Structural Reform of Financial Regulation in Canada

A Research Study Prepared for the
Expert Panel on Securities Regulation

Eric J. Pan

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Biography

Eric J. Pan

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Structural Reform of Financial Regulation in Canada

Executive Summary

Reform of its financial regulatory system affords Canada the opportunity to rethink not only how to better regulate its financial markets but also how to make its markets more attractive to financial market participants. In the current environment, where financial market participants are increasingly mobile, governments must be careful that achieving one objective is not at the expense of the other. Companies, investors, financial services firms and other financial market participants can now conduct business in a variety of locations around the world. Therefore, Canada, like all countries, can no longer take for granted the existence of a vibrant domestic financial market that will continue to meet the growing demands of Canadian businesses and households; rather it must consider how to attract financial activity to Canada in order to remain a leading global financial player.

The globalization of financial markets offers a compelling reason why Canada should pursue regulatory reform of its financial sector. In recent years, the United States, European Union and other jurisdictions have recognized that greater regulatory cooperation is needed to manage the cross-border markets. Many of Canada's economic competitors have devoted a great deal of resources to consider how to converge and harmonize their regulatory standards and seek formal and informal means to cooperate on the development of new regulation. As a consequence, international standards and best practices are being negotiated and developed today that may govern international capital raising, securities and derivatives trading, and lending practices for decades into the future. To the extent that the structure of Canada's financial regulatory system hinders Canada's full participation in these international discussions, structural reform should be undertaken to give Canada a stronger and more consistent voice.

With these objectives in mind, Canada should adopt the following reforms. First, regulatory authority should shift to agencies operating under the auspices of the national government capable of representing national as well as local and provincial interests. Financial activity frequently extends across more than one province and can be more effectively overseen by a national regulator. In addition, the national government is in the best position to represent all of Canada's interests in international forums and in negotiations with other jurisdictions. Second, the Canadian regulatory system should be restructured in accordance with objectives-based regulation. Individual regulators should be organized in accordance with one of three categories of financial regulation: (i) prudential regulation; (ii) business conduct regulation; and (iii) market stability measures. In pursuing objectives-based regulation, Canada should not let itself be trapped in a false choice between a "single regulator" model and a "twin peaks" model. What is most important is that Canada's regulators have clear lines of authority, share information freely and continuously, and coordinate regulatory actions. Finally, structural reform should be accompanied by additional resources for supervision and enforcement to enable the introduction of supervisory approaches and principles-based regulation. Such a shift in regulatory resources will improve the attractiveness of the Canadian markets in the eyes of global financial institutions as well as enhance the effectiveness of the regulatory system in ensuring the markets' safety and soundness.

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Structural Reform of Financial Regulation in Canada

Financial regulation has two goals: to ensure the safety and soundness of the financial system (which includes the promotion of consumer protection) and to foster the growth and development of the financial markets. In the current, global financial environment, where financial market participants are increasingly mobile, governments must be careful that achieving one objective is not at the expense of the other. Satisfaction of both goals will have great benefits for a country, including, among other things, lower cost of capital for businesses, greater opportunities for investors, tax revenue for the government and job creation in the financial and related industries.

Canada so far has avoided many of the economic problems that currently plague the United States and United Kingdom. Canadian financial institutions have not declared the large losses that have weakened, and in some cases crippled, US and UK financial institutions. At the same time, Canadian consumers do not appear to suffer from the same debt burden and crisis of confidence that currently weigh heavily on American and British households. Canada's economic fundamentals are also more favorable than that of the United States and United Kingdom with Canada enjoying relatively low unemployment, a healthy trade surplus and budget surpluses. Given the difficult economic conditions in the United States and United Kingdom, it is not surprising that the recent US and UK debate about financial regulation and possible regulatory reforms has focused on how to respond to the current financial crisis and prevent future crises.[1] Canada, on the other hand, enjoys the luxury of thinking more long-term and should consider how regulatory reform can be used to make the Canadian financial markets more robust, innovative and attractive to global financial players.

Regulation's role in making a country's financial markets more competitive relative to other countries' financial markets is of increased national concern. National financial markets are becoming increasingly interconnected and interchangeable. This globalization of financial markets manifests itself in the expansion of financial services now provided to Canadians by foreign financial services providers as well as the number of foreign customers now served by Canadian financial institutions. Many Canadian companies sell and list their securities on exchanges located outside of Canada and seek financing from foreign banks and investment funds, and prices for agricultural products, metals, oil and gas and other commodities that are so important to the Canadian economy are predominantly set by trading markets located outside of Canada. Companies, investors, financial services firms and other financial market participants can now conduct business in a variety of locations around the world. Therefore, Canada, like all

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[1] *See, e.g.,* Remarks by US Treasury Secretary Henry M. Paulson, Jr. on the U.S., the World Economy and Markets before the Chatham House (July 2, 2008), *available at* http://www.treas.gov/press/releases/hp1064.htm; Speech by the Chancellor of the Exchequer, the Right Honorable Alistair Darling MP, at Mansion House (June 18, 2008), *available at* http://www.hm-treasury.gov.uk/newsroom_and_speeches/speeches/chancellorexchequer/speech_chx_180608.cfm.

countries, can no longer take for granted the existence of a vibrant domestic financial market that will continue to meet the growing demands of Canadian businesses and households; rather it must consider how to attract financial activity to Canada in order to remain a leading global financial player.[2]

The globalization of financial markets further offers a compelling reason why Canada should pursue regulatory reform of its financial sector. In recent years, the United States, European Union and other countries have recognized that greater regulatory cooperation is needed to manage the cross-border markets. Many of Canada's economic competitors have devoted a great deal of resources to consider how to converge and harmonize their regulatory standards and seek informal and formal means to cooperate on the development of new regulation. In recent years, we have seen the wide-spread acceptance of International Financial Reporting Standards (IFRS) and eXtensible Business Reporting Language, negotiation of mutual recognition regimes for broker-dealers and exchanges, execution of bilateral and multilateral memoranda of understanding to facilitate information sharing, and new regulatory and standard-setting initiatives by international bodies such as the Bank for International Settlements, International Organization of Securities Commissions (IOSCO) and International Monetary Fund. These international developments directly affect Canadian companies, investors and financial services providers. International standards and best practices are being negotiated and developed today that may govern international capital raising, securities and derivatives trading, and lending practices for decades into the future. To the extent that the structure of Canada's financial regulatory system hinders Canada's full participation in these international discussions, structural reform should be undertaken to give Canada a stronger and more consistent voice.

With these objectives in mind, Canada should adopt the following reforms. First, regulatory authority should shift to agencies operating under the auspices of the national government. Financial activity frequently extends across more than one province and can be more effectively overseen by a national regulator. In addition, the national government is in the best position to represent all of Canada's interests in international forums and in negotiations with other countries. Second, the Canadian regulatory system should be reorganized in accordance with objectives-based regulation. Individual regulators should be organized in accordance with one of three categories of financial regulation: (i) prudential regulation; (ii) business conduct regulation; and (iii) market stability measures. As discussed in this report, Canada should not let itself be trapped in a false choice between a "single regulator" model or "twin peaks" model. What is most important is that Canada's regulators have clear lines of responsibility, share information freely and continuously and coordinate regulatory actions.

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[2] In its biannual report ranking the competitiveness of the top one hundred global financial centers, The City of London determined that three Canadian cities made the list: Toronto (12), Vancouver (30) and Montreal (31). The top ten cities were (in order of ranking): London, New York, Singapore, Hong Kong, Zürich, Geneva, Tokyo, Chicago, Frankfurt and Sydney. *See* The City of London, *The Global Financial Centres Index* 8 (4th ed., Sep. 2008), *available at* www.cityoflondon.gov.uk/researchpublications.

Finally, structural reform should be accompanied by additional resources for supervision and enforcement to enable the introduction of supervisory approaches and principles-based regulation. No reorganization of Canada's regulatory system will be successful without the retention of knowledgeable and dedicated regulatory professionals capable of working closely with financial institutions to ensure compliance with applicable rules and regulations. Such a shift in regulatory resources will improve the attractiveness of the Canadian markets in the eyes of global financial institutions.

This report is divided into four parts. Part One outlines the various issues that should be considered in designing the optimal regulatory system. The purpose of Part One is to set forth the basic concepts that are associated with the regulation of markets. It begins by reviewing the basic tasks that must be met by a regulatory system. It then discusses the ideal characteristics of such a system, including regulatory efficiency, accountability, competency and legitimacy. Part One also describes possible strategies that may be called upon by the regulatory system to achieve its objectives, outlining the pros and cons of regulatory competition and regulatory cooperation, and evaluates the relative merits of the single regulator and twin peaks models. Part Two of the report analyzes Canada's current regulatory system in light of the criteria set forth in Part One. In order to position Canada's system in relation to its main economic competitors, Part Three reviews the regulatory systems of the United Kingdom, Australia, United States, France, Germany, Hong Kong, Japan and Netherlands. In the case of the United States, the report discusses both the current US regulatory system and the system proposed by the US Treasury Department in its recent *Blueprint for a Modernized Financial Regulatory Structure*.[3] Finally, Part Four offers a series of recommendations for reforming the Canadian financial regulatory system. These recommendations draw upon the experience of other countries in effecting regulatory reform as well as a strategy to make the Canadian financial markets more attractive to financial market participants.

I. Designing an Optimal Regulatory System

The design of an optimal regulatory system should begin with an understanding of the objectives of the regulatory system, the ideal characteristics of such a system, the various regulatory strategies that might be applied to achieve those objectives, and, finally, the desired structure of the regulatory system.

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[3] *See* US Department of the Treasury, *The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure* (2008), *available at* http://www.treas.gov/press/releases/reports/Blueprint.pdf.

A. Regulatory Objectives

The first objective of financial regulation is to ensure the safety and soundness of the financial system. Accomplishment of this goal consists of three tasks: prudential regulation, business conduct regulation and market stability protection.[4]

Prudential regulation refers to the range of regulations and regulatory acts applied to certain financial institutions – banks, securities firms and insurance companies – to ensure that they are financially sound and capable of meeting their market obligations. Regulators have a great interest in the health and operations of these financial institutions as the failure of one or more of these institutions could result in a loss in confidence in the safety and soundness of the financial system – causing a sharp contraction in financial activity and the weakening of other financial institutions – and the need for public intervention. Prudential regulation includes, among other things, capital adequacy rules, internal controls and record keeping requirements, risk assessments and mandatory professional qualifications for key personnel. Prudential regulation also can refer to the monitoring and inspection of financial institutions on an on-going basis by the regulator accompanied by sanctions and prosecution for violations or unsafe practices. The purpose of prudential regulation is to make sure a financial institution is not assuming risks that could endanger the financial health of the institution and its commitments to investors and depositors as well as to provide the regulator with sufficient information to identify potential problems before such problems become serious enough to result in a failure of the institution.

In contrast, business conduct regulation focuses on protecting customers that buy financial products or otherwise entrust funds to financial institutions. Business conduct regulation provides consumer protection by addressing the unequal position of financial institutions relative to their customers. The most vulnerable customers are retail clients who often lack the sophistication and information necessary to protect themselves from fraud, market abuse or ill-informed advice and must rely on financial institutions and the representatives of those financial institutions to protect their interests.[5] Consequently, regulators must address this information asymmetry by imposing requirements on financial institutions to disclose conflicts of interest, offer appropriate disclosures of risk, provide detailed and understandable information about investments and financial products and services, train their personnel to comprehend the needs of customers and clients in order to provide appropriate advice and assistance, and assume certain fiduciary obligations. Business conduct regulation also includes regulations that promote

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[4] This breakdown of tasks has also been recognized by other commentators. *See, e.g.,* Michael Taylor, "Twin Peaks: A Regulatory Structure for the New Century," Centre for the Study of Financial Innovation Working Paper (1995); Howard Davies & David Green, *Global Financial Regulation* (2008); US Government Accountability Office, "Financial Regulation: Industry Trends Continue to Challenge the Federal Regulatory Structure" (GAO-08-32, Oct. 2007).

[5] *See* Taylor, *supra* note 4, at 2.

investor protection where regulators impose on securities issuers' obligations to provide accurate material information on an on-going basis to investors.

Beyond the regulation of financial institutions and the protection of customers, regulators also must safeguard the overall stability of the market. Regulators must sustain the financial infrastructure necessary to keep the financial markets operating in a smooth manner. This task includes maintaining the payments system, providing short-term and overnight lending and managing the money supply. The responsibility to ensure market stability also refers to the need to intervene during times of crisis and fulfill the role of lender of last resort and liquidity provider when the failure of a financial institution might cause serious harm to the financial system. Market stability protection is different from other regulatory activities because the responses associated with the protection of market stability frequently require the government to enter the market as counterparty in financial market transactions. Market stability regulation is often the responsibility of the central bank, independent of any direct regulatory duties of the central bank. As recent events in the United States and United Kingdom have demonstrated, however, market stability operations that require government intervention as a lender of last resort, a source of liquidity or a guarantor of financial obligations is inextricably tied to the protection of customer assets and the soundness of financial institutions, justifying a role for the central bank in the regulatory process.

The other objective of financial regulation is to foster the growth and development of the financial markets. A regulatory system makes financial market growth possible by promoting innovation and permitting the development of new markets for financial services. A regulatory system is more likely to attract innovation and new market development if financial market participants perceive that regulators are responsive to their interests and that applicable regulatory standards and requirements are appropriate. As a result, lack of growth or innovation may be the result of regulation that imposes higher-than-necessary costs on market participants or limits the ability of financial service providers to enter into new lines of business. In the current global marketplace, an unattractive market will cause the movement of financial activity to other markets. Financial markets are in competition with each other, and regulatory reform should take into consideration the impact of the structure of the regulatory system on financial market activity.

It should be noted that some traditional scholars of financial regulation may disagree that one of the objectives of financial regulation is to promote financial market competitiveness. Such scholars believe that the only objective that regulators should be concerned with is the safety and soundness of the financial system, including the provision of consumer protection. But such a view ignores the realities of global financial markets today where the free movement of capital and financial services activities means that markets compete against one another and

that regulators can no longer promulgate and implement new regulation without considering the costs of such regulation on financial market participants.[6]

B. Characteristics of an Optimal Regulatory System

In designing the optimal regulatory system to achieve the objectives described above, the system should have four basic characteristics: efficiency, accountability, competency and legitimacy. These four characteristics underpin a regulatory system's effectiveness in meeting its objectives. First, the organization and operation of regulators should seek to provide optimal regulation in the most efficient means possible. The structure of the regulatory system should be designed to avoid redundancy where different parts of the regulatory system have overlapping responsibility over a particular financial activity or entity. One of the problems with the current US system is that financial institutions, especially banks, find themselves regulated by more than one regulatory agency at both federal and state levels. US financial institutions complain of higher compliance costs and inconsistent regulation and enforcement by competing regulators. From the government's perspective, having more than one agency regulate the same matter is an inefficient deployment of regulatory resources. To address this problem, regulators should have clear lines of authority, eliminating unnecessary duplication. To the extent that several agencies have an interest in a single regulatory matter, one agency should have the lead in managing the problem with clear procedures for consulting with other interested agencies. Likewise, information processing and support operations should be shared by all regulators to eliminate overhead, and financial institutions should not have to report identical information to different agencies.

Second, the regulatory system should be designed to promote accountability. With respect to any regulatory matter, it should be clear which regulator is responsible for addressing the matter. Consequently, a financial institution should know where to direct inquiries or to whom they should raise concerns, and members of the public and elected officials should know, and hold responsible, that regulator for any regulatory failures. In the United States, there has

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[6] *See, e.g.,* Speech of Howard Davies, Chairman, UK Financial Services Authority, *Global Markets, Global Regulation*, 25th IOSCO Annual Conference, Sydney, Australia (May 17, 2000), *available at* http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/plen_1_davies.pdf/$file/plen_1_davies.pdf ("My interpretation of this new and more flexible world suggests that firms, intermediaries and investors will have far more choice about how and where they transact their business than they have had in the past. . . So regulators will themselves be, in a sense, in a competitive marketplace. We will need to demonstrate that the regime we offer is worth paying for, that it offers value for money. . .We regulators will come under ever increasing pressure to show that the package we offer to investors is worth paying for. My own view is that the package we currently offer in London is worth paying for, and indeed the evidence of business volumes transacted through London, and the number of applications for new authorisations we have in the pipeline, suggest that the balance of cost and flexibility we are offering is reasonably attractive to a lot of businesses, and a lot of investors.").

been extensive criticism of the failure of any regulatory agency to prevent or respond to the collapse of the subprime mortgage market. In reality, various agencies had partial responsibility for different aspects of the market.[7] The inability to identify which agency was responsible for this sector of the financial market is one reason for the dissatisfaction felt about the current structure of the US financial regulatory system.

Likewise, the regulatory system needs to promote international accountability. Foreign regulators should know whom to call if there is an issue that requires international coordination. One of the difficulties that plagued the early development of the European financial markets was the lack of a regulatory authority in the European Union that could speak for the European Union in matters requiring consultation with the United States and other major economic powers.[8] International accountability also means that one regulator should be authorized to represent the country's interests in international forums. The need to identify an agency that is accountable suggests consolidating disparate regulatory bodies or at least establishing a hierarchy of regulators.

Third, the regulatory system should be designed to promote competency. It goes without saying that regulators should be competent, but the manner in which the regulatory system is structured can further improve the competency of regulators by ensuring that those regulators with applicable skills and expertise are assigned to accomplish certain regulatory tasks. Competency consists of a variety of elements. Among them is expertise. A priority of the regulatory system should be to recruit and retain individuals who are knowledgeable about the financial sector and the activities that they are regulating. Also, the regulatory system should endeavor to assign regulatory responsibility to that part of the regulatory system that is in the best position to collect the necessary information and to respond to issues of regulatory concern. One (but not the only) justification for the delegation of regulatory authority to self-regulatory organizations (SROs) is that financial market participants that make up SROs are in a better position than a government regulator to understand market developments and to identify and resolve potential problems.

Another element is experience. Regulators should work on regulatory problems with which they have experience. This observation is an argument for reorganizing regulators along the lines of regulatory objectives (referred to herein as objectives-based regulation) as opposed to merely by financial sector or activity. For example, it would not be desirable to have a regulator with experience in prudential regulation to also oversee business conduct rules.

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[7] *See* The President's Working Group on Financial Markets, "Policy Statements on Financial Market Developments" (March 2008), *available at* http://online.wsj.com/documents/pwgpolicystatement20080313.pdf.

[8] *See* Eric J. Pan, "Harmonization of US-EU Securities Regulation," 34 *Law & Pol'y Int'l Bus.* 499 (2003).

Competency is also a function of culture and experience. Regulatory agencies – like all organizations – develop internal processes and practices over the course of time that govern how they approach regulatory tasks and apply past lessons to current problems. The US Securities and Exchange Commission (SEC), for example, has a long and distinguished history of being an effective and respected regulator of the US markets.[9] To the extent possible, structural reform of the regulatory system should keep existing, successful agencies intact, preserving institutional knowledge and practices.

Fourth, the regulatory system should be legitimate. Legitimacy is the ability of agencies to have their regulations recognized and accepted by market participants. While regulatory agencies may have legitimacy by virtue of their legal authority, regulatory agencies are more effective when their actions and decisions are viewed as substantively correct by market participants, producing confidence in the competence of the regulators.

Three factors that can help a regulatory system earn and retain legitimacy are independence from political interests, accountability to public and market opinion, and transparency. The credibility of regulatory agencies is undermined if their actions are viewed as being influenced by political interests (i.e., that regulatory actions favor certain political constituencies or are the result by current political trends rather than by sound principles of financial regulation). One example of where political influence undermined regulatory legitimacy is Japan's response to its financial difficulties in the 1990s. Until Japan reformed its regulatory system, the Japanese Ministry of Finance played an unusually active role in regulating Japan's troubled banks.[10] Many commentators attributed Japan's slow recovery to the Ministry of Finance's unwillingness to pressure the banks to declare their losses quickly and restructure themselves. Instead, the Ministry of Finance tried to prevent political backlash by helping the banks hide the true extent of the losses. It took several years before investor confidence in the Japanese financial markets returned to normal.

At the same time, however, regulators cannot be entirely independent of political pressure because their legitimacy also stems from their accountability to the public. One concern about the creation of a single super-regulator in the United States is that such an agency would be too powerful to control by the US Congress. Such a concern resonates with commentators in the United States because US regulatory agencies have a great deal of day-to-day autonomy from Congress and the President. But such concerns can be addressed if the legislature and executive retain the power to set the priorities of the regulators, have the power to remove and appoint the heads of regulatory agencies, and are briefed and consulted frequently by the regulatory staff. Regulators, on the other hand, must have the freedom to act without political interference and

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[9] *See, e.g.,* Joel Seligman, *The Transformation of Wall Street* (3d ed. 2003).

[10] *See* Davies & Green, *supra* note 4, at 175-76.

retain the ability to interpret their statutory objectives in developing relevant rules and regulations.

Finally, regulators must be transparent in how they develop their rules and regulations and conduct enforcement actions. Such transparency can be achieved by holding public meetings, providing notice and comment on new rules and regulations, allowing regulated entities to consult with – and seek guidance from – regulators on an on-going basis, and disclosing other relevant information about internal deliberations and policy interpretations. It should be noted that central banks tend not to be transparent which causes concern about their role as financial regulators. Together, legitimacy along with efficiency, accountability and competency are essential components of a successful financial regulatory system

C. Regulatory Strategies

The most challenging task for regulators is to strike the proper balance between the twin objectives of ensuring the safety and soundness of the financial system and improving the attractiveness of the market to provide the conditions for the growth and development of the financial markets. Under-regulation, which can mean either the absence of regulatory action or the under-enforcement of existing regulations, may leave the financial system susceptible to systemic failure, fraud or loss of confidence by market participants. But over-regulation may prevent financial institutions from doing business in a cost-effective manner and drive financial activity to other, more favorably regulated markets.

In order to find this right balance of regulation, regulators can look to employ three basic strategies: regulatory competition, regulatory cooperation and self-regulation. Regulatory competition is when regulatory regimes are set up as alternatives to one another. Those institutions and persons subject to regulation are allowed to move from one regime to another, choosing their preferred regulatory regime. In other words, market participants face a menu of regulatory choices, allowing them to select the set of regulations that best fits their needs. Customers and investors will participate only in those markets which have sufficient regulatory protections. At the same time, financial service providers and corporate issuers will only participate in those markets where the burden of regulatory compliance is reasonable. Regulatory competition addresses the problem of finding the right balance by allowing market participants – investors and customers, on the one hand, and financial firms and issuers on the other – the ability to select the regime that best meets their needs. The regime that attracts the most number of market participants and hosts the greatest level of financial activity is the one that offers the optimal level of regulation. In turn, regulatory competition assumes that regulators will modify and tweak their regulations to become more attractive to both sets of market participants. As a result, regulatory competition empowers the financial markets to identify the most suitable regulatory regime.

One concern frequently raised in connection with regulatory competition is the danger of a "race to the bottom" where the desire to attract financial service providers and corporate issuers (via deregulation) overwhelms the need to maintain adequate regulatory standards to ensure the safety and soundness of the financial system. The race to the bottom description, however, exaggerates the risk that regulators will abdicate their regulatory responsibility in order to attract

new business to their markets. Regulators also have a powerful incentive to impose additional regulation in order to make their markets more attractive to retail and institutional customers and investors. A race to the bottom is often more accurately a race to the middle.

Regulatory competition is an attractive regulatory strategy because it assumes that competitive pressure – pressure that will force regulators to improve repeatedly their regulatory systems – will result in the discovery of the optimal regulatory regime. Regulatory competition also may be a superior regulatory strategy if several optimal regulatory regimes exist for market participants with different characteristics. For example, sophisticated institutional investors may elect to invest in markets that have weaker investor protections because they feel more capable of protecting themselves in such a regime while retail customers and investors may prefer heavier regulated markets that emphasize stricter disclosure requirements and more investor protections.

One essential ingredient for regulatory competition is a "passport" system where firms that satisfy the requirements of one regulatory regime are given unfettered access to all other markets. Such a passport system has been attempted by other countries, most notably the European Union, with limited success.[11] Without a passport, regulated firms cannot move to the regime that offers a preferable set of regulatory requirements.

Regulatory competition, however, may not be an appropriate strategy if regulators have reason to believe that market participants do not have complete information or the skill to evaluate the appropriateness of different regulatory regimes, that regulators do not have sufficient resources or incentives to compete against one another, or that there are minimum regulatory standards that should be provided by all regulatory regimes regardless of their perceived value to market participants. As a result, an alternative regulatory strategy is regulatory cooperation. Regulatory cooperation is when regulators from different regimes look to converge and harmonize their regulations, causing the different jurisdictions to share approximately the same regulatory standards. Such convergence and harmonization eliminate the opportunity for market participants to evade these standards by moving to a different regulatory regime.

Regulatory cooperation assumes that the regulators know the appropriate level of regulation for the market and that all market participants must abide by the same regulations in every jurisdiction. While there is a risk that the standards set by the regulators may be too high, regulatory cooperation may produce cost savings by eliminating the need for market participants to evaluate the differences between competing regimes and other regulatory costs associated with individual regulatory agencies trying to stay competitive with each other.

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[11] *See* Howell E. Jackson & Eric J. Pan, "Regulatory Competition in International Securities Markets: Evidence from Europe in 1999 – Part I," 56 *Bus. Law.* 653 (2001) (describing the passport system used in the European Union).

The main challenge associated with regulatory cooperation is the process by which such cooperation takes place. In the case of the European Union, the European Commission attempted to impose a common set of regulatory standards on the individual member states through a series of directives.[12] The initial directives proved unsuccessful as some member states resisted the European Commission's efforts and refused to implement the directives in a full and consistent manner. More recent efforts by the European Commission to establish a common set of standards have proven more successful because the European Commission accompanied the new directives with, among other things, the establishment of the Committee of European Securities Regulators to provide a forum for regulatory cooperation and to ensure proper implementation of the directives. The EU experience offers a model for regulatory cooperation at both the national and international levels.

In the case of self-regulation, regulators delegate responsibility for standards-setting and rule-making to representatives of the market. The rational behind self-regulation is that market participants, by virtue of having better information and knowledge of market events, are in a superior position to determine the appropriate level and scope of regulation. SROs also may be able to respond more quickly and in a more flexible manner to market developments. Self-regulation is often considered less expensive (from the perspective of the government) than direct regulation as the financial industry is charged with paying for its own regulatory apparatus.

A prominent example of self-regulation is the Financial Industry Regulatory Authority (FINRA) in the United States and its predecessor, the National Association of Securities Dealers (NASD).[13] FINRA is the primary regulator of securities firms in the United States. It oversees nearly 5,000 brokerage firms and over 676,000 securities professionals.[14] As a self-regulatory organization, FINRA receives its authority from the SEC and is funded by its members. When the SEC recognized the first SROs, the then SEC Chairman William O. Douglas described the role of the SEC as being like a "shotgun, so to speak, behind the door."[15] The SEC would oversee the SROs, but would only intervene if it determined that the SROs were failing to carry out their respective regulatory missions. Over the course of the past 60 years, the SEC has intervened several times to tighten the regulation of the securities firms and has taken an active

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[12] *See* Pan, *supra* note 8.

[13] Before the creation of the Financial Services Authority, the United Kingdom employed SROs to an even greater extent. By 1994, there were three large SROs providing primary regulation for key areas of the UK securities market: Securities and Futures Authority, Investment Managers' Regulatory Organisation and Personal Investment Authority.

[14] *See* http://www.finra.org/AboutFINRA/CorporateInformation/index.htm.

[15] For a detailed description of the role of SROs in US securities regulation, please see Joel Seligman, "Cautious Evolution or Perennial Irresolution: Stock Market Self-Regulation during the First Seventy Years of the Securities Exchange Commission," 59 *Bus. Law.* 1347 (2004).

role in reviewing the regulatory actions of FINRA (and previously the NASD).[16] Nonetheless, the self-regulatory model offers a powerful means to give market participants an influential role in determining the appropriate level and form of regulation.

In restructuring the Canadian regulatory system, policymakers should consider how to utilize all three of these regulatory strategies in both its domestic and international affairs. Regulatory competition, for example, may be useful in considering whether to continue to allow for diversity of regulation among the provinces and to effect a full passport system to generate competitive pressures on the provinces. Regulatory cooperation, on the other hand, is helpful in understanding how Canada can go about developing a single set of regulations for the entire Canadian market. It also anticipates the task that lays ahead in converging Canadian regulation with those of other major financial market jurisdictions, most notably the United States and European Union. Finally, self-regulation supports the argument that some financial activities should not be directly regulated by any regulatory agency but rather left in the hands of market participants.

D. Organization of Regulatory System

The final consideration behind designing the optimal regulatory system is its organization. An examination of the regulatory systems adopted by many of Canada's main economic competitors (as described in Part Three of this report) reveals a diverse range of organizational forms. The United States, for example, has a multitude of federal and state regulators that separately regulate securities firms, banks and insurance companies (see Appendix B). Three federal regulators alone oversee US banks (with a fourth focused on credit unions). In the United Kingdom, almost all regulatory responsibility is in the hands of its Financial Services Authority (UK FSA). Australia and The Netherlands divide regulatory responsibility between two large regulators. Other countries organize their regulatory structures to fall in between the single regulator and "alphabet soup" models.

In determining the best way to organize Canada's regulatory system, three questions must be answered. First, how should regulatory responsibility be divided among regulators? One possibility is to have regulatory authority divided by financial sector. The United States offers one example of sector-based regulation, especially in the banking area, where the Office of the Comptroller of the Currency regulates national chartered banks, state banking authorities regulate state chartered banks, the Office of Thrift Supervision regulates saving and loans associations, and the National Credit Union Association supervises credit unions. The advantage of sector-based regulation is that each agency develops a deep expertise in its particular sector, giving it a better understanding of regulated firms' activities and practices. On the other hand,

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[16] The need for SEC intervention reveals one of the weaknesses with self-regulation: at times of crisis when the SROs fail to prevent a regulatory failure, the SROs are vulnerable to questions about their legitimacy and accountability.

sector-based regulation is inherently inefficient. Each regulator cares only for its small part of the financial system and is not in a strong position to identify and respond to systemic threats arising from other sectors in the financial system. It is also likely that such a system would produce frequent duplication of regulatory efforts. When a regulatory problem affects multiple sectors of the financial system, several agencies ultimately respond to the same problem – often in different ways and with different degrees of success. Sector-based regulation is especially ill-suited to regulate financial conglomerates that provide services across financial sectors. As many large financial institutions now provide banking, securities and insurance services, they find themselves subject to oversight by multiple regulators with no single regulator having responsibility for examining the overall health of the institution. Thus, sector-based regulation raises significant concerns that regulators are not providing appropriate protection for markets where sectoral divisions are increasingly irrelevant.

An alternative way to organize regulators (but still quite similar to the sector-based system described above) is having separate regulators focus on the type of financial activity. For example, there could be one regulator responsible for overseeing all deposit and lending activities, another responsible for the sale of insurance, a third responsible for securities issuance and trading, a fourth responsible for futures trading and a fifth regulating investment management services. Activity-based regulation, however, still suffers from the same basic flaw as sector-based regulation: it does not fully address the challenge of having individual financial institutions be subject to oversight by multiple regulators. Consequently, no single regulator has all of the necessary information and authority (and, arguably, the incentive) necessary to monitor the overall health of the financial institution and the impact that such financial institution may have on the overall safety, soundness and stability of the financial system.

A third option, and the one recommended in the recent US Treasury Blueprint, is to adopt an objectives-based approach. In contrast to the sector-based and activity-based approaches, the objectives-based approach recommends arranging regulators in accordance with the three tasks necessary to ensure the soundness and safety of the financial system: one regulator is responsible for prudential regulation, a second regulator responsible for business conduct regulation and a third regulator responsible for market stability measures. The advantage of the objectives-based approach is that regulators retain a certain degree of specialization (if one assumes that all prudential regulation, business conduct regulation and market stability responses are the same regardless of financial sector or activity), while each regulator has a "bigger picture" view of the financial system by virtue of regulating firms that operate across sectors. This bigger picture view increases the chance that regulators will be able to prevent systemic crises. The objectives-based approach appears best suited for the modern financial system where financial firms no longer neatly fall into the traditional categories of banking, securities and insurance.

The different approaches affect the number of regulators needed to oversee the regulatory system. The sector-based and activity-based approaches require more regulators than the objectives-based approach because the focus of each regulator is narrower. Even in the case of the objectives-based approach, there is a question as to whether regulatory authority should be concentrated in the hands of a single regulator (the single regulator model), two regulators focused respectively on prudential regulation and business conduct regulation plus a market

stability agency (the twin peaks model) or multiple regulators with one regulator responsible for managing the other regulators (the lead regulator model).

The single regulator model is attractive because of its simple organizational form. The single regulator does not have to share or coordinate actions with another regulator, eliminating any possibility that issues of concerns will fall between the jurisdictional cracks of separate regulators or be the subject of "turf battles" between agencies. There are economies of scale associated with having a single, large regulator handle all regulatory issues rather than having separate regulators work independently. Proponents of the single regulator model note that the United Kingdom's move to a single regulator in 1998 resulted in cost savings at least in the first four years of its existence.[17] A single regulator also is better equipped to oversee more complex financial institutions and financial products since it has undisputed regulatory authority over all aspects of the financial market. Furthermore, the single regulator model provides ultimate accountability since all queries and concerns are automatically laid at its doorstep.

The single regulator model, however, assumes that a single agency can meet all regulatory objectives simultaneously and in a satisfactory manner. This is easier said than done. The single regulator model shifts the decision of setting regulatory priorities and allocating regulatory resources from an external debate (i.e., the support of various regulatory agencies through the public budget) to an internal debate where the managers of the single regulator decide on regulatory priorities and allocate resources accordingly (often outside of public scrutiny). Such a shift poses several risks. One risk is that certain regulatory objectives are pursued at the expense of others, creating areas of under-regulation. Another risk is that the regulatory system moves from being one of many groups of specialists, with intense expertise in their respective areas of regulatory authority, to a single group of generalists. The concern is that sector-specific knowledge and expertise is lost, undermining the efficiency gains of having a single regulator overseeing all sectors of the market. A third risk is that the lack of clear lines of responsibility within the single regulator could lead to confusion, especially if the single regulator is attempting to integrate previously independent, and single-minded, regulatory agencies. It is unclear whether a single regulator that is assuming the responsibilities of several former regulatory agencies will be able to organize itself in a more effective manner to eliminate the turf battles and blind spots associated with the older regulatory system.

The twin peaks model also attempts to achieve many of the same benefits as the single regulator model – eliminate regulatory redundancy, reduce overhead and provide clearer lines of responsibility and authority for regulators. The twin peaks model, however, rejects the premise of the single regulator model that all regulatory authority can be combined in one body. Instead, the twin peaks model is based on the belief that there is a fundamental difference between the

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[17] *See* Clive Briault, "Revisiting the rationale for a single national financial services regulator," 16 (Financial Services Authority Occasional Paper Series No. 16, Feb. 2002), *available at* http://www.fsa.gov.uk/pubs/occpapers/op16.pdf (citing the UK FSA's 2001-02 budget).

objectives of prudential regulation and those of business conduct regulation – a difference that requires prudential and business conduct regulators to invoke different strategies and approaches. In the case of prudential regulation, the regulator assumes a more cooperative relationship with the financial institution. The regulator exists to assist financial institutions. Its role is to set standards and monitor the maintenance of those standards by the financial institution. To the extent a financial institution fails to meet certain standards or the regulator identifies a possible threat to the soundness of the financial institution, the role of the regulator is to work with the financial institution and find a solution. In contrast, a business conduct regulator is frequently in an adversarial position relative to the financial institution. This regulator is effectively a representative of the customers and investors, using its rulemaking powers to impose new requirements on financial institutions and its enforcement powers to discipline and punish financial institutions for business conduct violations. A concern with giving a single regulator responsibility for both prudential and business conduct regulation is that such a regulator would not apply the appropriate regulatory approach to each task. A single regulator may favor the stronger enforcement approach more suitable for business conduct regulation and apply such approach to prudential regulation, establishing an undesirable adversarial relationship where financial institutions avoid raising problems with the regulator for fear of prosecution. Such a result where financial institutions refuse to open themselves up to the regulator would undermine that regulator's ability to monitor and identify sources of systemic risk. Or, alternatively, the more cooperative approach that one would expect in matters of prudential regulation is applied to business conduct regulation to the detriment of unwitting customers and investors. The twin peaks model attempts to resolve this conflict by keeping separate prudential and business conduct regulation.

One of the weaknesses of the twin peaks model is the need for coordination between the two agencies. The potential for conflict is greatest when the two agencies representing the respective peaks are regulating the same financial firm – an occurrence that is quite common (consider, for example, the regulation of insurance companies which must satisfy prudential regulatory standards as well as business conduct rules in its dealings with policyholders). As large financial firms continue to expand their activities across the banking, securities and insurance lines, one would expect the application of both prudential regulation and business conduct regulation to be the norm, and the regulatory actions of one will affect the other. One can easily imagine how aggressive enforcement of such entities by the business conduct regulator could undermine the financial stability of the firm, requiring a response of the prudential regulator. Therefore, the twin peaks model must be accompanied by some mechanism of coordination to resolve conflict that may arise between the two regulatory agencies. It is tempting to give responsibility for resolving all inter-agency conflict to elected government officials, but such an approach threatens to politicize the regulatory process.

A third alternative to the single regulator and twin peaks models is the lead regulator model. This model requires the least amount of reorganization of the current regulatory system. Separate regulatory agencies, and their lines of authority, are maintained. The one change is that a single agency is designated the "lead regulator" and assumes responsibility for coordinating the regulatory actions of the other agencies. This model is appealing because it builds upon the regulatory experience and expertise of sector- and activity-based regulatory systems while giving the impression that there will be at least one regulator who is looking at the overall picture.

The lead regulator model, however, raises a number of concerns. First and foremost, which agency should be made the lead regulator? Selecting one agency as the lead assumes that this agency has the expertise and competency to evaluate not only its own regulatory interests but also the interests of the other agencies that are now reporting to it. It also assumes that the lead agency will not be inherently predisposed to prioritize its regulatory interests above all others. If these assumptions are wrong, then the lead regulator model will likely produce even greater risk of regulatory failure as the lead regulator has more opportunity to ignore the concerns of its subordinate agencies. The second concern is that even if a suitable lead agency is identified, how will this agency manage the other agencies? Just as in the case of the twin peaks model, the lead regulator model will require some mechanism of coordination to resolve conflict, promote the sharing of information between agencies, and enable the lead regulator to direct action from the other agencies as necessary. Such a system would be quite complex, which raises a third concern. The lead regulator model is the least efficient of the three models. The lead regulator model continues to promote divided regulatory agencies with overlapping competencies and separate overhead. This system seems to have few advantages over those of the single regulator and twin peaks models.

The exact organization of the regulatory system is less important than the means by which regulatory agencies and internal regulatory divisions are made to work together and act in a coordinated fashion. With respect to each structure, coordination is vital whether the coordination takes place internally (as in the case of the single regulator model) or externally (as in the case of the twin peaks and lead regulator models). With that said, the single regulator and twin peaks models are superior to the lead regulator model because they more effectively eliminate overlap between regulatory agencies and enhance efficiency. Therefore, this report recommends that Canada adopts either the single regulator or twin peaks model.

II. Canada's Regulatory System

A. Current Structure of Canada's Regulatory System

In Canada, separate regulatory agencies regulate banking, insurance, securities and credit unions with the Bank of Canada in charge of monetary policy and market stability. Regulatory responsibility is also split between the national and provincial governments. The Office of the Superintendent of Financial Institutions (OSFI) and the Financial Consumer Agency of Canada (FCAC) share the responsibility for the regulation of banks. The OSFI supervises all federally-chartered depository institutions and insurance companies in Canada. While seventy percent of Canada's securities dealers are owned by the country's banks, the OSFI has limited, indirect authority over these dealers. In all of the provinces, except Ontario, OSFI oversight extends only to federally-chartered banks and not their subsidiaries, and, direct supervision of securities dealers is handled by the provincial authorities. In Ontario, the OSFI and the FCAC have a greater role in regulating certain securities activities pursuant to the Hockin-Kwinter Accord of 1987 between the national government and Ontario. The FCAC provides Canadian consumers with information about financial products and services and monitors the compliance of federally incorporated financial institutions with consumer protection laws. The FCAC is also the primary regulator of bank conduct in Canada. The OSFI and FCAC divide their regulatory

responsibilities along the lines of prudential regulation (i.e., OSFI) and business conduct regulation (i.e., FCAC).

Regulation of insurance companies is divided between the national and provincial governments. The vast majority of insurance companies in Canada are subject to regulation by the OSFI and, to a limited extent, the FCAC.[18] While the provinces retain the authority to engage in prudential supervision of insurance companies operating within their borders, several provinces contract this function to the OSFI.[19] Business conduct regulation of all insurance companies in Canada, including those that are subject to prudential supervision by the federal agencies, is performed by the provincial governments.

While regulation of banks and most prudential regulation of the insurance industry take place primarily at the national level, the provinces have the lead role in regulating the securities industry and credit unions. Credit unions and *caisses populaires* are incorporated under provincial law, and the provinces set the applicable regulation. Outside of Quebec, the national government does play a limited role regulating the credit union industry as the Credit Union Central of Canada is chartered and regulated at the federal level. In addition, the central credit unions that serve British Columbia, Alberta, Saskatchewan, Manitoba, Ontario and Nova Scotia have elected to register under federal legislation in addition to being regulated at the provincial level.

Securities regulation is entirely in the hands of the provinces. Each province maintains its own securities commission. Four of these provincial commissions — Alberta, British Columbia, Ontario and Quebec — participate in IOSCO, although only Ontario and Quebec are voting members. Canada is the only major country that is not represented in IOSCO by its national government. In order to promote coordination of regulation across borders, the provincial commissions have formed the Canadian Securities Administrators (CSA), consisting of the chairs of the thirteen provincial securities regulators. The CSA's goal is to "harmonize and strengthen securities regulation in Canada through enhanced inter-provincial cooperation."[20] Towards this end, the CSA adopts national instruments designed to coordinate and harmonize changes to existing provincial laws. The impact of these instruments is limited, however, as the provincial regulators are under no obligation to enact them. The CSA has launched recently several initiatives to improve the functioning of securities regulation across Canada, including a Mutual Reliance Review System, System for Electronic Document Analysis and Retrieval,

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[18] According to Canadian government statistics, federally chartered insurance companies comprise ninety percent of the life and health insurance sector and three quarters of the property and casualty insurance sector. *See* Canadian Financial Services Sector, http://www.fin.gc.ca/toce/2005/fact-cfsse.html (last visited June 6, 2008).

[19] Less than 10 percent of insurance companies operating in Canada do so under provincial charters. Quebec is the only province that does not accept federal prudential regulation of insurance companies.

[20] Fin. Sector Div., Dep't of Fin. Can., *Securities Market in Canada* 19 (2003).

National Registration Database and System for Electronic Disclosure by Insiders. Despite these successes, the provincial securities regulators still operate relatively autonomously of each other.

In recent years, the provinces have made significant efforts to improve coordination of regulation and reduce the regulatory barriers that divide the country's securities markets. All of the provinces, with the exception of Ontario, participate in the Council of Ministers of Securities Regulation. One of the Council's most important initiatives is the passport system to allow market participants from each province to operate freely in other provinces. The Council has delegated the job of developing the passport system to the CSA.

The passport system is being implemented in two phases. The first phase took effect in September 2005. Pursuant this phase, a market participant that obtains approval from its home provincial regulator (such regulator being that firm's principal regulator) has the ability in limited cases to operate in other provinces without the need for further regulatory approvals. The implementation of a more comprehensive second phase of the passport system began in March 2008 and should be completed by mid-2009. Pursuant to this second phase, a market participant will be permitted to seek approval for its prospectus, register as a dealer or adviser or obtain regulatory exemptions from its principal regulator and in each case have such regulatory action recognized and honored by all other provinces.

Ontario has chosen not to participate in the passport system. Instead, the other provinces have agreed to unilaterally recognize Ontario such that the decisions of the Ontario Securities Commission concerning Ontario-based market participants will be accepted by the other provincial regulators. The Ontario Securities Commission, on the other hand, is under no obligation to recognize the decisions of the other provincial regulators.

In addition to the provincial commissions, several SROs play an important role in the regulation of Canada's securities markets. The most important of these are the Investment Industry Regulatory Organization of Canada (IIROC) and Mutual Fund Dealers Association (MFDA). The IIROC, formed in 2008 by the merger of the Investment Dealers Association of Canada and Market Regulation Services, regulates the conduct of all investment dealers in Canada and enforces the trading and market integrity rules for the Toronto Stock Exchange, TSX Venture Exchange, Liquidnet Canada and other major trading markets and platforms. IIROC shares many similarities with FINRA in the United States described above. The MFDA, which commenced operation in 2001, regulates the sale of mutual funds in Canada.

Finally, the Bank of Canada plays an important role as the lender of last resort, supplier of emergency liquidity for eligible institutions, fiscal agent of the Canadian government and issuer of currency. It also has oversight responsibilities over systemically important payment systems. Unlike the Federal Reserve in the United States, however, the Bank of Canada does not supervise banks. In this respect, the Bank of Canada is more comparable to the Bank of England.

At the national level, two coordinating committees report directly to the Minister of Finance: Financial Institutions Supervisory Committee (FISC) and Senior Advisory Committee (SAC). Both organizations are comprised of the Superintendent of the OSFI, Governor of the

Bank of Canada, Chair of the Canadian Deposit Insurance Corporation, Commissioner of the FCAC, and Deputy Minister of Finance. The FISC, which is chaired by the Superintendent of the OSFI, meets quarterly, but can be convened as needed, under a statutory mandate to review the health of regulated financial institutions and reports to the Minister of Finance. The SAC, which is not a legislated committee, meets as needed to review financial sector policy issues, including the existing legislative and regulatory environment. This group is chaired by the Deputy Minister of Finance.

B. Comments on Canada's Regulatory System

Canada has the framework for an objectives-based system, as defined in this paper. In the area of banking and insurance, the division of responsibility between OSFI and FCAC follows the basic template of one regulator focused on prudential regulation and another regulator focused on business conduct regulation. Canada can build upon these two agencies to apply the objectives-based approach to all areas of its financial system.

The weaknesses of the Canadian regulatory system lie in the fact that parts of Canada's regulatory system are still segmented by type of financial activity and regulation is split between the provinces and the national government. Ideally, Canada should strive to consolidate all of its regulatory activities in fewer agencies and, to the extent possible, consider giving primary regulatory responsibility for the securities markets to a national regulator.

Institutionally, FISC and SAC serve an important role as high-level coordinators of policy and regulation in the area of prudential regulation and market stability. It is unclear, however, what permanent arrangements exist among the other national regulatory agencies and between the national regulators and the provincial regulators to coordinate "lower-level" regulation, share information and cooperate on enforcement actions. The absence of the provincial regulators in the FISC and SAC is especially striking since it appears that the provincial securities regulators operate independently of OSFI and FCAC. To remedy this weakness, Canada should strengthen the cooperative links between the different regulatory agencies and consider the possibility of supporting the CSA to become an agency with power to take the lead on securities regulatory matters with legal powers over the provincial securities regulators.

To the extent securities regulation remains in the hands of the provinces, the passport system is an important development, albeit, as discussed later in this report, a second-best solution to a national securities regulator. As the experience of the European Union has shown, the implementation of a regulatory passport system naturally leads to enhanced regulatory coordination, regulatory convergence and the development of common regulations.[21] Over time

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[21] *See* Pan, *supra* note 8.

an expansive application of the passport may eliminate most significant regulatory differences between the provinces. But such a strategy will take time and may not unfold smoothly. The passport remains a product of inter-provincial negotiation and, therefore, reliant on the continuing desire of the provinces to cooperate with one another and implement faithfully the terms of the passport. The fact that the passport does not fully incorporate Ontario and the first phase of the passport was hampered by the absence of harmonized legislation among the participating provinces[22] illustrates some of the challenges to, and weaknesses of, the passport system. Furthermore, the passport system does not ask any one provincial regulator to look beyond local interests and consider the development of a national securities market, nor does it empower any agency to initiate regulatory action necessary to strengthen the national markets without first obtaining the consent of all other regulators. Consequently, cooperation among provincial regulators based upon the passport system does not offer a very efficient and nimble regulatory structure for a leading financial market.

III. Comparative Analysis of the United Kingdom, Australia, United States, France, Germany, Netherlands and Hong Kong

In recent years, several countries have considered the problem of how to restructure their financial regulatory system. The reasons why each country decided to effect these reforms varies by jurisdiction. In the case of the United Kingdom, the new Labour government pursued regulatory reform in response to growing dissatisfaction with the United Kingdom's then-current regulatory system's ability to supervise new financial conglomerates and provide appropriate protection to consumers and investors attracted to exotic financial products. The introduction of the Euro and the establishment of the European Central Bank spurred France, Germany and The Netherlands to examine anew the role of their national central banks and financial regulatory systems. Hong Kong twice made structural reforms to its regulatory system after sharp downturns in the stock market. The United States began a high-profile study of its regulatory system in 2007 in order to address concerns that US regulation was harming the competitiveness of the US financial markets. More recently, reform efforts, as set forth by the US Treasury Blueprint published at the end of March 2008, are being directed to fix perceived regulatory failures behind the credit crisis in the United States. Despite the fact, however, that all of these countries have studied the problem of how to design an optimal regulatory system, they have disagreed as to the right answer. Instead, most of them have adopted, or are seeking to adopt, variations on two different models of regulatory systems – the single regulator model and the twin peaks model – but in several cases have fallen short of implementing all necessary reforms to garner the full benefits of either model.

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[22] *See* http://www.securitiescanada.org/ (last visited Sep. 30, 2008) ("Phase one of the passport system was implemented by regulators through a rule (Multilateral Instrument 11-101 Principal Regulator System) and related rule and policy changes in September 2005, but its scope was limited by a lack of harmonized legislation").

A. United Kingdom

The United Kingdom follows the single regulator model, concentrating regulatory authority in the UK FSA. The creation of the UK FSA coincided with tremendous growth of London relative to other financial centers (including New York), leading some commentators to conclude that the United Kingdom's version of single regulator model has proven itself superior to other regulatory systems.

Until 1997, the UK financial markets were subject to oversight by a variety of regulatory agencies and SROs. The Bank of England was responsible for regulating banks. The Securities Investment Board (SIB), London Stock Exchange (in its role as Listing Authority), Securities and Futures Authority, Investment Managers' Regulatory Organization and Personal Investment Authority each had a role in regulating securities offerings and investment firms. The Insurance Brokers Registration Council regulated insurance companies. This panoply of agencies and SROs in the United Kingdom faced extinction in May 1997 shortly after the Labour Party under Tony Blair won the general election. Nineteen days into the term of the new government, then-Chancellor of the Exchequer Gordon Brown announced the consolidation of all banking, securities and insurance regulatory activities – the responsibility of nine different regulatory bodies – into the UK FSA.

Three observations can be made of the UK FSA. First, the decision by the United Kingdom to adopt the single regulator model was a great surprise. Before the general election, the Labour Party announced its intention to make only modest changes to the UK regulatory system. These pre-election proposals consisted mainly of recommending the shift of regulatory responsibility away from SROs to government agencies. The Chancellor of the Exchequer's announcement of the creation of the UK FSA on May 20, 1997 was the very first indication that the Labour Party favored a single regulator. Given the lack of public discussion preceding the announcement, it is unclear why the government decided that a single regulator was essential or even necessary. Some commentators suggest that the decision to concentrate authority in the hands of the UK FSA was to satisfy the parliamentary timetable rather than the result of reasoned deliberation by the government of the great merits of the single regulator model.[23] The best substantive justification for the single regulator model was offered by the Chancellor in his proposing statement that the organization of the regulatory system must be reformed to reflect the fact that the distinctions between banks, securities firms and insurance companies had broken down.[24] The same justification, however, can also be used to advocate the twin peaks model, but

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[23] *See, e.g.,* Eilís Ferran, "Examining the United Kingdom's Experience in Adopting the Single Financial Regulator Model, 28 *Brook. J. Int'l L.* 271-72 (2003).

[24] As set forth by Clive Briault, the complete reasons include: "(i) market developments such as the increase in the number of financial conglomerates and the blurring of the boundaries between products make sector-based regulation increasingly less visible; (ii) there are economies of scale and scope available to an integrated regulator, and there is value in being able to allocate scarce resources efficiently and effectively; (iii) there are benefits in (continued…)

there is no indication that the Chancellor considered this possibility. Strangely, the political origin of the UK FSA is rarely recalled by those who consider the UK FSA as strong evidence of the superiority of the single regulator model. Rather, a more skeptical commentator might conclude that the UK FSA's success was more due to good fortune than to design.

Second, while the UK FSA is the dominant financial regulator in the United Kingdom, it shares responsibility for overseeing the financial system with the Bank of England and HM Treasury. UK FSA, Bank of England and HM Treasury documented their respective responsibilities in a memorandum of understanding.[25] The Bank of England is responsible for maintaining market stability. In other words, the Bank of England is responsible for seeing that the financial system functions smoothly in settling financial transactions, providing liquid markets for the exchange of financial instruments, and intermediating between savers and borrowers. At the same time, HM Treasury is the main instrument of financial and economic policy with responsibility for the institutional structure of the financial regulatory system and related legislation. During a crisis, the memorandum of understanding states that the UK FSA would be responsible for "the conduct of operations in response to problem cases affecting firms, markets and clearing and settlements systems within its responsibilities" which it may undertake by "the changing of capital or other regulatory requirements and the facilitation of a market solution involving, for example, an introduction of new capital into a troubled firm by one or more third parties."[26] However, the Bank of England would remain in charge of "official financial operations … in order to limit the risk of problems in or affecting particular institutions spreading to other parts of the financial system."[27]

Third, the UK FSA maintains a complex internal structure that appears to be based on a combination of regulation by financial sector and activity and customer base. As the organizational chart of the UK FSA shows (see Appendix A), regulatory responsibility is divided between two branches – one branch focused on retail markets and another branch focused on wholesale and institutional markets. This structure implies that the level of regulation should be different for those financial services and activities that are made available to retail investors and those made available to the more sophisticated institutional investors. Within each branch, sub-

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setting a single regulator clear and consistent objectives and responsibilities, and in resolving any trade-offs among these within a single agency; and (iv) there are advantages in making a single regulator clearly accountable for its performance against its statutory objectives, for the regulatory regime, for the costs of regulation and for regulatory failures." Clive Briault, "FSA Revisited, and Some Issues for European Securities Market Regulation," in *Financial Markets in Europe* 323 (Mads Adenas & Yannis Avgerinos eds., 2003).

[25] *See* Memorandum of Understanding between the Bank of England, the Financial Services Authority, and HM Treasury (1997, updated March 22, 2006), *available at* http://www.hm-treasury.gov.uk/documents/financial_services/regulating_financial_services/fin_rfs_mou.cfm.

[26] *Id.* (as cited by Treasury Committee, The run on the Rock, 2007-08, H.C. 56-I, at 105).

[27] *Id.*

offices exist that focus on specific financial activities. For example in the retail markets group, there are separate offices for insurance, banking and mortgage, asset management and credit unions. The UK FSA also has "cross-sector leaders" that work across the retail markets and wholesale and institutional markets. These cross-sector leaders are focused on specific financial sectors, including asset management, capital markets, insurance, mortgages and financial stability. The UK FSA's internal structure does not seem to be set up to have one group of regulators focus on prudential regulatory objectives and another to focus on business conduct regulatory objectives. Rather, it appears that both of these objectives are managed simultaneously by the mid-level regulators. Such a structure marks a big difference from the twin peaks model where any coordination of prudential regulation and business conduct regulation takes place at the highest level.

The confusing organization of the UK FSA does raise questions as to whether the UK FSA has successfully integrated the different regulatory objectives under one roof or whether the same problems associated with separate regulatory agencies continue to exist. Much attention has been given to the UK FSA's failure to prevent, or at least mitigate, the collapse of UK bank Northern Rock. Critics have pointed out that UK FSA supervisors with expertise in insurance, not banking, were monitoring Northern Rock. Other critics have noted that the UK FSA failed to conduct an in-depth analysis of the bank until it was too late.[28] In addition, others noted that bureaucratic demands interfered with supervisory responsibilities.[29] And the UK Parliament Treasury Committee faulted the lack of coordination between the UK FSA and the Bank of England in responding to the Northern Rock collapse once the bank's problems became apparent, revealing serious flaws with the memorandum of understanding between the UK FSA, Ban of England and HM Treasury.[30] The Northern Rock case mars what has otherwise been an impressive regulatory record by the UK FSA.

One of the most notable achievements of the UK FSA has been its adoption of principles-based regulation.[31] The UK FSA defines principles-based regulation as a system in which

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[28] An internal study of the UK FSA found that the authority failed to uphold minimum standards in bank supervision with respect to Northern Rock. Among the failures noted by the study include inadequate number of staff assigned to supervise Northern Rock's operations, inadequate meetings with Northern Rock managers (only eight meetings with Northern Rock compared to an average of 74 with other UK banks), and a decision by UK FSA senior management – overruling the opinion of staff – to lengthen the time between formal reviews of Northern Rock from two to three years. *See* Jennifer Hughes, "FSA admits failings over Northern Rock," *Fin. Times* (Mar. 26, 2008), *available at* http://www.ft.com/cms/s/0/0833a416-fb0d-11dc-8c3e-000077b07658.html.

[29] *See id.*

[30] *See* Treasury Committee, The run on the Rock, 2007-08, H.C. 56-I, at 105, *available at* http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/56/56i.pdf.

[31] *See* Financial Services Authority, *Principles-based regulation: Focusing on the outcomes that matter* (2007), *available at* http://www.fsa.gov.uk/pubs/other/principles.pdf.

desirable regulatory outcomes are laid out in principles and outcome-focused rules, as opposed to detailed rules. The UK FSA believes that one of the major benefits of principles-based regulation is to allow firms to determine the most cost-effective means of satisfying the regulatory outcomes desired by the UK FSA. It is the UK FSA's belief that this shifting of responsibility onto the firm will encourage competition and innovation in the marketplace, resulting in more effective responses to industry regulation. In turn, as regulated industries become more practiced in interpreting the UK FSA's expectation, the principles themselves will be more effective than mere standards of minimal conduct as it will be harder for firms to evade the object and purpose of the regulations through clever lawyering and technical compliance.

The UK FSA's principles-based regulatory approach is founded upon eleven "Principles for Businesses":

1. A firm must conduct its business with integrity.
2. A firm must conduct its business with due skill, care and diligence.
3. A firm must take reasonable care to organize and control its affairs responsibly and effectively, with adequate risk management systems.
4. A firm must maintain adequate financial resources.
5. A firm must observe proper standards of market conduct.
6. A firm must pay due regard to the interests of its customers and treat them fairly.
7. A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.
8. A firm must manage conflicts of interest fairly both between itself and its customers and between a customer and another client.
9. A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.
10. A firm must arrange adequate protection for clients' assets when it is responsible for them.
11. A firm must deal with its regulators in an open co-operative way, and must disclose to the UK FSA appropriately anything relating to the firm of which the UK FSA should reasonably expect notice.[32]

To the extent these principles provide insufficient clarity regarding what the UK FSA considers proper conduct, the UK FSA intends to supplement the principles with interpretative guidance and rules expressed in "as outcome-focused a way as possible."[33] Firms that act according to UK FSA-issued guidelines will be assumed to be in compliance with the rules. Also, the UK FSA will publish a handbook detailing what it considers to be "minimal acceptable standards"

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[32] *Id.* at 8-9.

[33] *Id.* at 9.

for compliance with the principles. While firms are encouraged to go beyond those guidelines and minimum requirements, the UK FSA believes that it is for the firm to decide how much further it wishes to go.

The UK FSA is the most prominent regulatory agency in the world to implement principles-based regulation on such a large scale. What is significant about this move to principles-based regulation is that the UK FSA and the UK government see principles-based regulation as a way to make the UK financial markets more attractive to international financial firms.[34] Thus, part of the rationale behind principles-based regulation is to make the UK financial markets more competitive relative to other countries' financial markets. Not surprisingly, principles-based regulation sounds attractive to those firms that recently have been the target of tough government investigations and private lawsuits in the United States, and US financial firms have recommended that the United States replace its complex rules-based system with a principles-based system.[35] Skeptics of the principles-based approach note that the UK FSA still has a rather hefty rulebook and the need for extensive interpretative guidance sounds very similar to rulemaking. Skeptics also note that firms may end up regretting principles-based regulation when they realize that they will have to bear more of the burden (and the risk) of determining what is the appropriate application of the principles. Nonetheless, the UK FSA's move to principles-based regulation bears close observation as it may prove to be a competitive advantage for the UK regulatory system.

B. Australia

The Australian regulatory system is a very good example of the twin peaks model. The two main regulators are the Australian Securities and Investment Commission (ASIC) and the Australian Prudential Regulatory Authority (APRA). ASIC is a business conduct regulator with responsibility for the securities market and financial services providers. ASIC's powers include the ability to impose criminal or civil sanctions against financial firms and professionals. As a corporate regulator, ASIC regulates company directors and officers, capital raising, takeovers, financial reporting, market disclosure, managed investment schemes, shareholder rights, company administration and wind ups. ASIC also registers all corporate issuers, regulates trading markets and licenses and monitors financial services firms. Finally, ASIC has responsibility for protecting consumers against misleading or deceptive conduct related to financial products and services.

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[34] *See* Speech by Economic Secretary to the Treasury, Ed Balls MP, at Bloomberg (June 14, 2006), *available at* http://www.hm-treasury.gov.uk/newsroom_and_speeches/press/2006/press_42_06.cfm (describing the UK regulatory system as a "competitive advantage" for London).

[35] *See, e.g.,* Financial Services Roundtable, *The Blueprint for US Financial Competitiveness* (2008), *available at* http://www.fsround.org/cec/pdfs/FINALCompetitivenessReport.pdf.

APRA is a prudential regulator with oversight over deposit institutions, insurance companies and retirement funds. APRA acts primarily as a supervisory agency, ensuring that "financial promises made by regulated entities are met within stable, efficient and competitive financial markets."[36] APRA accomplishes this objective by measuring and managing various risks in a financial services firm's business (including, for example, setting capital adequacy requirements). To this end, APRA has three main regulatory tools: authorization or licensing powers, supervision and monitoring powers, and powers relating to the assumption of control of insolvent or otherwise troubled firms.

In order to resolve any conflicts between themselves, ASIC and APRA established a joint working group to identify and resolve regulatory overlap and share information between the two agencies.

Just as the UK FSA shares oversight over the UK financial system with the Bank of England and HM Treasury, ASIC and APRA share oversight responsibility for the Australian financial system with the Reserve Bank of Australia and the Australian Treasury. The Reserve Bank of Australia is responsible for national monetary policy and oversees the overall stability of the Australian financial system. In order to coordinate financial regulation among the different branches of the government, the Australian government set up the Council of Financial Regulators, composed of representatives of the Reserve Bank of Australia, APRA, ASIC and the Australian Treasury.

C. United States

1. Current System

In the United States, financial regulation is divided among a host of federal agencies, each devoted to regulating specific sectors of the financial system – depository institutions (i.e., banks, thrifts and credit unions), futures and securities – and state agencies that often provide additional regulation of the same sectors as well as primary regulation of the insurance sector. Appendix B, attached hereto, consists of a series of diagrams that depict the current US regulatory system. Coordination of regulation and information sharing is informal among most federal agencies and is ad hoc between the federal and state levels. Consequently, the United States has the dubious distinction of having one of the most complex and arguably least coordinated regulatory structures in the world.

Five different federal agencies share primary authority for the regulation of US depository institutions. These agencies are the Office of the Comptroller of the Currency (OCC), Federal Reserve, Federal Deposit Insurance Corporation (FDIC), Office of Thrift Supervision (OTS) and National Credit Union Administration (NCUA). Depending on its particular

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[36] *See* http://www.treasury.gov.au/documents/1197/HTML/docshell.asp?URL=Preconditions-08.asp.

organizational structure, a single depository institution may be subject to regulation by up to three of these federal agencies as well as a state regulator.

The OCC is an independent office within the US Treasury Department whose function is to charter, regulate and examine all national banks.[37] The OCC performs regular reviews of national banks to ensure compliance with federal statutes and regulations. If a deficiency is found, the OCC has broad enforcement powers, allowing it to levy sanctions on violators.[38]

All national banks chartered by the OCC are also required to be members of the Federal Reserve and are subject to Federal Reserve oversight. In addition, the Federal Reserve regulates state banks that have chosen not to seek an OCC charter, but wish to access the Federal Reserve's payment and liquidity facilities. For those state-chartered banks that do elect membership, the Federal Reserve becomes the primary regulator at the federal level. The Federal Reserve is also the national regulatory authority that oversees bank holding companies.[39]

The FDIC administers the Federal Deposit Insurance System. Membership in the FDIC is required for virtually all depository institutions in the United States. Banks which are members of the Federal Reserve also must be insured through the FDIC.[40] Even those banks which are not affiliated with the Federal Reserve (i.e., state banks without an OCC charter and access to the Federal Reserve's payment and liquidity facilities), however, are often bound to insure themselves through the FDIC, as federal law requires any depository institution which accepts retail deposits, other than credit unions, to carry federal deposit insurance. All depository institutions insured by the FDIC are subject to its regulations. For state-chartered banks who have not joined the Federal Reserve, the FDIC then becomes their primary federal regulator.

The OTS is responsible for overseeing federal chartered thrifts. Thrifts, commonly known as savings and loan associations or building and loan associations, are depository institutions primarily focused on providing residential mortgage loans. The OTS charters all federal thrifts and oversees all aspects of thrift operations using its powers to issue rules and legal interpretations.

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[37] A "national bank" is any bank which chooses to obtain its charter from the federal government rather than the local state authority.

[38] Possible sanctions include negotiating agreements with the bank to change their practices, issuing cease-and-desist orders, imposing fines and removing officers and directors of the bank.

[39] The Federal Reserve became the primary regulator of Goldman Sachs and Morgan Stanley when it approved the conversion of the two investment banks into bank holding companies.

[40] These banks include OCC-chartered national banks as well as state-chartered banks that elect membership in the Federal Reserve.

The NCUA charters and supervises all federal credit unions. The NCUA also provides depository insurance for federal credit unions and most state-chartered credit unions through the National Credit Union Share Insurance Fund.

Established in 1979 pursuant to an act of Congress, the Federal Financial Institutions Examination Council (FFIEC) is an interagency coordinating committee which seeks to harmonize regulatory policy between the existing depository institution regulators. The FFIEC includes the OCC, Federal Reserve, FDIC, OTS, NCUA and the State Liaison Committee, consisting of the Conference of State Bank Supervisors, American Council of State Savings Supervisors and National Association of State Credit Union Supervisors. It is important to note that the FFIEC has no regulatory authority of its own. It can only make recommendations and must rely on its members to effect such recommendations in their respective regulatory areas.

Regulation of futures is split between the Commodity Futures Trading Commission (CFTC), individual derivative and commodity exchanges, and the National Futures Association, which is a SRO. In recent years, the CFTC has distinguished itself from its larger and better known sister agency, the SEC, by applying a risk-based, tiered approach to regulation and relying more heavily on principles-based regulation. The CFTC also was an early adopter of mutual recognition principles, permitting foreign futures exchanges to have direct access to US customers in the United States.[41]

The SEC, on the other hand, is the primary regulator of the national securities markets and enforcer of the federal securities laws. Its three-part legislative mandate, as set forth in the Securities Exchange Act of 1934, is (i) to protect investors, (ii) to maintain the integrity and stability of securities markets and (iii) to promote efficiency in capital formation. While the SEC engages in a significant amount of rule-making, the SEC also relies heavily on the work of SROs, which are allowed to generate rules and policies for broker-dealers and trading markets. All securities firms doing business in the United States are members of FINRA. In addition, market rules are enforced by FINRA (in the case of Nasdaq) and NYSE Regulation (in the case of the New York Stock Exchange (NYSE)).

Unlike the rest of the US financial services industry, the insurance industry is primarily regulated by state authorities. State insurance regulation falls into two broad categories of regulation. The first area of regulation – solvency or financial regulation – focuses on the prevention of insurer insolvencies and mitigation of consumer losses in the case of insolvency. The second area of regulation – consumer protection and market regulation – is focused on unfair marketing practices, including deceptive advertising, unfair policy terms and unfair treatment of policyholders.

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[41] *See, e.g.,* Jerry W. Markham, "Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, the United Kingdom, and Japan," 28 *Brook. J. Int'l L.* 341-46 (2003) (describing the differences in regulatory philosophies of the SEC and CFTC).

After the October 1987 stock market correction, the President of the United States created the President's Working Group on Financial Markets (PWG). The PWG is designed to identify systemic problems in the US financial system and coordinate regulatory responses. The PWG is chaired by the US Treasury Secretary and composed of the chairs of the Federal Reserve, CFTC and SEC. As an entity, the PWG has no independent authority, and its members have only the ability to regulate what is within their respective mandates. As a result, the PWG acts primarily as a forum for discussion of financial policy issues.

2. Calls for Reform

In June 2007, US Treasury Secretary Henry Paulson announced that the US Treasury Department would begin work on a plan to restructure the US financial regulatory system.[42] By the time of Secretary Paulson's announcement, a number of blue ribbon committees and independent studies had voiced concerns that the US regulatory system had become unwieldy, expensive and inefficient, undermining the competitiveness of US financial markets.[43] Critics expressed in general four concerns with the US regulatory system.

First, the US regulatory system is too complex. Too many regulatory agencies at the federal and state levels are regulating the same financial institutions. Securities issuers and financial services firms have complained about the high cost of complying with federal and state rules and regulations. The effect of these high costs is that companies, especially those that are small and medium-sized, have found it difficult to access the capital markets and financial services firms have had to devote more resources to compliance and litigation departments or exit from certain markets. The lack of coordination between federal and state agencies also sometimes has resulted in individual state regulators taking the lead on certain issues which could be better handled at the national level or has resulted in substantial regulatory inconsistencies between states.

Second, the lack of coordination between state and federal regulators creates a hostile enforcement environment. Financial firms have found themselves in recent years being subject to civil penalties from the SEC, criminal charges from the US Department of Justice, and

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[42] *See* US Department of the Treasury Press Release, "Paulson Announces Next Steps to Bolster US Markets' Global Competitiveness" (June 27, 2007), *available at* http://www.ustreas.gov/press/releases/hp476.htm.

[43] *See, e.g.,* Interim Report, Committee on Capital Markets Regulation, Nov. 30, 2006, *available at* http://www.capmktsreg.org/index.html; Committee on Capital Markets Regulation, *The Competitive Position of the US Public Equity Market,* Dec. 4, 2007, *available at* http://www.capmktsreg.org/pdfs/The_Competitive_Position_of_the_US_Public_Equity_Market.pdf; *Sustaining New York's and the US' Global Financial Services Leadership*, *available at* http://www.senate.gov/~schumer/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf; *Commission on the Regulation of U.S. Capital Markets in the 21st Century - Report and Recommendations*, *available at* http://www.uschamber.com/publications/reports/0703capmarketscomm.htm.

criminal and civil charges from state regulators in addition to private lawsuits. Because federal and state regulators and prosecutors frequently fail to coordinate their enforcement actions, financial firms face the prospect of defending themselves against multiple agencies, unable to negotiate settlements or propose remedies that would allow the firm to free itself of further liability.

Third, competition between regulatory agencies is stifling the development of new financial products and services. One example is the conflict between the SEC and CFTC concerning the regulation of security futures.[44] Because the SEC regulates securities and the CFTC regulates futures, both agencies have claimed a role in the regulation of security futures products. While security futures have been traded in significant volumes in Europe, Africa and East Asia since the early 1980s, the SEC attempted to block the introduction of security futures in the United States because it viewed security futures as a competitive threat to the market for equity securities. Eventually, in the face of an act of Congress in 2000, the SEC withdrew its opposition to single stock and narrow stock index futures products, but continues to impede the development of a market in these products. Arguably, the SEC would not have opposed the offering of security futures if the SEC also had responsibility for overseeing the futures markets.

Fourth, the regulatory system is not adequate to regulate the new financial conglomerates with operations around the world. The largest US financial institutions, like their foreign counterparts, have active banking, securities and insurance operations. After the Gramm-Leach-Bliley Act of 1999 permitted the consolidation of commercial and investment banks in the United States, it became clear that the US regulatory system needed to catch up with these new financial conglomerates.

Given all of these concerns, the US Treasury Department began work on a plan to restructure the US financial regulatory system.

3. US Treasury Blueprint for a Modernized Financial Regulatory Structure

On March 31, 2008, the US Treasury Department released its *Blueprint for a Modernized Financial Regulatory Structure*. In the Blueprint, the US Treasury Department proposes consolidating the many current federal regulatory agencies into three agencies that are organized in accordance with the objectives-based approach: one agency focusing on market stability measures; a second agency focusing on prudential regulation; and a third agency focusing on business conduct regulation.

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[44] *See* Eric J. Pan, "Single Stock Futures and Cross-Border Access for US Investors," 14 *Stan. J.L. Bus. & Fin.* (2008) (forthcoming).

Market Stability Regulation. The Blueprint calls for responsibility for market stability to be vested in the Federal Reserve. This role would be carried out through the implementation of monetary policy and supply of liquidity to the market when necessary as well as formal supervisory powers.

The Federal Reserve's authority would be broadened significantly. The Blueprint proposes that all financial institutions be required to file reports with the Federal Reserve so that the Federal Reserve would have a detailed picture of the entire financial market. In addition, other regulators would be required to share with the Federal Reserve any reports that they generate upon request by the Federal Reserve, and the Federal Reserve would be given the power to create new reporting requirements as it deems necessary. Such power would make the sharing of information between regulators required by law rather than leaving the sharing of information up to negotiation between regulators on an ad hoc basis or through informal arrangements. Finally, the Blueprint advocates authorizing the Federal Reserve to put forward any necessary corrective actions to maintain market stability, including extending the availability of discount-window lending to institutions other than depository institutions. This reform would institutionalize many of the recent actions of the Federal Reserve to provide liquidity to US banks and investment banks.

Prudential Regulation. The Blueprint recommends the creation of a Prudential Financial Regulatory Agency (PFRA) to oversee all prudential regulation matters. According to the Blueprint, PFRA would regulate any financial institution that benefits from some type of explicit government guarantee of their business operations. When the government guarantees part of the business of the financial institution, the government has a heightened interest in the financial health of the institution. Therefore, the PFRA would ensure, among other things, that an institution is maintaining adequate levels of capital, follows certain investment limits and has in place suitable risk controls. Otherwise, the existence of the government guarantee without prudential regulation would create a moral hazard problem, likely causing an erosion in market discipline.

Implicit in the Blueprint's description of the types of institutions that would be subject to PFRA oversight is that previously unregulated institutions may be subject to prudential regulation in the future as the US government expands the scope of its guarantees. Therefore, one of the questions not answered in the Blueprint is how will investment banks (and other non-bank financial institutions) be regulated. As the US government has shown itself willing to provide limited guarantees in situations like the acquisition of Bear Stearns by JP Morgan Chase, it would be reasonable to assume that these investment banks – traditionally outside of the scope of banking supervision – would be subject to new prudential regulatory standards.[45]

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[45] Lehman Brothers' filing for bankruptcy, the sale of Merrill Lynch to Bank of America and the conversion of Goldman Sachs and Morgan Stanley into bank holding companies decreases the likelihood this question will need to be confronted in the near future.

Business Conduct Regulation. As a counterpart to PFRA, the Blueprint proposes consolidating all business conduct regulation under the auspices of a new Conduct of Business Regulatory Agency (CBRA). CBRA would be charged with monitoring the business conduct of all financial institutions, setting disclosure and business practice standards, and chartering and licensing of financial institutions. A major focus of CBRA's activities would be setting appropriate standards for financial institutions to enter the market and sell their products and services. In this respect, the CBRA would assume many of the responsibilities currently held by the several depository regulators, state insurance regulators, the SEC, the CFTC and the Federal Trade Commission.

Recognizing that full implementation of the Blueprint will take several years and require public debate at both the federal and state levels, the US Treasury Department also recommends a series of short-term and intermediate-term actions designed to streamline structural reforms and to address immediate regulatory concerns raised by the current credit crisis.

Among the recommendations is a proposal to create a national insurance regulator. At present, insurance companies are regulated only at the state level. Because there is little coordination of regulatory standards across states, insurance companies find it difficult and costly to provide insurance services in multiple states, hindering the growth of national insurance companies. In recent years, the need to overcome the myriad state insurance rules and regulations has become more urgent. The European Union has expressed dissatisfaction with how several US states impose discriminatory collateral requirements on foreign insurance companies attempting to offer insurance and reinsurance service in the United States. While certain states are willing to address the concerns of foreign insurance companies, other states continue to refuse to provide access to foreign insurers on equal terms to their US competitors. In response, the European Commission has raised the possibility with the US Treasury Department that US insurance companies may be subject to additional requirements when they conduct business in the European Union. The threat of this action has placed great pressure on the federal government to establish a role in the regulation of insurance companies.

The Blueprint recommends the creation of an "optional federal charter" for insurance companies. This federal insurance charter program, which would be administered by a newly created Office of National Insurance based in the US Treasury Department, would allow for the establishment of uniform national standards for licensing and operation of insurance companies. Insurers that obtain a federal insurance charter no longer would be subject to state regulation. Likewise, foreign insurers could apply for a federal charter, offer insurance products in multiple regions of the United States, and avoid having to satisfy local state requirements.

The Blueprint anticipates, however, that implementation of a national system for regulating insurance may meet strong resistance at the state level. As a compromise, an Office

of Insurance Oversight (OIO) could be created within the US Treasury Department with statutory authority to address international regulatory issues[46] and to advise the US Treasury Department on policy issues related to the insurance industry. The OIO also would be given the power to ensure that state insurance regulators implement in a uniform manner the international policy goals set by the OIO. Although chartering responsibility would remain largely with the states, the federal government would be able to step in and force state regulators to modify their regulatory requirements as necessary to satisfy federal concerns about the accessibility of the US insurance market to foreign and domestic insurance providers alike.

Finally, recognizing that the distinction between the securities and futures industries is quickly disappearing, the Blueprint calls for the consolidation of the SEC and CFTC into a single agency. Pursuant to this goal, the Blueprint anticipates the need to take several steps to harmonize the regulation of securities and futures trading. First, the Blueprint recommends the adoption by the SEC of overarching regulatory principles focused on investor protection, market integrity, and the reduction of systemic risk to unify the regulatory philosophy of the new agency. These principles would be based upon the current core principles that are the basis of the CFTC's principles-based regulatory approach.[47] Next, the Blueprint recommends allowing SROs to self-certify their own rules. This proposal would give greater autonomy to SROs, allowing them to respond more nimbly to market developments and regulatory actions taken by foreign regulators. Finally, the proposal calls for the creation of a joint CFTC-SEC task force to determine the optimal method for the harmonization of the trading regulations of the securities and futures markets. Eventually, the SEC and CFTC would be incorporated into the CBRA.

Public response in the United States to the Treasury Blueprint has been mixed to date. State regulators have criticized the Blueprint's proposals that diminish the role of state authorities in the financial system. Banking associations have criticized the Blueprint's plan to consolidate all banking regulation in the hands of a single prudential regulator. They feel that such a regulator would be insensitive to the interests of smaller and more specialized depository institutions, such as thrifts and community banks. Others have criticized the Blueprint's unwillingness to recommend tighter supervision of investment banks and hedge funds – entities that are perceived to be the primary drivers behind the "irrational exuberance"[48] that drove the market to unrealistic heights and ultimately a brutal fall. Given such opposition, along with an

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[46] The Blueprint specifically refers to reinsurance collateral – the heart of the European Union's complaint about discriminatory state regulation – as an issue to be handled by the OIO.

[47] The CFTC's core principles are listed in legislation and rules. *See* 7 U.S.C. § 7; 17 C.F.R. parts 37 & 38.

[48] To borrow the phrase first used by Federal Reserve Chairman Alan Greenspan in 1996 to describe the dangers of asset bubbles. *See* Alan Greenspan, Chairman, The Federal Reserve Board, *The Challenge of Central Banking in a Democratic Society*, Francis Boyer Lecture of The American Enterprise Institute for Public Policy Research, Washington, DC (Dec. 5, 1996), *available at* http://www.federalreserve.gov/BOARDDOCS/SPEECHES/19961205.htm.

out-going presidential administration and competing legislative priorities, little has been accomplished at this stage to implement the recommendations of the Blueprint. Events in September 2008, such as the failure of AIG, Washington Mutual, Wachovia and Lehman Brothers, and calls for an unprecedented $700 billion government bailout fund to purchase troubled assets from US financial institutions, have made it more likely that structural reform of the US financial regulatory system will be a high priority in the next Presidential administration. It is, however, too early to assess to what extent the Blueprint will be integral to this upcoming debate.

D. France

France's current system is the result of a partially-frustrated attempt to overhaul its regulatory system. The original plan for France's regulatory system was to adopt the twin peaks model. One peak would be managed by a new agency created out of a merger of the banking and insurance commissions. The Banque de France, however, resisted relinquishing its role in regulating banks.[49] It is useful to note why the UK government did not face the same opposition from the Bank of England when it took away the Bank of England's responsibility for banking regulation and gave it to the UK FSA. When it faced the loss of its role as the primary banking regulator, the Bank of England was mollified by the fact that the Chancellor of the Exchequer gave it full control over monetary policy. Such a bargain could not be struck with the Banque de France since it had already ceded monetary policy to the European Central Bank. Consequently, the Bank of France fought to hold on to its remaining regulatory responsibilities.

Instead, only the second peak was put into place. In 2003, the French government merged the former Stock Exchange Commission with the Financial Markets Commission and the Conseil de discipline de la gestion financière to create the Autorité des marchés financiers (AMF). The AMF has three responsibilities: safeguard investments in financial products, ensure that investors receive material information and maintain orderly financial markets.

Prudential regulation, on the other hand, continues to be divided among several different agencies. First, France's regulatory structure still reflects an unusual distinction between authorization/accreditation and continuing supervision. In banking, the Comité des établissements de crédit et des entreprises d'investissement (CECEI) is responsible for approving new banking licenses while oversight is the responsibility of the Commission bancaire in the Banque de France. Insurance regulation is similar to banking regulation. The prudential regulation of insurance is carried out by the Autorité de contrôle des assurances et des mutuelles while a separate committee is responsible for the authorization of new insurance companies. Finally there exists a board of financial authorities, which includes chairs of the various regulatory agencies, but the board lacks any formal powers.

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[49] *See* Davies & Green, *supra* note 4, at 174.

E. Germany

Germany made changes to its financial regulatory system in 2002 when it combined its securities, banking and insurance regulators into a single body, the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin). BaFin is responsible for the supervision of all financial institutions in Germany and has created internal supervisory divisions to handle conglomerate supervision, international issues and other cross-sectoral matters of interest to each division.

On the surface, BaFin looks like a good example of single regulator. But in reality Germany missed an opportunity to garner the benefits of the single regulator model by not taking advantage of the creation of BaFin to restructure how it approaches the regulation of the German financial system. Instead, BaFin appears to be only a new hat on the old German system. BaFin continues to divide its regulators into banking, securities and insurance silos as opposed to reorganizing its regulators along the lines of prudential and business conduct regulation. To be fair, BaFin has attempted to overcome this limitation by introducing cross-sectoral groups to encourage cooperation between silos, but the continued separation of banking, securities and insurance regulators is reinforced by the fact that BaFin physically keeps apart the different sets of regulators: BaFin's banking and insurance divisions are located in Bonn while the securities markets regulators are in Frankfurt.

In addition, the German government did not provide BaFin with full regulatory authority over banking or securities. Rather, BaFin shares banking supervision responsibilities with the Bundesbank. When the German Finance Minister first announced the creation of BaFin, the Bundesbank argued it would be unwise to separate banking supervision entirely from the central bank. As a result, BaFin is required to consult with the Bundesbank on the creation of new rules, and the Bundesbank is responsible for much of continued bank oversight. And, BaFin shares responsibility for the supervision of exchanges with the individual German states. Given these limitations, BaFin falls short of being a true single regulator.

F. Hong Kong

Hong Kong's regulatory system consists of four principal regulators: Hong Kong Monetary Authority (HKMA), Securities and Futures Commission (SFC), Office of the Commissioner of Insurance (OCI) and Mandatory Provident Fund Schemes Authority (MPFA). The HKMA is responsible for the prudential regulation of banks, securities firms and insurance companies. The SFC is responsible for the regulation of the securities and futures markets. The OCI is responsible for the regulation of the insurance market. The MPFA regulates pension and retirement schemes. In order to ensure coordination among the different regulators, Hong Kong has a Cross-Market Surveillance Committee, comprised of members from Financial Services and the Treasury Bureau (FSTB), HKMA, SFC, Hong Kong Stock Exchange, OCI and MPFA, to promote the exchange of information. In addition, the SFC and HKMA have entered into a memorandum of understanding laying out which agency should have the lead regulator role in response to certain financial crises.

The HKMA and Honk Kong Association of Banks (HKAB) share responsibility for banking regulation. The HKMA was established in 1993, through the merger of the Office of the

Exchange Fund and the Office of the Commissioner of Banking. As a result, the HKMA, like the Federal Reserve in the United States, is in charge of both monetary policy (including management of the Exchange Fund to maintain the stability of the Hong Kong dollar) and supervision of the Hong Kong banking system. The HKAB arose out of the former Exchange Banks Association, which was founded in 1897 as the representative body of Hong Kong's major banks. Although the HKMA issues banking licenses, no fully licensed bank can operate in Hong Kong without also being a member of HKAB and complying with HKAB rules. Governed by its members, the HKAB sets business conduct rules and best practices applicable across the industry. The HKMA also consults with the HKBA on rulemaking.

Most regulatory reform has taken place in the area of securities and commodities regulation. Prior to the stock market downturn of 1973-1974, stock and commodities markets in Hong Kong were largely unregulated. After the downturn, the government created two commissions, one to regulate the securities markets and the other to regulate the commodities markets. After the Hong Kong stock market suffered again in October 1987, a government expert committee concluded that the two commissions lacked on their own adequate resources to regulate properly Hong Kong's markets and criticized the regulators for acting too passively in the face of market developments. In response, the government combined the securities commission and commodities commission into the SFC. The SFC is divided into four operational divisions: Corporate Finance, Intermediaries and Investment Products, Enforcement, and Supervision of Markets. In addition, the Hong Kong Stock Exchange operates as a SRO with responsibility for listings, admissions and market surveillance.

With the exception of the United States, Hong Kong appears to have the most fragmented regulatory structure among the large financial capitals of the world. This fact is not surprising given the rather ad hoc development of regulatory agencies in Hong Kong. One commentator describes Hong Kong's system as the product of trial and error, resulting in a "confusing matrix of sectoral laws and agencies with many gaps and inconsistencies."[50] Despite it complex and inefficient structure, Hong Kong has not announced any plans to restructure its regulatory system to the same degree as other countries discussed in this report.

G. Japan

Japan reformed its regulatory system in response to problems with its financial markets that became evident in the 1990s. Until 1998, the Ministry of Finance (MOF) supervised almost the entire Japanese financial system, making the MOF effectively Japan's single regulator. The financial problems that plagued Japan in the 1990s and early attempts to address these problems, however, revealed that the MOF sometimes put political considerations ahead of its responsibility to ensure the safety and soundness of the country's financial institutions.[51] As a

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[50] Berry F.C. Hsu, et al., *Financial Markets in Hong Kong* 476 (2006).

[51] *See* Davies & Green, *supra* note 4, at 175.

result, Japan's experience with a powerful MOF is a cautionary tale for other countries that try to consolidate power in a single regulator without adequate protections against political interference.

As its financial difficulties continued, Japan engaged in several attempts at regulatory reform. In 1998, Japan established the Japanese Financial Supervisory Agency (JFSA). The JFSA initially had responsibility for the inspection and supervision of all financial institutions. In this respect, the JFSA began as a prudential regulator. In 2000, the government increased the powers of the JFSA beyond prudential supervision to include business conduct regulation. Renamed the Financial Services Agency, the JFSA took over the Financial System Planning Bureau of the MOF and secured new powers to draft laws and promulgate business conduct rules, mandate disclosures by financial institutions, carry-out inspections and sanction financial institutions. The JFSA also was given responsibility to regulate the Japanese securities markets and to represent Japan in IOSCO. In recent years, the JFSA has delegated most of it supervisory power to the Securities Exchange Surveillance Commission (SESC). The SESC conducts investigations of illegal activity such as insider trading, market manipulation, loss compensation or guarantees, and violations of disclosure regulations. With these additional powers, the JFSA has become a powerful single regulator – arguably the most powerful single regulator in the world after the UK FSA – having regulatory responsibility for all of Japan's financial markets with the exception of certain prudential supervisory duties that it shares with the Bank of Japan. What is noteworthy about the Japanese system is that Japan always had a single regulator. The big achievement in taking power away from the MOF and creating the JFSA was to establish a politically independent single regulator.

H. The Netherlands

In 2002, around the same time that regulatory reform was being contemplated in France and Germany, The Netherlands was also considering how to reform its financial regulatory structure. The impetus for reform in The Netherlands was recognition that the Dutch financial system was ill-prepared to handle the growth of the cross-border markets, the rise of financial firms involved in banking, insurance and securities activities, the growth of a single market for financial services in the European Union and the ability of current agencies to meet the new demands proposed by the EU Financial Services Action Plan.

The Netherlands decided to adopt the twin peaks model with the De Nederlandsche Bank (DNB), the Dutch central bank, responsible for protecting market stability. Before 2004, the DNB and Pensioen- en Verzekeringskamer (PVK) shared responsibility for prudential supervision, and the Authority for Financial Markets (AFM) was responsible for all business conduct regulation. The three supervisors were parties to a joint agreement, establishing rules for co-operation and coordination. In 2004, The Netherlands fully-adopted a twin peaks model, by merging the PVK into the DNB to make the DNB the country's sole prudential supervisor. The AFM remains the second peak, responsible for business conduct regulation.

The Netherlands chose the twin peak model for several reasons. The Dutch believed that the twin peaks model would more effectively supervise financial conglomerates with operations across financial sectors. The Dutch also concluded that reducing the number of regulatory

agencies would reduce the opportunity for regulatory arbitrage where firms could take advantage of inconsistencies between the approaches and standards of competing regulators. Finally, the decision to adopt the twin peaks model resulted from a need to clarify the role of the DNB, since it no longer had responsibility for monetary policy after the establishment of the European Central Bank. In contrast to the Banque de France and the Bundesbank, the DNB assumed an explicit leadership role in the regulation of the financial markets. With the completion of this restructuring of the financial regulatory system, The Netherlands joined Australia as the other prominent example of a country that has adopted the twin peaks regulatory model.

IV. Recommendations

The organizational structures of the various financial regulatory systems around the world reflect the unique circumstance of each country. The most striking (but least surprising) lesson that can be garnered from the experiences of these other countries is the degree to which entrenched political interests (whether from central banks, state governments or established regulators) have frustrated the most ambitious plans for regulatory reform. The second lesson is that often financial regulatory reform has been undertaken because external events have provided the necessary sense of urgency for reform, such as a financial crisis (stock market downturns or financial crisis) or developments in foreign jurisdictions and international markets (creation of the European Central Bank, threats of regulatory retaliation by foreign powers or a fear of the loss of financial activity "market share" to foreign markets). Nonetheless, the experiences of these countries and the degree to which their regulatory reforms have succeeded and disappointed offer helpful data points for Canada as it considers its own structural reforms.

This reports makes four recommendations to the Expert Panel on Securities Regulation and the Canadian government regarding how to improve the structure of the Canadian financial regulatory system: (i) have primary regulation of the financial markets originate from the national government rather than from the provinces; (ii) adopt an objectives-based approach in reorganizing the responsibilities of each regulatory agency; (iii) create a regulatory coordination body that has legal powers to direct regulatory actions, mandate the real-time sharing of information and manage enforcement actions; and (iv) increase resources to enforcement and supervisory functions to enhance the attractiveness of the Canadian financial markets.

A. Speaking with One Voice: Promotion of National Regulation

It is in the interest of Canada to attempt to shift regulatory power from the provinces to the national government. This recommendation is especially true in the case of securities regulation where the national government plays a non-existent role in the regulation of the securities markets. The continued regulation of the securities markets at the provincial level is inefficient and creates uncertainty. Differences between provincial regulations create an undesirable situation where different Canadian companies find themselves subject to different disclosure and reporting rules. These differences make it difficult for investors to compare companies and understand the significance of the different regulatory requirements. The Canadian market is even more confusing for foreign investors and issuers as Canada is the only major country to have such a fractured system.

As others previously have recommended the consolidation of the provincial securities regulators into a single national regulator, this report focuses only on two reasons why a national securities regulator should replace the provincial regulators. First, the provinces are not in the best position to provide appropriate regulation for a national securities market. It is questionable whether all of the provinces devote the necessary resources to the regulation of securities, creating differences between the scope and sophistication of the provincial securities regulatory regimes. Undoubtedly, the four provinces that have the most active interest in regulating securities activity – Ontario, Quebec, British Columbia and Alberta – devote substantial resources to improving their securities regulation and interacting with other regulators within Canada and the rest of the world. It is less clear whether the other provinces have the same interest or incentive to do so. The notion that a country's securities markets can be regulated at the provincial level seems outdated and goes against the desire for a larger, more integrated securities market to maximize liquidity and lower the cost of capital. Arguably the fact that many of Canada's companies register their shares in the United States and make a second listing on the NYSE or Nasdaq indicates that the Canadian securities markets are not fulfilling their potential.

But an equally compelling reason to give the national government regulatory authority over the securities markets has to do with the increasing importance of global financial regulation. In recent years, initiatives arising out of multilateral and bilateral forums such as IOSCO and the US-EU Transatlantic Economic Council have resulted in revisions to offering documents, acceptance of new accounting standards, enhanced supervision of financial conglomerates, new regulation of trading markets and closer cooperation on enforcement matters. The push to develop these cross-border standards stems from the recognition in the United States, European Union and other jurisdictions that the financial markets increasingly have become integrated and that capital is mobile. Therefore, regulatory differences either impede financial market growth or cause capital to move offshore. Canada and its markets are no different.

Even the United States, which has the largest securities market in the world, is not immune from these pressures. There have been several cases in the past few years where the United States has had to amend its regulatory standards in order to accommodate foreign issuers and meet foreign standards. The SEC reversed its long-standing insistence on foreign issuers to reconcile their financial statements in accordance with US Generally Accepted Accounting Principles (US GAAP) in the face of growing acceptance in the European Union and elsewhere of IFRS and the possibility that foreign countries may force US companies to reconcile their US GAAP financial statements to IFRS. The SEC took on the responsibility for overseeing so-called "Consolidated Supervised Entities" in response to pressure from the European Union that threatened to require the major US investment banks to submit to supervision by an EU member

state if the United States did not provide equivalent supervision.[52] And, as discussed above, the US government is trying to move the regulation of insurance companies from the states to the federal government to address concerns by the European Union that European insurance companies are not being treated in an equivalent manner as US insurance companies are in Europe. These examples demonstrate that countries can no longer make regulation without taking into consideration how such regulation will affect foreign firms operating within their borders and domestic firms attempting to operate abroad.

Canada must have the strongest voice possible in the international arena to ensure that Canadian interests are fully represented in the development of these new global standards. If Canada does not fully participate in these on-going discussions, then it faces the prospect of having to adopt standards that are set in Washington, Brussels and other regulatory capitals outside of Canada. To the extent that Canada must speak through provincial governments – provincial governments that are not acting on behalf of the entire country but only their local interests – Canada will have limited influence on other national regulators.

Recognizing that shifting regulatory authority from the provinces to the national government would be legally and politically controversial, a second best solution would be to encourage the provincial regulators to continue to pursue their passport system in the hopes that a common regulatory regime could be developed by the provinces in the near future. In a passport system which enables regulatory competition, the provinces have the incentive to respond to competitive pressures and work with one another through the Council of Ministers of Securities Regulation and CSA to eliminate their regulatory differences. The CSA (with assistance from the Council) is the natural leader for such a process and also could serve as the representative body of Canada in international negotiations. Given the role played by the national government in matters related to foreign trade and commerce, the national government should be invited to join the CSA in order to ensure the CSA can fulfill its role as Canada's voice in international forums.[53] As the EU experience demonstrates, however, the passport system is delicate because it requires the full cooperation and participation of the various members. The European Union took over twenty years to lay the legal framework for a single European securities market. Canada can undoubtedly improve on this record, but a national regulator offers a better chance for success.

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[52] On September 26, 2008, the SEC announced the termination of the Consolidated Supervised Entities program to address flaws in the program identified by the SEC Inspector General and to reflect the fact that all of the investment banks that had voluntarily participated in the program have either ended operations or have become subject to oversight by the Federal Reserve as bank holding companies. *See* SEC Press Release, "Chairman Cox Announces End of Consolidated Supervised Entities Program" (Sep. 26, 2008), *available at* http://www.sec.gov/news/press/2008/2008-230.htm.

[53] Whether the Canadian Constitution requires the national government to be part of any such international representation is a question of Canadian law and beyond the expertise of the author of this report.

B. Objectives-based Regulation

In pursuing regulatory reform, Canada should build upon its current regulatory system and freely adopt the objectives-based approach to financial regulation. The danger of regulating by financial sector is that regulators end up trying to accomplish two goals simultaneously – protecting the safety and soundness of the financial institution to minimize systemic problems and offering sufficient safeguards for retail and institutional customers. As discussed above, these two goals are often in conflict with one another, and it becomes difficult for smaller, narrow-focused regulatory agencies to balance properly these two objectives. Instead, it is more sensible to organize regulatory resources such that one set of regulators focuses on the prudential regulatory aspects of the banking, securities and insurance sectors while another focuses on the business conduct regulatory aspects of those sectors.

Several of Canada's peer countries have moved in this direction. Australia and The Netherlands have adopted the twin peaks model, creating separate agencies to focus on prudential regulation and business conduct regulation. France attempted to reorganize its regulatory system in the same way, but was frustrated at the end by political opposition. And the United States in its Treasury Blueprint is explicit in its endorsement of the objectives-based approach. Fortunately, Canada is already a step ahead. In the area of banking and insurance, Canada has the laid the groundwork for an objectives-based approach with the OSFI and FCAC.

C. Choice between Single Regulator and Twin Peaks Models

Acceptance of the objectives-based approach, however, does not automatically mean that Canada needs to adopt the twin peaks model. In fact, the Canadian government should not let itself fall into the trap of having to believe that it must choose between the single regulator and twin peaks models. Rather, the most important task is to ensure that there is sufficient regulatory coordination, information sharing and allocation of resources between regulatory agencies.

Without sufficient coordination between regulators, no regulatory model will provide adequate protection of the financial markets. One of the most appealing features of the single regulator model is the fact that one regulatory agency is responsible for supervising all aspects of the financial markets. But a single regulator is vulnerable to the same problems and concerns as the other models if its internal structure does not provide for sufficient coordination between the different regulatory teams. Germany, for instance, appears on the surface to have a single regulator, but when the internal structure of the BaFin is examined in detail it appears that the BaFin staff still operate semi-autonomously of each other. Likewise, the internal structure of the UK FSA appears to show that the internal regulatory teams are organized by financial sector rather than by objectives. The twin peaks model is also going to provide minimal improvement if there is no mechanism to coordinate regulatory decisions between the prudential regulator and the business conduct regulator.

Whether Canada chooses the single regulator model or the twin peaks model, it must ensure that the there is a legal mechanism that will promote coordination of regulatory policy, sharing of real-time information and cooperation on enforcement matters. To this end, Canada should avoid contact committees like the President's Working Group in the United States and the

board of financial authorities in France that consist of the representatives from the finance ministry, central bank and lead regulators but have no independent legal authority. Canada should also avoid relying on interagency agreements to provide the legal framework for the sharing of information or the coordination of rulemaking. Instead, Canada should strive to create a permanent coordinating body that will garner the benefits of the objectives-based approach but will ensure that the prudential regulator, business conduct regulator and market stability regulator have automatic access to each other's reports, work together on new rulemaking and cooperate on enforcement and supervisory matters.

D. The Enforcement Dilemma: Supervisory Approaches and Principles-Based Regulation

The final recommendation is that regulatory reform should be accompanied by the allocation of additional resources to enhance enforcement and supervisory capabilities. Learning from the debate in the United States about capital markets competitiveness and the experience of the United Kingdom with principles-based regulation, Canada should take the opportunity also to rethink how it goes about regulating its markets and how it can make the Canadian financial markets more attractive to financial services providers and retail and institutional customers. In the United States, the financial industry has called for a shift in regulatory strategy from strict liability enforcement to supervisory approaches.[54] The rationale behind this request is that the financial firms feel overburdened by the risk of prosecution from federal and state regulators and private lawsuits. Even in cases where the firm self-reports a violation, it opens itself to heavy fines and penalties. The result is that firms devote significant time and money to compliance programs and litigation. The alternative would be a supervisory approach where firms are given the opportunity to identify violations, consult with regulators and agree upon a solution with regulators that will prevent similar violations from taking place in the future. The supervisory approach shares many of the same advantages as those of principles-based regulation. From the perspective of the regulated firms, principles-based regulation offers them more opportunity to meet their regulatory obligations in a way that is cost-efficient. Firms find rules-based regulation to be too rigid, offering little room for error. Together, the supervisory approach and principles-based regulation have the potential to lower the cost of regulatory compliance for firms.

From the perspective of the regulator, the supervisory approach and use of principles-based regulation require a shift in emphasis from prosecution and enforcement to consultation and advice. In a rules-based system, a great deal of effort is put into writing a rule, but after that point the regulator steps back and intervenes only when there is a violation of the rule. In a principles-based system, the role of the regulator lies in working with the firm to determine the appropriate way to satisfy each principle. The UK FSA, for example, intends to publish guidelines on a continuous basis and make available its staff for consultations. In order to provide such services to the financial institutions, regulators will need to recruit or re-train staff.

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[54] *See, e.g.,* Financial Services Roundtable Report, *supra* note 35.

Therefore, reorganization of Canada's financial regulatory system offers an opportunity also to reallocate resources to enable Canada to effect a supervisory approach and introduce principles-based regulation.

V. Conclusion

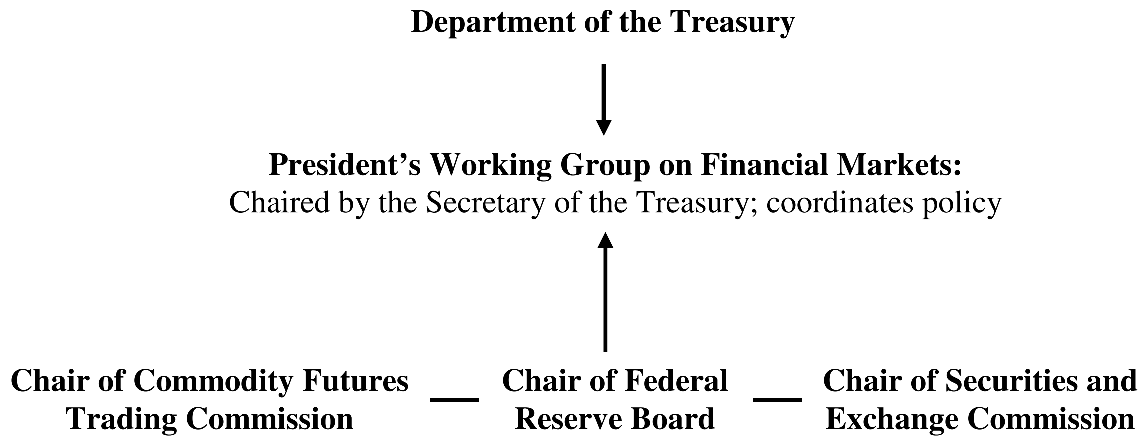
This report aims to lay out for the Expert Panel on Securities Regulation and the Canadian government a framework to think about how the Canadian regulatory system can be improved to better achieve the objectives of protecting the safety and soundness of the financial markets and making Canada more attractive to international financial market participants. Canada is not alone in re-examining its regulatory system. The United States, United Kingdom and Canada's other competitors are engaging in a similar exercise. It is worth repeating that in comparison with these other countries Canada is in a unique position – its economy is strong and its financial institutions are sound. Now is a good time for Canada to be thinking about the future development of its markets and considering regulatory changes that will better position Canada to welcome new financial activities and be an important part of a more globalized financial system.

Appendix A:
UK Financial Services Authority Organizational Chart

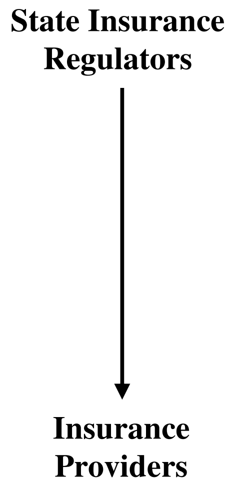
Available at http://www.fsa.gov.uk/pages/About/Who/PDF/orgchart.pdf

Appendix B:
US Financial Regulatory System

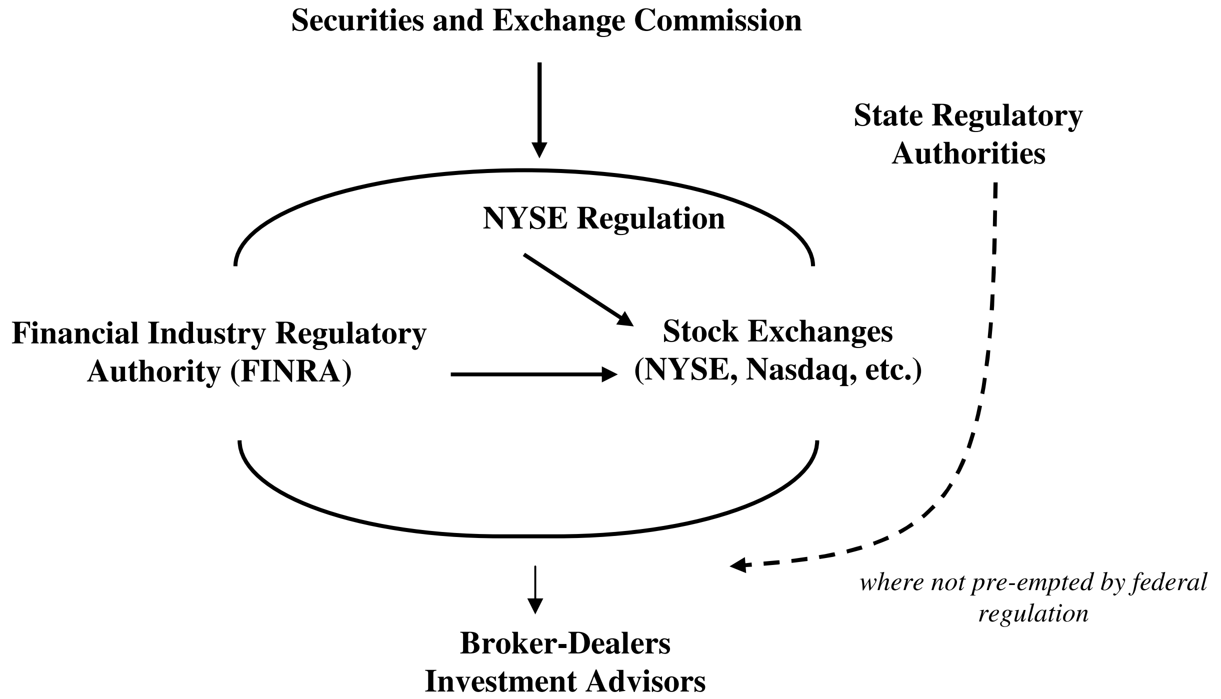
President's Working Group on Financial Markets



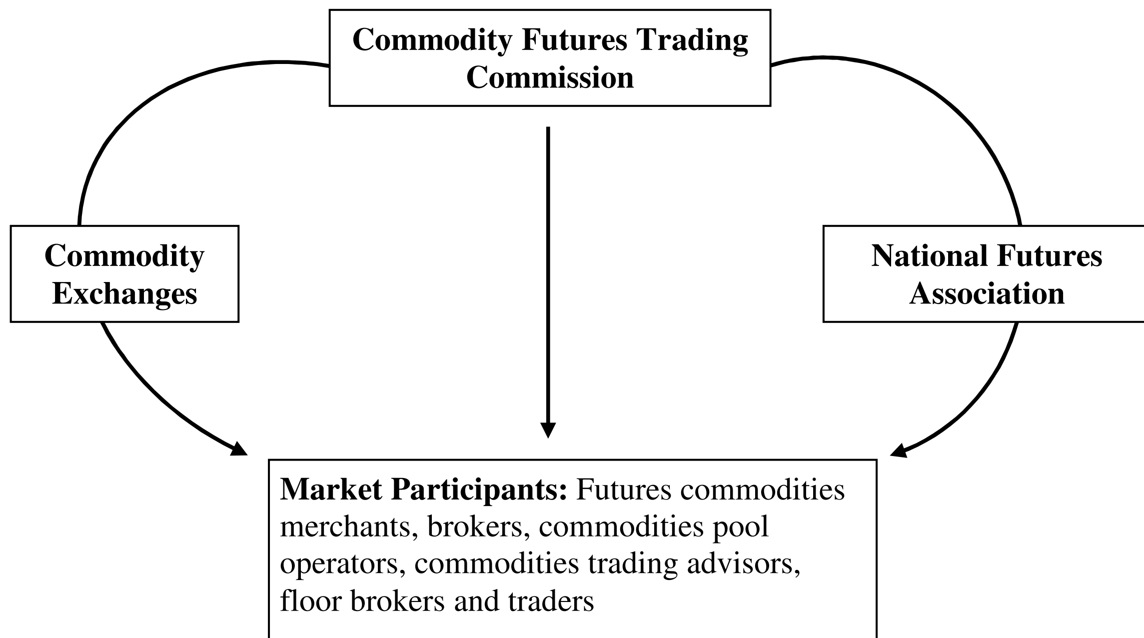
Insurance Regulation



Securities Regulation



Futures Regulation



Regulation of Depository Institutions