should be on changing the dynamics in the criminal justice system, not on blaming provincial regulation."

In Canada, the federal Parliament has exclusive jurisdiction to bring securities crime under the ambit of the Criminal Code. It is worth noting that the Criminal Code was amended in 2005 to make insider trading and tipping a criminal offence. This amendment got Canada to where the rest of the world was; indeed in the rest of the world insider trading has long been considered a crime. Questions have been raised, notably by Michael Watson, Director of Enforcement of the Ontario Securities Commission, whether the standard of evidence required is too stringent to make these new provisions effective.

However, I note with satisfaction that tangible efforts have recently been made in the enforcement field. At the end of 2003, Integrated Market Enforcement Teams (IMETs) were created in Toronto, Vancouver and Montréal. Unlike the situation in the United States and the United Kingdom, the creation of an entity such as this was late in coming in Canada (the United Kingdom formed the Serious Fraud Office in 1987), its funding appears to be limited and its operations appear to be still in the starting-up period. I recently met with Joseph Borg, President of the North American Securities Administrators Association, who was unequivocal in his insistence that full sharing of information within joint task forces that include the police, forensic experts, regulators and prosecutors was critical to success.

In October 2006, all the provincial and federal Ministers of Justice created a task group mandated to recommend measures to strengthen the prosecution of securities fraud. Their report is expected in November and should bring useful recommendations.

I have proposed to my ministerial colleagues that we examine the possibility of establishing an independent securities tribunal system. That tribunal system would be inter-provincial. It's a matter of separating the supervisory function from the quasi-judiciary function of the securities commissions.

The goal of such an undertaking is to strengthen the quasi-judiciary function by establishing a uniform interpretation of common rules in Canada.

I want to end by stressing the following five points:

- First, the structure of the Canadian financial sector has a profound influence on the workings and competitiveness of our capital markets. Its evolution towards a very concentrated industry has few parallels in industrialized countries. The implications for the efficiency and competitiveness of the

Canadian capital markets are enormous and need to be given proper weight in the formulation of policy.

- Second, the empirical evidence demonstrates that Canada ranks amongst the best with respect to the quality of its securities regulations and protection of investors. The federal government should stop denigrating the existing system, especially outside the country. A more positive assessment is clearly warranted.
- Third, the Canadian regulatory machinery has adapted to the evolution of the structure of the industry. As a result of the very high concentration in certain segments such as exchanges, clearing houses, etc., it has become, de facto, national in scope, as and when warranted. Moreover, Canadian securities commissions have adopted mechanisms which, in effect, will provide one-stop access.
- Fourth, as a result of these initiatives, the degree of harmonization of securities laws in Canada will lead to the creation of a truly national system. Our securities regulations are as uniform as in the United States despite the fact that the provinces have maintained their jurisdiction. The efficiency of this remarkable example of inter-provincial cooperation has been demonstrated by international comparisons and empirical studies.
  - Let's be clear: the passport system builds on what already works. It will eliminate the remaining duplication of administrative tasks just as effectively as a single regulator. It will do so faster, at a lower cost, and all without the kind of constitutional dispute we can all do away with.
- Fifth, in our view, most of the criticisms about the current system emphasize shortcomings at the enforcement level. In this area, the government of Canada has an important role to play.

## **Conclusion**

In conclusion, I want to say publicly that we fully support the efforts of Mr. Flaherty to establish free trade in securities with the United States and other G7 and international partners that share stringent standards of investor protection. It is important to remember that free trade in

securities is based on mutual recognition just like the passport system. Free trade demonstrates that the passport system works.

But I sincerely ask the Ontario government to work with us to improve the Canadian regulatory system. Ontario must join the passport system. The entire country would benefit. It may be noted that Europe has adopted the passport system.

Next, I hope all the provinces will support my proposal for an independent securities tribunal system. My colleagues have agreed to examine the potential benefits of such a tribunal system.

Investor protection requires that we work closely together.

Let us not become Cassandras. While the OECD and the World Bank rate Canada ahead of the US and the UK in terms of investors' protection, let us not sell our achievements short. I am neither ashamed nor embarrassed by our securities regulations track record. On the contrary, I am proud of it and intend to promote and improve it.

Thank you for your attention.