# 2009 Report of the Expert Panel on Securities Regulation in Canada

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## Introduction

On January 12, 2009, the Expert Panel on Securities Regulation in Canada (the "Panel") released its report (the "Report") and draft legislation (the "Draft Act"). The Panel has recommended that all provinces and territories adopt federal securities legislation and that the federal government adopt a phased-in to the implementation of such legislation. The Panel's recommendations address both the structure and general direction of the proposed regulatory regime. The federal government welcomed the Report and has committed to introducing securities legislation later this year.

## Structure of the Regime

### Canadian Securities Commission

The Report recommends the creation of a Canadian Securities Commission (the "Commission") to administer the Securities Act (the "Act") and to be responsible for policy and rule-making. The Commission would also retain jurisdiction over making discretionary exemptions from securities regulations and rules as well as matters regarding contested take-over bids.

The Commission's Executive Management Team would consist of a Chair, a number of Vice-Chairs, other members of the Commission, and an Executive Director. The Report recommends that the head office be located in one of the four largest provinces. The Report also recommends regional offices in the major financial centres, with those in the largest provinces headed by a Vice-Chair. Smaller local offices will be maintained to serve local market participants and to conduct local enforcement actions. Local offices could specialize in the regulation of specific sectors or types of financial instruments.

The Commission would be self-funded, with fees set on a cost recovery basis. The Report recommends that the federal government negotiate a direct compensation arrangement to ensure that provinces do not experience a revenue shortfall as a result of the new regime. The Commission would be accountable to the federal government though the Minister of Finance. The Minister would have the right to veto rules proposed by the Commission.

### Independent Panels

The Report recommends the establishment of two independent panels: one to represent the view of investors and the other to represent small reporting issuers. The panels would receive dedicated and separately-funded secretariats.

### Governance Board

The Report recommends a Governance Board to oversee the Commission. The Panel did not agree on the exact nature of the role. Some members felt that the Board could provide strategic perspective on the Commission's financial and other non-regulatory affairs, and also wanted the Board to provide an

oversight role in policy and rule development. The Board would be independent of the management of the Commission.

**Nominating Committee**

The Report recommends a federal-provincial Nominating Committee, which would be responsible for recommending candidates to the federal Minister of Finance for the members of the Commission including the commissioners, the members of the Governance Board and the adjudicators of the independent adjudicative tribunal.

**Council of Ministers**

The Report recommends a Council of Ministers, which would include the federal Minister of Finance and a Minister designated by each participating jurisdiction. The Council would discuss the development of securities policy and the ongoing administration of the system. The Council would serve as a forum to discuss issues related to Canadian capital markets and ensure that the Commission supports the needs of the regions and industrial sectors across Canada. The Council could also consider proposed legislative amendments to the Act and the provinces would have the power to veto any proposed legislative changes.

**Administrative Tribunal**

An independent administrative tribunal has been proposed, which would assume adjudicatory functions currently exercised by the Commissions. Cases involving quasi-criminal or criminal matters would continue to be referred to the court system. The Report recommends that retired judges and former commissioners from the provinces make up the adjudicators, and that the tribunal should have offices across Canada.

**Self-Regulatory Organizations**

The report recommends that SROs (e.g., IIROC, the MFDA and the exchanges) continue to play a critical role in the regulation of Canadian public markets. They would be overseen by the Commission.

**Capital Markets Oversight Office**

**Implementation Strategies**

The Panel included a discussion of how a transition could occur from the current regulatory system to the proposed system. The Panel anticipates that it will take approximately three years to phase in the new system, including one year to establish the foundation by creating a transition and planning team with a budget. A transition and planning team (the "Team") would be created, which would be responsible for supporting the inter-governmental negotiations and MOU formation towards a federal regulatory system. It would plan for the institution of the Canadian Securities Commission and the independent tribunal. The Team would also assist with working with both the federal and provincial governments in developing the proposed legislation to be debated in Parliament.

The Panel recommended the establishment of a Capital Markets Oversight Office, which would report to the Minister of Finance. The office would be responsible for providing leadership in the domestic and international regulation of securities. It would interact with regulators to ensure that policies reflect the best interests of Canada as a whole and that moderate global financial markets. The function of the Office would be phased out upon the Commission becoming operational.

Following the passage of the Act, it is expected that there would be a transition period of approximately two years, during which the various committees and positions would be filled. The existing rules and regulations of the participating jurisdictions would be adopted during this time as rules under the Act. Staff would be hired, where possible, from among the provincial commissions' existing staff. The Commission would address issues related to the non- participating jurisdictions in a manner similar to the existing passport system. A detailed review of all local laws, regulations, rules of all local jurisdictions and all national and multilateral instruments and notices and policies would then occur.

The Commission would have to be operational for at least a year before the Act's effective date. The legislation of the participating jurisdictions would be repealed upon the coming into force of the Act, with the exception of necessary transitional provisions. The report acknowledges that some grandfathering will likely be necessary.

The report states that, in the event that a successful transition could not be made to a single set of national securities laws, the federal government consider unilateral action to implement such as regime. According to the Report the Panel the federal government has the constitutional ability to do so.

**Opt-in Procedure**

In the absence of unanimity, the Act could contemplate voluntary participation and the limiting of the application of the Act to a limited number of jurisdictions. Under this provision a non-participation jurisdiction would continue to exercise jurisdiction over its securities regulation. Participants with a substantial connection to any of the non-participating jurisdictions could be given the option to elect to be regulated under the federal regime only. Participants who made this election would then be regulated by the federal regime only and not the non-participating regime. Participants would have the option of filing a form indicating that only the federal regime is applicable; the form would be shared with the provincial regulator.

Participants who do not choose the federal regime would continue to be regulated by the securities laws of each non-participating jurisdiction in which they carry out the regulated activity, and by the federal regime to the extent the activity was carried out in more than one participating jurisdiction. The federal regime would automatically apply to issuers that have a substantial connection to a participating jurisdictions under the opt-in models to the exclusion of the remaining non-participating jurisdictions.

In the event that a sufficient number of provinces did not participate, the Panel suggested that the Government consider a market participation opt-in feature in the Act's transition provisions. This would allow the participants to opt-in and be governed by the federal legislation to the exclusion of provincial legislation. These participants would have the ability to comply exclusively with the Act regardless of a provincial opt-in.

The opt-in would apply to both public and private companies. Issuers and market participants with no substantial connection to a Canadian jurisdiction would be deemed to have a connection to a Canadian jurisdiction and therefore subject to the federal regime.

**Policy Directions**

**Systemic Risk**

The Draft Act and the Report focus on systemic risk in the broader financial markets (rather than merely the capital markets). The report suggests an expansion of systemic risk management, from clearing and

settlement issues and seeking capital and solvency requirements on dealers, through to becoming involved in systemic risk through monitoring, coordination and crisis management .

The Report states that recent developments in the global financial system have highlighted the need for securities regulators to be involved in the management of systemic risk that in the past has been largely confined to banking regulatory structures. The Report also points to financial innovation as a reason for securities regulators to become more involved in systemic risks. Increasingly complex instruments such as hedge funds, the increasingly international nature of securities' firms, and the tendency of banks to become more involved in global trading activities (particularly OTC derivatives) are all cited in support of broader regulation.

**Principle-Based Regulation**

Another important aspect of the Report is its emphasis on principle-based, rather than rules-based, securities regulation. The Panel expects this to lower compliance costs, improve regulatory outcomes and improvement competitiveness with other jurisdictions. In the Panel's view, since capital markets are becoming more sophisticated and dynamic, principle-based regulation would allow participants greater flexibility in how they choose to comply. Businesses when confronted with ambiguous situations would no longer be bound by strict rules. Principle-based regulation is said to facilitate better enforcement actions by holding participants more accountable for infractions including those that, despite achieving technical compliance, violate the public interest.

**Proportionate-Based Regulation**

The Report considers differences in participants' size and sectors in recommending that the Government adopt proportionate-based securities regulation. Such regulation would build on current disclosure-relates rules and TSX-V rules that make such distinctions. This type of regulation could result in innovative approaches that streamline reporting requirements and that reduce undue regulatory burdens for small public companies. The Report states that resources should be allocated to regulating those market participants that pose the greatest risk to investors and the economy generally. The Report notes that the current enforcement system may not serve the development of a proportionate-based securities regulatory system, and that a single securities regulator would be better positioned to advance such an agenda.

**Investor Protection**

The Report seeks to improve investor complaint-handling and redress mechanisms. Measures would include allowing the Commission to order compensation rather than requiring investors to file suit. The Report also recommends the establishment of a compensation scheme, funded by regulated entities, that would directly compensate investors. The Panel recommends the legislation of the mandatory dispute resolution of registrants. Theses services could be provided either by the Commission or by another regulatory body.

The Report considers the AMF's process in this respect to representative a Canadian best practice. An investor who receives a ruling from the Quebec tribunal can submit a claim for compensation of up to $200,000. The amounts paid flow from the financial services compensation fund, which is funded by fees levied by regulated entities in Quebec. The AMF can then recoup the money from the monies paid out from the those responsible.

**The Draft Legislation**

**Recognition of Certain Entities**

Part 3 of the Draft Act provides for the "recognition" by the Commission of exchanges, SROs, clearing agencies and quotation and trade reporting systems (each a "recognized entity") .

The Draft Act would prohibit anyone from carrying on business as an exchange or as a quotation and trade reporting system (or facilitate trading in securities or exchange-traded contracts in a manner similar in nature to a quotation and trade reporting system) without recognition by the Commission. The Draft Act would not prohibit anyone from carrying on business as a clearing agency without recognition, although this would seem to be a drafting oversight.

Recognized exchanges and recognized SROs would have responsibility for regulating the business conduct of their members and former members as well as members' and former members' representatives and former representatives. Exchanges and SROs would also be permitted to delegate any of their authorities to a council (such as IIROC's district councils), committee or other ancillary body, subject to approval by the Commission.

The Commission would have authority to make decisions in respect of all by-laws, rules, regulations, procedures and practices of a recognized entity. Anyone affected by the administration of a recognized entity's by-laws, rules, regulations procedures or practices, or by a direction, decision, order or ruling made there under would have a right of appeal to the Tribunal.

**Registration**

Part 4 of the Draft Act would require the registration of dealers, advisers and investment fund managers. It would also require the registration of individuals who trade or advise with respect to securities or who perform "prescribed functions" on behalf of a registrant firm.

The Draft Act definition of "dealer" incorporates the 'business trigger' for registration as does the definition of "adviser." The Panel has thus followed the CSA's approach under the registration reform project. However, the Draft Act definition of "investment fund manager" would capture only those entities that actually direct the business, operations or affairs of an investment fund, rather than the broader category of entities that are "permitted to direct" a fund's business, operations or affairs as contemplated by NI 31-103.

Interestingly, the Draft Act does not specifically call for the registration of "ultimate designated persons" or "chief compliance officers". Instead, the Draft Act simply requires the registration of individuals who perform "prescribed functions," meaning those functions that are prescribed by regulation under the Draft Act. Although it seems likely that the Panel had UDPs and CCOs in mind when drafting this section of the Draft Act, this legislative approach is very different from that taken by most of the provincial legislatures in the context of the registration reform project. Most provinces considered it necessary to amend their securities legislation to specifically define the roles of UDPs and CCOs.

The Draft Act would impose standards of care on all registrants. It would also impose fiduciary duties on advisers (with respect to monies managed under discretionary authority) and on investment fund managers (with respect to the funds for which they are responsible).

The Draft Act would also permit the Minister to establish a body to deal with complaints from clients of registrants and, by regulation, require registrants to become "members" of such a body. This proposal is very similar to the dispute resolution service contemplated in conduct rules in NI 31-101.

**Trading in Securities and Exchange Contracts**

With regard to exchange-traded derivatives, the Panel concludes that the regulation of such derivatives should be prescribed in securities legislation. This is the approach currently used by Alberta and British Columbia. Ontario and Manitoba regulate certain exchange-traded contracts under a separate *Commodity Futures Act*. Quebec recently adopted a *Derivatives Act* that regulates both exchange-traded and OTC derivatives.

The Draft Act defines the term "exchange contract" in the same manner as does Alberta's *Securities Act* (the "Alberta Act"), as any futures contract or option which is cleared by a clearing corporation and that trades on an exchange. "Futures contract" is also defined as any contract to take future delivery of a commodity, a security or cash, where the value of cash is based on the value of a price of a security, commodity, interest rate, exchange rate or an index. Consistent with the Alberta Act, the Draft Act does not define "option." The approach is thus broader than the Ontario and Manitoba commodity futures legislation, which cover only options on commodity futures contracts and which consider other exchange-traded options to be securities. Additionally, the definition of the term "commodity" is narrower than that used in Ontario and does not explicitly cover items such as weather, emissions and credit obligations.

The Draft Act, like the Alberta Act, carves out exchange contracts from the definition of security but includes all other futures contracts and options in the definition of security. Unlike Ontario and Manitoba, but like Alberta, British Columbia and Quebec, only a single registration is required to advise on or deal in both securities and exchange contracts. Finally, exchanges and exchange contracts are regulated by the Draft Act. Exchanges are required to be recognized by the Commission and the form of all exchange contracts must be accepted by the Commission before trading occurs.

The regulation of OTC derivatives, however, was perhaps the more interesting focus of the Report. The Panel noted that OTC derivative markets are largely unregulated in Canada. While various provincial authorities have spent considerable time trying to develop new regulation in this area (e.g., the new Quebec derivatives legislation), these efforts have met with fierce opposition from market participants. Such participants argue that regulation would impede the growth of the Canadian derivatives market, making it uncompetitive with larger markets abroad. The Panel stated that while more regulatory oversight was needed over OTC derivatives, the Panel was conscious that the United States and other jurisdictions were also contemplating regulatory changes in this area. It would thus be a mistake for the Panel to recommend a regulatory approach that would risk being out of step with regulation globally.

The Panel concluded that the Commission would be in a much better position than the assorted provincial regulators to participate in international discussions and to direct the development of corresponding OTC derivatives regulation in Canada. The Panel recommended that the Commission be endowed with sufficient policy depth and resources to determine the best way forward for the regulation of OTC derivatives in Canada.

**Prospectus Requirements**

The Draft Act's prospectus requirements are modeled on the Alberta Act. The Panel has, however, streamlined the provisions to provide the rule-makers greater flexibility. For example, the Draft Act defers to the rules concerning the circumstances in which a preliminary prospectus will be required. It also defers to the rules concerning those activities permitted between the issuance of a receipt for the preliminary prospectus and the final prospectus.

The basis prospectus requirement is found in section 72(1). Section 73(4) permits certificate requirements to be waived, although the Draft Act does not appear to impose any requirements in this regard. Unlike the Ontario Act's delineation of different forms of prospectuses, the Draft Act defers to the rules in this

regard. Unlike the Ontario Act, the Draft Act also largely relegates to the rules the circumstances in which a receipt will be refused.

The Draft Act provides for prospectus exemptions at section 82(1). Unlike the Ontario Act, the Draft Act does not appear to provide for the lapsing of prospectuses. Unlike the OSA, the Draft Act also does not require the prospectus to include a statement of the recipients' rights.

**Continuous Disclosure**

The Draft Act largely relegates continuous disclosure to the rulemaking process. The Commentary refers readers to NI 51-102 and NI 81-106 in this regard. The Draft Act also relegates proxy solicitation requirements to the rules.

Section 86 requires the periodic disclosure of the issuer's affairs and the timely disclosure of material changes. Section 87, like section 76(1) of the Ontario Act, prohibits the purchase and sale of securities by those in a special relationship with the issuer without appropriate disclosure. However, unlike the Ontario Act, the Draft Act does not define a "special relationship." The section includes a detailed list of exemptions (e.g., for dividend re-investment plans) from the purchase and sale prohibition. Sections 88 and 89 then prohibit both tipping and the recommending of a stock prior to the disclosure of a material fact or material change. Section 90 specifically prohibits parties to takeover bids, reorganizations, and large asset purchases from disclosing information before it has been made public. Finally, section 91 provides a due diligence defence for offences to sections 87 to 90.

**Takeover Bids**

The Draft Act largely relegates take-over and issuer bid requirements to the rules. The Commentary refers readers to MI 62-104 in this regard. Ontario does not subscribe to MI 62-104 and instead relies on Part XX of the Ontario Act and OSC Rule 62-504. Passage of the Draft Act may thus require Ontario to adopt the existing multilateral instrument.

The take-over bid and issuer bid definitions in section 93 of the DSA are virtually identical to those in the Ontario Act. Pursuant to section 94, bids must comply with the rules. Section 95 requires directors or officers to accept or reject bids, subject to the rules. Section 96 calls for the equal treatment of shareholders and prohibits collateral agreements. Section 97 enables the Commission to make compliance orders. Section 98 provides a non-exhaustive list of compliance orders that might be made by a court.

**Insider Trading and Self-Dealing**

In keeping with the principle-based approach of the Draft Act, the technical requirements governing insider trading and self-dealing would be relegated to the rules to be adopted under the Draft Act.

The Draft Act adopts a primary filing requirement, under which insiders of a reporting issuer would have to file a report detailing their direct and indirect holdings of the issuer. However, no technical requirements in respect of such filings are provided in the Draft Act. Instead, it is stated that insiders "shall comply with the disclosure requirements of the rules". Presumably, the rules would provide for the form of disclosure and the delay within which such form would have to be filed.

Insiders of a reporting issuer would also have to report on their holdings of "related financial instruments", which include any financial instrument that alters the insider's economic interest in a security of the reporting issuer.

Similarly, provision is made for an early-warning report similar to that which is currently required when a shareholder's voting percentage reaches a specified threshold. However, the Draft Act merely refers to "a prescribed percentage of the outstanding securities of that type or class". The "prescribed percentage" would be provided in the rules.

Under the rubric of self-dealing, mutual funds would be prohibited from entering into transactions with their officers and directors that present the possibility of a conflict of interest.

**Investigations**

The Draft Act sets out in detail the investigative powers of the Commission, including provisions that would allow the Executive Director to order a registrant to produce documents and other records, to conduct searches and seizures and to compel witnesses to appear. The Commission would also be empowered to appoint receivers, managers, trustees or liquidators in connection with its investigations. In addition, provision is made for the Commission to share information with other governmental authorities and law enforcement agencies.

**Enforcement**

This part contains general prohibitions against making misleading statements or otherwise knowingly making statements that could reasonably be expected to have an effect on the market price or value of a security.

Quasi-criminal sanctions currently found in provincial securities legislation would be maintained in this part of the Draft Act, while criminal sanctions would remain in the Criminal Code. The Draft Act states that the Commission may order financial compensation as an alternative to the conventional court process. The Draft Act includes a due diligence defence that could be invoked against certain alleged offences.

Fines of up to $5 million and imprisonment of up to 5 years are provided as maximum penalties for the contravention of securities laws. In addition, the guilty party could be obligated to reimburse the full amount of any ill-gotten profits.

The Draft Act does not address administrative monetary penalties, although a note is contained in the Draft Act providing for the possibility of such penalties eventually being introduced.

**Civil Liability**

If, during a distribution of securities, a person purchases a security offered under a prospectus that contains a misrepresentation, that person would have a right of action for damages against the issuer and any underwriter, selling security holder, corporate director or other party who signed the prospectus.

In addition, an investor who purchased securities under a misrepresentation would benefit from a right of rescission. Similar rights would be granted to those who have purchased securities under an offering memorandum or take-over bid circular that contains a misrepresentation.

The Draft Act also imposes civil liability for failure to send required offering documents and for contravening insider trading restrictions. Finally, the Draft Act sets out statutory defences that could be invoked against allegations of these various offences.

**Civil Liability for Secondary Market Disclosure**

As in most existing provincial securities legislation, the Draft Act sets out a number of offences for which issuers and others would be liable to secondary market investors (as opposed to the civil liability provisions discussed above, which set out liability in the primary market). These offences include a failure to comply with timely disclosure obligations relating to material changes or cases where a misrepresentation is contained in a public document or public oral statement. The Draft Act also sets out defences against allegations of secondary market liability and the procedure for making claims in respect of secondary market offences.

**The Government's Response**

The Government immediately welcomed the Report. Furthermore, in speaking to the budget introduced on January 27, Finance Minister Flaherty stated that the Government intends to introduce a Securities Act later this year. He also emphasized that participation by the provinces will be voluntary. The budget includes a commitment to fund an office responsible for creating a transition plan within one year.