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ONE ECONOMIC MARKET OR A COLLECTION OF JEALOUS RIVALS?

Ensuring the Effectiveness of Securities Reform in Canada

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EXECUTIVE SUMMARY

Canada's banking regulations have been hailed by international organizations as an important reason why Canada avoided the worst of the global financial crisis. However, these same organizations are critical of our fragmented and inefficient regulatory landscape in securities.

The federal government has introduced new legislation that proposes a national securities regulator to address these shortcomings. The introduction of a Canadian Securities Regulatory Authority (CSRA) is intended to improve investor and consumer protection, enhance our attractiveness as an investment destination and improve market efficiencies while also balancing the needs of regional industries and investors. These goals are not mutually exclusive, but rely on a delicate balance.

In order to properly balance the twin goals of delivering significant advances in consumer and investor protection and meeting regional needs, three components are crucial:

- Regional offices that can cater to local market needs;
- a national governance structure that facilitates input from provincial governments; and
- a legitimate head office located where market activity is clustered.

A "legitimate head office" houses the majority of decision-makers and staff under one roof and is responsible for enforcing one set of rules and ensuring a coherent, national approach across Canada.

The first two components are part of the proposed legislation and are in direct response to concerns expressed by some provinces, such as Alberta and Quebec. The third component, which is necessary to protect all Canadians, is notably absent. Instead, the federal government says it prefers a "virtual" headquarters with the regulator's powers and decision-makers dispersed across the country.

This is a mistake. As financial markets become more complex, the concentration of regulatory authority where market activity takes place is essential. Location in Canada's financial cluster will better position the regulator to keep abreast of market developments, to make quick and effective regulatory decisions, to be held to account for regulatory failures, and to draw on the skills and talents necessary to exercise effective oversight and provide maximum protection to consumers and investors.

The same compelling logic that led to the creation of the CSRA should now govern decisions about its location and administrative structure. If Canada wishes to maximize the significant advantages of a CSRA, a legitimate head office must be based in Toronto.

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Ensuring the Effectiveness of Securities Reform in Canada

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The federal government's announcement of new legislation to create a Canadian Securities Regulatory Authority (CSRA) follows through on a long-standing commitment to improve oversight of securities markets, provide better protection to the consumers of financial services and attract investment to Canada.

Canada's banking regulation has been praised internationally and is a significant reason why Canada avoided the financial sector meltdowns experienced by other countries. Local and international experts, such as the International Monetary Fund (IMF) and the Organization for Economic Cooperation and Development (OECD), agree that securities regulation is one area, however, where Canada lags and is vulnerable.

> *The current diversity of regulations—for example, each province has its own securities regulator—makes it difficult to maximise efficiency, and increases the risk that firms will choose to issue securities in other countries. A single regulator would eliminate the inefficiencies created by the limited enforcement authority of individual provincial agencies.*
>
> - **The Organization for Economic Co-operation and Development, 2008**
>
> *A federal regulator could coordinate more readily with other regulators in monitoring risks and responding quickly to a crisis, and could also have an enhanced focus on the issues that securities markets may pose for national financial stability.*
>
> - **International Monetary Fund, 2009**

Canada is the only industrialized country in the world without a national regulator for securities markets. This creates regulatory gaps, produces unnecessary administrative overlap, deters investment, weakens enforcement and exposes investors. Canada's patchwork of regulators is one of the country's most troublesome internal trade barriers and largest obstacles to the smooth functioning of the Canadian economic union. As aptly described by the federal Minister of Finance, our fragmented system is "an embarrassment."

Getting regulatory architecture right is a matter of national importance. The creation of the CSRA is a step in the right direction. Many key details, including the mandate of the CSRA, have been landed and are in line with internationally accepted best practice. However, the current federal proposal for a "virtual" headquarters with provincial offices largely intact is an unwelcome innovation that delivers only modest improvements over the status quo.

The title of this paper is a reference to the depiction of Australia's system of state-level securities regulation prior to 1991 as communicating that Australia was a collection of "jealous colonies" rather than one economic market (*Australian Financial Review*, 1987, p. 12).

The financial crisis that is still reverberating around the world clearly demonstrates, in financial regulation, policy must trump politics. This *Mowat Note* assesses the capacity of the "virtual" versus "legitimate" headquarters model to exercise the CSRA's mandate to protect consumers and investors and respond to the concerns of the international community. We find that in order to deliver the full benefits of a national regulator, regulatory authority and capacity should be concentrated in a legitimate head office in Toronto, where market activity is concentrated. Our data show that there is no persuasive policy rationale for a virtual model.

It appears Canada's old regional politics have given rise to a "second-best" solution.

THE CASE FOR THE CANADIAN SECURITIES REGULATOR

The case for the CSRA is well-stated and supported by several independent and credible voices. The expert consensus is that the CSRA will be better positioned to:

- Ensure a single, high standard of protection for investors across Canada;
- conduct regulatory activities more efficiently, reducing costs for investors and the Canadian consumer;
- clarify accountability;
- promote domestic and international confidence; and
- deter criminal behaviour in Canadian securities markets.

The trade in securities has emerged as a vital component in linking firms to capital and funding employment expansion across the entire country. According to 2009 data, approximately $313 billion in debt and equity capital was raised through the securities markets. In 2002, capital markets provided 88 per cent of the long-term financing of Canadian firms, compared to only 73 per cent in 1990 (Department of Finance, 2003). Every Canadian has a stake in a robust regulatory architecture.

As a recent editorial in the Calgary Herald summarized it, "a single regulator should lead to a smaller, simpler, less costly and more efficient system, making it easier and cheaper for companies to raise capital on the markets. Instead of dealing with the bureaucracy of 13 regulators, companies only have to register once" (Calgary Herald, May 23, 2010).

Some recent arguments against the CSRA have focused on the idea that a new national regulator would somehow diminish access to finance for local firms and regionally specialized sectors, such as energy and resource extraction.

However, the legislation proposes a governance structure that would facilitate input from across Canada in decision-making and the overall management of the organization. Further, the establishment of regional offices would allow "across-the-desk" contact with market participants and a mechanism to ensure that regional concerns are heard and local needs met.

But the capacity of the regulator to effectively and efficiently monitor financial markets and respond quickly to individual failures or market turmoil is also important. The legislation already accommodates regional concerns and it is now necessary to ensure that the effectiveness of the CSRA is not compromised by a failure to concentrate regulatory capacity in a manner and location where it can best perform its job. Unfortunately, the federal government's announcement of July 13, 2010 anticipates a dispersion rather than a concentration of regulatory capacity.

LOCATION, LOCATION, LOCATION?... NOT ONLY

Under the federal government's current proposal, the regulator will not have a head office at all. Instead, the regulator will operate from regional offices, with decision-makers and administrative functions dispersed across Canada. This arrangement is likely perceived federally as a compromise on a contentious issue.

Vancouver does not have its "fair share" of federal agencies (Vancouver Sun, April 14, 2010); locating the regulator in Montreal or Calgary could be a means of placating local opposition to the Canadian securities project writ large; headquartering the regulator in Calgary could also be symbolic recognition of Calgary's importance to the national economy. Others assert that an Ottawa-based regulator would be above the fray of provincial jealousies and would avoid being dominated by a single province's existing regulatory authority (Expert Panel on Securities Regulation, 2009).

Instead of adopting the right choice from a policy perspective, it appears Canada's old regional politics have given rise to a "second-best" solution.

In other federations, the core regulatory functions in the financial sector are typically the jurisdiction of the national government. In those countries where sub-nationals have traditionally played a role in regulating financial entities, this has been changing and regulatory functions have been increasingly uploaded and concentrated in a single office. Australia and Germany are recent examples. The Obama administration in the United States now recognizes the liability of its fragmented regulatory structure and is proposing to concentrate some shared federal-state regulatory oversight at the federal level (US Department of Treasury, 2010).

The logic behind uploading regulatory functions from an administrative efficiency perspective is compelling. A frequent complaint about the current Canadian securities environment is the duplication of regulatory bureaucracies across 13 jurisdictions. Consolidating regulatory activity to the extent possible generates administrative economies of scale. A 2002 study by Charles River Associates estimates a savings of 36.5 per cent over current practice if a "one head office/five regional office" model was adopted.

Note that financial regulation is operated on a cost recovery basis through fees and levies on industry participants, which are typically passed on to consumers. Maximizing administrative efficiencies saves Canadian businesses and consumers money.

However, there are other important reasons to concentrate regulatory authority: to minimize the regulatory gaps that can be exploited by unscrupulous actors; to clarify to market players "who's in charge"; to improve accountability and diminish opportunities for blame avoidance for regulatory failures; to facilitate more responsive policy development that reflects the rapidly changing global market place; and to enable faster and more coherent domestic and international responses to financial sector failures that can easily spill over market segments and borders.

BETTER POLICY AND QUICKER CRISIS RESPONSE

One of the key findings of the Wise Persons Committee appointed by the federal Minister of Finance in 2003 was that policy development in Canada's securities policy space is characterized by "compromise and delay". "Canada cannot respond as effectively or innovate as quickly as it should in the fast-changing global marketplace" (Department of Finance, 2003: 11).

The current framework is plagued by "joint-decision traps," whereby policymaking is slowed by the need to secure national consensus. A joint-decision trap occurs when multiple actors are involved in the development of a policy and each actor possesses a veto on decisions. In such cases, the result is often an inability to secure policy reform, or a new policy that achieves little substantive change. Joint-decision traps are common where decision-making is shared across governments or agencies.

At best, the results of such joint-decision traps are slow decision-making and lowest common denominator policies that are impediments to the sector's growth and competitiveness globally. A well-designed regulatory framework enables swift policy responses and regulations that allow domestic firms to keep up with international trends in the marketplace. Regulators should have "the ability to move swiftly" and "the wisdom to move slowly, when appropriate. Canada's current regulatory system can move slowly, but cannot move swiftly" (Department of Finance, 2003: 11).

At worst, joint-decision traps can delay responses to regulatory emergencies. In this respect, the global financial crisis provides an important lesson that should inform decisions around the organization of the CSRA and the distribution of decision-making. As noted by the IMF, the recent financial crisis underlines the need for better and faster responses to systemic events (IMF, 2009), which can be understood as events where individual failures can spread within and across national borders and infect otherwise healthy financial institutions.

The failure of Lehman Brothers and the bankruptcy of Icelandic banks are useful reminders that financial institution failures in one country can spill across borders and also that resolving financial institution failures requires cross-border coordination. Improving cross-border cooperation is an ongoing issue at international fora.

At present, Canada has 13 interlocutors with the international regulatory community. As noted by a key official interviewed for this study: "When the (US) SEC (Securities Exchange Commission) needs to call someone on an emergency or enforcement issue, they are confused about what number they dial. Or, they have to call the Ontario Securities Commission, who then has to call and coordinate responses from the other provincial regulators" (anonymous interview, 2010). This has been a perennial problem.

Concentrating decision-making in a single head office would rid the Canadian system of the joint-decision traps and coordination problems and would enable swifter regulatory action when needed and better, more responsive policy that keeps up with the pace of change in the global market place.

A CSRA that has a nominal or "virtual" headquarters and whose decision-making and capacity is diffused geographically is unlikely to be as effective in meeting the objectives of financial regulation. A regulator that preserves the current diffusion of decision-making authority and administrative capacity is only a modest step forward. Concentrating regulatory authority, including decision-making authority and the critical mass of administrative functions, is necessary to realize fully the potential gains from the CSRA.

PROXIMITY MATTERS! REGIONAL CLUSTERS AND REGULATORY CAPACITY

Clusters of firms in high value-added sectors are the lynch-pins of the global economy. Policy makers increasingly recognize the importance of these clusters for promoting growth and innovation. Focusing economic development policy on stimulating cluster development is among the most effective ways that governments can boost competitive advantage (Bradford and Wolfe, 2010).

Toronto is Canada's undisputed financial capital. Toronto is also an increasingly important international financial sector cluster in banking, insurance, and securities. With respect to the securities industry, Toronto is home to:

- Canada's senior equity exchange (ranked 12th in the world in terms of Market Capitalization) as well as most of Canada's equity and fixed income Alternative Trading Systems (ATSs);
- five of the top six Canadian securities dealers representing over 70 per cent of the industry's profits in 2009;

RESOLVING SYSTEMIC EVENTS: LESSONS FROM THE FINANCIAL CRISIS

The ability to call together the major players in the financial sector to a single table on short notice has emerged as an important tool in resolving systemic events. For example, the Federal Reserve in New York was able to convene "a weekend of frantic around-the-clock negotiations" between Wall Street bankers "to try to avoid a downward spiral in the markets stemming from a crisis of confidence" (New York Times, 2008). The Washington-based Securities and Exchange Commission was relegated to a secondary role in the resolution of Lehman Brothers and Bear Stearns insolvencies.

Such meetings offer the possibility of including the private sector in the resolution of failures, while reducing the exposure of the taxpayer, and, ultimately, calming panic in financial markets.

A number of securities firms are now systemically important to Canada's financial system writ large. As Table 1 demonstrates, the systemically important securities firms are clustered primarily in Toronto.

If the concentration of decision-making matters in crisis response, so too does the location of that decision-making. It is obvious from a policy perspective that distribution of regulatory authority and capacity should be focused where the major market players are based.

- 129 securities firms and 167 inter-listed issuers, representing 64 per cent of total domestic market capitalization;
- self-regulatory agencies such as the Investment Industry Regulatory Organization of Canada and the Mutual Fund Dealers Association of Canada; and
- national industry associations, such as the Investment Industry Association of Canada, the Canadian Bankers Association, the Investment Funds Institute of Canada, Advocis, the Canadian Foundation for Investors Rights, the Canadian Institute for Chartered Accountants, and the Canadian Institute of Financial Planners.

The world is undoubtedly becoming smaller. Advances in telecommunications and information technology mean that information can span continents and oceans in an instant. While some of the old logic behind location has dissipated, clusters are still a prominent feature of the global economy for a number of reasons—access to information and talent being among the most important.

Firms cluster in order to better tap information about the latest products and production techniques in locally embedded social networks and to keep an eye on innovation among their rivals.

> *Geographic, cultural, and institutional proximity provides companies with special access, closer relationships, better information, powerful incentives, and other advantages that are difficult to tap from a distance. The more complex, knowledge-based, and dynamic the world economy becomes, the more this is true.*
>
> - **Michael E. Porter, 1998**

The location of regulatory agencies among financial market players similarly enhances the capacity of regulators to penetrate local networks of financial professionals and stay abreast of innovation in financial products and to exchange information with market players about risk. This is important. As noted by the IMF: "appropriate coverage and quality of information is critical to... the capacity to assess risks and vulnerabilities" (IMF, 2009).

The rapid pace of innovation in financial markets and the increased complexity of financial products are frequently cited as contributing factors to the global financial crisis (see, for example, IMF, 2009). Financial products such as derivatives have become so complex that consumers and regulators are often unable to accurately assess their risk. The trade in these products has been marked by deep information asymmetries between regulators and the regulated, which has enabled some unscrupulous players to evade oversight and dupe consumers.

A virtual headquarters model with decision-making and staff dispersed among regional offices would only compound the challenge of overcoming these information asymmetries. Concentrating decision-making and administrative functions in Toronto would improve the regulator's ability to stay abreast, if not ahead, of emerging trends and market innovations and better enable it to achieve its core mandate—the provision of better and more consistent protection for investors across Canada.

BANK REGULATION IN CANADA

Approximately 50 per cent of the staff of the Canadian bank regulator is now based in Toronto, even though its headquarters is in Ottawa. The location of the Office of the Superintendent of Financial Institutions (OSFI) is a legacy of decisions made in the 1800s (OSFI, 2008). If the location was to be decided today, there would a strong case to locate its head office in Toronto, given the unnecessary administrative costs associated with running two offices of approximately the same size in separate cities, the gradual consolidation of the industry in Toronto, and the regulatory advantages that proximity confers.

Note that the proximity of OSFI's Toronto-based staff to the Toronto-based banks is cited as a contributing factor in Canada's financial sector stability. As noted by the Economist, "keeping tabs on the banks is much easier when all ... are based within a few hundred yards of each other and of regulators in Toronto" (Economist, May 6 2010).

PROXIMITY MATTERS! ACCESS TO TALENT

Firms also cluster to take advantage of local talent pools. Firms are drawn to the local concentration of skill sets and the ability to draw people from other sector players in order **(continued on page 7)**

TABLE 1: TORONTO AND OTHER CANADIAN CITIES COMPARED (CANADIAN RANK IN PARENTHESES)

CITY	RANKING, INTERNATIONAL FINANCIAL HUB[1]	HQs FOREIGN BANKS[2]	EMPLOYMENT SECURITIES SECTOR[3]	EMPLOYMENT FINANCIAL SECTOR[4]	FINANCIAL ESTABLISHMENTS[5]	FINANCIAL ESTABLISHMENTS 550+ STAFF[6]	FUNDS AND OTHER FINANCIAL VEHICLES - ESTABLISHMENTS[7]	STAFFING OSFI	INTERNATIONAL RANK LOCAL STOCK EXCHANGE (MCAP)[8]
Calgary	Not ranked	1 (4)	8,500 (4)	29,900 (4)	4,818 (4)	6 (2)	102 (3)	0 (5)	N/A
Montreal	32 (3)	4 (2)	14,200 (2)	95,600 (2)	10,770 (2)	6 (2)	114 (2)	10 (3)	N/A
Vancouver	23 (2)	3 (3)	13,800 (3)	59,400 (3)	8,854 (3)	5 (4)	91 (4)	18 (4)	N/A
Ottawa	Not ranked	1 (4)	3,300 (5)	23,400 (5)	2,329 (5)	0 (5)	37 (5)	400 (1)	N/A
Toronto	**12 (1)**	**45 (1)**	**44,800 (1)**	**232,200 (1)**	**23,313 (1)**	**36 (1)**	**508 (1)**	**375 (2)**	**(8)**

1. City of London, Global Financial Centres, 7.
2. Figures include both schedule 2 and schedule 3 foreign bank headquarters.
3. Source: Statistics Canada 2009 Labour Force Survey.
4. Ibid.
5. Securities, Commodity Contracts, and Other Financial Institutions - number of establishments, number of establishments with over 550 employees, and number of Funds and Other Financial Vehicles establishments from Statistics Canada annual estimates of employment, earnings and hours based on the North American Industrial Classification System NACIS December, 2008. Ibid.
6. Ibid.
7. Ibid.
8. http://www.world-exchanges.org/statistics/ytd-monthly

to learn their competitors' methods and practices. "Companies in vibrant clusters can tap into an existing pool of specialized and experienced employees, thereby lowering their search and transaction costs in recruiting" (Porter, 1998).

Like firms, regulators need to attract top talent and tap sector expertise. In order to effectively monitor market players and assess risk, they also need to draw on the same skill sets as the entities they regulate. International agencies warn of the consequences when regulatory agencies are unable to keep up to regulated entities in talent and know-how (see, for example, IMF, 2009).

Fortunately, Canada has an existing large talent pool in securities markets for a CSRA to draw from. Toronto has the second largest securities cluster in North America after New York (Institute for Competitiveness and Prosperity, 2007). Further, as Table 1 demonstrates, there are more people employed in the securities industry in Toronto than in Canada's next five largest cities combined—Montreal, Vancouver, Calgary, Ottawa and Winnipeg.

Cluster development is an important direction in economic policy writ large. It should also inform regulatory design. Presumably, the "logic of clusters" motivated the decisions to locate the National Energy Board in Calgary, where approximately 80 per cent of Canada's oil firms are based, and the Canadian Grain Commission in Western Canada, where almost 90 per cent of Canada's grain is grown. A similar policy rationale should drive decision-making on the location of the CSRA.

The international trade in financial services has clustered in a small number of global financial centres. Toronto is the only Canadian city that can realistically aspire to be among them.

ALIGNING REGULATORY AND ECONOMIC DEVELOPMENT POLICY

In its March 2010 Speech from the Throne, the federal government identified financial services as a key sector for the economy. The Speech noted that: "Canada's strategy for economic success must leverage our considerable strengths, in particular our world-leading financial industry". The government also committed to "build upon this advantage to make Canada an even stronger world financial centre" (Government of Canada, 2010).

The decision on where to locate the regulator is strategically important from a sector development perspective. Regulators generate positive spin-offs for the economy and the sector. They employ highly qualified individuals. They also procure high value products and professional services. Further, the presence of a regulator's head office can influence the location decisions of new market players.

The value of the location of government/regulatory authorities is recognized in the Global Financial Centres Index, which includes the presence of government and regulatory bodies when it calculates the international ranking.

Increasingly, governments around the world see the value in focusing their economic development investments on regional specialization and the support of strong clusters; increasingly they understand that spreading sector support geographically for the purposes of equalization is ineffective and thwarts the emergence of internationally competitive clusters—a key to wealth creation in the 21st century. There is enormous virtue in investing in sectors in areas that demonstrate the greatest concentration of capacity and capability (Bradford and Wolfe, 2010).

As the Ontario economy undergoes transition, it makes sense to invest in those sectors that are emerging to take the place of those that are in decline. Independent organizations such as the OECD have touted securities and financial services generally as a high potential sector for southern Ontario and one in which Ontario is emerging as a global leader (OECD, 2009).

The international trade in financial services has clustered in a small number of global financial centres. Toronto is the only Canadian city that can realistically aspire to be among them. In the 2010 Global Financial Centre Index, Toronto ranked 12th internationally and among the "Global Leaders" in financial services, ahead of Frankfurt, Paris, Boston, and Beijing (City of London, 2010). In order to qualify, a city has to have both broad and deep financial services activities and be connected with many other financial centres.

> *Toronto is the 3rd North American Financial centre and the clear leader in Canada.... New York, Chicago and Toronto all fit the profile of Global Leaders—they are well diversified, connected and have strength across the sectors.*
> - **City of London, 2010: 15**

Enhancing Toronto's status as a legitimate global financial centre serves all of Canada. It increases the prospect of Canada capturing a larger share of the global trade in financial services. Further, it facilitates the ability to project Canadian leadership in global finance and regulation.

The international bank tax proposed recently by some European governments demonstrates that regulatory decisions taken outside the country can have a real impact on Canadian businesses and consumers. It is in all Canadians' interest to ensure Canada maximizes its international clout on regulatory matters.

Much as the energy patch is crucial to the success of the Alberta economy, the financial services sector has emerged as crucial to the Ontario economy. The federal government acknowledged the strategic value of maintaining and enhancing Canada's position as a global financial centre. It should ensure that all of its policies are aligned accordingly.

BALANCING REGIONAL VOICES WITH REGULATORY IMPERATIVES

Canadians from all regions are ill-served by Canada's current fragmented regulatory environment. Experts have long been concerned about the gaps in investor protection, the costs imposed by administrative duplication across 13 jurisdictions and the confusion caused by 13 sets of rules. The CSRA represents an historic opportunity to improve our investment and regulatory climate.

The opposition to locating a CSRA in Toronto has coalesced around an important point—the risk of a single regulator being dominated by the existing Ontario Securities Commission and, consequently, Toronto-based interests overwhelming other regional interests.

This concern is ill-founded, given that the CSRA's proposed governance structure has been explicitly designed to respond to such concerns. The establishment of regional offices, along with a representative governance structure, will ensure that the CSRA will be safeguarded from domination by one participating jurisdiction. As noted by the Government of Canada, "the regional offices would give the CSRA the capacity to meet local, regional, and national priorities" (Department of Finance, 2010).

The federal government has undertaken substantive responses to legitimate regional concerns and interests. The capacity of the regulator to effectively monitor financial markets and respond quickly when necessary is also a paramount concern—and that means the establishment of a head office in Toronto. The legislation for a national securities agency is due for debate in Parliament after the Supreme Court of Canada rules on its constitutionality next year. Canada should use this time to reconsider its model and get the regulatory structure correct. Canada's old-style politics of equalization and regionalism should not be allowed to trump good public policy.

A regulator that is far removed from the entities it regulates, or a regulator with a virtual headquarters where decision-making is diffuse and spread across the country, will not resolve many of the long-standing problems in Canadian securities regulation. Someone has to be able to make decisions, and that person has to be located where the systemically important players are.

The creation of the CSRA is a step in the right direction. The same logic that compelled the introduction of this controversial legislation ought to drive decisions relating to its organizational structure, including its headquarters. The success of the project for all Canadian investors and consumers depends not only on the existence of the CSRA, but also its design. MC

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Josh also brings policy and management experience from the public sector, having served in various positions with the Government of Ontario in Intergovernmental Affairs, Cabinet Office and the Ministry of Finance.

Prior to beginning his Ph.D., he lived in Central Europe and worked for Bank Austria in its financial markets research division.

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The Mowat Centre for Policy Innovation is an independent, non-partisan public policy research centre located at the School of Public Policy and Governance at the University of Toronto.

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