# Reforming Canadian Securities Regulation: Risks and Opportunities

Speech by

Douglas M. Hyndman
Chair, British Columbia Securities Commission

The Fraser Institute – February 23, 2009

Thank you for inviting me to speak to the Fraser Institute today.

As I was preparing my remarks, I thought about how much has changed since last year at this time. Let`s just review that ancient history for a moment.

- On February 22, 2008, the Dow Jones Industrial Average closed at 12,381. It closed last Friday at 7,366, down 41%.
- The TSX index closed a year ago at 13,586. It closed Friday at 7,950, also down 41%
- The Canadian dollar has dropped from 98 cents US to 80 cents.
- Oil was at $98 a barrel and rising. Now it's at $39.
- Last February, most Canadian investors were still seeing and expecting positive returns on their investments; commodity prices were rising; mining companies, big and small, were acquiring new properties, and each other.
- In BC, employment was at an all time high and the government was projecting more surpluses; the big policy issue of the day was climate change.

Not everything was rosy, of course. There were dark clouds on the horizon.

- The credit market turmoil that had struck the world in August 2007 was proving difficult to fix. In Canada, we were struggling to restructure the non-bank asset-backed commercial paper that had been frozen for six months, although the resolution seemed to be in sight.
- In the US things were worse. The credit market problems were spreading to the insurance and banking sectors and fears were growing that the US might go into recession. Indeed, the data later showed that the recession had already started. However, Congress was riding to the rescue with an economic stimulus package. It sounded pretty big — $150 billion — although it looks like a pittance in retrospect.
- Britain was also facing problems, notably the failure of Northern Rock, and concerns were rising about the excessive leverage in the financial system there and elsewhere in Europe.

The common view in Canada was that we would avoid a recession because our financial system was better capitalized and we would benefit from the continuing boom in commodities. That boom was driven by the extraordinary growth in emerging markets, which were, some said, decoupled from the struggling developed economies.

In February 2008, the Globe and Mail ran an article with the headline: *A rosy forecast possible if it all goes right*.

It didn't all go right.

Now, we are inundated with analysis about what caused the financial and economic crisis infecting the world. The specific triggers that set off the credit market turmoil, and the mechanisms through which it has been transmitted across sectors and countries, are complex and murky. The root causes are fairly simple.

A debt-financed boom in consumption and asset prices, especially but not only in the United States, created unsustainable imbalances and temporarily rewarded risky and shoddy practices. Excessive leverage in the financial system was an accident looking for a place to happen. When things began to unravel in the US sub-prime mortgage market, the accident happened.

All of this is much more obvious in retrospect than it was at the time. While many worried about the imbalances, few, if any, saw the size or scope of the sea change that was coming. Authorities everywhere are struggling to find ways to reverse, or at least mitigate, the damage it is causing.

In Canada, we have been fortunate in not facing financial and economic problems as severe as those in the US and many other industrial countries. Our banks and other financial institutions have been hit hard but they are faring far better than those elsewhere because they were better capitalized and had fewer toxic assets.

Nevertheless, we have learned once again that a small, open economy like Canada's is not insulated from the problems of our trading partners. It was never realistic to think that we could avoid being affected by the deteriorating economic conditions in the countries that buy our exports. Nor was there ever much merit in the claim that China and India were somehow decoupled from the US. In a globalized world, we're all in this together.

In the result, the downturn has spread from its original source to other sectors and other countries. Economic growth will be low or negative in most of the world this year. Canada is in recession. Employment is falling and our governments have moved from surplus to deficit as their revenues fall and they launch stimulus programs to cushion economic activity and employment.

Canadian investors, like those in the rest of the world, have lost heavily — many losing from 30 to 50% of the value of their investments. These losses affect peoples' lives today and their hopes and dreams for tomorrow. Many are now wondering just how long they will have to work before they can retire with a decent income. And job losses from

the recession have more people worried about whether they will even be able to work longer.

With the daily torrent of gloomy news on the financial markets and the economy, it would be easy to conclude that we are in an economic free fall from which we might never emerge. This gloom is the mirror image of the irrational exuberance that preceded it. Many thought we had tamed the business cycle, guaranteeing continuous expansion and ever-rising prices for houses and stocks. That was obviously not true; nor is it true that this recession will go on forever.

In the coming months and years, the world will purge the excessive leverage and deal with the toxic assets, building the foundation for another recovery and, perhaps, another round of exuberance.

In the meantime, we should learn what we can from the last cycle to help us handle things better the next time.

Some suggest US fiscal policy created the problem. Certainly cutting taxes while paying to fight two wars seemed imprudent and helped fuel the financial imbalances.

Others say that monetary policy was the culprit. There's an old saying that the central banker's job is to take away the punch bowl just when the party gets going. The US Federal Reserve Board, for whatever reason, chose to refill the punch bowl even though the parties in the financial and housing markets were getting raucous.

I'll leave it to others to suggest how we might handle those levers of macroeconomic policy in future cycles, and comment on areas closer to my field of expertise.

What role did financial regulation play in allowing the current situation to happen? To what extent did weak rules or a lack of vigilance permit unsound products and practices to infect our markets? What, if anything, could we have done, with the knowledge we had, to prevent the market from getting so far out of balance or to detect and stop the many abuses that worsened the damage?

It is easy in hindsight to say that banking or securities regulators should have foreseen and prevented the situation from developing. But let's remember that many of our most sophisticated institutions and market participants failed to detect the risks they were taking on. Is it realistic to expect regulators spot things that are missed by the people on the front lines, evaluating products and investing billions of dollars of their own money? Can we really expect regulation to prevent the periodic crises that have affected our financial markets for centuries?

The financial system is one of the miracles of the modern world. Banking, insurance, securities and derivatives have enabled the growth and development of our modern

global economy, which has raised living standards and delivered a dizzying array of products and services to consumers everywhere. The financial sector allows us to channel our savings to productive investments, to deploy assets to the best opportunities, and to manage risks. Through Adam Smith's invisible hand, the financial market coordinates millions of individual decisions to achieve the optimal outcomes.

At least, that's the theory. In practice, it's not always that pretty. Financial markets are vulnerable to wild swings in sentiment, fads, misjudgments, and cheating by the unscrupulous.

Governments around the world are looking for solutions that would protect the financial markets from these threats and prevent the kind of crisis we are now experiencing. Would new rules or new structures help us get through this crisis and stop it from happening again?

Before we can answer that question, we need to understand whether regulatory failure caused or contributed to the crisis and, if so, whether that failure resulted from an inadequate structure or insufficient rules. I suggest that it is far too early for us to reach any conclusions on this.

We see that the crisis struck countries with all different types of regulatory structure. Of the G7 countries, it hardest in the US, in which financial regulation is split among a myriad of federal and state agencies, and in the UK, which has consolidated all financial regulation in a single agency. Hard to draw any conclusions from that! Canada has suffered the least damage and is being held up as the poster child for regulatory prudence, so we probably shouldn't rush to copy anyone else's structure in the thought it would have served us better.

There seems to be an easier case for more rules. After all, everyone knows the damage caused by unregulated activities of hedge funds and unregulated trading in exotic instruments like collateralized debt obligations and credit default swaps. But what do we really know about those things?

There is no doubt that many supposedly sophisticated market participants seriously underestimated the risks and volatility of new financial instruments, and even some old style instruments. They also found, when the trouble started, that some of these instruments were so complex and opaque that investors couldn't figure out what they actually owned and what their underlying risks really were. That uncertainty continues to plague the markets eighteen months later.

But is a raft of new rules the right answer to this problem?

To the extent that misjudgments and imprudence by sophisticated investors fed the crisis, that is exactly the kind of error that the market itself is effective in correcting. Weighing in with more regulation could undermine the market's own corrective mechanisms and cause delay in solving the problem.

To the extent that market professionals misrepresented the features or risks of investment products, or sold unsuitable investments to unsophisticated investors, we already have rules against that type of conduct. Rather than devising new rules for what is already illegal, we need to marshal our compliance and enforcement resources to detect and deter this activity.

This is not to say that we shouldn't consider any rule changes. We should, for example, deal with credit rating agencies, either by removing their current recognized status under various rules or by imposing substantive requirements on their conduct and disclosure.

Any new rule, however, should be based on thorough analysis that shows it to be the best option for achieving a desired regulatory outcome. All too often, policymakers start with the presumption that a situation demands new rules, and they ignore other options, like enforcing existing requirements, that could more quickly and effectively deal with the problem. We need accurate rifle shots, not random shotgun blasts, to improve regulation of our markets.

To quote a recent article in the Economist, the ability of a fraudster like Bernie Madoff to mislead everyone around him "illustrates the limits of law, not the need for more of it."

Let me turn now to Canada's regulatory structure.

You are all familiar with the constant refrain that Canada needs to update our decentralized system of securities regulation by replacing provincial regulators with a single, national securities commission. This debate began in the 1930s, when the US layered the federal SEC over its existing structure of state regulators. Since the early 1960s, we've seen a serious push to establish a national regulator once or twice each decade. With the release of the Expert Panel report last month, we are now in the midst of the third push of the current decade.

It's important to have perspective on this issue. Contrary to the claims of many single regulator proponents, we have a good system of securities regulation in Canada. Our rules, processes and results measure up very favourably in international comparisons. We meet all but a few of the standards established by the International Organization of Securities Commissions and we are close to filling those few gaps. And the cost imposed on market participants is not excessive. Indeed, Canada has about the most favourable environment in the world for small companies to raise capital publicly.

Could our system be improved? Yes, it could. No system is perfect and ours has some shortcomings.

- Time and effort is required to coordinate and achieve consensus among a group of independent regulators. This can sometimes delay regulatory responses to issues for which the market needs answers. We have struggled to agree on the right solution to the multiple trading market environment that has emerged in recent years. However, our consensus approach can also help us avoid hasty and ill-considered regulatory actions. Extra time and consideration led Canada to a less costly solution to internal controls regulation, for example.
- Some differences remain among provinces in rules and regulatory approaches. We are narrowing these differences, though not as quickly as we would like, through our harmonization work and the passport system, but some differences are inevitable in our structure. These are both a cost and a benefit. They make the system more complex and can affect compliance costs but they also provide scope for innovation and requirements better tailored to local needs. On balance, this flexibility is a net benefit to Canada.

What is the best way for Canada to make sure we have the best possible regulatory system for the future? Most proponents of a single regulator seem to think that consolidating everything in a single agency would, no matter how it's done, be better than what we have now. That, simply, is not so.

It is important in considering a change of this magnitude to realistically consider both the potential benefits and the risks. Reports on this subject, including the most recent one, significantly overstate the potential benefits of a single regulator, and ignore its risks.

They simply assert that a single regulator would be more efficient, produce better policy more quickly, and conduct better enforcement than our current system. We had hoped that the Expert Panel would, rather than simply repeating this type of assertion, conduct a thorough analysis to assess what could realistically be achieved through a single regulator — a real world agency, not an imagined one without flaws — in comparison with a fully implemented Passport system. We were disappointed not to see that work done.

So, what is the answer to the question? Would a single, national securities commission do a better job of regulating Canada's securities markets for the 21$^{st}$ century? The only answer we can give at this point is: perhaps.

Our Premier, the Honourable Gordon Campbell, and our Finance Minister, the Honourable Colin Hansen, have recently stated that BC now supports the concept of a

national regulator. They have identified this project as part of a broader objective of reducing interprovincial barriers and strengthening Canada's economic union.

However, the Premier went on to say and I quote: "We've said that it's very important that this not become a system of prescription and penalties; we think it's got to be policy-based and performance-based. All of these things are part of creating a smart, modern regime."

The Premier and the Finance Minister have also made it clear that the devil is in the detail and that BC interests must be recognized in any new entity.

As we enter discussions on the possibility of creating a national regulator, BC should have one over-riding goal: to provide Canadians with the effective regulation they need to protect our investors in a global market and to support a dynamic capital market that provides investment opportunities and access to capital. Any changes that we make to Canada's regulatory system should meet that test.

I am not going to comment on all of the ideas and concepts in the Expert Panel Report but I will make a few observations:

- First, our commission was encouraged to see the Report's call for making regulation cost-effective and more principles-based. However, we see nothing in the report's recommendations or the draft legislation that would actually make that happen. How can we make sure that governments work together to turn lofty recommendations and hopeful descriptions of what a national regulator could accomplish into a living, breathing organization that has the talent, motivation and culture to deliver the kind of regulation we want?

- Second, the report proposes a very complex organizational structure — a commission, a governance board, advisory panels, a separate tribunal, a new compensation fund, a nominating committee, and a council of ministers — while leaving many unanswered questions about how it would all work. If the proposal is to move forward, the negotiators will have to fill in a lot of blanks. Let's hope they do so in a way that produces the nimble regulator that many proponents say they want.

- Third, the report proposes a very aggressive assertion of federal jurisdiction, which would likely attract years of litigation. One would hope that, if a national regulator proceeds, it is built on a sound constitutional foundation so our markets aren't faced with years of uncertainty and disruption.

Let me emphasize that the BC government, not the BCSC, will decide whether to pursue discussions on creating a national regulator and what conditions would be necessary for BC to participate.

However, I suggest that British Columbia should have three goals for its participation in a national securities commission:

- Saving strengths of the current system
- Mitigating the most serious risks of moving to a national regulator
- Capturing benefits a national regulator offers

First, how can we save the strengths of the current system? In our decentralized structure, BC has been able to make policy that addresses the needs of the local market. Think about our recent problem of dealing with the abuses perpetrated from BC in the US over-the-counter markets. We have been able to develop a multi-part solution consisting of enforcement, compliance reviews, education, and rule and policy initiatives, to deal with this problem. We need to preserve this ability to deal with local problems in a new national commission.

In addition, the current structure supports innovation in regulatory thinking. In fact, BC's approach to regulation has helped prevent the desire to over-regulate by some provincial policy makers.

One of the key tools for regulators to protect investors is through enforcement. It is the ultimate on-the-ground regulatory function necessary to respond to localized threats to investors and markets. Enforcement is most effective at the local level. We need to keep it there in order to provide investor protection where it is needed. More about that in a moment.

Second, moving to a national securities commission carries significant risks. The serious ones are obvious.

- Policy-makers might be pre-occupied with issues concerning the larger companies and dealers, ignoring local market concerns and smaller companies.
- Without competing voices, there would be less impetus to find innovative solutions. BCSC`s problem-focused and outcomes-based approach to policy making could be lost and Canada might slide back into interventionist, rule-based regulation.
- BC`s influence on policy-making might be lost, or perhaps limited to mining and venture capital issues. Market participants and policy-makers here have much to offer Canadian regulation. It would be tragic for that influence to disappear.

- Local service to BC market participants could deteriorate. Dealing with regional offices of national agencies is not often a rewarding experience. In comparison, BC companies can talk to our folks in Corporate Finance to solve issues in a timely way.

Third, there are benefits we could capture through a national regulator. We think that there is an opportunity to revisit the 2004 British Columbia *Securities Act,* which is more principles-based, simpler, and easier to read and understand than other provincial acts. You will recall that BC spent two and a half years developing the new act, but we set it aside in order to implement the Passport system. The work was sound and the thinking behind the 2004 act should be considered while crafting a national securities act.

As mentioned by the Premier, moving to a national securities commission brings the opportunity to create a principles-based approach to securities regulation. Let me spend just a couple of minutes on this because there is a lot of confusion out in the market as to what this really means.

At the BCSC, we prefer to use the term outcomes-based regulation to describe an approach to regulation that can be more effective than a regime based on imposing prescriptive rules and dictating the internal processes of market participants. A properly designed outcomes-based regime uses both principles-based and prescriptive rules and places a strong emphasis on using other regulatory tools.

Here are some of the features of an effective outcomes-based system of regulation. It's primary focus is external, not internal. It focuses on determining what the problem is – risks or threats to investors and markets – and seeks to fix those problems by eliminating or reducing the risks and threats it identifies.

Keeping an external focus is harder than it sounds. Staff must have the discipline to look for the source of the problem and analyze how it affects investors and markets. It is very important for the regulator to avoid the natural tendency to define a problem by referring to the regulator's own requirements and processes. This can lead to the conclusion that there is a regulatory gap to fill and results in solutions that don't really solve the problem.

In order to regulate from this perspective, the challenge would be to create a culture in the new commission that is problem-focused and outcomes-based.

Finally, creating a national commission might bring an opportunity to establish a specialized criminal investigation unit with financial, investigation and forensic accounting skills to deal with securities fraud. The unit's staff should include lawyers whose mandate is to prosecute the cases in criminal courts.

However we do it, we must take this opportunity to improve Canada's track record on enforcing securities fraud through the criminal justice system. We know that Canadians would like our justice system to treat securities fraud more seriously. In order to protect Canadian investors going forward, we must develop a stronger criminal deterrent. Canadian regulators are doing their jobs – a recent CSA Enforcement Report demonstrates that provincial regulators are very active across the country – now it is time for criminal enforcement to step up to the plate.

All of this points to a structure that respects regional office autonomy in certain areas. Regional offices need to be able to carry out compliance and administrative enforcement to ensure that those issues important to the local market will be given the appropriate resources and priorities. By contrast, centralizing enforcement would make decision-making remote from both victims and suspects, adding significant delays and higher costs.

Although economies of scale implicit in the establishment of a national securities commission suggest that centralized criminal investigation and prosecution units could be effective, they will only work if they are set up as service agencies to local enforcement. Whether administrative or criminal, the reality remains that enforcement is local. The regional offices must have the authority to set the priorities for criminal prosecution and identify the cases to be pursued criminally.

For obvious reasons, I am not going to comment on the location of the head office. But more important than the head office location is ensuring that the national commission adopts a regulatory culture similar to the one we have at the BCSC.

In summary, we must be very careful not to throw out the good work and experience we have working within the current system. The old saying goes "if it ain't broke, don't fix it." There are many attributes to the current system that aren't broken.

If Canadians really want to create a national securities regulator that's better than what we have now, we need to break the mold of national regulatory agencies and build something new. Before we embark on this exercise, we need agreement on what we want to achieve.

Too many people think that nothing could be worse than what we have now. I can say with confidence that that is not so and, if the creators of a national regulator start with that view, it will probably guarantee that what we get <u>will</u> be worse than what we have now.

In the meantime, we at the BCSC will be working with our colleagues in other provinces to focus on effective regulation that protects investors and market integrity during an extremely difficult stage of the economic cycle. Thank you.