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## By E-mail

David Murchison  
Executive Director  
Expert Panel on Securities Regulation  
Ottawa, Ontario  
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Dear Sirs/Mesdames:

### **Re: A Public Consultation Paper Issued by the Expert Panel on Securities Regulation in Canada — Request for Submissions**

This letter is submitted in response to the above-noted request for submissions. I have read the Ontario Bar Association submission and agree with its recommendations. I wish to make some additional observations.

I am a lawyer with a practice concentrating on capital market issues. Previously, I held a number of positions over a twenty-one year period at The Toronto Stock Exchange and the CNQ Stock Exchange giving me a broad experience dealing with issuers, registrants and retail and institutional investors.

Before responding to the specific consultation requests, I would like to make some general comments.

Any new securities regulatory regime must build upon the strengths of the current one and mitigate its weaknesses. The principle of "first, do no harm" should be invoked by the Expert Panel in its deliberations. To that end, the following should be borne in mind:

- A new regime must result in capital markets that are more efficient and better regulated than is currently the case. It would be unfortunate if the end result was simply to add a new regulatory layer on top of that currently in place, or to implement a "unitary" system that only a few provinces join.
- A new regime must take into account the increasing globalization of capital markets. The current regime was developed at a time of local markets that served local investors and intermediaries. Today, investors are looking beyond national markets and cross-border mergers of stock exchanges are becoming commonplace. It is more important than ever that Canada speak with one voice internationally.

The current regime does not accomplish this and makes it difficult for foreign regulators to reach agreement with their Canadian counterparts.

- A new regime must be comprehensive. It should include commodity futures trading and regulation of commodity futures exchanges. This undoubtedly will create problems; although securities regulation is largely harmonized, derivative and futures regulation is more of a patchwork and largely outdated.<sup>1</sup>
- A new regime must take into account non-governmental means of achieving regulatory objectives. The existing civil remedies for investors (including civil liability for continuous disclosure that exists in many jurisdictions) and the self-regulatory system must be retained and strengthened.

I will now respond to the specific consultation requests:

### **Objectives, Outcomes and Performance Measures**

Regardless of whether a rules-based or principles-based regulatory regime is recommended, it is important that clear outcomes be specified. At a minimum, these include investor protection and fostering fair, efficient and competitive capital markets. It would be preferable not to list too many objectives as they will invariably overlap and conflict. Specific performance targets (e.g. turnaround times on complaints) should definitely be set by the commission but not set out in legislation.

Care must be taken not to set performance targets that create conflicts of interest. For example, enforcement targets based on the number of actions brought may create an incentive to undertake dubious actions. A corporate finance target based on the number of prospectuses receipted may create an incentive to give prospectuses a cursory review.

### **Principles-Based Securities Regulation**

There are arguments both for and against adopting a principles-based regulatory regime. It is true that a principles-based system focuses on positive outcomes rather than technical compliance and exploitation of loopholes. However, a move to a principles-based system of regulation, coupled with potential regulatory sanctions or civil liability for non-compliance, will greatly increase the need for definitive guidance as market participants will demand assurance that they are on-side. The published guidelines could end up more voluminous than the rules they are intended to replace.

Complexity in rulemaking does not necessarily originate with the regulator. Often market participants will seek a myriad of exemptions from a general prohibition on the basis that applying the prohibition to certain activity is unnecessary to achieve the regulatory objective.

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<sup>1</sup> The Québec National Assembly has adopted a *Derivatives Act*, S.Q. 2008, c. 24, which has not yet been proclaimed in force.

To cite but one example, U.S. securities regulation has a clear prohibition on fraudulent practices in connection with securities transactions, but does not spell out what constitutes fraud. This is appropriate, as any attempt to exhaustively define fraud will inevitably create loopholes that the unscrupulous will exploit. However, it also raises the possibility that the Securities and Exchange Commission will launch an action for certain relatively common market activity that, ex post facto, it views as fraudulent. Underwriters were concerned that the SEC might construe routine market stabilization activities in connection with a distribution to be manipulative as the underwriter could be influencing the market price of the distributed security. While the SEC agreed that normal course stabilization was not manipulative (and indeed could be beneficial), it was unwilling to grant a blanket exemption; to do so would open the doors to potential manipulation in the guise of stabilization. To balance these competing interests, the SEC passed an extremely complicated and technical series of rules setting out what could and could not be done by a participant in a distribution.<sup>2</sup>

Rulemaking is not the only possible response. The SEC has also adopted "safe harbours" which set out conduct that the SEC deems not to constitute a violation of a particular rule, without ruling that conduct that does not conform to the safe harbour is necessarily a violation. However, because of the uncertainty of non-compliance, safe harbours inevitably become de facto rules.<sup>3</sup>

### *Impact on Enforcement*

Moving to a principles-based approach may also have a negative impact on civil and enforcement actions. On the one hand, the commission or plaintiff must prove a violation that results in liability. Without clear-cut rules, considerable time, effort and money could be spent litigating threshold issues rather than the merits of a particular action. If the principles are too vague, enforcement may be impossible in all but the most egregious cases.

On the other hand, a principles-based approach could leave the door open for a commission to "regulate through enforcement," with market participants facing enforcement action for activities they believed in good faith were permitted.

This is discussed in more detail below.

### *Rules-Based Regimes Can Be Overly Complex*

While expressing some scepticism concerning principles-based regulation, I do not intend to suggest that lengthy, convoluted rules are preferable. In my view, the best system will likely be a mix, with a series of rules that lead to the outcomes sought by the overarching principles. Regulation should be tailored; new rules should not be enacted if they are not needed and they should not regulate more than is absolutely necessary. Rules should also not

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<sup>2</sup> Former rules 10b-6, 10b-7 and 10b-8 under the Securities Exchange Act of 1934. This is not to say that rules in response to requests for clarification need to be complex; the SEC replaced the rules with the more streamlined (and straightforward) Regulation M.

<sup>3</sup> The SEC's market stabilization rules noted above are written as safe harbours. They are de facto rules.

duplicate SRO or exchange rules unless they apply only to persons outside the SRO's or exchange's jurisdiction.

### **Proportionate Securities Regulation**

Regulation should be proportionate. Currently, smaller issuers are exempted from many CSA requirements. In the United States, the SEC is required to assess the impact of new regulatory initiatives on small businesses.

Undoubtedly, some companies go public at an earlier stage of their evolution than they probably should, but the regulatory regime should not be so daunting that it discourages issuers at the appropriate stage from going public, or encourages them to go to unregulated markets such as the U.S. Pink Sheets.

Smaller issuers often find detailed governance requirements problematic. It is difficult to attract experienced directors. Complex financial reporting requirements are also burdensome, and probably not very useful to investors given the company's stage of development.

Generally speaking, smaller issuers should not be subject to less onerous disclosure rules. Full, true and plain disclosure is the lifeblood of the capital markets. If an issuer is unable or unwilling to provide full disclosure, it should not be accessing the capital markets.

In most instances, the answer will not be in different rules for smaller companies. All issuers will benefit from clear, straightforward rules supplemented with practical compliance guidance from the regulator, all written in plain language. Education programs for issuers such as those done for investors can be developed.

### **Enforcement**

Regardless of the reality, there is a perception that enforcement in Canada is inadequate. There is also a perception that enforcement actions are being used, in effect, to create new rules. If a principles-based approach is adopted, it must allow for effective enforcement. Similarly, any new body must be given adequate resources to run an effective enforcement program.

Commission enforcement action is not the only compliance mechanism. Investors have the ability to bring civil actions for certain disclosure violations. SROs can enforce their own rules and can use failure to comply with securities laws as justification for suspension or expulsion. These should be maintained.

The one gap is with respect to stock exchanges and listed companies. Exchanges are not SROs of public companies, and their only recourse for non-compliance is to suspend or delist the company. This is often too severe for a particular violation and punishes the company's shareholders rather than the persons responsible for the violation. An exchange should be able to apply to the Commission for an order that a listed company comply with its rules. Violation of the order would subject those responsible to Commission enforcement action.

### *Independent Adjudication*

The risk of a principles-based system exacerbating rulemaking through enforcement can be mitigated by having an independent tribunal. This would also end the perception of structural bias. Over time, the tribunal would develop expertise and consistency.

Enforcement would also be faster if there was a large panel of potential adjudicators. Today, a panel of commissioners must hear the action, which can result in scheduling difficulties.

The Commission should retain the ability to issue exemptive orders, with or without conditions, and the ability to order an investigation. It should also be able to issue interim orders in appropriate cases (e.g. an interim cease-trade order caused by a violation of securities law). The Expert Panel should consider whether the Commission should also have the power to issue permanent orders.

### **Securities Regulatory Structure**

Even if Ontario joined the passport system, it would only go part way to the objective of strengthening the efficiency and competitiveness of the Canadian capital markets, as the passport system is necessarily limited in scope.

The passport/mutual recognition system is limited to granting of exemptive relief and the acceptance of documents for filing. There is a mutual recognition system with respect to stock exchanges,<sup>4</sup> but not other SROs such as the Investment Industry Regulatory Organization of Canada ("IIROC").

A passport system does not guarantee equal results for participants. A market participant or issuer seeking exemptive relief or a stock exchange seeking approval of a rule change to make its market more competitive may get a quicker result in one jurisdiction than another. This may be due to available resources or the fact that staff of one commission is more familiar with the issues presented by the application and can analyze it more quickly.

The more serious problem is that a passport system cannot resolve policy disagreements among regulators. Policy initiatives can be held up because of the inability to reach consensus, or proceed on the basis of multilateral instruments rather than national ones. Even when consensus is achieved, it may not be absolute. The recent registration reform proposals are an example, with some jurisdictions declining to adopt an "exempt market dealer" category of registration and some declining to move from a "trade" to a "business" trigger for registration.

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<sup>4</sup> Each stock exchange has a lead regulator and is exempted from recognition by the others. Québec does not grant an exemption but defers to the lead regulator. The TSX Venture Exchange has both British Columbia and Alberta as lead regulators, but my understanding is that they have divided oversight responsibilities to avoid duplication.

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Similarly, IIROC's predecessor organizations<sup>5</sup> have seen rule proposals subject to lengthy delays because of the inability for the regulators to reach consensus.

These issues can only be resolved by having a single, national securities commission. Provincial government concerns can be addressed in several ways. It would be expected that a national commission would have offices in most, if not all, provinces and would employ staff of the current commissions. Particular offices could become responsible for different policy issues, drawing on local expertise (e.g. derivatives in Montréal, commodity futures in Winnipeg, venture issuers in Vancouver). Provincial governments could have a role in nominating commissioners and adjudicators.

An intra-province exemption from prospectus requirements could be created, similar to the one in American legislation. This would continue to allow provinces to facilitate corporate finance innovations for local issuers and investors.

I thank you for this opportunity to comment. If you have any questions, please call or e-mail me.

Yours truly,

A handwritten signature in cursive script that reads "TSBaikie".

Timothy Baikie

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<sup>5</sup> The Investment Dealers Association of Canada and Market Regulation Services Inc.