Securities:
Effective and Appropriate Provincial Regulation

Québec

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EXECUTIVE SUMMARY

On November 19, 2002 the Department of Finance Canada released the letter written by Harold MacKay concerning securities regulation in Canada. After holding consultations, Mr. MacKay concluded that the existing system of securities regulation is inefficient and costly. He recommends that the federal government, working with provincial governments, form a “wise persons’” committee to study the existing system and recommend improvements. He suggests asking the committee to pay particular attention to two models: an enhanced version of the present system and a single Canadian securities commission.

The Québec government is of the view that nothing, apart from the perceptions of the interested persons consulted, supports the assertions as to the inefficiency and excessive cost of the current system. On the contrary, many analyses show that it works rather well and at a reasonable cost.

Concerning costs, the fees payable by reporting issuers to the various authorities are minimal compared to the total costs they bear in the course of an initial public offering. In addition, a recent study shows that the Canadian IPO market is efficient compared to the U.S. market.

Another study shows that 87% of time devoted to regulatory compliance relates to harmonized rules. This confirms the success of the harmonization initiatives of the Canadian Securities Administrators. The same study suggests that, to reduce the compliance efforts of all reporting entities, regulatory authorities should review regulation rather than the regulatory structure.

As Mr. MacKay acknowledges, the Canadian Securities Administrators’ harmonization efforts have produced results, particularly concerning the regulation of issuers. Many initiatives, such as the Mutual Reliance Review System and the System for Electronic Document Analysis and Retrieval have resulted in a regulatory system that is pan-Canadian in many regards.

In addition, it is false to maintain that an issuer must deal with 13 jurisdictions. In fact, an issuer generally deals with the authority of the jurisdiction where its head office is located. This authority then acts as intermediary with the others.

Lastly, representatives of securities dealers and advisers generally register in a single jurisdiction. In cases of registration in more than one jurisdiction, harmonization initiatives are also planned to facilitate the procedure.

Furthermore, contrary to popular belief, the U.S. securities regulatory system is not simplified by the existence of a federal securities commission, the Securities and Exchange Commission. Each state has its own securities legislation and a securities commission. In general, financing of small-size companies is regulated by the states, while financing for large companies is subject to the Securities and Exchange Commission. Dealers, unless they have an exemption, must register in each state in which they do business.

The Canadian securities industry, which mainly represents a market of small-cap companies, more closely resembles, in terms of the size of companies, the American securities market regulated by the states.

The presence of a securities authority in each jurisdiction in Canada offers a number of advantages. In particular, it encourages a variety of opinions on current events that affect securities regulation. The variety of fields of expertise and the distinct approach taken by each authority also helps bring different points of view to bear on regulatory compliance by reporting entities. Also, the additional costs, if any, due to the presence of many securities authorities are fully justified if they help prevent abuses, such as those recently observed in the United States and which prove much more costly for society in general.

In addition, healthy competition among regulatory authorities is itself a plus in view of the high level of concentration of ownership of dealers and other key participants in Canadian financial market.

Lastly, the existing securities regulatory system has given rise to many initiatives that have been favourable for the securities market and the financing of companies. Examples include the junior capital pools program initially set up by securities authorities in western Canada and the introduction of the short form prospectus by the *Commission des valeurs mobilières du Québec*.

The Constitution Act, 1867 assigned complete jurisdiction over the regulation of trade, apart from a few exceptions that are specifically mentioned, to the provinces. Accordingly, from the outset, the provinces had responsibility for regulation in the securities field. Despite advances in technology and the growth in trading volume, the actual nature of this commercial activity has not changed and has always encompassed a significant transborder component. Moreover, the courts have on many occasions confirmed that the provinces have exclusive jurisdiction in the securities field.

In short, the recommendations of Mr. MacKay, mandated by the government of Canada, are based on perceptions that are contradicted by the facts.

However, the Québec government and *the Commission des valeurs mobilières du Québec* are aware that the existing regulatory system can be improved further and they are convinced that they have the mechanisms to do so, in particular by continuing the efforts at harmonization.

Moreover, the creation of the *Agence nationale d'encadrement du secteur financier* will bolster Québec's capacity to continue improving the existing system. The implementation of an effective and competent organization will facilitate efforts to adapt regulation to current needs and the continuation of efforts to harmonize regulation in Canada, North America and internationally.

1. BACKGROUND

1.1 The MacKay Report

On November 19, 2002 the Minister of Finance of Canada, Mr. John Manley, released a letter he received from Harold MacKay. This letter was further to a mandate Mr. MacKay had received on October 3, 2002 to recommend a process for determining the best securities regulatory system for Canada.

Essentially, Mr. MacKay recommends that Mr. Manley form a committee of six "wise persons", working with provincial governments, that would be instructed to find the most appropriate model for securities regulation in Canada. Mr. MacKay suggests that the committee pay particular attention to two models, i.e.:

- an enhanced version of the present securities regulatory system that could include the adoption of the single passport model;

- a single Canadian securities commission in which provincial governments would pool their authorities in a single regulator administering a single set of rules.

Prior to formulating his recommendations, Mr. MacKay described his approach and provided an overview of the current situation.

His approach consisted in first consulting many people and organizations interested in securities regulation throughout Canada. This consultation enabled him to identify a number of fundamental points on which there was consensus, including:

- the importance of a sound, efficient securities regulation system;

- the need for world-class regulatory structures;

- the need to take regional interests into account;

- the necessity of improving the current system.

In describing the current regulatory system, Mr. MacKay acknowledged the success of many harmonization initiatives, including the Mutual Reliance Review System (MRRS). He then listed a number of problems that were frequently raised during his consultation:

- serious inefficiency problems leading to excessive costs and delays in execution (direct and indirect costs of compliance with rules in multiple jurisdictions);

- cumbersome nature and sometimes slow pace of developing strategic regulatory measures;

- lack of a single Canadian voice internationally;

- difficulty encountered by securities regulators in participating in Canadian financial sector policy development;

- lack of strong enforcement of securities laws in Canada and difficulty in setting strong enforcement standards and practices on a consistent basis.

He points out that these consensus opinions should form the foundation of the changes to be made to the securities regulation system.

1.2 Reaction of the Québec government

The Québec government is of the view that Mr. MacKay's recommendations are based on a number of premises that are without grounds. In particular, nothing supports Mr. MacKay's assertions concerning the inefficiency and excessive cost of the current securities regulation system.

The Québec government and the Commission des valeurs mobilières du Québec (CVMQ) are aware that the existing system can be improved further and they believe they have mechanisms to do so. With this objective in mind and to foster greater harmonization among jurisdictions, securities authorities have been working together within the Canadian Securities Administrators (CSA). Mr. MacKay says in his letter that most securities market participants agree that the CSA has had successes, including the MRRS.

It has not been demonstrated that the current system does not work well. On the contrary, studies have shown that it works rather well.

In addition, the MacKay report deals only with costs relating to the primary market. Yet transactions costs and other costs inherent in the secondary market are even more costly for securities market participants. These costs are influenced not only by the regulatory structure of the financial market but, more importantly, by the efficiency of its participants and the liquidity of the market.

2. OPERATION OF THE CURRENT SYSTEM IN CANADA

2.1 Issuers

2.1.1 Costs

2.1.1.1 An analysis of scenarios of fees payable in the course of an initial public offering (IPO)

When a company wants to make a pan-Canadian IPO, it has two types of costs: direct costs and indirect costs. Direct costs include underwriter's compensation,[1] fees to be paid in each province, auditors' fees, legal fees, fees to the transfer agent, the expense of printing the prospectus and taxes. Indirect costs correspond to the value of the underpricing[2] of the public offering.

Scenarios have been analyzed to determine the proportion of fees payable[3] in relation to total direct cost that issuers must assume for a pan-Canadian IPO.

Table 1 shows the amount of each type of direct cost and its proportion for a pan-Canadian IPO of $100 million:[4]

Table 1: Costs of a $100-million pan-Canadian IPO

	% of the offering	C$ ('000)	% of total direct cost
Direct cost			
Underwriter's compensation	6.00	6 000	75.00
Other expenses:			
Fees payable	0.06	59	0.74
Other*	1.94	1 941	24.26
Total other expenses	2.00	2 000	25.00
Total direct cost	**8.00**	**8 000**	**100.00**

* Other: auditors' fees, legal fees, fees of transfer agent, expense of printing the prospectus, and taxes.
Sources: Ministère des Finances, de l'Économie et de la Recherche and Kooli, Maher and Jean-Marc Suret 2002, *How cost-effective are Canadian IPO markets?*, Scientific series *CIRANO*.

This table indicates that fees payable[5] as a proportion of total direct cost amount to only 0.74% of total direct cost, i.e. $59 000 out of $8 million. This is very little compared to other types of costs.

[1] The underwriter designates the firm-commitment underwriter as well as the best-efforts underwriter.
[2] Underpricing, resulting from the fact that the shares are generally sold at a price below their fair market value, is calculated as follows:
(first closing price – offering price)/offering price).
[3] Fees payable correspond to the fees charged by securities authorities, as shown in Table A in Appendix 2.
[4] The data of the study by Kooli, Maher and Jean-Marc Suret 2002, *How cost-effective are Canadian IPO markets?*, Scientific series *CIRANO,* were used to determine the proportions of each type of direct cost.
[5] For the fees payable in British Columbia and Alberta, it was assumed that one quarter of the total offering is issued in each of these two provinces.

For a $35-million pan-Canadian IPO,[6] the proportion of fees payable to total direct cost is roughly the same as in the first scenario. Out of the total value of the IPO, fees payable range between 0.06% and 0.07%. This shows that fees payable are relatively low. Underwriter's' compensation accounts for the largest portion of costs in the two scenarios (between 65% and 75% of total direct cost).

Accordingly, even if the creation of a single Canadian securities commission would help reduce regulatory fees, this would have only a minor impact on the total direct cost issuers bear. Nor would a single Canadian securities commission have much of an impact on other fixed costs, as shown in a study by Sawiak,[7] which states that 90% of issuers believe that the fact that they report to many authorities costs them no more than an additional $10 000.

Accordingly, creating a single Canadian securities commission would certainly not resolve the problem, if there is one, of excessive costs.

2.1.1.2 Efficiency of the Canadian IPO market compared to the market in the United States.

The Suret & Kooli (2002) study[8] shows that the Canadian securities market is efficient in terms of costs compared with the U.S. market. The study concludes that on average, Canadian IPOs are under-priced to a lesser level than American IPOs (5.11%[9] versus 38.16%) on a weighted-average basis.[10]

On the basis of total direct cost, the Suret & Kooli (2002) study concludes that underwriter's' compensation is the largest component of total direct cost in the two countries and that on average it is a little lower in Canada than in the United States (6.88% versus 7%). The same conclusion is reached on a weighted-average basis (5.35% versus 5.79%). Another study, by Kryzanowski & Rakita (1999),[11] also shows that underwriter's' compensation for an IPO is, on average, lower in Canada than in the United States (6% versus 7%).

However, it is shown that, on a weighted-average basis, other expenses are higher in Canada than in the United States (1.84% versus 1.43%). This difference is attributable to the higher proportion of IPOs between US$1.0 million and US$9.9 million in Canada than in the United States (41.41% versus 10.02%).[12]

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[6] See Table D in Appendix 4.

[7] G.V. Sawiak, W.J. Braithwaite and P.L. Olasker, *Report to the Standing Committee on Banking, Trade and Commerce on the transaction costs of a decentralized system of securities regulation*, April 1996.

[8] Table 6 of the Suret & Kooli (2002) study is reproduced in Appendix 3.

[9] The 5.11% result is an average weighted by the gross size of IPOs of the entire sample while the other averages (by category) are equi-weighted (30.61%, 11.35%, 10.76% and 8.88%). However, the weighted average of the 4th category ($100 million or over) is 2%. This result is attributable to the existence of cases where the level of underpricing is low or even negative for large offerings.

[10] The weighted average is used to allow for the *Size* effect of IPOs. On the basis of the average, the conclusion remains the same (18.95% in Canada versus 37.75% in the United States).

[11] Kryzanowski & Rakita, 1999, *Is the U.S. 7% solution equivalent to the Canadian 6% solution?,* Canadian Investment Review*, pp.* 27-35. The study covers the period 1984-1997.

[12] See Table C in Appendix 3.

2.1.1.3 Direct cost relating to regulation

Under the current securities regulation system, Canadian issuers must comply with the regulations and requirements of each jurisdiction to which they report, which necessarily produces costs. However, because of the coordination efforts of provincial authorities, a large number of rules and requirements have been harmonized and common processes set up[13] with the result that the compliance efforts of issuers have been reduced.

According to a recent study by the British Columbia Securities Commission (BCSC),[14] Canadian issuers allocate on average 87% of their regulatory compliance efforts to regulatory segments that are already greatly harmonized, in particular prospectus preparation (39% of their efforts), preparation of annual and quarterly financial information (28%) and preparation of reports and news releases on material changes (10%). The author suggests that the creation of a single Canadian securities commission or the continuation of harmonization efforts could only produce results regarding the remaining 13%.

A corollary to this conclusion is that harmonization efforts have produced tangible results.

2.1.1.4 Unavoidable costs

There are many unavoidable costs tied to the enforcement of laws other than those governing the securities industry as well as the maintenance of regional offices by any potential single securities commission. Regardless of whether or not there is a single Canadian securities commission, it is difficult to separate the costs inherent in regulating securities from the costs resulting from incorporating acts. An offering of securities necessarily implies the existence of a corporation, capital stock, a board of directors, shareholders, which are regulated by incorporating acts of each province or of Canada. In addition to the applicable incorporating acts, each person is regulated by the laws of general application of the jurisdictions where it does business.

Some costs stem from laws specific to each jurisdiction. For instance in Québec, the use of French in a public corporation's communications with its shareholders is governed by the *Charter of the French Language* and the *Securities Act*. In addition, the *Québec Civil Code* applies regardless of who regulates the securities sector.

Lastly, implementation of a single Canadian securities commission would require the creation of a number of regional offices to meet local needs.

[13] See section 2.1.2. Harmonization.
[14] Christina Wolf, *Better Disclosure, Lower Costs – A Cost-Benefit Analysis of the Continuous Market Access System*, British Columbia Securities Commission.

2.1.1.5 A review of regulation, not structures

Another option for reducing compliance costs that must be explored is a review of regulation.

In Québec, the reform of financial sector regulation that led to the adoption of the *Act respecting the Agence nationale d'encadrement du secteur financier* also seeks to review the various regulations with a view to greater harmonization and consistency. This exercise could reduce the administrative burden on entities subject to the *Securities Act*.

Québec is not the only one to consider this option. In a document released in June 2002 (*New Proposals for Securities Regulation*),[15] the British Columbia Securities Commission makes proposals to reform securities regulation in Canada. These proposals concern the information disclosed by issuers, registration of dealers and advisers, remedies of investors as well as enforcement measures and the powers of public authorities.

According to the BCSC, a thorough review of regulation is needed. Over the years, regulation has become too complex and has not kept pace with fast-moving markets. In particular, the BCSC proposes replacing the current information system based on prospectuses with an enhanced continuous disclosure system. The BCSC believes that such a system would be more effective, while enabling issuers to achieve real compliance cost savings.

2.1.1.6 Continuous disclosure requirements

Many consider that Canadian issuers must assume significant costs relating to continuous disclosure requirements. In reality, the costs relating to the continuous disclosure requirements for a pan-Canadian issuer are relatively low.[16] Even if these costs could be reduced by creating a single Canadian securities commission, that would have only a minor impact on the total fees payable by issuers.

2.1.2 Harmonization

In Canada, the current securities regulation system involves 13 provincial authorities. [17] Some claim that they operate independently from each other and that they all have specific regulatory requirements. However, the truth is completely different.

For many years, provincial securities authorities have worked closely together within an informal group known as the Canadian Securities Administrators (CSA) to harmonize rules and set up mechanisms to streamline the administrative burden on reporting entities.

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[15] British Columbia Securities Commission 2002, *New Proposals for Securities Regulation, a New Way to Regulate*, June 5, 2002.
[16] See Table E in Appendix 5.
[17] For the purposes of this text, the term "provincial authorities" is used to designate both provincial and territorial authorities.

As a result, a very large proportion of securities regulation in Canada is based on rules, standards or policy statements that are jointly formulated through the CSA. Accordingly, much of regulation is uniform for all provinces.

In addition, the CSA have also designed mechanisms to simplify the conduct of business for persons or corporations subject to one or more jurisdictions. Examples include the MRRS for issuing prospectus receipts or prospectus-related exemptions, and the System for Electronic Document Analysis and Retrieval (SEDAR), the system that allows issuers to simultaneously file financial reports and other documents with the various authorities. A number of other projects are also currently under way including a uniform rule for the continuous disclosure of information, the System for Electronic Disclosure by Insiders (SEDI), etc.

All these initiatives are designed to ease the administrative burden on reporting entities while maintaining the jurisdiction of each authority. Many of these initiatives have achieved their objectives fully.

2.1.2.1 Description of initiatives in place and under development

2.1.2.1.1 Harmonization of rules

The CSA have formulated many “pan-Canadian” rules that make many aspects of regulations harmonized, even uniform, in all jurisdictions.

Marketplace regulation

The most recent example of pan-Canadian standards is the adoption of rules 21-101, *Marketplace Operation* and 23-101, *Trading Rules*, that govern the activities of marketplaces, including stock exchanges and alternative trading systems. Adoption of these two standards then led to the creation of Market Regulation Services Inc. (MRS), a self-regulatory organization that oversees the activities of marketplaces. MRS has been recognized as a self-regulatory organization by provincial securities authorities and its oversight is covered by a memorandum of understanding among them under which the Ontario Securities Commission (OSC) has been designated as the lead authority. As such, the OSC formulates the oversight program, coordinates the examination and approval of rules and is responsible for inspecting MRS. However, the other authorities retain the power to express their point of view and to reject some of these rules, if need be.

Continuous disclosure regulation

In June 2002, the CSA released a draft instrument for discussion, *Instrument 51-102 Continuous Disclosure Obligation*. This instrument that will be adopted eventually by every provincial security authorities defines the obligations of reporting entities regarding the filing and content of financial statements, the annual information form, management discussion and analysis, material changes reporting, business acquisition report and proxy solicitation circular. This instrument would apply to all reporting entities with the exception of mutual funds. Harmonization of continuous disclosure requirements will enable entities reporting

in many jurisdictions to easily know and comply with their requirements, at lower cost.

Rule respecting escrow for initial public offerings

Rule 46-201 respecting the conditions of escrow for an initial public offering seeks to set conditions requiring principals[18] to maintain their shareholding in the issuer for a reasonable time after the IPO. Its adoption by every provincial securities authority[19] will result in harmonization of various Canadian policies in this matter. The instrument establishes a self-management program to free shares deposited in the hands of a third party, eliminating the requirement to obtain authorization from an authority.

2.1.2.1.2 Harmonization of processes

As previously mentioned, the presence of 13 jurisdictions gives rise to some additional compliance efforts for reporting entities even though rules are harmonized to a large extent. That is why the CSA are also working on mechanisms to facilitate compliance procedures for reporting entities. Accordingly, over the years, the CSA have mounted initiatives such as SEDAR and the MRRS, and plan to launch SEDI.

The System for Electronic Document Analysis and Retrieval (SEDAR)

SEDAR was launched on January 1, 1997 to enable reporting issuers and others to electronically file in one place the documents required by securities authorities, in particular prospectuses, financial statements, annual reports and news releases. The user need only file the documents, specify the jurisdictions covered and pay the fees.

Documents filed with SEDAR are received electronically by the competent authorities for study and, as the case may be, approval. Once accepted, they are added to the publicly accessible database. Investors then have access to the information they contain free of charge.

This system has substantially reduced the administrative burden on reporting issuers and others. Previously, they had to send all the documents to each of the jurisdictions concerned to comply with regulatory requirements. It was also more difficult and lengthier for investors to obtain information on issuers.

[18] "Principals" means major interested parties, including a shareholder holding over 20% of the stock, the person or company acting as the issuer's promoter and an officer or director of the issuer.

[19] The text was adopted as a policy statement on June 30, 2002 in all jurisdictions except Québec, which will soon adopt it as a regulation.

The Mutual Reliance Review System

The MRRS was set up in 1999[20] to streamline the examination of documents filed by issuers and exemption applicants, thus reducing their administrative burden. Mutual reliance review means that the decision-maker of a given authority can, in exercising the discretionary power conferred on him by the securities legislation of his province, rely substantially on the analysis and examination made by the staff of another authority.

The MRRS does not involve any renunciation of decision making power by a securities authority. Each authority retains its power to impose specific requirements and exercises the full discretionary power conferred on it by law for the examination of documents filed under the MRRS. In practice, each authority has a given period of time to withdraw from the MRRS regarding a case that does not meet its requirements. However, the number of withdrawals remains very small.

The lead authority is designated by the filing issuer in accordance with criteria set out in the instruments adopted by each of the CSA. By default, the lead authority is determined by the location of the issuer's head office, though it may also be determined on the basis of a reasonable link with the territory, i.e. the place where management is located, the place where the assets are located or the place where the stock exchange is located.

Under the MRRS, a filing entity reporting to more than one jurisdiction files the documents with each of them (using SEDAR), but generally deals only with the lead authority, from which it receives a document confirming the decision reached by each authority that has not withdrawn from the MRRS regarding the application.

For now, the MRRS is limited to the examination of prospectuses and applications for exemption, but it could eventually apply to other parts of regulation.

The System for Electronic Disclosure by Insiders

The CSA are currently working to develop the System for Electronic Disclosure by Insiders. Using this system, insiders will be able to electronically file insider reports that will be received by each of the authorities concerned. The system was initially launched on October 29, 2001, but had to be suspended by provincial securities authorities due to technical problems. The CSA have formulated national instrument 55-102 that sets out the rules and policies governing the operation of SEDI.

In practice, insiders will only have to file insider reports once to comply with the filing requirement in all jurisdictions. Currently, they must file a report in each jurisdiction.

[20] Previously, placements in Canada were covered by policy statement C-1, *Approval of Documents Across Canada*, which dated from August 20, 1986.

Investors will thus have faster access to insider reports, directly on the SEDI website. Lastly, it will be easier for authorities to monitor compliance with insider reporting requirements.

2.1.2.2 Marginal effect of a single Canadian securities commission

In view of the high degree of harmonization of securities regulation and of processes in Canada, it has not been shown that the creation of a single Canadian securities commission would have a significant impact on regulatory costs, particularly those of issuers. This is also the view of the BCSC which states that, to reduce compliance costs of issuers, a review of regulations is preferable to changing the regulatory structure.

2.2 Dealers, advisers and their representatives

2.2.1 Regulatory requirements regarding distribution

The regulation of dealers, advisers and their representatives is part of the system regulating the distribution of financial products and services. This system is designed to allow consumers to acquire products that meet their requirements and to ensure that the representative is able to advise his client well while placing his client's interests ahead of his own.

The regulation of distribution is linked to the specific features and practices of a market. For instance, in Québec, the integration of mutual fund and insurance products distribution activities led to the adoption, in 1998, of the *Act respecting the distribution of financial products and services.* This approach, which has no equivalent elsewhere in Canada, allows distributors (firms and representatives) active in the two sectors to hold many permits and be governed by a single piece of legislation. In our view, "pan-Canadian" regulation would not have allowed for such flexibility.

In addition, the regulation of distribution depends on thorough knowledge of the practices and specific features of participants. Accordingly, compliance is more easily enforced by a local organization.

2.2.2 Registration of representatives in a single jurisdiction

As previously pointed out, the distribution of financial products and services is, mostly, a local activity. Representatives therefore generally register in a single jurisdiction. In cases of registration in more than one jurisdiction, provincial regulatory authorities have developed mechanisms to reduce the administrative formalities.

2.2.3 Process harmonization initiatives under development

Harmonization measures bearing chiefly on the registration of dealers and advisers and/or representatives are currently under development. The first is the Registration Streamlining System (RSS) and the second, the National Registration Database (NRD). These new measures will initially provide representatives, and eventually dealers and advisers, with a simplified and harmonized way to register in many jurisdictions.

The Registration Streamlining System[21]

The RSS was set up in most provinces[22] on October 1, 2002 to reduce the administrative burden on representatives wishing to register with one authority and with the Investment Dealers Association of Canada (IDA). The RSS will change administrative practices, but will have no effect on regulatory requirements.

Under the RSS, a representative can use a copy of his initial authority's form to register in another jurisdiction. Once registration with the initial authority is complete, the representative sends a photocopy of his application to the other authority. This application must be accompanied by the documents required by the other authority and the related fees. For a representative to be able to use the RSS, his employer must be registered with the other authority.

The National Registration Database

The NRD will be accessible via the Internet and will initially enable representatives to electronically file their registration form.[23] A subsequent version of the NRD could enable dealers and advisers to register. This project is an initiative of the CSA and the IDA.

While the NRD will involve harmonization of registration forms, provincial securities authorities will not renounce their responsibilities. Each authority will retain and exercise all the discretionary power conferred on it by law. The NRD should substantially facilitate the registration process of representatives active in more than one jurisdiction. It will reduce the number of registration procedures required for a representative wishing to register in Québec and elsewhere in Canada.

2.2.4 The importance of the specific characteristics of local markets

The regulation of dealers, advisers and representatives must take regional characteristics into account. The same is true of enforcement. A centralized regulatory regime offers no such flexibility.

[21] The RSS can be described as a "temporary" measure because once the NRD is operational, it will exceed the functions and advantages of the RSS.
[22] Authorization is underway for Québec to join RSS.
[23] Québec is studying the legislative amendments needed to participate in this project.

2.3 Stock exchanges and other self-regulatory organizations (SROs)

The securities commissions of Alberta, British Columbia, Québec, Ontario and Manitoba have agreed on a memorandum of understanding on the oversight of stock exchanges and quotation and transaction reporting systems. The memorandum covers the TSX Venture Exchange Inc., TSX Inc., Winnipeg Commodity Exchange Inc. and Montréal Exchange Inc.

The memorandum of understanding is based on the principle of the lead authority. In this context, the CVMQ is the lead authority for the Montréal Exchange and, as such, is responsible for its oversight. The lead authority for the TSX Inc. is the Ontario Securities Commission. The joint lead authorities of the TSX Venture Exchange Inc. are the securities commissions of British Columbia and Alberta. Lastly, the lead authority for the Winnipeg Commodity Exchange is the Manitoba Securities Commission.

The memorandum of understanding eliminates overlapping regarding oversight of activities of an exchange, by giving to a single securities authority responsibility and coordination of oversight. A similar agreement among securities authorities covers Market Regulation Services Inc.[24] Accordingly, implementation of a single Canadian securities commission would offer no additional benefit as far as oversight of exchanges and other SROs is concerned.

[24] This agreement is described in section 2.1.2.1.1.

3. FEATURES OF THE CANADIAN SECURITIES MARKET

The Canadian securities market is often compared to the U.S. market. However, the comparison is strained. The Canadian industry more closely resembles the market regulated by the American states. In addition, the Canadian market, unlike the market in the U.S., is highly concentrated.

3.1 Similarities with the segment of the U.S. market regulated by the states

According to the Suret (2002) study,[25] there are 4 177 listed companies in Canada. Of these, 913 must be considered as inoperative. Over 90% of the companies in operation have their head office in the following four provinces: Québec, Ontario, Alberta and British Columbia.

A study by Suret and Carpentier (2002)[26] shows that of a total of 2 055 IPOs between 1991 and 2000, 1 368 raised less than $5 million, including 1 080 that raised no more than $1 million. Accordingly, most Canadian IPOs are small (66% raise less than $5 million).

The study mentions that in the United States, financing of small companies is regulated by the states, not by the Securities and Exchange Commission (SEC). Each state has its own program, the Small Corporate Offering Registration (SCOR) program, that enables small-cap companies to raise funds more easily and less onerously than with a traditional IPO.

The Canadian securities industry consists mainly of small-cap companies and thus more closely resembles the securities market regulated by the American states.

3.2 Concentration of the Canadian securities market

In Canada, unlike the United States, the financial market is highly concentrated. The six largest Canadian banks control the bulk of banking activity (90% of Canadian bank assets) and, through their subsidiaries, almost two thirds of securities brokerage activity.[27] In 2001, the seven largest integrated brokerage firms in Canada generated roughly 70% of the industry's sales. And of these firms, six belong to the big Canadian banks.

Concentration extends beyond banking and securities activities. First, the big banks, their associated dealers and other dealers directly and indirectly control many Canadian self-regulatory organizations. For instance, the dealers, through IDA, are shareholders with TSX Group in Market Regulation Services Inc., which regulates markets. In addition, through IDA, they are co-owners of the Canadian

[25] Jean-Marc Suret, *Réglementation des valeurs mobilières au Canada*, Working paper CIRANO 2002 (upcoming)
[26] Céline Carpentier and Jean-Marc Suret, 2002, *Les systèmes financiers canadien et américain : concurrence et réglementation*, Cirano and Université Laval. (upcoming).
[27] Op. cit. note 25.

Depository for Securities Ltd., the only Canadian body offering share deposit and clearing services. The other co-owners are the big Canadian banks and the Toronto Stock Exchange.

Second, the big banks, their associated dealers and other dealers directly and indirectly control stock exchange activities in Canada. Moreover, the big dealers are shareholders in one of the two alternative trading systems, Candeal.ca Inc.

Accordingly, it is difficult to compare the Canadian financial market, which is concentrated, with the more competitive market in the United States.

4. THE SECURITIES REGULATION IN THE UNITED STATES

The United States has a centralized securities commission. And yet, the regulation of the American securities market is highly complex.

4.1 Complexity of the American system

Each American state has its own securities legislation. In general, each state has jurisdiction over solicitation and transactions made on its territory. Laws may vary from state to state, but they have the following objectives in common:

- combat fraud;
- monitor financial players;
- require registration of securities offered.

Since the states have different securities laws, each of these laws must be consulted even though they are harmonized under the North American Securities Administrators Association.

In addition, at the U.S. federal level, there exists a securities law as well as a securities commission, the Securities and Exchange Commission. This legislation regulates interstate commerce as defined in section 2(a)7 of the Securities Act of 1933:

> The term "interstate commerce" means trade or commerce in securities or any transportation or communication relating thereto among the several States or between the District of Columbia or any Territory of the United States and any State or other Territory, or between any foreign country and any State, Territory, or the District of Columbia, or within the District of Columbia.

In addition, section 5 of the same law stipulates that it is illegal to offer or to sell securities by means of any method of transportation or communication without having first filed a registration application concerning the securities offered and obtaining the approval of the SEC.

In 1996, the U.S. federal government passed the *National Securities Markets Improvement Act* (NSMIA). This legislation was a major overhaul of American securities law.

NSMIA introduces the concept of covered securities. Covered securities are securities listed on the New York Stock Exchange or on the NASDAQ's National Market System, but not listed on the NASDAQ Small Cap Market. Under NSMIA, the U.S. federal government exercises all powers regarding the registration of covered securities.

States no longer have a say on an issuer or on the sale or offer to sell in relation to covered securities. Nonetheless, states do retain some powers, as listed by Guy Forget in his book "Introduction au droit américain des valeurs mobilières"[28]:

- take appropriate legal procedures to combat fraud; [29]
- take legal procedures against dealers or representatives engaging in illegal conduct;
- require that written notice be filed when securities are offered on their territory;
- require payment of fees, at least for the three years after the adoption of NSMIA.

Soon after NSMIA was passed, some states adopted new standards for reviewing registration applications. The new system is known as the Coordinated Equity Review. In his book, Guy Forget explains how the system works:

> Under the new rules, when a small issuer files a registration application with the SEC, it also files, in each state having jurisdiction, an application for registration as well as a copy of his registration application filed with the SEC and a cheque for the required fees. At the same time, it notifies each state concerned that it wishes to avail itself of the new system. In addition, similar notice is given to the State of Arizona, even if no securities are offered there, because Arizona administers the system.
>
> Once it has received the application, the Arizona Securities Division appoints two securities commissions as lead regulators: the first studies the disclosure information and the second examines the merits of the application. [TRANSLATION]

Thirty-eight states participate in this system. Of the non-participating states, nine have given exemption from registration for certain offerings registered with the SEC.

Information on securities regulation in the United States shows that although there is a federal securities commission, the U.S. system is more complex that it appears at first glance. While there is a central organization, reporting entities must still comply, where applicable, with the regulations of the states that continue to play a role in the American regulatory structure.

4.2 Registration of dealers and their representatives

Dealers who engage in interstate commerce must register with the SEC and with a self-regulatory organization such as a stock exchange or the National Association

[28] Forget, Guy. "Introduction au droit américain des valeurs mobilières", Carswell, Canada 1999.
[29] The adoption by the U.S. federal government of the *Securities Litigation Uniform Standards Act of 1998* limits the capacity of states to undertake legal proceedings.

of Securities Dealers (NASD). A representative of a dealer registered with the SEC must register with the SRO his employer is a member of and satisfy the registration and maintenance rules of the SRO. In addition, barring an exemption, a dealer registered with the SEC must also register with the securities authorities of the states in which he intends to do business.

A dealer who does business exclusively within the boundaries of a state must only register with the regulatory authority of such state. Each state has its own requirements for authorizing a dealer to do business on its territory.

The NASD has set up the Central Registration Depository (CRD), a single centre for filing registration documents. Accordingly, if a dealer who is a member of the NASD wishes to register in another state, he must do so through the CRD. In addition, the registration form is standardized.

The National Registration Database, proposed in Canada and described earlier, is broadly similar in operation to the CRD.

4.3 The Multijurisdictional Disclosure System (MJDS)

Since July 1, 1991 some Canadian issuers can use a special system for purposes of meeting the requirements of reporting issuers when they make an offering in the United States. The system allows Canadian issuers to make use, for the most part, of documents prepared in Canada to satisfy Canadian securities authorities, when they must register their securities in the United States. More specifically, the system allows the use of documents prepared according to Canadian generally accepted accounting principles. However, the anti-fraud rules and sections of American law prescribing civil liability remedies remain applicable.

An examination of the prospectuses of certain Canadian corporations reveals that their receipt was obtained in only one jurisdiction to enable the corporation to use the MJDS and thus facilitate access to the American capital market. In such cases, it is clear that the offering is intended for the American market rather than the Canadian market.

In short, Canadian companies that use the MJDS derive at least the following two advantages:

- First, using the MJDS allows the issuer to partially avoid the requirements and constraints of the U.S. system by making use of an administrative shortcut.

- Second, using the MJDS speeds up the process significantly. A Canadian corporation that uses the MJDS will obtain authorizations from the SEC in three to six weeks compared with four to eight months for an application filed with the SEC directly. By way of information, an offering with short form prospectus made with the CVMQ is processed within an average of two weeks.

Accordingly, many Canadian issuers targeting the U.S. market prefer the Canadian system, in spite of the criticisms that are made, and register with a provincial authority rather than directly with the SEC.

5. BENEFITS OF HAVING MANY SECURITIES AUTHORITIES

The current system, under which securities regulation comes under provincial jurisdiction, offers a number of advantages. In particular, it encourages a variety of opinions, a reduction in the risk of irregularities and regional initiative. In addition, in view of the specific Canadian context in which ownership of brokerage firms and certain other key players in the financial market is highly concentrated, healthy competition among regulatory authorities is itself a plus.

5.1 A variety of viewpoints on various aspects of regulation

The current system encourages the expression of varying opinions on current events that affect securities regulation. An example is the various reactions of some authorities to the adoption of the *Sarbanes-Oxley Act* in the United States:

- Pierre Godin, acting chairman of the Commission des valeurs mobilières du Québec, cautionned that small and medium-size companies would be particularly vulnerable if overly stringent regulations, along the lines of the *Sarbanes-Oxley Act,* were adopted here. “It's a law that's essentially for the big listed companies, which are huge corporations compared with the vast majority of Canadian companies.”[30]

- David Brown, chairman of the Ontario Securities Commission, wrote to leading Bay Street stakeholders asking for their opinion, while pointing out the importance of harmonizing American and Canadian standards. “There is no reason to believe Canada is immune from the failures of governance that struck companies such as Enron Corp. or WorldCom Inc. within the past year. We have exactly the same market pressures and forces here in Canada.”[31]

- Douglas Hyndman, chairman of the British Columbia Securities Commission, said that “Instead of copying the U.S. rules in the name of harmonization, we should look at this as an opportunity to distinguish our market. We know we can have well-regulated markets with lower costs of compliance compared to the U.S.”[32].

The current securities regulatory system gives Canadian reporting entities the assurance that the implementation of rules and processes will take into account a variety of views and that the representatives of small markets will act as a counterweight to those of the major markets.

[30] Bertrand Marotte, *The Globe and Mail,* October 29, 2002, p. B10.
[31] Janet McFarland, Elizabeth Church and Lily Nguyen, *The Globe and Mail,* October 7, 2002, pp. A1-6 and Martyne Couture, *La Presse,* September 23, 2002, p. D6.
[32] *The National Post,* September 19, 2002, p. 15 and Madhavi Acharya-Tom-Yew, *The Toronto Star*, October 10, 2002, pp. D1-14.

5.2 Lower risk of irregularities

In a multijurisdiction securities regulatory system, the resources of each securities authority are used to analyze documents submitted for approval. In addition, the current system has allowed each securities authority to develop expertise specific to its economy. The variety of fields of expertise together with the approach preferred by each authority can bring different and complementary points of view to bear on compliance by reporting entities. For instance, examination of a prospectus by specialists of a number of commissions, under the MRRS, can certainly help detect irregularities or require additional information to satisfy regional concerns.

At first glance, the additional operating costs of many securities authorities may seem high, for some people. However, these costs are justified if they help prevent abuses, such as those recently observed in the United States, which lead to much higher costs for society in general.

5.3 Regional initiatives

The existing securities regulation system has given rise to many initiatives that have been favourable for the securities market and the financing of companies in Canada. Examples include the Stock Savings Plan, labour funds and the short form prospectus that were developed in Québec as well as junior capital pools initially set up by securities authorities in western Canada.

Lastly, the creation of the International Organization of Securities Commissions, which has become the international organization of reference, results largely from the initiative of the Commission des valeurs mobilières du Québec.

6. CONSTITUTIONAL ASPECTS

On many occasions, superior courts have affirmed that the provinces have exclusive jurisdiction in the field of securities. They have noted that this is a matter that comes under property and civil rights, as understood in paragraph 13 of section 92 of the *Constitution Act, 1867*, and that was not assigned to the central parliament by section 91 of the same act. But paragraph 11 of section 92 also grants exclusive jurisdiction to the provinces to legislate on the incorporation of companies for provincial purposes. When the Fathers of Confederation agreed to this division, they knew what they were doing. A recent article[33] by professor Nelson-Martin Dawson shows that the Fathers of Confederation had a thorough knowledge of financial and corporate affairs. It could not have been otherwise because they played an active part in these fields, and they belonged to the legislative body that, in particular, passed legislation in this field.

Prior to and at the time of Confederation, the laws creating companies naturally included elements relating to the securities field. Companies necessarily had capital stock. Many of them were authorized to issue debentures and bonds. Laws determined how these securities could be traded and the rights that accrued to holders of debentures and bonds. This was known to the Fathers of Confederation who considered that the matter was of purely local and private interest in the province.

This reasoning was retained even though many of these laws had extra-territorial reach. Some laws simply allowed companies to borrow within or outside the province. Others went further and allowed these companies to have places of business abroad, to open subscription books there, to carry out share transfers there, to have agents and even local boards of directors there and convert foreign shares into Canadian shares and vice versa. There were even laws allowing directors and shareholders to hold their meetings outside the province. Other laws contemporaneous with Confederation allowed companies to transfer their head office outside the country and from there, to carry on their business in Canada. Nonetheless, the Fathers of Confederation decided to assign exclusive jurisdiction in this field to the provinces, and despite advances in technology and the growth in trading volume, the actual nature of this commercial activity has not changed.

[33] Nelson-Martin Dawson, 2002, *La finance : un monde connu des Pères de la Confédération,* Groupe de recherche sur l'histoire des institutions financières, Sherbrooke.

7. CONCLUSION

In short, the recommendations of Mr. MacKay, mandated by the government of Canada, are based on perceptions that are contradicted by the facts.

However, the Québec government and the Commission des valeurs mobilières du Québec are aware that the existing regulatory system can be improved further and they are convinced that they have the mechanisms to do so, in particular by continuing the efforts at harmonization.

Moreover, the creation of the *Agence nationale d'encadrement du secteur financier* will bolster Québec's capacity to continue improving the existing system. The implementation of an effective and competent organization will facilitate efforts to adapt regulation to current needs and the continuation of efforts to harmonize regulation in Canada, North America and internationally.

APPENDIX 1

Recommendations made by Harold MacKay to the Minister of Finance of Canada, contained in his letter of November 15, 2002

1. Work with provincial colleagues to establish a wise persons' committee to conduct the necessary review and make recommendations to policy makers (the federal government and the provincial and territorial governments) in a timely manner. Mr. MacKay does not support the idea that the federal government should exercise its jurisdiction unilaterally. He hopes that the provincial governments will support the project, but recommends that the project go forward if they refuse.

2. The committee should consist of six respected Canadians with an interest in the Canadian economy and whose commitment to the best interests of Canada is beyond question.

3. The mandate of the committee should be to identify the appropriate model for securities regulation in Canada. This model must protect investors, ensure the efficiency of markets, allow investors everywhere in Canada to have equal protection, encourage dynamism and present a positive image of regulation in Canada.

4. Without constraining the scope of its recommendations, Mr. MacKay suggests that the committee pay particular attention to two models, namely:

    - an enhanced version of the present system that could include the adoption of the single passport model;

    - a single commission model in which provincial governments would pool their authorities in a single regulator administering one set of rules.

5. Because the project is of interest to the whole country, Mr. MacKay recommends that the federal government provide the funding necessary for useful work.

6. The project should go forward expeditiously and report to governments by September 30, 2003. Governments should then deal promptly with the committee's conclusions.

7. Market participants, academics and regulators should be invited to participate in the committee's work.

APPENDIX 2

Table A: Provincial prospectus fees in Canada

	Initial fee	Final fee
QUÉBEC	$1 000	Excess over initial fee of: 0.04% x 1/4 x overall value of securities offered
ONTARIO[1]	$800	Excess over initial fee of: 0.032% x overall value of securities offered
BRITISH COLUMBIA	$400 *	Excess over initial fee of: 0.02% x overall value of securities offered in British Columbia
ALBERTA	$1 000	Excess over initial fee of: 0.025% x overall value of securities offered in Alberta
MANITOBA	$1 000 If more than one category of securities: $325 for each additional category	
SASKATCHEWAN	$1 000 If more than one category of securities: $250 for each additional category	
NOVA SCOTIA	$850 if not lead authority $1 250 if lead authority If more than one category of securities: $300 for each additional category	
PRINCE EDWARD ISLAND	$600 If more than one category of securities: $100 for each additional category	
NEW BRUNSWICK	$1 000 if not lead authority $1 250 if lead authority If more than one category of securities: $300 for each additional category	
NEWFOUNDLAND	$850	
NORTHWEST TERRITORIES	$350 per category of securities	
YUKON	$150 if authorized by another Canadian authority $250 if lead authority plus $100 for each additional category	
NUNAVUT	$350 per category of securities	

* Fees reduced for one year starting January 7, 2002.
[1] Reflecting a temporary reduction in fees of 20%.
Source: Commission des valeurs mobilières du Québec.

APPENDIX 3

TABLE B: *Comparison of cost by size offering, excluding junior capital pools companies, for the 1997-1999 period*

Canada

Size of offering (US $ millions)	Number of IPOs[1]	Underwriter's' compensation (%)*	Other expenses (%)*	Total direct cost (%)*	Level of underpricing (%)*
1.0 - 9.9	53	8.12	7.86	15.98	30.61
10.0 - 49.9	49	6.14	3.31	9.45	11.30
50.0 - 99.9	10	6.00	2.00	8.00	10.76
100 and more	16	5.53	1.75	7.28	8.88
Average		6.88	4.90	11.78	18.95
Weighted average (by size)		5.35	1.84	7.19	5.11

United States

Size of offering (US $ millions)	Number of IPOs	Underwriter's' compensation (%)*	Other expenses (%)*	Total direct cost (%)*	Level of underpricing (%)*
1.0 - 9.9	119	9.29	8.70	17.99	9.05
10.0 - 49.9	532	6.93	3.70	10.63	26.15
50.0 - 99.9	300	6.88	2.12	9.00	55.57
100 et plus	237	6.09	1.20	7.29	67.19
Average		7.00	3.30	10.30	37.50
Weighted average (by size)		5.79	1.43	7.22	38.38

* Significant at 1%.

Source: Kooli, Maher and Jean-Marc Suret 2002, *How cost-effective are Canadian IPO markets?*, Table 6, *Scientific series CIRANO*.

TABLE C: Number of IPOs and proportion according to size of offering in Canada and the United States

Size of offering (US $ millions)	Canada		United States	
	Number of IPOs	Proportion (%)	Number of IPOs	Proportion (%)
1.0 - 9.9	53	41.41	119	10.02
10.0 - 49.9	49	38.28	532	44.78
50.0 - 99.9	10	7.81	300	25.25
100 or more	16	12.50	237	19.95
Total	128	100.00	**1188**	**100.00**

Sources: Ministère des Finances, de l'Économie et de la Recherche and Kooli, Maher and Jean-Marc Suret 2002, *How cost-effective are Canadian IPO markets?*, *Scientific series CIRANO*.

[1] IPO : Initial Public Offering

APPENDIX 4

TABLE D: Pan-Canadian IPO of $35 million

	% of offering	C$ ('000)	% of total direct cost
Direct cost			
Underwriters' compensation	6.14	2 149	64.97
Other expenses:			
Fees payable	0.07	25	0.75
Other*	3.24	1 134	34.28
Total other expenses	3.31	1 159	35.03
Total direct cost	**9.45**	**3 308**	**100.00**

* Other: auditors' fees, legal fees, fees of transfer agent, expense of printing the prospectus, and taxes.
Sources: Ministère des Finances, de l'Économie et de la Recherche and Kooli, Maher and Jean-Marc Suret 2002, How cost-effective are Canadian IPO markets?, Scientific series CIRANO.

APPENDIX 5

TABLE E: Costs relating to continuous disclosure requirement

Jurisdiction	Annual report – annual financial statements (annual costs)				News release
	That satisfies certain conditions	If not, that is listed on a Canadian stock exchange	If not, that files an annual notice	Other	Fees payable for a news release
QUÉBEC	2 000 $	1 000 $	500 $	500 $	**100 $**
ONTARIO[1]	1 600 $	800 $	400 $	200 $	**80 $**
BRITISH COLUMBIA	$75 * $800 late $1 100 late plus ban				**0 $**
ALBERTA	$2 000 plus $100 if late			$250 plus $100 if late	**0 $**
MANITOBA	100 $				**0 $**
SASKATCHEWAN	100 $				**0 $**
NOVA SCOTIA		$250 $150 if not registered			**25 $**
ÎLE-DU-PRINCE-ÉDOUARD	0 $				**0 $**
NOUVEAU-BRUNSWICK	0 $				**0 $**
TERRE-NEUVE	250 $				**0 $**
TERRITOIRES-DU-NORD-OUEST	0 $				**0 $**
YUKON	0 $				**0 $**
NUNAVUT	0 $				**0 $**
TOTAL:					**205 $**

* Fees reduced for one year starting January 7, 2002.
[1] Reflecting a temporary reduction in fees of 20%.
Source: Commission des valeurs mobilières du Québec.

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