

2010

Canadian Securities Regulation and the Global Financial Crisis [The Walter S. Owen Lecture]

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Recommended Citation

Condon, Mary. "Canadian Securities Regulation and the Global Financial Crisis [The Walter S. Owen Lecture]." *UBC Law Review* 42.2 (2010): 473-491.

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THE WALTER S. OWEN LECTURE

CANADIAN SECURITIES REGULATION AND THE GLOBAL FINANCIAL CRISIS

MARY CONDON[†]

I. INTRODUCTION

I would first like to express my deep gratitude to the UBC Faculty of Law for welcoming me as the Walter S. Owen Chair in Law for 2008–2009. I particularly want to express thanks to the Owen family for providing the law school with the opportunity to appoint someone in this capacity. I am pleased to participate in commemorating Walter Owen, who had many distinguished achievements and appointments over the course of his career. I should also add that reading the list of Owen lecturers who have preceded me is a humbling experience.

The topic I have chosen to talk about tonight is the possible implications of the global financial crisis (“GFC”) for Canadian securities regulation. It seems particularly foolhardy to wade into these waters for a number of reasons. One is that the crisis is not yet over, and it may yet take a number of unanticipated turns. Another related reason is that grappling effectively with these problems may require rethinking the entire architecture of international financial systems—a rather ambitious task! But foolish as it may be, I thought I would attempt in this lecture to break off a little bit of this capa-

[†] 2009 Walter S. Owen Chair in Law, University of British Columbia Faculty of Law. Aside from some minor editorial re-formatting, this paper has not been substantially updated since it was delivered as a lecture on 26 March 2009. This paper represents the personal views of the author, and not those of the Ontario Securities Commission, of which the author is a Member.

cious topic by trying to articulate some of the challenges that the current financial turmoil raises for securities regulators in Canada. Specifically, I want to concentrate my remarks about the effects of the GFC on Canadian securities regulation in three areas: (i) the possible effects of the GFC on recent discourses of securities regulation, by which I mean emerging philosophies such as “principles-based regulation” and “risk-based regulation”; (ii) the increasing influence of international securities organizations, especially the International Organization of Securities Commissions (“IOSCO”), on domestic regulation; and (iii) the burgeoning international debate about structural reforms to domestic regulatory arrangements in the financial sector. I need to start, however, with a little primer on the major elements of the GFC as it is currently understood.

II. THE CAUSES OF THE GFC

The GFC can be described as something of a witches’ brew, which has a number of unsavoury elements. There is a good deal of consensus in the media, among knowledgeable commentators, and in emerging academic accounts about the elements of the crisis, although not about the direction of “causality.” For example, most commentators agree that the securitization of mortgage products (whereby packages of mortgage loans were pooled by creditors, sold to special purpose vehicles, and then fragmented again as investment opportunities to third parties) was a major factor in the crisis. There is less agreement on why the mortgage securitization market collapsed. Was it caused primarily by irresponsible behaviour on the part of low-income earners who took out mortgages they could not afford, leading to widespread defaults on those mortgages and therefore no stream of income to pay investors? Or, alternatively, was it caused by a concerted push by financial service providers to generate revenue through irresponsible and less-than-transparent lending activities?¹ Those commentators who espouse the latter view point to the trend towards the “originate to distribute” model of securitizing assets that was engaged in by investment banks and other financial in-

¹ See Shannon O’Byrne & Ronnie Cohen, Address (Paper presented to the workshop on Managing Business Risk at Green College, University of British Columbia, January 2009) [unpublished]; Peter Gowan, “Crisis in the Heartland” (2009) 55 *New Left Review* 5.

stitutions. This is claimed to have had the effect of loosening the risk-based oversight such institutions would normally engage in. In other words, mortgage providers no longer cared about the credit worthiness or ability to pay of the mortgage holder because they had dispersed the risk of default in the underlying assets to third-party investors in the securitized investments. These pools of assets were often sold and re-sold in tranches that had different credit ratings associated with them. Other assets underlying the investment opportunities could be corporate debt obligations (“CDO”), such as bonds or debentures; hence the term collateralized debt obligations. The size of the CDO market grew from \$275 billion in 2000 to \$4.7 trillion in 2006. By 2002, asset-backed securitizations began to exceed the total amount of conventional debt securities issued by public corporations in the U.S.² Compounding the phenomenon of the growth of the CDO market was another development whereby the leverage ratios of U.S. investment banks—that is, the ratio of net capital they needed to keep on their balance sheets to fund their liabilities—were also reduced by regulators in the U.S. in the mid-2000s.³ To be eligible for this reduction, investment banks voluntarily entered the SEC’s Consolidated Supervised Entity Program.⁴ This meant that these institutions were particularly vulnerable to declining asset holdings causing capital shortfalls.

Another major focus during this period has been the activities and business model of the credit rating agencies, a highly concentrated service within the financial services industry. These agencies played a very significant role in providing a credit rating for the tranches of assets and receivables that were securitized and sold to investors in over-the-counter transactions. It is one thing when the bank that originates a mortgage or a credit card then securitizes those assets in a separate vehicle and sells tranches of them to other investors; it is another thing when the parties to a derivative contract that is linked to an underlying set of assets or an underlying “reference entity” have

² John C. Coffee & Hillary A. Sale, “Redesigning the SEC: Does the Treasury Have a Better Idea?” (Columbia Law and Economics Working Paper No. 342, 1 November 2008) at 28, online: SSRN: <<http://ssrn.com/abstract=1309776>>.

³ Gowan, *supra* note 1 at 15; Coffee & Sale, *supra* note 2 at 21.

⁴ Coffee & Sale, *ibid.*

no ownership or creditor interest at all in the underlying reference entity. As the credit derivatives market grew throughout the last decade, this transformation of the use of derivatives from a risk hedging device on the part of creditors to an opportunity to speculate on the economic fortunes of an underlying reference entity contributed significantly, first to this market's staggering growth, and later to its ultimate fragility.

A prominent example of this type of transaction was the credit default swap ("CDS"), where a protection buyer (often one of the new breed of specialist credit hedge funds) enters into a contract to buy protection from the risk of default of the chosen underlying entity (e.g. General Electric) from a protection seller. The protection buyer makes payments to the protection seller to this end. If the underlying reference entity defaults on its obligations, such as an obligation to make an interest payment on debt securities, the protection buyer gets paid by the protection seller. That protection seller, of course, increasingly came to be the current pariah of the insurance system, AIG. Between 2001 and 2007, the size of the CDS market grew from \$920 billion to \$62 trillion. There is a very cogent account of this phenomenon in Janis Sarra's recent paper on the credit derivatives market, where she demonstrates how the growth of the CDS market worked to skew traditional incentive structures.⁵ In a manner similar to short selling, protection buyers could be more interested in the underlying reference entity failing than in it succeeding, because the value to the protection buyer of having the credit event triggered could be significant, depending on the size of the derivative contract. Finally, the circle gets squared, as it were, when it turns out that one type of CDO that it was possible to buy was a form in which the underlying pool of assets were a group of CDSs, thus trading a derivative of a derivative.⁶

⁵ Janis Sarra, "The Conceptualization and Management of Risk in Financial Products Markets and Bank Capital Requirements, New Winds or Shifting Sands?" (Paper presented to the workshop on Managing Business Risk at Green College, University of British Columbia, January 2009) [unpublished].

⁶ See Investment Industry Regulatory Organization of Canada, *Regulatory Study, Review and Recommendations concerning the manufacture and distribution by IIROC member firms of Third-Party Asset-Backed Commercial Paper in Canada* (October 2008), online: IIROC <<http://docs.iiroc.ca/DisplayDocument.aspx?DocumentID=3CAB660DB44E41C2875DD3DBD27FADEA&Language=en>>.

Expanding the cast of characters involved in the crisis further, various associations of institutional investors have publicly engaged in self-criticism for not probing more aggressively the solidity of the underlying assets of various derivative products in which they invested. Another related debate is whether excessive compensation packages for key banking or insurance company employees designing, underwriting, and trading these credit derivative products was merely a symptom of the credit market bubble or were in fact a prominent cause of excessive risk-taking, in the sense that the increased short-term profitability of derivatives trading units within banks was a driver of compensation bonuses. The saga of the political frenzy over the compensation packages payable to AIG officials is an obvious example of this theory.

In all of this, Canada's financial system has been relatively unscathed, a fact that has caused the country to be a source of some envy among financial sector watchers internationally. However, Canada may have been the canary in the coal mine in that our home-grown asset-backed commercial paper ("ABCP") crisis, which erupted in 2007, involved the freezing up of the market for short-term commercial paper, which was ultimately backed by similar assets to those that have proven toxic world-wide. A major element of the Canadian version of the crisis was that the commercial paper being sold was designed to involve a short term to maturity, whereas the assets underlying the notes involved long-term liabilities such as mortgages and other loans. As the health of the underlying assets began to appear fragile and produce less income, new buyers of notes became scarce and sellers had insufficient cash to redeem them. It should also be acknowledged that the portion of the ABCP market that actually froze in 2007 was the non-bank sponsored products.⁷

How does securities regulation connect into all this? There are several ways in which it is implicated in this ongoing saga, both directly and indirectly. One point of connection is that securities regulators, in principle, regulate the issuing and trading of securities by banks and other financial service providers, including ABCP.⁸ Insofar as investors purchased these finan-

⁷ See *ibid.*

⁸ As discussed later, the threshold legal question of whether certain kinds of derivatives are securities is a vexed one.

cial products, securities regulators are mandated to provide protection.⁹ More generally, the way in which financial sector regulation is conceptualized, organized, and fragmented among a number of regulatory bodies, including securities, banking and insurance regulators, is a major subject for ongoing debate.

III. WHITHER PBR/RBR?

One matter of considerable debate elsewhere,¹⁰ is whether regulators themselves contributed to the crisis. This question relates both to the philosophies of regulation that undergird what financial regulators do and the way that regulatory authority is divided among different bodies. Two of the most prominent trends in regulatory theory generally, and financial sector regulation more specifically, has been the move to “principles-based regulation” (“PBR”) on the one hand, and “risk-based regulation” on the other.¹¹ PBR is a particularly live issue in the Canadian context, because the final report of the Expert Panel on Securities Regulation, which was set up by the federal government in 2008 and which reported earlier this year, expressed considerable confidence in the concept of PBR as applied to securities regulation.¹² I should add that this was in significant measure because of Professor Cristie Ford’s extremely cogent and thoughtful presentation of the issues connected to a move to PBR in the background research paper she prepared for the Expert Panel.¹³ A shift to PBR was also recommended by the U.S. Treasury De-

⁹ See e.g. *Securities Act*, R.S.O. 1990, c. S.5, s. 1.1.

¹⁰ Especially in places like the U.K.

¹¹ See Mary Condon, “Comparative Models of Risk-based Financial Services” (Paper prepared for the Ontario Expert Commission on Pensions, 31 October 2007), online: Blake Cassels & Graydon <<http://www.blakes.com/english/practiceareas/pensionsOECP/papers/5%20Comparative%20Models%20of%20Risk-based%20Financial%20Services.%20Condon%20.pdf>>.

¹² See Expert Panel on Securities Regulation, *Final Report and Recommendations* (Ottawa: Department of Finance Canada, 12 January 2009), online: Expert Panel <http://www.expertpanel.ca/eng/documents/Expert_Panel_Final_Report_And_Recommendations.pdf>.

¹³ See Cristie Ford, “Principles-Based Securities Regulation” (Paper prepared for the Expert Panel on Securities Regulation, 12 January 2009), online: Expert Panel <<http://www>

partment, in its “Blueprint for a Modernized Financial Regulatory Structure” published last year.¹⁴

So what is PBR? It is generally taken to have the following components:

- promulgation of high-level standards that are drafted at a broad level of generality;
- a focus on an outcomes-based approach, which is concerned more with whether a regulatory participant achieves a certain outcome, such as “treating customers fairly” than whether it abides by universally-applied procedural rules drafted by a regulator;
- a commitment to enhanced stakeholder participation in the design of principles;
- increased responsibility of regulated entities’ senior management for the implementation of principles within firms; and
- reliance on constant improvement of industry best practices and guidance with respect to best practices rather than prescriptive rule-making.

The Financial Services Authority (“FSA”) in the U.K., an integrated financial regulator responsible for regulating a broad range of financial service providers, including banks and securities firms, has been the most enthusiastic exponent of PBR. However, as Julia Black put it in December 2008:

[PBR] invoked a re-framing of the regulatory relationship from one of directing and controlling to one based on responsibility, mutuality and trust. ... The regulated would adopt a self-reflective approach to developing processes and practices to meet the goals, and both would trust each other to fulfil their side of this new regulatory bargain. What was killed in this crisis was not the desirability of this vision, but the possibility that the trust on which

.expertpanel.ca/eng/reports/research-studies/principles-based-securities-regulation-ford.html>.

¹⁴ U.S., Department of the Treasury, *Blueprint for a Modernized Financial Regulatory Structure* (March 2008), online: Department of the Treasury <<http://www.treasury.gov/press/releases/reports/Blueprint.pdf>>.

it has to be based could be re-formed in the near future, or even at all. The trust has gone ...¹⁵

Somewhat more pungently, Hector Sants, the chief executive of the FSA, has said that “a principles-based approach does not work with participants who have no principles.”¹⁶

While there may be an element of rhetorical posturing here, one empirical question to ask is whether that trust between financial market participants and regulators has been as severely impaired in Canada as it has elsewhere, such that PBR can still work in Canadian securities regulation. The logic of PBR assumes an underlying theory about how organizations behave. That theory is that organizations will typically seek to achieve regulator-sanctioned outcomes if they are relatively easy to follow and if competitors also comply with them. There is well-respected empirical work in the law and society tradition that purports to demonstrate the truth of these propositions.¹⁷ I have myself subscribed to this approach in some of my earlier work.¹⁸ The intriguing question is whether this theory of organizational behaviour, as it applies to financial institutions, remains robust after the GFC. It is true, of course, that much of what I described earlier as the elements of the GFC did not necessarily encompass illegal activities, though it may have involved excessive risk-taking. It is also true that, as the crisis unfolded, some firms financially supported their money market funds or special investment vehicles even when they were not contractually required to do so. This suggests that some financial institutions did more than was legally necessary,

¹⁵ Julia Black, “The death of credit, trust—and principles based regulation?” *Risk and Regulation* (December 2008) 8, online: Risk and Regulation <<http://www.lse.ac.uk/collections/CARR/pdf/RiskRegulationFinancialCrisis2008.pdf>>.

¹⁶ Peter Thal Larsen, “Gloves to come off as FSA ends ‘light touch’ era” *Financial Times* (13 March 2009), online: Financial Times <<http://www.ft.com/cms/s/0/e3cd02de-0f6f-11de-ba10-0000779fd2ac.html>>.

¹⁷ See e.g., Neil Gunningham & Robert A. Kagan, “Regulation and Business Behavior” (2005) 27 *Law & Pol’y* 213; OECD, Public Management Committee, *Reducing the Risk of Policy Failure: Challenges for Regulatory Compliance* (2000), online: OECD <<http://www.oecd.org/dataoecd/48/54/1910833.pdf>>.

¹⁸ See Mary Condon, “Rethinking Enforcement and Litigation in Ontario Securities Regulation” (2006) 32 *Queen’s L.J.* 1.

though whether this was prompted by a concern for their reputation, to avoid additional regulatory scrutiny, or more altruistically to do the “right thing,” is a matter that would repay close empirical examination. Thus, it may be the case that different financial institutions, no less than in other business sectors, are positioned differently with respect to a willingness to embrace PBR.

But, at the very least, the GFC appears to demonstrate that if PBR is to work, such that market participants embrace results-oriented principles in their own internal processes, regulators need to be more hard-nosed about taking the organizational culture and internal incentives of regulated participants more directly into account. Coffee and Sale’s recent analysis of the crisis with respect to the U.S. points to the role of “competitive pressure and the need to establish a strong position in a new and expanding market” as significant factors contributing to the lack of self-discipline exhibited by investment banks operating in the credit derivatives area.¹⁹ In a similar vein, McLroy argues that the growth of securitizations was a “market response to the strictures of the First Basel Capital Accord”, which required banks to hold specified reserves of capital which weighted corporate lending as requiring more capital reserves than mortgage lending.²⁰ Furthermore, “securitisation became seen as an essential way of offloading loans in order to free up regulatory capital so that further loans could be made.”²¹ It could well be that case that internal organizational cultures within Canadian financial institutions are materially different from those driving profit-making in the U.S. and the U.K., which might preserve a space for a rigorous outcome-oriented approach to take hold. For example, banks in Canada have a stronger commitment to retail depositors than the investment banks at the centre of the GFC in the U.S., though this is by definition not true of hedge funds.

Finally, given that PBR proposes that ultimate responsibility for achieving outcomes should lie with senior management, what should we make of the fact that the U.K. House of Commons Treasury Committee was sur-

¹⁹ Coffee & Sale, *supra* note 2 at 27

²⁰ David Halliday McLroy, “Regulating risk: A measured response to the banking crisis” (2008) 9 *Journal of Banking Regulation* 284 at 290.

²¹ *Ibid.*

prised in the fall of last year to discover that “the Chairman of the UK branch of a leading investment bank could not explain to us what a CDO is, a financial product in which he told us that his organisation deals?”²²

A. RISK-BASED REGULATION

Meanwhile, one dominant lesson of the GFC for securities regulators is the need to pay renewed attention to issues of risk management. By this, I mean both risk management practices at a financial firm level, and the implementation of risk-based approaches at the regulatory level. Many accounts of what went wrong in the GFC identify inadequate techniques of risk management inside financial institutions as a key culprit. As Donald MacKenzie describes it:

An investment bank with a big presence in the market will have thousands of positions in credit default swaps, CDOs, indices and similar products. The calculations needed to understand and hedge the exposure of this portfolio to market movements are run, often overnight, on grids of several hundred interconnected computers.²³

Thus, the technology required to adequately risk manage the complex products being traded may have been lacking. But the problem was clearly not just technological deficiencies. An important story here is also the superficiality, and ultimate failure, of the risk assessment techniques that were supposed to assist in making product design and trading decisions.

It turns out that the risk of default in specific tranches of CDOs tended to be calculated by banks, not by piecing together the individual default risks of each element of an underlying package of assets or loans, but by seeing that risk as correlated with the trading prices of credit default swaps written on the same or similar assets. Since the CDS market was itself of quite recent origin, there was little historical analysis that went into the calculations of the risk of these asset pools defaulting, and therefore the accurate calculation of the prices at which they were being bought and sold. Much calumny has been heaped on the head of the hapless Canadian-educated statistician who is said

²² *Ibid.* at 288.

²³ Donald MacKenzie, “End-of-the-World Trade” *London Review of Books* (8 May 2008), online: *London Review of Books* <http://www.lrb.co.uk/v30/n09/mack01_.html>.

to have designed this risk modeling convention, but the problem is obviously more about the widespread failure to interrogate the model as it became widely used in the derivatives market.²⁴

Risk issues were also a focus of a report by the so-called Senior Supervisors Group, which reported in March 2008, before the GFC had fully matured.²⁵ This group included the FSA, the SEC, the Federal Reserve, as well as banking regulators from France, Germany, and Switzerland. One very interesting finding of this group of bank supervisors was that the banks that were surviving the crisis best were those that relied on robust *internal* risk assessment processes, as opposed to relying primarily on external risk assessment processes, such as those provided by credit rating agencies. Similar to the comments made above, they also identified as a problem the incorrect assumptions that were made about how CDOs and CDSs would behave, especially the assumption that they would behave like more conventional corporate bonds. As the report put it, “[t]he focus on growth without an appropriate focus on controls resulted in a substantial accumulation of assets and contingent liability risk that was not well recognized.”²⁶ The group therefore recommended more guidance from regulators on risk management practices, as well as on valuation practices, including the development of common approaches to the valuation of illiquid assets. In particular, it proposed the establishment of risk management committees that would discuss risk exposure issues across the firm, as well as timely provision of good information to senior management.

Again, the issue we are interested in here is whether this should change anything that securities regulators do. In its report of earlier this year, the Expert Panel on Securities Regulation recommends that a guiding principle of regulatory conduct should be “facilitating the reduction of systemic risk, including through monitoring of systemic events or developments and coop-

²⁴ See Felix Salmon, “Recipe for Disaster: The Formula That Killed Wall Street” *Wired* (17 March 2009) 73, online: *Wired* <http://www.wired.com/techbiz/it/magazine/17-03/wp_quant>.

²⁵ Senior Supervisors Group, “Observations on Risk Management Practices during the Recent Market Turbulence” (6 March 2008), online: FSA <http://www.fsa.gov.uk/pubs/other/SSG_risk_management.pdf>.

²⁶ *Ibid.* at 7.

eration and coordination with other financial authorities”²⁷ In particular, the panel recommends increasing attention by securities regulators to the fact that it has become easier to access capital directly from capital markets rather than through traditional banking institutions, as well as to the introduction of increasingly complex financial instruments. It also noted with some concern that market participants like hedge funds and private equity funds are less regulated and more opaque.

So what might a renewed focus on risk regulation mean for securities regulators? Are these prescriptions from the Expert Panel sensible ones? I should note immediately that several provincial securities commissions, including the Ontario Securities Commission (“OSC”) and the British Columbia Securities Commission (“BCSC”), consider themselves risk-based regulators already. For example, the BCSC has identified two major risks that it intends to prioritize for the 2009–12 period.²⁸ They are unsuitable investments on the one hand and securities fraud on the other. The attention to unsuitable investments is specifically linked to the concern about retail investor involvement in the ABCP crisis, and builds on the work being done by the Investment Industry Regulatory Organization of Canada (“IIROC”) in this area. The targeting of fraud is recognition that in a period of market decline, retail investors may be more vulnerable to high-pressure sales pitches offering above average returns. Meanwhile, the OSC has focused in the past several months on proactively making contact with market participants such as investment funds and hedge funds, in order to gather information to determine if there is compliance or other systemic problems within these organizations. The Canadian Securities Administrators (“CSA”) have also been scrutinizing the disclosure of those Canadian reporting issuers that held material amounts of ABCP, and of banks specifically, with respect to their securitization practices. Much of this focuses on the valuation methods used by originators and holders of ABCP to describe the fair value of these instruments. The CSA has also made a number of recommendations in response to

²⁷ *Supra* note 12 at 10.

²⁸ British Columbia Securities Commission, *Service Plan 2009–2012* (6 August 2009) at 6.

the credit market turmoil, notably with respect to the treatment of credit rating agencies, a topic to which I return below.²⁹

But what about the Expert Panel's concern with systemic risk? What would this look like in a securities regulation context? One important reminder here is that securities regulators have a number of different points of contact with financial institutions like banks. Banks are issuers of equity securities and, indeed, they have been engaging in this activity frequently in the recent past in order to access additional capital. As we saw they also increasingly originate other investment products like asset or liability securitizations, and of course in Canada a bank will also be the parent of a market registrant that is performing a variety of investment banking and retail investor functions. In other words, the various business activities of banks will produce dispersed responses across a securities regulatory organization. In this context it is relevant that the FSA's internal audit report on Northern Rock, a major U.K. mortgage lender, published last year, decried the failure of the agency to *actually implement* risk-based supervision for Northern Rock, despite the FSA's public and detailed commitment to a risk-based approach to regulation.³⁰ The audit also found a level of organizational opaqueness within the FSA which prevented any one division from "taking ownership" of Northern Rock's problems. No less than within financial institutions themselves, this example points to the need for an organizationally integrated approach to the risk regulation engaged in by securities regulators.

But it begs a bigger question as to whether the ultimate responsibility for overseeing internal risk management processes across financial institutions like banks should lie with securities regulators or with banking regulators. Banks in Canada do have "enterprise level risk management" processes, in which the securities dealer component, which is regulated by securities regulators, is typically represented. The Office of the Superintendent of Financial Institutions ("OSFI") is also committed to risk-based regulation, and has re-

²⁹ Canadian Securities Administrators, *Securities Regulatory Proposals Stemming from the 2007-08 Credit Market Turmoil and its Effect on the ABCP Market in Canada* (6 October 2008), online: BCSC <<http://www.bsc.bc.ca/uploadedFiles/securitieslaw/policy1/CSA%20Consultation%20Paper%2011-405.pdf>>.

³⁰ Financial Services Authority, *The supervision of Northern Rock: A lessons learned review* (March 2008), online: FSA <http://www.fsa.gov.uk/pubs/other/nr_report.pdf>.

cently, for example, signalled that it will consider issues related to compensation practices, to the extent that they increase the risk profile of the bank as a whole. Compensation practices generally have long been of interest to securities regulators, in relation to their corporate governance agenda.

I will return to this issue of whether we should have integrated or diversified risk regulators later, and I will also return to the Expert Panel's targeting of the increased complexity of financial instruments as a problem. But let me just conclude this comment on risk regulation by securities regulators by suggesting that what the GFC has shown us that it is not just problematic that there are inadequate models for pricing risk or that there are failures of risk controls within diversified financial organizations. Mainly it has shown us that *markets themselves* become fragile if the systems for guaranteeing the *ongoing credibility of those markets* don't work well, producing the result that market participants don't trade.³¹ Guaranteeing the credibility of a trading market through systems for promoting transparency of trades as well as the data that allows financial instruments to be valued, standardization of trading terms and minimizing the risk of trade failures seems to be an important element of the challenge facing securities regulators going forward.

IV. INTERNATIONAL CONVERGENCE

One phenomenon that has been in evidence over the last number of years, but has been accelerated by the GFC, is the internationalization of securities regulation and, in particular, the enlarged role played by IOSCO. In its Consultation Paper of October 2008, the CSA explicitly notes that one of the principles guiding its work is to be that its "approach to responding to the Credit Turmoil should be consistent with international developments, including initiatives led by, among others, ... IOSCO, the SEC, the Committee of European Securities Regulators ..., the Financial Stability Forum ..., and the U.S. President's Working Group on Financial Markets."³² While there are IOSCO task forces examining issues of the regulatory approach to be taken to hedge funds and to unregulated products, the one that is furthest advanced at this point involves the regulation of credit rating agencies

³¹ See MacKenzie, *supra* note 23.

³² *Supra* note 29 at 12–13 [citations omitted].

("CRAs"). Thus, the CSA proposes to establish a framework for the regulation of CRAs that embeds the newly revised IOSCO Code of Conduct for CRAs into the domestic regulatory framework, while also allowing the CSA to require changes to a credit rating agency's practices and procedures. The IOSCO Code of Conduct for CRAs is based on a "comply or explain" model. This is a model where the market participant discloses whether or not it is adhering to specific items identified in a code of best practice, and if it is not, explains how it is achieving the overall objectives of the code otherwise. The IOSCO code addresses issues such as conflicts of interest in a CRA's business model, clarity about what ratings mean, and disclosure of historical information about the performance of ratings. The CSA is also considering whether to require public disclosure of all information provided by an issuer and used by a CRA in rating an asset-backed security. A similar proposal has been made by the SEC, which also regulates the CRAs currently operating in Canada. The idea here is to increase the transparency of the products being sold in the securitization market.

The challenge with a project of international convergence, of course, is the appropriate balance to be drawn between international consistency and domestic autonomy. In the case of CRAs, this issue is not raised particularly starkly as there is only a single domestically-located credit rating agency in Canada, with the others operating primarily internationally. But more generally, to the extent that the Canadian capital markets differ materially from those in the United States, as Professor Nicholls found in his study for the TFMSL,³³ the GFC raises the issue of the extent to which Canada's response needs to be sensitive to local market conditions and participants. It is also interesting to note that the "comply or explain" approach being adopted here for CRAs has apparently been rejected by the CSA in a different context, that of standards of corporate governance to be used by publicly-traded issuers, via the proposed revisions to NI 58-101. The final major issue with respect to the role of IOSCO is that the enforcement of the best practices es-

³³ Christopher Nicholls, "The Characteristics of Canada's Capital Markets and the Illustrative Case of Canada's Legislative Regulatory Response to *Sarbanes-Oxley*" (Paper prepared for the Task Force to Modernize Securities Legislation in Canada, 15 June 2006), online: Task Force to Modernize Securities Legislation in Canada <[http://www.tfmsl.ca/docs/V4\(3A\)%20Nicholls.pdf](http://www.tfmsl.ca/docs/V4(3A)%20Nicholls.pdf)>.

tablished by these kinds of international codes can only occur through the efforts of domestic regulators, which has the effect of retaining autonomy for the domestic regulator, but may ultimately produce inconsistent results in the actual implementation of the codes.

V. IS THERE A NEED FOR STRUCTURAL REFORM OF FINANCIAL SECTOR REGULATION IN CANADA?

The final issue that I want to turn to is whether the distinction between the disclosure-oriented basis of securities regulation and the prudentially-oriented basis of banking regulation continues to be the right division of responsibility for Canada. I raise this because the question of overarching reform of the structure of financial sector regulation is the subject of *intense* debate in a number of other countries, notably the U.S. and the U.K. Although Julia Black cautioned in December that it would be a mistake to forge new regulatory structures before, as she put it, “the cocktail of causes is well understood”,³⁴ this has not stopped the juggernaut of policy debate among political commentators, academics, and politicians. What is interesting about the debate in the U.K. and the U.S. is that both jurisdictions come from very different places, in terms of their pre-existing structures, and the suggestion is that each move closer to the others’ arrangements. Thus, the proposal from the opposition Conservatives in the U.K. is that the integrated responsibilities currently exercised solely by the FSA be divided, with the prudential responsibilities of the FSA becoming exercisable by the Bank of England and the FSA retaining responsibility for business conduct issues. This distinction between a “business conduct” regulator and a “prudential” regulator is characterized as the “twin peaks” model.³⁵ Meanwhile, there are various proposals for reform on the table in the U.S., which generally suggest variations on the theme of consolidation of a very fragmented system of sector-based regulation. Coffee and Sale suggest, for example, that prudential

³⁴ *Supra* note 15.

³⁵ Eric J. Pan, “Structural Reform of Financial Regulation in Canada” (Paper prepared for the Expert Panel on Securities Regulation, 12 January 2009) at 13–14, online: Expert Panel <<http://www.expertpanel.ca/documents/research-studies/Structural%20Reform%20of%20Financial%20Regulation%20-%20Pan%20.English.pdf>>.

supervision of the safety and soundness of investment banks should be undertaken by banking regulators, and that the SEC should maintain authority over consumer protection and oversight of business practices.³⁶ They argue that the SEC should not be a prudential regulator, but that the prudential regulation of banks, hedge funds, insurance companies, and indeed all financial institutions that are “too big to fail” should be undertaken by the Federal Reserve.³⁷

In his research study for the Expert Panel on securities regulation, Eric Pan proposes that Canada adopt what he calls an “objectives-based approach.”³⁸ This means that 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. He views it as essential that these regulators have clear lines of authority, share information freely and continuously, and coordinate regulatory actions.

Pan points out that a common assumption is that the regulatory stance required to engage in prudential regulation is fundamentally different from that of business conduct regulation. In a prudential model, which focuses on assuring the financial soundness of institutions, the regulator tends to have a cooperative relationship with regulated entities, while in a business conduct model the regulator frequently assumes an adversarial stance with institutions, because of its mandate to protect consumers of financial products.

This is, of course, not exactly what happens in Canada at the moment. Securities regulators have some prudential responsibilities with respect to securities dealers and other registrants, in tandem with self-regulatory organizations. At the same time, they are not the only regulators responsible for business conduct issues, since the Financial Consumer Agency of Canada also plays a role here.³⁹ I agree with Coffee and Sale’s point that trajectory of

³⁶ See Coffee & Sale, *supra* note 2 at 7.

³⁷ *Ibid.* at 52. For a different set of proposals, see Howell E. Jackson, “A Pragmatic Approach to the Phased Consolidation of Financial Regulation in the United States” (Harvard Public Law Working Paper No. 09-19, 12 November 2008), online: SSRN <<http://ssrn.com/abstract=130043112>>.

³⁸ *Supra* note 35 at 13.

³⁹ See IIROC, *supra* note 6 at 65.

a country's regulatory reform should be forged from its own past and commitments, rather than wholesale adoption of structural approach that derives from the logic of another jurisdiction's politics and legal system. Thus Coffee and Sale argue that the reason why the U.K. chose a single regulator model in the first place had to do with the immediately preceding history of the creation of a set of self-regulatory authorities which were unable to cope with the widespread retailization of the financial markets that occurred in the U.K. during the Thatcher era. The question for Canada then is whether the distinction between the roles of OSFI and provincial securities regulators is an example of a healthy tension (both of philosophy and structure) or a fragmentation of regulatory oversight that has negative effects.

While I cannot yet provide a definitive answer to this question, let me try to provide a concrete example of the dilemma here by circling back to where I started, which is with the phenomenon of the derivative itself. If the trading of derivatives was at the centre of the GFC, who is in fact charged with regulating them in Canada? Who should regulate them? There is a proposal in the U.K. that derivative regulation there should be approached from a prudential stance, which might require for example that banks *not* sell all the risks in the products they originate. This is also the approach favoured by Coffee and Sale in their recent article. Alternatively, should derivative regulation be approached from a disclosure stance, which would require enhanced identification and quantification of risk?

The background to the issue of the regulation of derivatives in Canada is a fascinating lesson in political economy and, specifically, some might argue, a demonstration of the influence of the highly concentrated Canadian banking sector on financial policy. In the mid-1990s, the OSC attempted to regulate the trading of over-the-counter derivatives, by proposing a rule to this effect, which relied heavily on exemptions from regulatory requirements for transactions involving sophisticated parties. The proposed rule prompted an adverse reaction from the banking sector and was never implemented. Similarly, when the issue of the regulation of so-called "principal-protected notes" surfaced some years later, this was resolved by the assertion of jurisdiction by the federal Department of Finance. Despite the significant involvement of the retail investor sector in purchasing these products in the early 2000s, the logic here was that they were issued by federally-regulated financial institutions, and that they operated more like deposits than investment products.

While disclosure requirements were imposed, their adequacy was monitored by the Financial Consumer Agency of Canada rather than securities regulators.

In my view, it is now a matter of some urgency that we re-open the debate about the appropriate approach to regulating derivatives in Canada. As a matter of public policy, we need to have a comprehensive though flexible framework here. If we adopt the functional distinction posited above between business conduct regulation and prudential regulation, it seems to me that the GFC has demonstrated that there are significant market-oriented and business conduct issues, such as transparency and pricing methodologies, which are raised by the proliferation of derivatives trading. This is not least because the players here are no longer only banks, but other investment entities as well, such as hedge funds and pension funds. Securities regulators, because of their expertise in transparency and the promotion of standardization, need to be closely involved in designing such a regulatory framework.

Let me close, then, with this simple thought. I would argue that the GFC has shown us that, far from regulation being a drag on markets as the neo-classical law and economists would have it, regulation is actually intrinsic to the survival of markets.⁴⁰ If we can accept that basic premise, the “only” matter left for debate about is how to effectively accomplish that regulation! Thank you all for your attention.

⁴⁰ See Mary G. Condon, *Making Disclosure: Ideas and Interests in Ontario Securities Regulation* (Toronto: University of Toronto Press, 1998).