

**Notes for a speech by Monique Jérôme-Forget**

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**The Passport Securities System**

**The Investment Funds Institute of Canada**

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**I am particularly happy to be here today to speak about the passport system related to the Canadian securities industry. Even more so, since I**

have recently sent a letter on the subject to be published in the Globe and Mail - without success unfortunately...

But before I address the subject of the passport system, I would like to briefly review the economic and fiscal situation in Quebec and the turnaround my government has operated since 2003.

### **Sound Public Finances Promote Economic Growth**

**Our Government has taken very seriously the promotion of economic growth based on healthy public finances since we took office in 2003.**

**We have undertaken a number of initiatives since 2003 to encourage job creation and stimulate wealth creation.**

- **We have tightly controlled government expenditure. The annual rate of expenditure growth for government programs between 2003 and 2007 has remained on average at 4.2% in Québec compared to an average of 7.4% for the other provinces (7.9% in Ontario and 9.9% in Alberta). Besides British Columbia, it was the lowest average for government spending in all of Canada.**
- **We have reduced income taxes for individuals. Québec no longer ranks as the province that imposes the heaviest tax burden on its citizens. Five other provinces have a heavier tax burden than Quebec.**
- **We have relieved the tax burden on businesses. The tax on capital will be gradually eliminated by the end 2010.**
- **We have re-launched major works in the hydroelectric sector. We have introduced a new energy policy that puts emphasis on the export of electricity.**
- **We have considerably increased our investment in public infrastructure.**
- **We have restored fiscal health. Recognizing the intrinsic value of our hydro resources, we created the “Generations Fund” which is our “Heritage Fund”. The sole purpose of the “Generations Fund” is to collect hydroelectric royalties and pay down the accumulated public debt in accordance with specific milestones established by law. By 2026, the Fund will have raised \$42 billion, all of which will be devoted to paying down the debt. Our debt level will be reduced to 25 % of GDP by then.**

**The Government's actions have produced results:**

- **The unemployment rate has dropped from 9.3 % to 7 %, its lowest level in 33 years;**
- **The employment rate has reached an historical peak of 61.1 %. Never before have there been so many Quebecers at work;**
- **There are 57,000 fewer people on the welfare rolls;**
- **We received a strong vote of confidence from international rating agencies which have raised Québec's credit ratings to its highest level in more than 30 years.**

**We are proud of these results. And we intend to stay the course.**

**Passport System versus a Single securities Regulator**

**Now, I will talk about the main topic of my speech, the passport system.**

**Several proposals have been made in recent years to overhaul the Canadian securities regulation system. They embody either one of two competing views of a preferable securities regime.**

**The first model is a single regulator, promoted by Ontario and the federal Finance minister Jim Flaherty. The second model is the "passport" or "principal regulator" system that makes best use of the existing provincial regulatory institutions as the cornerstone of a harmonized pan-Canadian regulatory system.**

**All the provinces and territories have already accomplished giant strides to improve the effectiveness of the regulatory system in Canada.**

**Thanks to information technologies and an adapted regulatory framework, systems and practices of a truly pan-Canadian nature have been implemented. This already eliminates many functions previously performed on a local basis by individual securities commissions.**

**As a result, we today possess:**

- **SEDAR, an electronic system for filing documents;**
- **SEDI, a system for electronic disclosure by insiders;**
- **NRS, the National Registration System;**

- **NRD, the National Registration Database;**
- **MRRS, the Mutual Reliance Review System;**
- **The adoption and implementation of 25 national general instructions and 24 national policies regarding key aspects, such as prospectus requirements, regulation of mutual funds, rights issues, regulation of buy offers, registration and prospectus exemptions, requirements relating to continuous disclosures, and so on.**

**But, as we must do better, all the jurisdictions, except Ontario, have agreed to put in place the passport system. We have committed ourselves to implement Phase II of the passport system before the end of 2008. This pan-Canadian « passport » system will give each issuer, dealer and registered participant a single-window access to the Canadian market. The reform, with its imminent implementation, is no trivial matter.**

- **The passport system will give issuers access to the capital market across Canada while dealing solely with the securities regulator of their home jurisdiction and by complying with the rules of this authority which are highly harmonized in all jurisdictions.**
- **Similarly, dealers or representatives who wish to do business anywhere in Canada need only register with their home jurisdiction.**

**It is obvious to practitioners and observers that the passport system initiative is causing a profound transformation of our securities regulation system.**

**The passport system builds on what already works. It will eliminate the remaining duplication of administrative tasks just as effectively as a single regulator. It will do it faster, at a lower cost, and all without the kind of constitutional disputes that nobody wants because of the challenge to the provinces' jurisdiction over securities commissions.**

**To show our good faith, even though Ontario has not joined the passport system, an issuer registered with the Ontario Securities Commission will be recognized by the commissions of all other provinces. For the good of Canada, should'nt Ontario do the same?**

**A majority of the market participants that the Crawford Panel consulted mentioned that Ontario should join the passport system. This simple action would deliver additional economies to issuers across Canada in a very short time without closing the door to further improvements. One would hope that the Minister of Finance of Canada would use his influence to**

encourage Ontario to listen to this sound advice. It is unfortunate that Ottawa's energy is not geared to support a process which is already yielding considerable benefits to Canadians and our economy.

I agree completely with the Premier of Alberta, Mr. Ed Stelmach, who mentioned in a Speech last week in front of the Empire Club here in Toronto that:

« I want to make my position very clear. The passport system is a model provinces can quickly implement to create a national system – so let's accept the passport and move on to other matters. »

One of the prime objectives of regulating the securities industry is to ensure that investors are protected. It is telling that the proposals to replace the present system are not supported by rigorous comparative analysis of the performance of the Canadian system and that of other jurisdictions. As nothing is perfect in this world, an imaginary perfect system as a standard of comparison is not useful. The issue is where we rank on a world scale.

In fact, it appears that Canada does extremely well by such comparisons.

- In 2006, a study by the World Bank and Lex Mundi ranked Canada 3rd in the world for investor protection. The United States ranked 7th, and the United Kingdom 9th.
- In its 2006 report, the OECD ranked Canada 2nd for securities regulation quality, ahead of the United States (4th), the United Kingdom (5th), and Australia (7th).

With these results, it's surprising that the federal government continues to denigrate the Canadian regulatory system from both inside and outside our country. That's what I call shooting yourself in the foot.

Three myths about the competitiveness of the Canadian market

I want to reply today to three myths amongst others about the competitiveness of the Canadian securities market that are being trotted out by the promoters of a single securities commission.

These three myths are as follows:

- Our regulatory system is more cumbersome and costly;

- Our regulatory system comes with higher financing costs for businesses;
- A single commission would reduce the costs of transactions on the secondary market.

I will respond to each of these myths.

**First myth: higher cost of our regulatory system**

**In a recent speech, the federal Minister of Finance stated:**

**« The benefits of moving to a Common Securities Regulator will save money and give all regions a real say...A Common Securities Regulator would better serve our common interest by having a structure that would allow all regions of the country to participate in market regulation in a more meaningful and constructive way. By having a structure that would ensure broad and equal participation by all provinces and territories (13 commissions), with a strong on-the-ground presence in all regions with local expertise that would respond to regional needs. »**

**But what are the facts ? In 2002, the direct costs of regulation per million dollars of capitalization were \$145.80 in Canada compared to \$141.90 just for the *federal* regulatory bodies in the United States. Add to that the costs of regulatory bodies in each state, and the situation is strongly in Canada's favour. It is inaccurate to believe that in the US one deals with only one securities regulator; in effect there are state regulators in addition to the SEC.**

**How can one seriously suggest that a structure supported by a strong organization in each province, in addition to a head office in Toronto or Ottawa responsible for directing and coordinating 13 regional offices, will result in a cost structure that is less onerous than the existing decentralized system?**

**Second myth: higher financing costs in Canada**

**The main factors determining the costs of financing are of three kinds. First, remuneration of dealers; second, costs associated with legal services, fees, and prospectus preparation; and third, initial undervaluation of share price.**

**The results of empirical studies speak volumes. Findings reveal that the average total direct cost of a Canadian small-cap share issue (1 to 10 million US dollars) is less (15.98 %) than an American one (17.99 %). The direct cost for larger-cap issues (over 100 million US dollars) is similar in both countries.**

Once again, the facts contradict the promoters of a single securities commission.

**Third myth: a single commission would reduce the cost of transactions on the secondary market**

**The liquidity of the secondary market for corporate shares is a determining factor in the cost of capital stock. This aspect is extremely important because investment decisions are affected by the cost of capital.**

**The empirical data portrays a worrisome picture for anyone interested in the competitiveness of the Canadian capital market. For example, a recent study compared transaction costs for shares of a company listed on the TSX and an American stock exchange. The results indicate that transaction costs in Canada were 52.4 basis points, compared to 38.1 in the United States.**

**However, this disadvantageous situation for the Canadian market does not arise from the present regulatory system. The odds are that a centralized agency would instead tend to exacerbate the problem as a result of a more cumbersome bureaucracy.**

**The real problem is the low level of competitiveness in the Canadian market. We must consider that the big Canadian banks alone control the bulk of the securities industry in Canada.**

**Moreover, it's interesting to note that it took the threat of competitive alternative markets in Canada (Pure Trading, Instinet, and Alpha) for the TSX to announce a reduction of its fees and the development of Quantum, a faster transaction system. Here as elsewhere, the answer to many inadequacies of the Canadian capital market is not found in upheavals of the securities regulating system architecture, but rather in greater competition within the industry.**

**I can already hear some people retort, «yes, but a single securities commission would be so much more rational, more coherent, like in the United States. » I can't say whether this is ignorance or bad faith. However, the reality is this:**

- **In the United States, contrary to a widely-accepted myth, the states have their own securities regulating agency. The American system is a lot more decentralized than it appears.**

- On several occasions, state authorities reacted more quickly and more effectively than the central agency, the Securities and Exchange Commission (SEC)—for example to correct abuses by financial analysts or to put a halt to questionable practices by mutual funds. One of the big scandals of the 1980s, the fraudulent schemes of the managers of Prudential-Bache, was brought to light as a result of the tenacity of securities commissions in some American states, and there are more examples.
  
- The SEC didn't save Americans and other investors from the disasters of Enron, Global Crossing, Tyco, and more recently, the « subprime » crisis.

In fact, a detailed comparison of Canadian and American securities regulating systems reflects this paradox: the present Canadian system, even without any federal or national commission, is as uniform and harmonized as the American system.

A single, lone Canadian securities commission is not the panacea it is touted to be, and is not what we need.

#### **Elements of an Action Plan**

To increase the efficiency of our regulatory system, I propose a two-point action plan:

- The rapid implementation of Phase II of the pan-Canadian “passport” system;
  
- The strengthening of the means for punishing violations of the laws governing securities, in other words, enforcement.

Phase II of the passport system will be completed in 2008. I will present various harmonization measures to the Quebec National Assembly over the coming months as will do other provinces. Meanwhile, I hope Ontario will see reason and, in everyone's interest, join the system.

The second point in this action plan, namely strengthening the means of enforcement, is very important. Many practitioners and observers believe that the regulatory bodies in Canada have fallen short in this area. They are correct. However bear in mind that it is not the proper role of regulatory bodies to lead criminal prosecutions.



As Doug Hyndman, Chair of the British Columbia Securities Commission said:

« Canadians do not feel that the authorities treat investment fraud as seriously as other crimes. They think that people who defraud others “generally get away with it”. Unfortunately, they’re right. Canada will have to work hard to fix this problem. Our focus should be on changing the dynamics in the criminal justice system, not on blaming provincial regulation. »

The fact of the matter is that, in Canada, the federal Parliament has exclusive jurisdiction to bring securities crime under the ambit of the Criminal Code. It is instructive that the Criminal Code was amended in 2005 to make insider trading and tipping a criminal offence.

These amendments got Canada to where the rest of the world was; indeed in the rest of the world insider trading has long been considered a crime. Questions have been raised, notably by Michael Watson, Director of Enforcement of the Ontario Securities Commission, whether the standard of evidence required is too stringent to make these new provisions effective.

I note with satisfaction that tangible efforts have recently been made in the enforcement field. At the end of 2003, Integrated Market Enforcement Teams (IMETs) were created in Toronto, Vancouver and Montréal. Unlike the measure that has won favour in the United States and the United Kingdom, the creation of an entity such as this was late in coming. Its funding seems to be limited and its operations would appear to be still in the starting-up period. I recently met with Mr. Joseph Borg, the President of the North American Securities Administrators Association, who was unequivocal in his insistence that full sharing of information within joint task forces that include the police, forensic experts, regulators and prosecutors was critical to success.

In October 2006, all the provincial and federal Ministers of Justice created a working group whose mandate is to recommend measures to strengthen the prosecution of securities fraud. Their report is expected in November and should hopefully bring useful recommendations.

I welcome the recent decision to appoint a senior expert adviser to the RCMP to help improve the effectiveness of the IMET.

However, we cannot overlook the fact that the Canadian government created these teams long after the UK created the serious fraud office in 1987. In the U.S. the Corporate Fraud Task Force was created in 2002 as

a dedicated unit to detect fraud under the direction of the US Department of Justice representatives.

While I refer to the U.S., let us not forget the significant institutional and cultural differences between our two countries. For example, the litigiousness of the U.S., that we may not want to imitate, and the fact that public prosecutors are elected may explain the dedication with which suspected fraud is prosecuted. The prosecution of Martha Stewart and the successful elevation of the then prosecutor Mr Spitzer to the New York State Governor's Mansion may not be unrelated.

At the Canadian level, I proposed to my ministerial colleagues that we examine the possibility of establishing an independent securities tribunal system. That tribunal system would be interprovincial. It's a matter of separating the supervisory function from the quasi-judiciary function of the securities commissions.

The goal of such an undertaking is to strengthen the quasi-judiciary function by establishing a uniform interpretation of common rules in Canada.

In summary, it is time we face what for some may be unwelcome news. Unless Ontario, the Federal Government and all the other Provinces and Territories discuss the issues concerning the architecture and functioning of our capital market free of cloying clichés and political prejudice, we will find it difficult to manage the changing nature of the Canadian and global capital markets to our mutual benefit. I will therefore conclude by drawing to your attention the following five important points:

- First, the structure of the Canadian financial sector has a profound influence on the workings and competitiveness of our capital markets. Its evolution towards a very concentrated industry has few parallels in industrialized countries. The implications for the efficiency and competitiveness of the Canadian capital markets are enormous and need to be given proper weight in the formulation of policies;
- Second, the empirical evidence demonstrates that Canada ranks amongst the best with respect to the quality of its securities regulations and protection of investors. Canada is ill served by official sweeping statements to the effect that Canadian securities regulations are so deficient that nothing less than a profound structural reform is needed. A more positive assessment is clearly warranted;
- Third, the Canadian regulatory machinery has adapted to the evolution of the structure of the industry. As a result of the very high concentration in certain segments such as exchanges, clearing houses,

etc., it has become, de facto, national in scope, as and when warranted. Moreover, Canadian Securities Commissions have adopted mechanisms which, in effect, will limit to a single window the interface between, on the one hand, the securities commissions and, investors, issuers and the securities industry, on the other hand;

- Fourth, as a result of these initiatives, the degree of harmonization of securities laws in Canada that will exist at the end of the year together with the national instruments and policies already implemented will be so extensive as to create, in practice, a truly national system. The fact is that securities regulations in Canada are as uniform as in the United States despite the fact that the Provinces have maintained their jurisdiction. This remarkable example of inter-provincial cooperation to create the conditions that foster an efficient Canadian capital market has been proven to work as shown by international comparisons and empirical studies;
  - Let's be clear: the passport system builds on what already works. It will eliminate the remaining duplication of administrative tasks just as effectively as a single regulator. It will do it faster, at a lower cost, and all without the kind of constitutional dispute we can all do away with;
- Fifth, in our view, most of the critics about the current system point to the lack of enforcement activities in Canada. In this area, the federal government has an important role to play.

That we need to be relentless in pursuing continuous improvements is in the nature of things and a responsibility we must all shoulder. To this effect, I have proposed the establishment in Canada of an independent securities tribunal system following the adoption of harmonized securities laws and implementation of phase two of the passport system by all provinces. It's a matter of separating the supervisory function from the quasi-judiciary function of the securities commissions. We sincerely hope the Canadian Government will actively support this constructive proposal.

## Conclusion

In conclusion, I call on federal Minister of Finance Jim Flaherty, whom I deeply respect. I want to say publicly that we fully support his effort to establish free trade in securities with the United States and other G7 and international partners that share high standards of investor protection. It is important to remember that free trade in securities is based on mutual

recognition just like the passport system. Free trade demonstrates that the passport system works.

But I ask my colleague Gerry Phillips to work with us in improving the Canadian regulatory system. His input is essential in having Ontario subscribe to the passport system. The entire country would benefit. It may be noted that the passport system has been adopted by Europe.

Next, I urge everybody ask Mr. Flaherty to support my proposal for an independent securities tribunal system. My colleagues agreed to examine the potential benefits of such a tribunal system.

Our investor protection goal demands we work closely together.

Let us not be afflicted by our all too frequent bronze medal syndrome. While the OECD and the World Bank rate Canada ahead of the US and the UK in terms of investors' protection, let us not undermine our present achievements. Let us, instead, build them up from what we already have. I am neither ashamed nor embarrassed by our securities regulations track record. On the contrary, I am proud of it and intend to promote and improve it.

Thank you for listening.