



## A Path Towards a Modern SRO

Over the past several years, the financial services sector in Canada has been reshaped in response to a dynamic and rapidly evolving external environment. New technologies, business models and players have driven transformation and innovation in the marketplace like never before. Simply put, the world around us has changed.

This new world requires fresh perspectives and constructive inputs on the best way forward for the regulatory framework of Canada's investment sector. There is broad agreement that the current multi-regulatory model is unnecessarily burdensome, costly, inefficient and susceptible to risk. While it remains unclear exactly what form future change might take, there is no doubt that a rethink of the existing structure is due. The recently announced SRO framework review by the CSA recognizes that such a review is in order.

This process demands a critical reconsideration of the role that SROs will play in whatever structure might emerge from this review. Stakeholders recognize the need for this reconsideration and that the solution is broader than a simple, status quo merger.

The Mutual Fund Dealers Association of Canada ("MFDA") is pleased to offer the following report: "A Proposal for a Modern SRO" for consideration. When we refer to a "modern SRO," we mean one which is suited to the changes of the past decade, which improves on the existing model and which is adaptable to the dynamic nature of securities regulation in Canada. We believe that a renewed SRO model provides an opportunity to improve the current system and ensure that Canada's investment sector is nimble, secure and competitive in the 21st century.

The model we have arrived at, which we have dubbed "NewCo," has its grounding in several key principles. Firstly, we believe a successful model is one which addresses concerns about the current SRO framework while maintaining the historically successful and beneficial attributes of SROs. Second, an effective, modern SRO is founded on the principle that "like conduct should be subject to like regulation." Third, NewCo achieves regulatory burden reduction without compromising investor protection. The final and paramount principle guiding the way forward is that the model is truly investor-focused and beneficial to all Canadians.

Guided by these principles, as well as a tacit understanding that any modern SRO framework must be adaptable to evolving changes in provincial and territorial securities legislation including the Capital Markets Regulatory Authority initiative, the NewCo model has been designed with four essential benefits in mind.

**(continued on reverse)**



## **1. Real change in the public interest**

By designing a new SRO from the ground up, rather than simply patching together existing structures, there is an opportunity to pursue meaningful change which will create real and lasting benefit for Canadians.

Of course, action “in the public interest,” means different things to many different stakeholders — the job of any regulatory body is to balance these different interests. This is what NewCo is designed to do, through an investor-centric approach which ensures that Canadians who engage with similar products and services will have similar protections, regardless of their dealer’s registration category.

## **2. A scalable, flexible and forward-looking model**

Given the practical reality of impending change in Canada’s securities regulation, the NewCo model is designed with the current and future needs of Canadian capital markets in mind. The model is also scalable, with mandate, membership and regulation activities open to modification by CSA statutory regulators as they see fit.

## **3. An empowered CSA and a renewed SRO**

The NewCo model would provide the CSA with greater SRO oversight capacity, registrant and market conduct visibility and regulatory expertise. This arrangement will bolster public confidence in a renewed SRO and foster a stronger relationship between NewCo and the CSA.

## **4. Collaborative, rather than competitive reform**

In order to overcome certain obstacles which have historically stood in the way of effective and comprehensive reform of Canada’s securities regulation, the MFDA has approached the design of NewCo as a highly collaborative process. Under the proposal outlined here, if implemented, the MFDA would no longer exist as a separate SRO, allowing for the establishment of an “ideal” SRO, based on meaningful cooperation with CSA members, SROs, industry and public stakeholders.

## **A long-term solution for Canada**

Canada’s securities regulatory evolution has often been characterized by an ad hoc approach that has been reactive to situational developments, without the benefit of thorough policy analysis. We need to do better for Canada.

The MFDA special report represents a considered, balanced approach that has been prepared with this larger public interest objective in mind. Acting on behalf of all Canadians, we need to pursue the overarching goal of “getting it right”. As public interest regulators charged with navigating the future of Canadian securities regulation, we cannot compromise for the sake of expediency. There is simply too much to be gained from a successful outcome to risk missing such a significant opportunity.



**Mutual Fund Dealers Association of Canada**  
Association canadienne des courtiers de fonds mutuels

# A Proposal for a Modern SRO

## **SPECIAL REPORT**

### **on Securities Industry Self-Regulation**

**The SRO model proposed in this Paper represents a  
Modern CSA/Securities Industry Regulatory Partnership.**

February 2020

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Acronyms are used throughout this Paper and for ease of reference are set out below:

<b>AMF</b>	Autorité des marchés financiers
<b>ASIC</b>	Australian Securities and Investments Commission
<b>ASX</b>	Australian Securities Exchange
<b>ATS</b>	Alternative Trading System
<b>CCIR</b>	Canadian Council of Insurance Regulators
<b>CIPF</b>	Canadian Investor Protection Fund
<b>CMRA</b>	Capital Markets Regulatory Authority
<b>CPAB</b>	Canadian Public Accountability Board
<b>CSA</b>	Canadian Securities Administrators
<b>CSF</b>	Chambre de la sécurité financière
<b>EMD</b>	Exempt Market Dealer
<b>FINRA</b>	Financial Industry Regulatory Authority
<b>FISF</b>	Fonds d'indemnisation des services financiers
<b>FSA</b>	U.K. Financial Services Authority
<b>FSAP</b>	Financial Sector Assessment Program (IMF)
<b>FSIO</b>	FINRA and Securities Industry Oversight
<b>ID</b>	Investment Dealer
<b>IDA</b>	Investment Dealers Association of Canada
<b>IFIC</b>	Investment Funds Institute of Canada
<b>IIAC</b>	Investment Industry Association of Canada
<b>IIROC</b>	Investment Industry Regulatory Organization of Canada
<b>IMF</b>	International Monetary Fund
<b>IOSCO</b>	International Organization of Securities Commissions
<b>MFD</b>	Mutual Fund Dealer
<b>MFDA IPC</b>	MFDA Investor Protection Corporation
<b>NASD</b>	National Association of Securities Dealers
<b>NYSE</b>	New York Stock Exchange
<b>OSFI</b>	Office of the Superintendent of Financial Institutions
<b>PCAOB</b>	Public Company Accounting Oversight Board
<b>PM</b>	Portfolio Manager
<b>RS</b>	Market Regulation Services Inc.
<b>RSP</b>	Regulation Services Provider
<b>SEC</b>	U.S. Securities and Exchange Commission
<b>SPD</b>	Scholarship Plan Dealer
<b>SRO</b>	Self-Regulatory Organization
<b>UMIR</b>	Universal Market Integrity Rules

# Part I

## Introduction & Purpose

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The Mutual Fund Dealers Association of Canada (MFDA), like all securities regulators in Canada, is facing a dynamic future. It must be prepared to plan and adapt with its statutory oversight regulators (“CSA” or “CSA statutory regulators”) to ensure that its contribution as a regulator continues to serve the objectives of investor protection, efficient capital markets and the public interest.

In response to this dynamic environment, the MFDA has conducted extensive analysis with respect to MFDA operations and the future role of the MFDA and SROs in Canada. In October 2016, the MFDA prepared for relevant stakeholders a discussion paper: “Responsible Regulation in a Dynamic Environment. The MFDA as a Self-Regulatory Organization” (the “2016 discussion paper”). The 2016 discussion paper did not propose or describe any specific regulatory design or model for Canadian securities regulatory structures going forward. Rather, it identified several possible models together with considerations applicable to each model.

The 2016 discussion paper concluded that the appropriate time to deal with the role of SROs in Canada was after the overall statutory regulatory structure of securities regulation in Canada was settled and implemented. As long as the national securities regulator initiative, the Capital Markets Regulatory Authority (CMRA), was still in development, with the stated prospect that the role of SROs would be reviewed after such regulator was operational, it would be premature, unproductive and confusing to consider the SRO issue. Today, while the CMRA initiative has had some modest progress, it has taken much longer than predicted. While certainty regarding the CMRA initiative would be desirable before any SRO model changes are implemented, the MFDA is of the view that the time for planning and action has arrived. This view is consistent with the recently announced review by the CSA of the framework for self-regulatory organizations in Canada (the “CSA SRO Review”). Noting the significant evolution of the industry since the development of the current SRO regime in Canada, the CSA is re-examining the policy reasons for the current regulatory framework as well as its benefits, strengths and challenges, with the goal of publishing a consultation paper in mid-2020.<sup>1</sup>

In MFDA's recent strategic planning stakeholder outreach, several stakeholders, including members of the CSA, noted the evolving regulatory structure in Canada with specific reference to both the CMRA initiative and role of SROs. It was suggested that it would be helpful if the MFDA updated and supplemented the 2016 discussion paper with additional thought and analysis regarding the future role of SROs in Canada as well as MFDA's views as to a specific model for an SRO design that could best meet Canada's future needs. Accordingly, the MFDA has prepared this discussion paper: **“A Proposal for a Modern SRO. Special Report on Securities Industry Self-Regulation”**. This Paper (i) updates and incorporates relevant sections of the 2016 discussion paper; (ii) provides analysis and commentary relevant to the SRO experience in Canada, and (iii) proposes a new Canadian business conduct and prudential securities regulator - referred to as “NewCo” - which is a new kind of SRO.

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<sup>1</sup> CSA, Canadian Securities Regulators Announce Review of Framework For Self-Regulatory Organizations, December 12, 2019, online: <<https://www.securities-administrators.ca/aboutcsa.aspx?id=1853>>.



Most recently, on December 12, 2019, the CSA SRO Review was announced. As the analysis and discussion in this Paper is directly relevant to the issues and subject matter of the CSA SRO Review, this Paper is also intended to support and assist the CSA and all relevant stakeholders in such review.

While this Paper outlines the concept of a new Canadian securities regulator and the principles and practical considerations on which it is based, it is not a full analysis of all of the technical, operational, policy or legal issues that are relevant or may be raised. However, the concept of such a new regulator has been “high level tested” with the extensive experience of the MFDA, its directors, interested industry participants and the MFDA’s advisors in respect of frontline Canadian securities regulation. The MFDA believes that there are no issues that are either insurmountable or unable to be addressed by willing and cooperative effort.

Before considering any SRO model design, it must first be determined whether the CSA statutory regulators believe it is in the public interest to continue to rely on SROs to assist them in fulfilling their public interest mandate through the performance of certain regulatory functions. Currently, the core regulatory functions performed by SROs in Canada fall largely into three general categories: business conduct regulation, prudential regulation and aspects of market regulation. The forward-looking and first principles question is: “Whether it is in the public interest for the frontline regulation of any or all of these areas of regulatory responsibility to be performed by an SRO?”. Answering this question requires a consideration of the public interest and a determination of whether these regulatory functions, in whole or in part, would be better or more appropriately performed by CSA statutory regulators or by other means.

There are many approaches, options and considerations in contemplating the future role of SROs in the Canadian securities regulatory structure. (*See Schedule 1, “Alternative Models”*.) When considering the optimal regulatory model or structure (SRO or otherwise), the overriding goal should be to adopt the model that best serves current and expected regulatory requirements in Canada, while providing flexibility for nimble adjustments to accommodate future, uncertain requirements. The model should not be constrained by theory, status quo or special interests and considerations that may not serve the broader public interest in Canada. Ideally, the best of the current regulatory structure is preserved, and the changes necessary for the future are identified, accepted and implemented.

**NewCo is designed to serve the public interest according to the regulatory objectives and principles described in this Paper. The public interest requires that the interests of all relevant constituencies — investors, securities industry participants of all kinds, regulators, governments and Canadian society in general — be taken into account in a fair and balanced way. This approach is consistent with the specific objectives of Canadian securities legislation — namely, to protect investors and foster fair and efficient capital markets and confidence in the capital markets.**

It is expected that there will be continued robust debate and discussion in Canada on the requirements of, and solutions for, effective securities - and broader financial - industry regulation, including the role of SROs in the context of the CSA SRO Review. The hope is that this Paper can contribute to that discussion including any redesign of the current SRO system with a view to best meeting Canada’s current and future needs. Accomplishing this type of significant regulatory structure change will require strong leadership, vision and firm resolve and it is hoped that this Paper assists the CSA statutory regulators and other relevant stakeholders in that regard.

# Part II

## Executive Summary

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**A New Regulator.** This Paper proposes that a new “purpose built” regulator (“NewCo”) be established as an SRO. NewCo would be investor focused and responsible for the business conduct and prudential regulation of its members and their personnel to the extent that the members’ business constitutes registrable activity under securities laws to trade or advise in respect of securities (including portfolio management services) to investors in Canada. NewCo will consolidate many of the existing elements of securities regulation in Canada in an innovative way that serves the objective of an improved regulatory environment. The form of NewCo as a new SRO, and participation in its governance by CSA statutory regulators together with industry and independent directors, preserve the strengths of what exists today while eliminating or reducing the weaknesses and barriers that have developed in the current system. This approach is consistent with Canadian securities legislation and the public interest in general.

**Mandate.** NewCo’s proposed regulatory authority over its members would include:

- Registration;
- Business conduct standards;
- Prudential matters;
- Policy and rule development; and
- Enforcement.

NewCo’s mandate would not include market regulation or surveillance. Regulation of markets and exchanges would be consolidated in the CSA statutory regulators.

**Membership.** All firms requiring registration under securities laws to trade or advise in respect of securities (including portfolio management services) would be required to be members of NewCo, subject to limited exceptions deemed appropriate by CSA.

**Governance.** The affairs and activities of NewCo would be managed and overseen by a board of directors comprising the three key stakeholder groups:

1. Industry participants;
2. Public/Independent persons; and
3. Nominees of CSA members.

**Staffing.** NewCo would be home to most current SRO and CSA member staff conducting activities within the new mandate of NewCo. Similarly, the CSA statutory regulators would be home to IIROC staff currently conducting market regulation and surveillance activities and other roles not within the mandate of NewCo.

**The Case for Change.** The effective regulation of the conduct of persons trading or advising in respect of securities with the Canadian public is diminished by lack of a coordinated and harmonized focus among multiple regulators and governmental authorities. This circumstance is tolerated at a high cost in terms of public confidence, market risk, regulatory burden, efficient use of resources

and future prosperity. Canada can and should do better. This view has been expressed by Canadian and provincial governments and their agencies (including most securities regulators) in the discussions around the establishment of a national regulator; industry participants who have to contend with a fragmented and expensive system; investors who are often the losers in regulatory failures; and international and expert/academic observers of the Canadian securities regulatory system.

**Benefits of a New Regulator.** The benefits in the design of NewCo include:

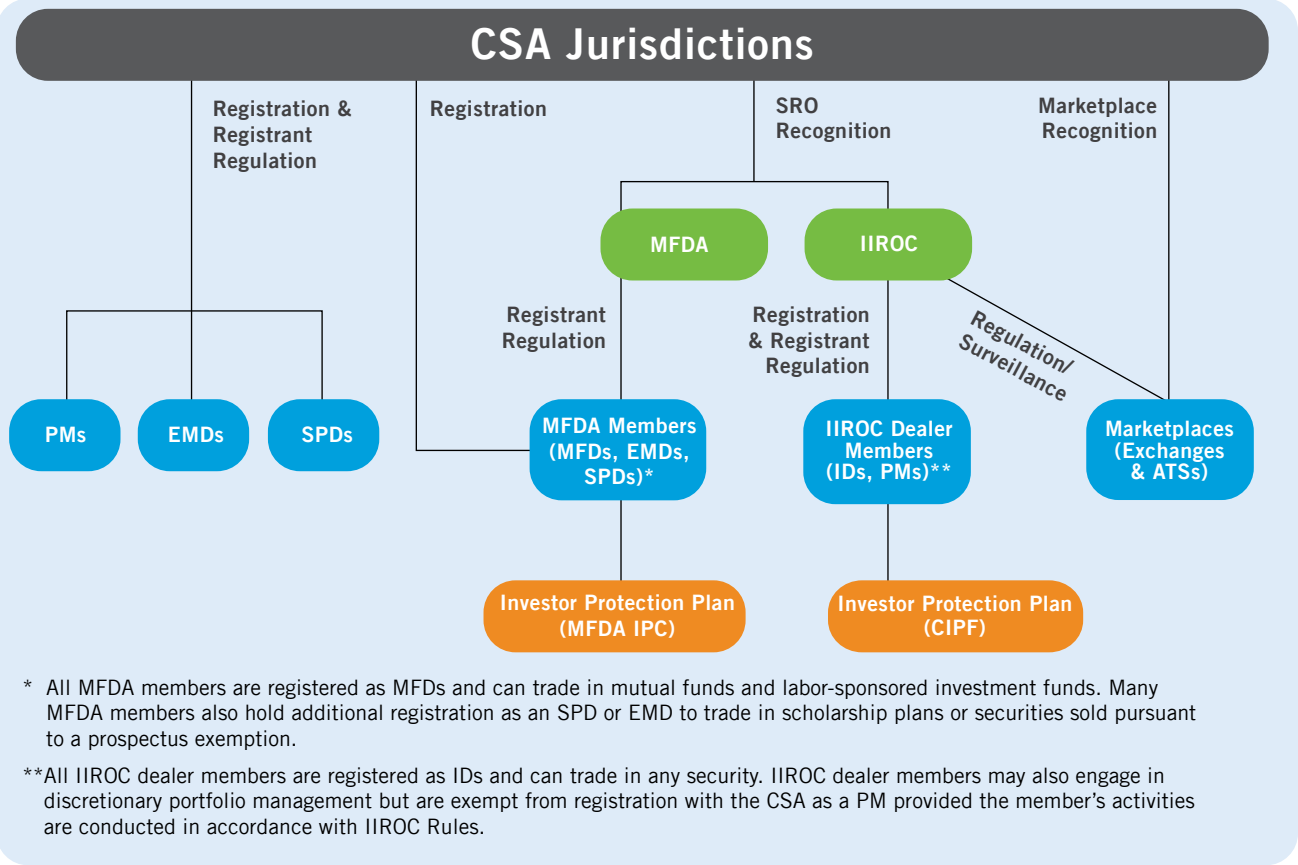
- **Harmonization and Consolidation** of business conduct and prudential regulation in NewCo will contribute to greater understanding, efficiency, accessibility, fairness and effectiveness of the system.
- **A Level Playing Field** for registrants with like conduct and activities being subject to similar regulation, rather than outdated product-based and historical registration categories, will simplify and enhance both registrant compliance and public/investor understanding.
- **Public Confidence** in Canada's regulatory system will increase with an investor focused, single regulator under the direction of the three key stakeholder groups of: securities industry participants, the investing public (through independent directors), and nominees of the CSA as the statutory regulators. Public confidence will be further supported with the CSA statutory regulators maintaining and enhancing their supervisory oversight role.
- **Burden Reduction** in regulatory costs is a key objective in Canada and elsewhere in the world and the prospect of registrants only having to deal with a single "portal" for registration, business conduct and prudential compliance and enforcement matters will significantly contribute to such reduction.
- **Regulatory Focus and Effectiveness** are complementary dynamics in a securities regulator and restricting NewCo's activities to business conduct and prudential matters, with the CSA statutory regulators assuming full responsibility for the regulation of markets and exchanges, will benefit both areas and contribute to increased effectiveness and expertise of both NewCo and the CSA statutory regulators.
- **Flexibility and Nimbleness** are prerequisites in a regulator in the current and expected rapidly evolving financial markets – globalization, technology, product convergence and consumer choices in distribution, among others, being the drivers – and a single comprehensive regulator is best positioned to meet those challenges.
- **SRO Strengths** such as industry expertise, efficiency, knowledge of industry operations, trends and developments, policy participation and peer accountability - will be preserved.
- **SRO Weaknesses** such as conflicts of interest, regulatory capture, diluted regulatory focus and expertise, overlapping and duplicate regulation, limited powers and authority, lack of transparency and low public confidence and trust - will be eliminated or minimized.

**Bold and Achievable.** The proposal to establish a new, comprehensive securities regulator in NewCo is at once both formidable and achievable. The creation of a new kind of SRO by the CSA statutory regulators and current SROs is the easiest path to the kind of forward-looking and investor focused regulatory system that Canadians deserve, rather than attempting to work with the existing outdated structure. Attempting to restructure the current historical patchwork of regulation will result in complexity, delays and, most importantly, compromise of the overarching objective of achieving a regulatory model that best serves Canada.

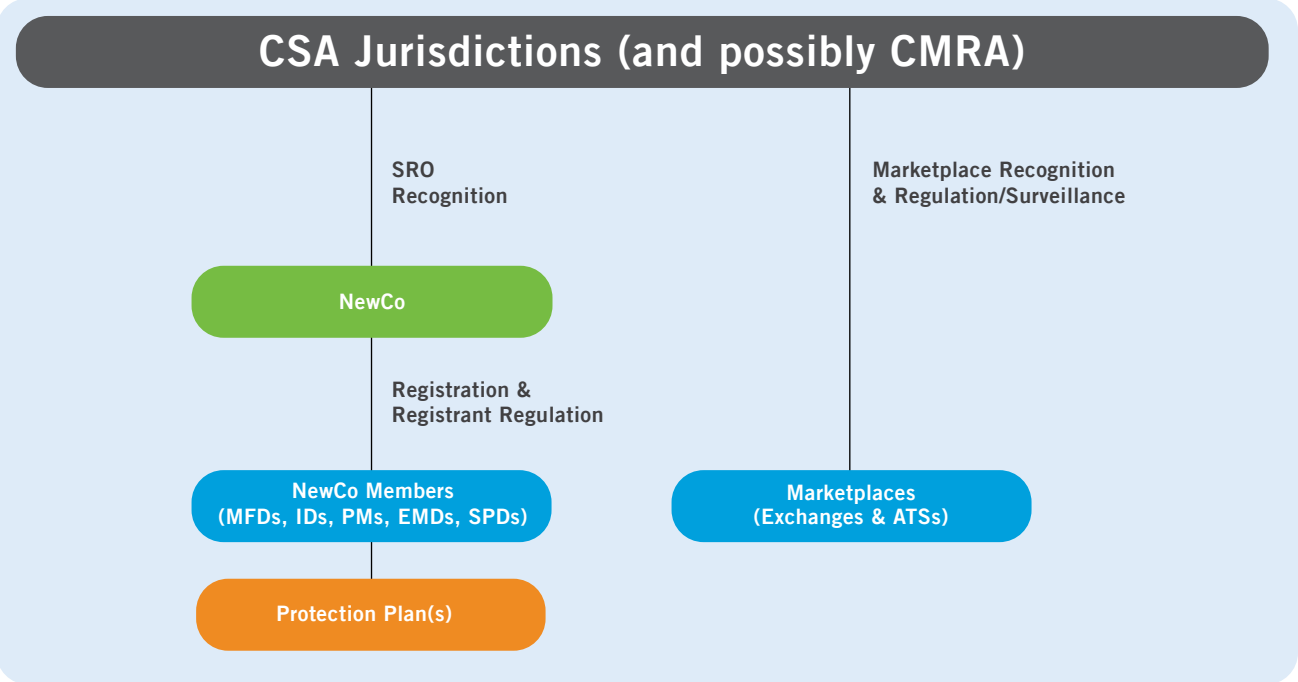
The advantages of beginning with a "blank page" new regulator include: (i) the ability to sequence an orderly transition of regulatory roles to NewCo as is determined practical; and (ii) impress on the securities industry, the investing public and oversight governments and regulators that meaningful improvements for Canada are intended and are being achieved.

# Canadian Regulatory Landscape – Before and After NewCo

## Before:

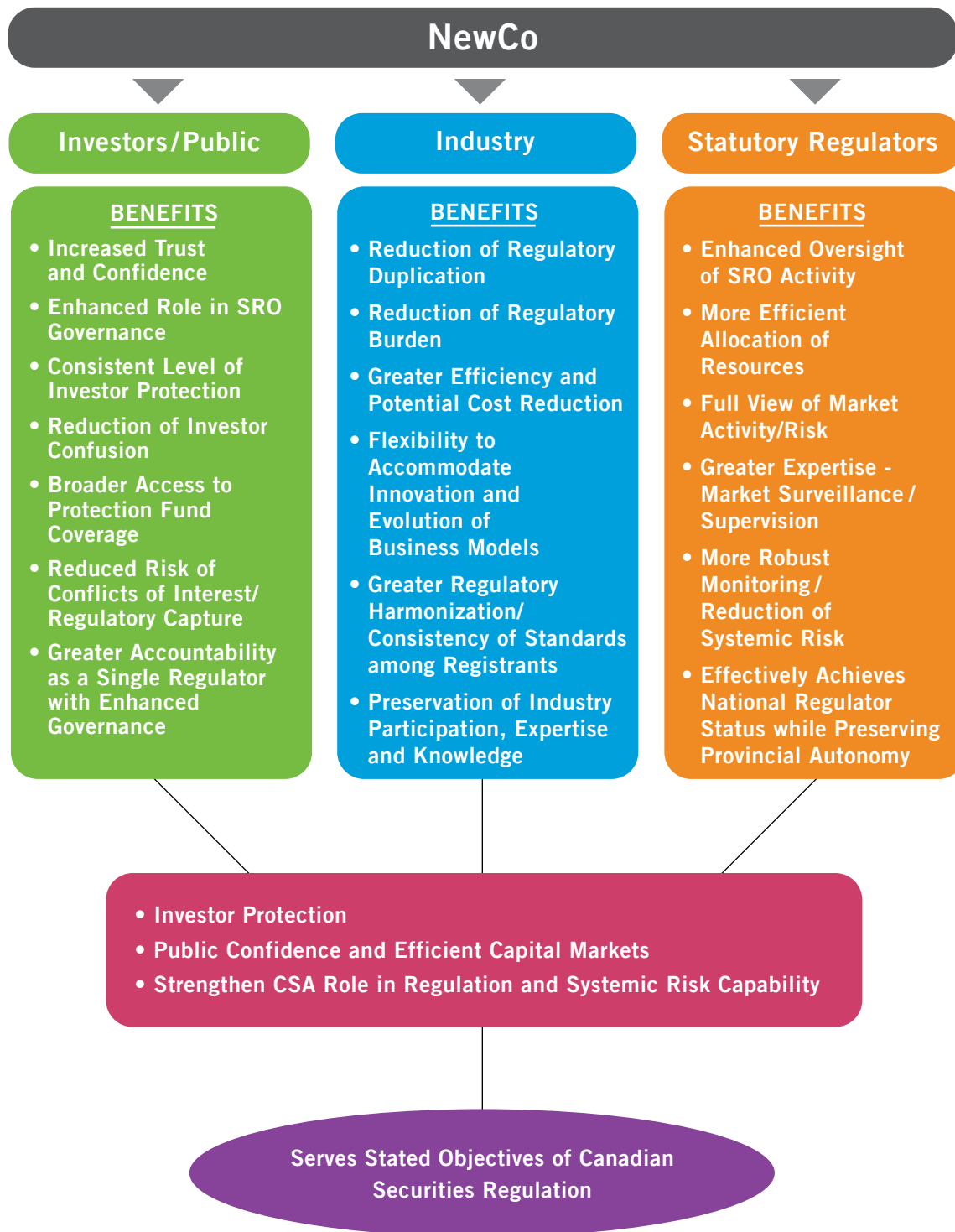


## After:



## Snapshot of NewCo Benefits for Canada

NewCo maintains the benefits of self-regulation, while incorporating improvements designed to address concerns that have been expressed with the present system.



## Structure of Paper

This Paper is divided into 8 main Parts including the *Introduction & Purpose* and this *Executive Summary*.

**Part III: A Model for a New Regulator** - reviews the key elements of a model for a new securities regulator established as an SRO and referred to in this Paper as “NewCo”. The model is designed to suit Canada’s current and future needs; preserve the benefits of the current SRO model while avoiding concerns; and reflect an increased and necessary role for CSA statutory regulators in (i) SRO governance and oversight, and (ii) frontline market regulation and surveillance. Some of the main features of NewCo include:

- A “purpose built” mandate focused on business conduct and prudential regulation;
- Potential membership comprised of all entities engaging in trading or advising activities requiring registration under securities legislation; and
- A governing body comprised of industry participants, public/independent persons and nominees of the CSA.

**Part IV: The Case for Change** - outlines the need for regulatory structure change in Canada. The design of NewCo is informed by principles and practical considerations relevant to the present as well as future requirements of our capital markets such as:

- Harmonization and consolidation to address regulatory fragmentation and inconsistent levels of investor protection;
- Balancing interests of public, industry and regulators and reducing the potential for industry conflicts; and
- Burden reduction resulting in capital market efficiencies without loss of investor protection.

**Part V: The SRO Experience - Benefits, Concerns and Trends** - reviews the benefits and concerns identified with respect to self-regulation. Part V also discusses trends that have emerged in the Canadian and global context with respect to securities regulation and the design and effectiveness of SROs.

**Part VI: SRO Reliance - Canadian and International Perspective** - outlines considerations with respect to the Canadian financial services regulatory landscape relevant to the role of SROs in Canada. Part VI also summarizes key considerations from an international perspective regarding SROs, which are instructive in reviewing the experience of SROs in Canada.

**Part VII: Benefits of NewCo - An SRO Built for the Future** - discusses current issues and concerns relevant to SROs and the Canadian experience as expressed by public/investors, industry and statutory regulators, that would or could be addressed/resolved by NewCo.

**Part VIII: The Way Forward for MFDA and SROs in Canada** - proposes principles to be applied in the design and implementation process for NewCo.

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**Schedule 1: Alternative Models** - identifies several regulatory models that may be considered together with considerations associated with each model.

**Schedule 2: Market Regulation and Surveillance by CSA** - provides additional analysis supporting CSA’s assumption of frontline market regulation responsibilities.

**Schedules 3 and 4: Canadian Regulation and International Perspective** - discuss the Canadian and International securities regulatory landscape and experience with SROs.

**Schedule 5: References**

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# Part III

## A Model for a New Regulator

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### 1. NewCo – A New Comprehensive “SRO”

NewCo, a new, single securities regulatory authority would be created as an “SRO” and be recognized or approved under existing provincial and territorial securities legislation. NewCo would be a frontline, client facing business conduct and prudential regulator and accountable to the CSA statutory regulators.<sup>2</sup> NewCo would assume, expand and integrate the current registrant /member regulation responsibilities of the two existing national SROs as well as each of the CSA members with respect to all firms requiring registration under securities laws to trade or advise in respect of securities (including portfolio management services) subject to limited exceptions. From the options identified in the 2016 discussion paper and described in Schedule 1, the NewCo model represents a version of the “New Comprehensive SRO” model with a focus on business conduct and prudential regulation.

The NewCo model is designed to suit Canada’s current and expected needs; be nimble and flexible to adapt and respond to future unknown and unexpected developments; preserve the benefits of the current SRO model while avoiding or minimizing its concerns and; reflect an increased and necessary role for CSA statutory regulators in SRO oversight and frontline market regulation and surveillance.

NewCo would be a “purpose built” SRO modelled on practical considerations and best practices derived from relevant, modern regulatory principles. The NewCo model would bring together the appropriate combination of functions of each of the SROs and statutory regulators in a single organization that would develop and enforce harmonized rules and standards and address the concerns regarding potential regulatory gaps in Canada.

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<sup>2</sup> Three types of regulation are referred to in this Paper: prudential, business conduct and market regulation. The requirements that fall into each category may vary across the jurisdictions. Further, they are not mutually exclusive terms. Some aspects of business conduct regulation overlap into prudential regulation, such as asset segregation requirements. Business conduct regulation designed to prevent market abusive transactions also is a part of market regulation.

The way these terms are used in this Paper are:

- Prudential regulation deals with the safety and soundness of regulated firms and seeks to ensure that market participants have in place adequate capital, sufficient liquidity, proper internal controls and suitable risk management systems for the nature of their business.
- Business conduct regulation deals with behaviour of market participants and seeks to ensure that they act within the ethical and statutory parameters that have been designed to protect investors and maintain market confidence. Business conduct regulation encompasses investor protection requirements such as suitability, know the client, know the product obligations and other sales practices. It also is targeted at preventing behaviour that can damage market integrity.
- Market regulation deals with the operations of the markets, primarily organized markets such as exchanges and alternative trading systems, but also with over-the-counter markets where intermediaries deal directly with counterparties. Market regulation encompasses authorization of trading venues/marketplaces, setting standards to be met regarding access, transparency and proper trading, supervision of the operation of these markets and surveillance to ensure market integrity is maintained and/or misconduct is detected and suitably punished. It also includes regulation of markets to promote financial stability and prevent systemic risk.



## 2. Overview of NewCo

The main regulatory and organizational features of NewCo are summarized below.

### 2.1 Regulatory Status

NewCo would be treated as a self-regulatory organization for statutory purposes and be subject to recognition /approval and oversight of CSA statutory regulators, but have broader governance participation by public and CSA stakeholders than the historic SROs.

### 2.2 Mandate

The regulatory objectives and mandate of NewCo would be the business conduct and prudential regulation of its members and their personnel to the extent that their business constitutes registrable trading of, or advising on, securities in Canada. The rules and standards that would apply would be determined according to the function /activity performed rather than the products involved or organizational form. NewCo's mandate would be based on the principle that "like conduct should be subject to like regulation".<sup>3</sup>

NewCo would not conduct market regulation and surveillance or engage in systemic risk issues (except as incidental to its core mandate and in support of CSA statutory regulators). The CSA statutory regulators would be responsible for these tasks. (*See Part IV, Section 4.1 for Market Regulation and Surveillance by CSA discussion.*)

### 2.3 Membership

The membership of NewCo would comprise all entities requiring registration within the scope of NewCo's mandate and under the jurisdiction of CSA members pursuant to applicable securities legislation subject to limited exceptions.<sup>4</sup>

### 2.4 Regulation Activities

NewCo would be the frontline regulator within its mandate and would carry out regulation in the following areas operating under the oversight of the CSA statutory regulators:

- Registration on a delegated or functional basis;
- Setting and supervising business conduct standards;
- Setting and supervising prudential matters, subject to limits according to activities of other federal or provincial authorities;
- Policy and rule development; and
- Enforcement of applicable rules and regulatory requirements.

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<sup>3</sup> In this regard, development and consideration of NewCo could be done in concert with a review of current dealer registration categories under existing securities legislation reflecting the evolution of advice-based regulation vs. product-based regulation. (*See Part IV, Section 4.2 for Registration Categories discussion.*)

<sup>4</sup> NewCo members would include current mutual fund dealer members of MFDA, investment dealer members of IIROC (IDs) and non-SRO registrants such as portfolio managers (PMs), exempt market dealers (EMDs) and scholarship plan dealers (SPDs), that the CSA collectively determines appropriate in the public interest. When CSA recognized MFDA as an SRO for mutual fund dealers and adopted a rule requiring mutual fund dealers to become members of the MFDA, many mutual fund dealers applied to the relevant CSA jurisdiction for an exemption from this requirement citing such factors as unique business model or client base. It is anticipated that a similar but more limited exemption process could be employed in the case of NewCo.



## 2.5 Scalability of Mandate, Membership and Regulatory Activities

The mandate, membership and regulatory activities of NewCo would be scalable as determined desirable by the CSA statutory regulators. This aspect of NewCo's flexible structure is important in three key respects and would be provided for in NewCo's constating documents.

- First, the implementation of NewCo and its commencement of regulatory operations will most effectively and easily be on an incremental and transitional basis. It is not practicable or likely desirable that a single point of time or “Big Bang” commencement date be adopted. Some commentary on the process for the establishment of NewCo is included in Part VIII.
- Second, once NewCo is operational, CSA members would be able collectively (or on their own) to reduce or add to the NewCo mandate, membership and regulatory activities as they deem appropriate and in the public interest as market and industry conditions change. The ability to be responsive to such changes will be important in view of the predicted developments in financial services and securities markets.
- Third, the NewCo model would be flexible enough to accommodate registrants in other financial sectors should relevant governmental authorities deem it appropriate and in the public interest.<sup>5</sup>

## 3. CSA Authority, Governance, People and Money

The organizational form and operations of NewCo will resemble in most respects the current SRO model. However, there are some key aspects of NewCo, both in its initial creation and continuing operations, that deserve comment.

### 3.1 CSA Authority

The members of CSA are created by statute and must act within the scope of their authority. The legal constitution of the various CSA members ranges from having the powers of a natural person to being constrained by more limited specific duties and responsibilities. Within that range, there do not appear to be any legal constraints on participation by any CSA member in an organization such as NewCo. It is also noted that most provincial securities legislation endorses the reliance on SROs as appropriate in the public interest. The extent to which governmental blessing or authorization may be necessary or in order in any jurisdiction is best left to each respective CSA member to determine; however, if the case for NewCo is sound, hopefully such authorization would be available.

It is noted that, as a matter of fact, CSA members participate in third party organizations to varying degrees without any explicit statutory authority. Examples are: the CSA itself, the Canadian Public Accountability Board (CPAB), the Joint Forum of Financial Market Regulators, the International Organization of Securities Commissions (IOSCO) and, importantly in the context of NewCo's activities, the existing SROs themselves as CSA staff routinely work with SRO and industry committees on various regulatory initiatives.

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<sup>5</sup> For example, it has often been noted that individuals licensed as insurance advisors and selling segregated funds are engaging in similar conduct to mutual fund advisors, yet are not subject to comparable regulation.

## 3.2 Governance

Success in NewCo achieving its public interest and investor protection regulatory objectives depends on a sound governance structure. To this end, the affairs and activities of NewCo would be managed and overseen by a board of directors comprising:

1. Industry participants;
2. Public /Independent persons; and
3. Nominees of CSA members.

This structure reflects a composition based on the three key constituents of effective regulation within NewCo's mandate, namely industry, the independent public (including investors), and CSA statutory regulators. Each of these constituents brings together particular skills and perspectives to the governance table needed to ensure the highest quality decision making for the public good. Board members would also collectively possess the desired and necessary skills and experience as set out in an appropriate skills matrix which would include relevant industry, regulatory and investor/consumer issues experience.

The role of industry members as registrants would be participation in governance as industry board members and, most importantly, participation in the policy development and enforcement functions which is the strength of the current SRO structure on both a national and regional basis.

With respect to public /independent board members, to guard against the perception of undue industry influence, public /independent directors with previous securities industry background would be subject to an appropriate cooling off period.

CSA nominees could be either or both of (i) executive management or commissioners with a CSA member, or (ii) individuals with experience as investors or financial industry professionals. The inclusion of CSA nominees in the governance structure of NewCo requires some comment. First, the principle of such participation reflects current SRO governance trends.<sup>6</sup> Second, it also reflects the reality of the current business conduct regulatory regime for SRO registrants in that the activities of SROs are significantly constrained by legislation, recognition orders and working relationships with recognizing statutory regulators. In other words, the key governance features of power and decision making authority are effectively shared between the SRO and recognizing statutory regulator. Finally, the CSA statutory regulators are ultimately responsible for ensuring the public interest is served by the overall regulatory framework. The logical conclusion is to align this reality in a governance structure as proposed for NewCo.

At the same time, the aspect of a possible conflict in governance roles by CSA members appointing SRO board representatives must be recognized. As a legal matter and on sound governance principles, the two roles can be managed. In fact, CSA members already effectively manage such conflicts: internally in their operations (e.g. review of staff decisions and approval of policy developed in the organizations they oversee /manage) and in respect of participation in third party organizations such as the CSA itself where rules developed by cooperative CSA activities are taken back to the individual CSA members for adoption /approval. In addition and as noted above, the current policy development, monitoring and enforcement activities of the SROs routinely engage CSA member staff

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<sup>6</sup> See discussion in Part V, Section 3.6, *Amplifying the Public Director and Statutory Regulator Presence in SRO Governance*.

to varying degrees - all of which activities are subject to CSA oversight. A strict separation between the SRO oversight functions and the process by which NewCo directors would be nominated by CSA and participate in NewCo would reinforce the conflict protections.

### **3.3 People: The Best Professional Management and Staff**

NewCo would be home to most current SRO and CSA member staff conducting activities within the new mandate of NewCo. For example, if portfolio managers (PMs) were required to join NewCo, then CSA compliance staff presently engaged in examining PMs would move to NewCo. Similarly, the CSA statutory regulators would be home to IIROC staff currently conducting market regulation and surveillance activities and other roles not within the mandate of NewCo. CSA members would also continue to retain sufficient knowledgeable staff in order to conduct effective and active oversight of the activities of NewCo.

The people constituting NewCo's management and staff will be its most important asset. Accordingly, the best human resource conditions and standards need to be adopted and applied. The practical aspects of establishing NewCo as a desirable destination for high quality management and staff would not be materially different than for any other organization in the financial services sector. The blending of "CSA public sector" and "SRO private sector" employment situations would need to be addressed as well as transfers from and to new employers with fair maintenance of benefits, entitlements and service terms. The recent and continuing experience in the establishment of the Canadian Securities Transition Office and other CSA staff secondment arrangements may be drawn upon.

### **3.4 Money: Start-up and Operational Funding**

NewCo's funding requirements in respect of both its establishment and continuing operations are expected to be able to be met from either or both of its SRO assessment authority and the registration and other fee authority of the CSA members (which is retained). The SROs and the CSA members have extensive fee experience in recent years. The principles that have been developed would be expected to be maintained to the extent the same regulatory activities are involved. A broader range of potential registrants with NewCo may require consideration of transitional fee structures and concerns with respect to cross-subsidization among market sectors. The current concern with respect to appropriate allocation and cross-subsidization in respect of market regulation activities will be largely eliminated.

# Part IV

## The Case for Change

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### 1. Proposition

The NewCo SRO model outlined in Part III is based on the proposition that:

***The effective regulation of the conduct of persons trading or advising in respect of investment products with the Canadian public is diminished by lack of coordination and harmonized focus among multiple regulators and governmental authorities, and tolerated at a high cost in terms of public confidence, market risk, regulatory burden, efficient use of resources and future prosperity. Canada should do better - and can do so with NewCo.***

This proposition is not intended as a criticism of any persons, bodies or constituencies, but is an invitation to improve frontline securities regulation and expertise on a coordinated and cooperative basis. In this regard, MFDA believes that the NewCo model described in Part III would be a substantial, practicable and achievable response to the unsatisfactory consequences of the current regulatory arrangements reflected in the proposition above.

### 2. Establishing the Case for Change

#### 2.1 Stakeholder Group Views

The case for change is, in the MFDA's submission, relatively easy to establish. Apart from the views of the MFDA reflected in this Paper, there is ample evidence from other diverse and interested constituencies in support, as set out in the discussion below.

##### 2.1.1 Governments/Statutory Regulators

The broad (but not unanimous) support by Canadian governments and their agencies, including most securities regulators, for a national securities regulatory system of some kind is based in large part on the same concerns that drive much of the work of the CSA: the undeniable advantages of harmonized and efficient regulation to serve Canadian investors and the capital markets. In making its recommendation for a single Canadian securities regulator, the Hockin Report noted that the current fragmented structure does not allow Canada to be as responsive and effective as it should be, especially when capital markets are under stress and it imposes undue costs on market participants.<sup>7</sup>

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<sup>7</sup> Expert Panel on Securities Regulation, *Creating an Advantage in Global Capital Markets: Final Report and Recommendations*, (Hockin Report), January 2009 at p.41, online: <[http://www.expertpanel.ca/eng/documents/Expert\\_Panel\\_Final\\_Report\\_And\\_Recommendations.pdf](http://www.expertpanel.ca/eng/documents/Expert_Panel_Final_Report_And_Recommendations.pdf)>.

## 2.1.2 Industry Participants

Securities industry firms that trade and advise in securities with the investing public and their associations are likely the most informed and articulate in their views of the need for improvements to our securities regulatory system, notwithstanding some understandable self-interest. For instance, the head of the Investment Industry Association of Canada (IIAC), recently referred to the existing regulatory structure as “difficult, costly, confusing and inconvenient” for clients and urged regulators to begin to dismantle the existing archaic and inflexible regulatory structure.<sup>8</sup> Also, the former head of the Investment Funds Institute of Canada (IFIC), has expressed similar views in a recent paper citing among other things the “operational complexity and costs for dealers”.<sup>9</sup> While the solutions these individuals have proposed are different than those proposed in this Paper, many of the underlying concerns that need to be addressed are the same.

## 2.1.3 Investors/Public

The challenges for individual investors in the current Canadian financial services landscape are obvious with financial sector regulatory fragmentation and geographical balkanization; multi-product and service convergence; rapid innovation in terms of products, business model and delivery channels aided by advancing technology; globalization of markets; and the increasing complexity and sophistication of retail financial products. Both investor advocates and public stakeholders have recognized that a comprehensive or “wholesale” review of Canada’s regulatory approach is needed to best address these issues and that the solution is broader than a simple merger of the two SROs.<sup>10</sup> The needed review should include consideration of the regulatory structure overall and not be limited by history or status quo regulatory structures but should start with a blank slate and be driven by investor protection and regulatory concerns rather than dealer cost savings or competitive strategy.

## 2.1.4 International and Academic/Professional

There has been no shortage of commentary and observation on the Canadian securities regulatory system from both international and informed domestic sources. On the one hand, Canada and its provincial securities regulators have clearly punched above their weight in contributing to international forums such as IOSCO. On the other hand, the fact of our multi-regulatory system with its inherent costs, inefficiencies and risks has not been lost on international observers including the International Monetary Fund (IMF).<sup>11</sup>

## 2.2 Responding to Hurdles and Resistance

While there is an easily identified structural problem with frontline securities regulation in Canada, there is little agreement on what to do about it. The big picture, “boil the ocean” approach of a national regulator is currently, and has been, challenging. Even more modest proposals relating to specific aspects of securities regulation, such as registration categories, investor disclosure

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<sup>8</sup> Ian Russell, Op-Ed re: *Why Securities Regulations Need Overhaul*, The Hill Times, April 25, 2019, online: <<https://www.hilltimes.com/2019/04/25/why-securities-regulations-need-overhaul/197753>>.

<sup>9</sup> Joanne De Laurentiis, *Ripe for Reform: Modernizing the Regulation of Financial Advice*, C.D. Howe Institute, October 24, 2019, at p.3, online: <[https://www.cdhowe.org/sites/default/files/attachments/research\\_papers/mixed/Commentary%20556.pdf](https://www.cdhowe.org/sites/default/files/attachments/research_papers/mixed/Commentary%20556.pdf)>.

<sup>10</sup> James Langton, *Merging the SROs is not the Answer*, Investment Executive, November 1, 2019, online: <[https://www.investmentexecutive.com/newspaper/\\_comment-insight/merging-the-sros-is-not-the-answer/](https://www.investmentexecutive.com/newspaper/_comment-insight/merging-the-sros-is-not-the-answer/)>; See Also Clare O’Hara, *Canadian Securities Administrators Reviewing the Regulatory Framework of IIROC, MFDA*, The Globe and Mail, December 12, 2019, in which Ermanno Pascotto, Executive Director of FAIR Canada noted the need for a “wholesale” review, online: <<https://www.theglobeandmail.com/business/article-canadian-securities-administrators-reviewing-the-regulatory-framework>>. OSC, Investor Advisory Panel, *Response to IIROC White Paper: The Public Policy Implications of Changes to Rules Regarding Proficiency Upgrade Requirements and Directed Commissions on the IIROC Platform*, (Response to IIROC White Paper), March 31, 2016, online: <[https://www.iiroc.ca/Documents/2016/832bbee6-791b-40ea-a4f6-3e8d3efd6927\\_en.pdf](https://www.iiroc.ca/Documents/2016/832bbee6-791b-40ea-a4f6-3e8d3efd6927_en.pdf)>.

<sup>11</sup> IMF, *Canada: Financial Sector Assessment Program. IOSCO Objectives and Principles of Securities Regulation Detailed Assessment of Implementation* (IOSCO Assessment Canada), IMF Country Report No. 14/73, March 2014, online: <<http://www.imf.org/external/pubs/ft/scl/2014/cr1473.pdf>>; IMF Canada: *Financial System Stability Assessment*, IMF Country Report: No. 19/177, June 24, 2019, online: <<https://www.imf.org/en/Publications/CR/Issues/2019/06/24/Canada-Financial-System-Stability-Assessment-47024>>.

requirements, mutual fund fees, registrant standards of conduct and the passport system relying on other CSA members, have been met with mixed enthusiasm and support and/or resistance from various constituencies. However, the NewCo model is based in large part on its avoidance of some of the bigger historical hurdles such as the need for legislative change, loss of regulatory jurisdiction and authority, as well as the fact that both CSA statutory regulators and SROs have had some success in developing practical and helpful improvements to the system on their own.

It is important to note that if the history and experience of the development of Canadian securities regulation to date is any guide, it can be expected that resistance to change will be loud and easily mustered. The examples of the excuses and reasons why change is not needed (including self-interest veiled as public interest) or technical roadblocks that can be drawn on are legion and at hand for anyone who wants to raise them. The MFDA experienced the full range of such resistance in its formation 20 years ago. It should also be noted that such resistance was largely overcome by (i) the leadership and resolve of the CSA statutory regulators, (ii) industry participants acting in the broader public interest, and (iii) the positive, although relatively passive, endorsement by provincial governments. The same basic dynamic is proposed to be harnessed to create and empower NewCo.

## 2.3 An Empowered CSA and a Renewed SRO

In addition to avoiding the historical hurdles noted above, the NewCo model achieves the benefits of an empowered CSA with (i) greater SRO oversight capacity, and; (ii) greater market visibility and expertise in market regulation and surveillance. The model also addresses perceived weaknesses with the current SRO governance structure with enhanced public member independence and CSA statutory regulator involvement while preserving the strengths of the current SRO structure with continued industry involvement in governance, policy development and enforcement processes. The NewCo model responds to the regulatory fragmentation issue by embracing the principle that all registrants dealing with Canadian investors should be subject to comparable, while business model appropriate, regulation. In other words, Canadian investors who invest in comparable products and access similar advisory services should have the same level of regulatory protections, regardless of the type of registrant with which they are dealing.<sup>12</sup> Finally, the proposed model is flexible and adaptable and can respond to the future needs of Canada. For example, the supervision of other financial sector registrants engaging in similar conduct to securities registrants could also be accommodated if felt appropriate by governments or regulators having jurisdiction.<sup>13</sup>

## 2.4 CSA and CMRA

In conducting a forward-looking assessment of the role of SROs in Canada, the MFDA is mindful of the fact that, as a regulator, it does not exist or perform in a vacuum. First and foremost, the MFDA's (and IIROC's) relationship with the CSA statutory regulators must be taken into account. The CSA statutory regulators are both the architects and ongoing stewards of the current SRO regime in Canada. The MFDA and IIROC operate under formal terms and conditions of recognition imposed by the CSA and are subject to continuous and robust CSA oversight. Accordingly, the input from the CSA is critical to the assessment of the SROs and their operations. Ultimately, any change to SRO regulatory responsibilities or the current two SRO regime in Canada falls within the domain of the CSA statutory regulators and is subject to their approval.

Second, the MFDA is mindful of the current prospect of the development of a cooperative national securities regulator, the CMRA. If established, it would have a critical role in determining the future role of SROs in Canadian securities regulation. This role was expressly contemplated by the Expert

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<sup>12</sup> Such regulatory protections include rules and other regulatory requirements, active oversight and supervision by the frontline regulator and investor protection plan coverage in the event of registrant firm insolvency.

<sup>13</sup> For example, the NewCo model could accommodate insurance advisors selling segregated funds and financial planners offering financial and investment advice.



Panel on Securities Regulation in the Hockin Report published in January 2009. The Hockin Report focused primarily on the form of a national securities regulator established by government (now founded on a constitutional cooperative model). However, it also indicated that if and when some form of national securities regulator were established and operating, a subsequent step would be for that regulator to examine the role of SROs in such a structure, and in particular, to “take stock of the performance and responsibilities of the SROs”.<sup>14</sup>

While the MFDA is not in a position to comment on the prospects or desirability of a national securities regulator of any form, any proposed SRO redesign must fit within the overall Canadian legislative regulatory structure that is in place at that time. In this regard, for the purposes of this Paper and the anticipated roles of current CSA statutory regulators or the CMRA, the NewCo model described is designed to apply to and be achievable with either of the two likely future scenarios: (i) the CMRA does not become operational and the existing 13 jurisdiction CSA remains, or (ii) the CMRA becomes operational either in all jurisdictions or with a number of non-participating jurisdictions.

### 3. Principles and Practical Considerations

NewCo has been designed as a new Canadian securities regulator based on principles and practical considerations relevant to the present as well as the evolving future requirements of our capital markets. Historically, substantive changes to Canadian securities regulation have often proved complicated and difficult for various reasons. Adherence to clear and agreed principles while being cognizant of the practical realities of the market and industry are necessary to ensure successful design and implementation.

#### 3.1 The Public Interest

The first and overriding principle on which NewCo is proposed is that it must serve the public interest over all other interests – in other words, the public interest is paramount. The MFDA itself has adopted this approach in all of its activities. In proposing NewCo, which contemplates the termination of MFDA as a separate SRO, the MFDA puts aside its own interests in favour of what it perceives to be the greater public good or “public interest”.

The concept of the “public interest” is often acknowledged to be difficult and elusive to define. This is true in general and in the context of securities regulation where the diversity of investors, securities industry participants, products, business models and regions in Canada make a precise definition of the public interest a challenge. However, some of the common hallmarks of the public interest in the regulatory context are: balance, inclusion of all interests and constituencies, fairness, transparency, efficiency, effectiveness and, importantly, flexibility to accommodate public interest concerns, which are not static. In the particular circumstances of the Canadian securities industry, investor protection and fair and efficient capital markets and confidence in the capital markets inform what is meant by the public interest.

NewCo is based on the view that the public interest requires the interests of all relevant constituencies - investors, securities industry participants of all kinds, regulators, governments and Canadian society in general - be taken into account in a fair and balanced way. The features of NewCo described in this Paper are intended to reflect that approach, including the overall structure of being a comprehensive, purpose-built and investor focused regulator of all securities industry registrants engaged in trading or advising in respect of securities in Canada.

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<sup>14</sup> Hockin Report, supra note 7 at pp.9 and 46.

## 3.2 A Bold and Achievable Model

The need to be bold in addressing change in many regulated industries around the world is a frequent observation. The rapid pace and significant nature of change in the structure and distribution of securities and investment products is undeniable, and there is, accordingly, recognition that the “old” models (i.e. SRO structure, registration categories) may not effectively achieve the “new” protections and efficiencies required. In terms of responsive change, the slower evolutionary or ad hoc approach to adapting securities regulation that has characterized the Canadian experience is inadequate. Innovative approaches, based on thorough policy analysis, are required. Finally, while speed of change is desirable, it should not be allowed to compromise the overarching goal of “getting it right”.

Any proposed changes must be reasonably achievable, or the results can be and are often disappointing. The concept of being “bold” has both positive and negative connotations. On the one hand, the prospect of new and innovative solutions to address new and challenging market developments is attractive. On the other hand, there can be risk and concern for moving dramatically beyond the status quo. The NewCo model attempts to build on the positive aspects of being bold while minimizing the perceived risks and “friction” that can accompany radical change and impair achievement of the goals.

The NewCo SRO model is attractive because:

- reliance on SROs is already recognized in current securities legislation as being a tool for CSA statutory regulators to use across all Canadian jurisdictions;
- the laws have no set requirements as to the form, governance or organization of an SRO as long as (according to statutory definition) it has a regulatory purpose in respect of the operations and business conduct of its members and their representatives with a view to promoting the protection of investors and the public interest; and
- the SRO remains subject to the ultimate control and oversight of the CSA statutory regulators by which appropriate accountability can be assured.

In other words, the SRO model provided for in existing provincial securities legislation is a “blank page” on which to design and operate a new kind of regulatory organization that can best serve the public good.

## 3.3 Blank Page Approach Critical

The proposal for NewCo should not be confused with perpetuating the historical model of SROs such as MFDA and IIROC in Canada or the Financial Industry Regulatory Authority (FINRA) in the U.S., which are among the few remaining full SROs operating in the world.

The reasons for the decline of the traditional SRO model are well-documented and include public mistrust, lack of accountability, conflicts of interest, regulatory capture, duplicative functions, limited authority and tools, and the lack of “commonality of member interests” in the modern securities industry. Also, additional resources at statutory regulators have made it more feasible to take back various supervisory responsibilities from the SROs.

The NewCo model would retain the positive and effective features of an industry participant organization such as expertise, private sector innovation and flexibility while addressing the concerns and negative features noted above. Importantly, the membership of NewCo as an SRO would be expanded to include all categories of registrants engaged in trading or advising in respect of securities (including portfolio management services) to Canadian investors and, therefore bringing them and their investor clients into the harmonized system, resulting in reduced duplicative and/



or uncoordinated regulatory efforts. Public confidence would also be increased with a visible single business conduct and prudential securities regulator that is structured to address the most common concern about SROs, namely conflicts of interest, by providing greater accountability and enhanced governance in the public interest.

The proposal for NewCo should also not be treated as a consolidation of the two existing national SROs in Canada. In the first place, a merger of MFDA and IIROC would result in a mere tweaking and perpetuation of the current SRO status quo model and would not address the larger public interest concerns and weaknesses with SROs noted above or fully achieve the benefits desired for Canada. In the second place, the necessary combination of different functions, cultures and approaches would be difficult to achieve as has been the case in previous self-regulatory reorganizations. In the third place, a fresh blank page approach would be easier, faster and less complicated to achieve. NewCo should be viewed as such a fresh approach and its development and the interests of Canada should not be compromised by a temptation to perpetuate the current SRO model because it is “what we are familiar with” or that “change is too hard”. (See also Schedule 1, Section 3 for Merger of Existing SROs discussion.)

### 3.4 Efficient and Effective: Burden Reduction with Capital Markets Enhancements

The call for the reduction of regulatory burden in the securities industry - as well as other regulated sectors of the economy in Canada and around the world - is clear and must be satisfied by efficiency improvements to foster strong capital markets. At the same time, the need for more effective investor protection is equally strong as the variety, scale, tools, sources and techniques for demonstrated and potential abuses develop. The purpose and design of NewCo are intended to introduce efficiencies to Canadian securities regulation as well as provide more effective investor protections. The goals of efficient regulation and effective investor protections are not mutually exclusive in this context; the better that regulatory services can be delivered, the better it is for investors.

### 3.5 Investor Focused

The legislative mandate of Canadian securities regulation is built on the protection of investors and their confidence in the capital markets. Accordingly, NewCo’s role must focus on the needs of investors and be responsive as markets, and the resulting needs of investors, evolve.

**Regulatory Protection.** The NewCo model embraces the principle that “like conduct should be subject to like regulation” to ensure that Canadian investors receive the same level of regulatory protection regardless of what type of registrant they deal with. The resulting fairer outcomes should bolster investor confidence. In addition, by including all registrants trading or advising in respect of securities (including portfolio management services) in NewCo’s mandate, NewCo will have a broader line of sight over business conduct, prudential pressures and registrant/investor relationships which will benefit not only investors, but also regulators. The broader mandate will also facilitate early identification of developing trends that may need regulatory intervention.

**Reduced Confusion.** Understanding and having confidence in the current balkanized Canadian securities regulatory regime, to say nothing of the broader financial services sector, is all but impossible for most investors other than the very sophisticated ones. NewCo will serve to reduce at least some investor confusion in the market by allowing more investors to understand what regulation there is and “who does what”.

**Governance.** The NewCo governance model, which provides for public/independent directors with no material connection to industry through an appropriate cooling off period; and a direct and visible role for CSA statutory regulators, will enhance investor and public confidence in the SRO. In addition, the Board skills matrix would include relevant investor/consumer issues experience.

### 3.6 Harmonization and Consolidation

As the single business conduct and prudential regulator for securities registrants in Canada engaged in trading or advising in respect of securities, NewCo would have the ability to consolidate and harmonize the existing diversity of rules and standards as is appropriate. Such consolidation and harmonization would benefit investors, industry members and regulators. Common standards will be more easily understood and be capable of being adhered to and enforced. They also simplify the compliance and supervisory systems that must be put in place and their related costs.

It should be noted that while NewCo reflects the principle that “like conduct should be subject to like regulation”, this does not mean that all registrants and investors would be treated identically. NewCo rules would be tailored to recognize that differences in things such as business models and investor types may necessitate different regulatory requirements. In other words, NewCo would recognize that there may be sound market, product, experience, regional and broader policy reasons for appropriate differentiation. However, the prospect of ensuring that such differences are responsive and fair increases significantly when one regulatory authority with full information can assess the circumstances and make the recommendations or decisions.

### 3.7 Balancing Interests and Reducing Conflicts

Ensuring appropriate accountability of SROs to statutory regulators, industry members and investors has been, and continues to be, a challenge. This is true in Canada and in other jurisdictions where SROs have existed. The core problem has been how to manage the inherent conflicts of interest in a regulatory model where registrants manage themselves to a greater or lesser degree. The so-called “self in self-regulation” principle has healthy and beneficial elements to it, but always carries with it the risk of self-interest. Developments intended to balance the various and divergent interests of oversight regulators, industry members, investors and the SRO itself have not always been successful. The reasons for this vary but include: lack of public and investor transparency; reduction in the active role and responsibility of industry members in SRO activities; inability of statutory regulators to effectively and efficiently oversee SRO operations; and unsatisfactory board composition and governance dynamics. As long as industry participants play a meaningful role in their organization, which is both a positive and negative feature of self-regulation, the inherent conflicts of interest will not be eliminated. However, NewCo is designed to bring better balance to, and management of, these conflicts with the ultimate goal of ensuring public confidence in the SRO model through the following enhancements:

- Board composition would include industry, public/independent and CSA statutory regulator nominees;
- Public/independent director requirements that include an appropriate industry cooling off period;
- An expanded SRO membership representing the broader range of registrant members would reduce the tendency and ability of any one membership constituency to drive decisions based on self-interest. The potential for regulatory arbitrage among members’ registration categories would also be eliminated;
- A single, consolidated and more transparent SRO with clear CSA statutory regulator involvement in the SRO governance would reduce public confusion and public mistrust that may exist; and
- The ultimate control and oversight by the CSA statutory regulators would be able to be exercised in a better informed and more efficient manner.

## 3.8 Flexible and Nimble for a Fast Moving Industry

The prospect of achieving the core objectives of successful securities legislation requires that regulators be both flexible and nimble in carrying out their roles. The ability of one organization to efficiently identify, consider and resolve securities regulatory issues is greater than that of multiple regulators. The processes for identifying securities regulatory needs, developing policy, testing consequences and ultimately enacting, implementing and enforcing necessary changes are cumbersome, slow and often subject to compromise when done on a jurisdiction by jurisdiction basis. NewCo avoids this problem as the SRO form is flexible and NewCo is a blank/fresh page model. Initial design, as well as responses to future changes in markets and investor needs, can be achieved on a Canada-wide basis with few barriers.

## 3.9 Address Regulatory Gaps

### 3.9.1 Different Levels of Regulation for SRO vs. non-SRO Registrants

A significant feature of the current two SRO model of MFDA and IIROC is that it is based on registration categories. The combined membership of MFDA and IIROC is approximately 250 members. There are approximately 1,000 non-SRO market participants registered under other registration categories – PMs, EMDs, and SPDs - that are dealing with investors in Canada in a similar fashion and are not subject to the active regulation of the current SRO system.<sup>15</sup> The level of active regulatory oversight and supervision applied to these non-SRO registrants differs materially across the country. Further, clients of these non-SRO registrants are not directly protected from losses caused by a failure of a firm by a fund like the MFDA Investor Protection Corporation (MFDA IPC) or the Canadian Investor Protection Fund (CIPF).

### 3.9.2 Lack of Full Market Visibility of CSA Statutory Regulators

Active surveillance and supervision of trading in Canada on the stock exchanges and other trading venues is performed by IIROC and not the CSA statutory regulators. Markets are increasingly interconnected and market trading activity and systems are becoming increasingly complex. Fragmentation of trading among various types of trading venues further complicates the picture. There is also a growing recognition that such regulation can have systemic risk implications. Continued reliance on an industry SRO for frontline regulation in this area impairs the ability of the CSA statutory regulators to have a complete and timely view of the markets as well as the ability to develop the expertise necessary to keep up with them. Internationally, there is a recognition of the need for full market visibility and “whole of market” supervision – of both the traditional stock and future exchanges and of the other types of trading venues. The recent assumption of market regulation and surveillance activities by the Australian Securities and Investments Commission (ASIC) from the Australian Securities Exchange (ASX)<sup>16</sup> and the work in the European Union on market transparency and oversight, are examples.<sup>17</sup>

## 3.10 Legal Considerations

The formation of a new SRO recognized in each Canadian jurisdiction will require a detailed review of a number of legal considerations relating to securities regulatory and governance matters. MFDA

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<sup>15</sup> OBSI 2018 Annual Report, at p.21, online: <<https://www.obsi.ca/Modules/News/index.aspx?feedId=c84b06b3-6ed7-4cb8-889e-49501832e911&lang=en&newsId=77f8b13e-fd9b-407f-86a9-e7cb7bed4e66>>.

<sup>16</sup> Chris Bowen, Minister for Financial Services, Superannuation and Corporate Law, *Reforms to the Supervision of Australia's Financial Markets*, (Australian Media Release), No.013 Media Release, August 24, 2009, online: <<https://ministers.treasury.gov.au/ministers/chris-bowen-2009/media-releases/reforms-supervision-australias-financial-markets>>.

<sup>17</sup> European Parliament, *Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU*, June 12, 2014, online: <<https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0065&from=EN>>.

and its advisors have preliminarily considered a number of legal matters relating to the formation, recognition and governance of NewCo, which include:

- (a) whether the right to nominate directors to the board of NewCo compromises the authority of the CSA statutory regulators to recognize NewCo as an SRO;
- (b) the right of the CSA statutory regulators to nominate directors of NewCo;
- (c) the authority of CSA statutory regulators to review decisions of NewCo;
- (d) the regulation of multiple categories of registrants by an SRO having regard to the purposes of securities legislation; and
- (e) the ability of NewCo to be self-funded by members.

The MFDA believes the CSA statutory regulators have the authority to implement the NewCo structure described in this Paper. The legal considerations that we have identified above should not be a bar to implementation and could be addressed by the CSA in the planning stages.

## 4. Consequential Changes and Other Considerations

The creation and implementation of NewCo as a new comprehensive SRO is likely to require consideration of other issues or consequential changes to other existing regulatory structures and organizations, apart from the two current SROs and the registrant membership of NewCo. Set out below are some of the identified issues and organizations directly affected by NewCo to a greater or lesser degree. It is beyond the scope of this Paper to analyze all of the effects or potential changes that require consideration, but they must be acknowledged and, in some cases, addressed early.

### 4.1 Market Regulation and Surveillance by CSA

#### 4.1.1 Appropriate Fit for CSA Statutory Regulators

Under the proposed NewCo model, the regulation and surveillance of marketplace activities on exchanges and other marketplaces by their participants would be consolidated in and assumed by the CSA statutory regulators. There are three primary reasons for this proposal:

- First, the nature of trading markets being global, interconnected and having systemic risk implications dictates – as is the case in most other jurisdictions – that such markets and the trading on them be subject to direct governmental supervision.
- Second, the trading activities that must be subject to surveillance are not just being carried on by firms that are members of the domestic SRO on a wholly domestic trading venue.<sup>18</sup>
- Third, from the perspective of SRO regulatory efficiency and commonality of member interests, the relationship between frontline business conduct and prudential regulation of firms and market regulation and surveillance is slight in terms of the regulatory function and number of registrants affected. Accordingly, to have all of these functions performed in the same SRO undercuts its regulatory efficiency.

The manner in which market regulation and surveillance is carried out by the CSA will have to be determined, but the statutory authority of CSA members to do so is clear. Some CSA members already exercise direct oversight of the markets themselves. Adding the participant regulatory functions, including those currently governed by regulation services provider agreements, would

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<sup>18</sup> Direct market access by institutional investors, cross-border trading links and alternative trading systems that are part of global networks are increasingly common.

seem to be a logical and natural approach in achieving efficient and comprehensive market regulation. CSA members have extensive practical experience in dealing with national regulatory policy and operations. There is no reason why market regulation and surveillance activities could not be performed directly by CSA members on the same basis. The goal of such a structure would be to provide CSA statutory regulators with direct regulatory expertise, data access and a full picture of all trading and control over such market regulation and surveillance activities on a national basis.

#### **4.1.2 Responsive to CSA Business Plan: 2019-2022**

The assumption by CSA of the market regulation and surveillance functions (and related systems capabilities) currently performed by IIROC under regulation services provider agreements with the various exchanges and alternative trading systems (ATs) would also appear to support and be consistent with many of the identified strategic goals and initiatives as set out in the CSA Business Plan for 2019-2022. These include enhancing enforcement and deterrence effectiveness by improving market analytics capacity and strengthening enforcement capabilities (Strategic Goal 3); and promoting financial stability and reducing financial risk through effective market oversight (Strategic Goal 4).<sup>19</sup>

#### **4.1.3 Responsive to 2019 IMF FSAP Report**

In its most recent assessment of Canada in 2019 under its Financial Sector Assessment Program (FSAP), the IMF recommended that the capacity to conduct Canada-wide surveillance should be strengthened and supported by continued efforts to address data gaps. Assumption by CSA statutory regulators of market regulation and surveillance activities would be responsive to this IMF finding.<sup>20</sup>

(See Schedule 2, “Market Regulation and Surveillance by CSA” for additional discussion.)

### **4.2 Review of Registration Categories**

Current dealer registration categories under securities legislation are based in large part on the types of services and products offered. Several of the categories are based on historical business structures and are not reflective of how the business is conducted today. In today’s dynamic environment, financial advice delivery channels have evolved with registrants increasingly focused on the provision of broad based holistic financial advice rather than simple product sales or monoline service offerings. This has resulted in dealers in different categories engaging in similar financial advice and product activities with similar clients but not being subject to similar regulatory requirements.

The public, industry and regulators, have all noted the need to “rethink” the appropriateness of the current registration category regime as part of a broader review of the SRO securities regulatory structure in Canada. In the MFDA’s experience this issue has been raised in the context of requests by IIROC (and its predecessor IDA) to allow investment dealer firms to employ restricted license mutual fund representatives without obtaining the necessary investment dealer representative proficiency (the 270 Day Requirement). In denying such a request in 2007, the Ontario Securities Commission (OSC) stated as follows: *“The consequences of removing the 270 Day Requirement would be to permit a business model that would be inconsistent with the design of the existing regulatory system. ....We therefore believe it is appropriate to maintain the 270 Day Requirement until such time as the roles of these SROs in our regulatory system is re-evaluated.”*<sup>21</sup> Elimination of the 270 Day Requirement was also the subject of broad industry and public consultations by MFDA

<sup>19</sup> CSA, CSA Business Plan 2019-2022, June 13, 2019, online: <[https://www.securities-administrators.ca/uploadedFiles/General/pdfs/CSA\\_Business\\_Plan\\_2019-2022.pdf](https://www.securities-administrators.ca/uploadedFiles/General/pdfs/CSA_Business_Plan_2019-2022.pdf)>.

<sup>20</sup> IMF Country Report No. 19/177 supra note 11 at pp.1 and 8.

<sup>21</sup> Notice of Amendment to OSC Rule 31-502 *Proficiency Requirements for Registrants*, March 9, 2007, (2007) 30 OSCB 2097. Similar public policy issues were raised by the CSA in 2014 in connection with an exemption granted by IIROC with respect to the 270 Day Requirement. The exemption was ultimately withdrawn.



and IIROC in 2014-2016 in which many industry and public/investor stakeholders noted similar public interest issues and echoed the need for a broader review of dealer categories and the SRO regulatory structure and role in Canada.<sup>22</sup>

A thorough review of the role of SROs in the securities regulatory system in Canada would logically and necessarily include a review of registration categories and related proficiency requirements. Consideration of the NewCo model could be done concurrently and efficiently within such a review.

### 4.3 Quebec

The recognition or approval of NewCo as an SRO by CSA members in place of recognition or approval of MFDA and IIROC raises particular considerations in Quebec where the MFDA is not recognized. Functionally, the member regulation of MFDA members in Quebec is coordinated pursuant to a Cooperative Agreement between the Autorité des marchés financiers (AMF), Chambre de la sécurité financière (CSF) and the MFDA. If the continuation of the current approach is considered appropriate by the Quebec government and regulators, NewCo could function in much the same way that the MFDA and IIROC do at present either under a Cooperative Agreement or formal SRO recognition scenario. It should also be noted that it is recognized that CSF is an SRO in Quebec and the NewCo proposal is not intended to impact CSF or its operations in Quebec. At the same time, the functions performed by the CSF are consistent with the functions proposed for NewCo.

### 4.4 Protection Funds

Clients of MFDA and IIROC members are covered for member insolvency risk by investor protection plans, being the MFDA IPC and the CIPF respectively. In Quebec, the AMF administers the Fonds d'indemnisation des services financiers (FISF), which provides coverage to mutual fund dealers and other registrants including fraud risk. Clients of firms registered in other categories, such as PMs and EMDs, do not have direct protection coverage. Consideration as to the continuing or new coverage of customers of members of NewCo will be required. The issues include: underwriting risk assessment of various members and their business structures; contribution assessment models; historical funding fairness; coverage eligibility; scope of coverage; prudential standards; investor perception and marketing advantages. It is noted that the prospect of consolidating the MFDA IPC and CIPF protection plans has been considered in the past in the context of a consolidated protection plan with separate risk profiles and segregated fund pools for the different dealer categories. The ideal of a comprehensive, integrated coverage model is likely achievable, but is not a necessary condition for NewCo's creation or success in its regulatory goals.

### 4.5 Industry Trade Associations

Historically in Canada, there has been some commonality of membership between industry trade associations representing the commercial interests of their members and securities registrant categories. For instance, IIAC, as a spin off from the IDA, is composed of IIROC members. Other registrant categories have associations to represent them. Some industry associations have broader memberships, e.g., IFIC and the Federation of Mutual Fund Dealers represent more than just mutual fund dealers. How or to what degree these organizations would adapt to a comprehensive SRO such as NewCo would be for them to consider. Again, the form the industry associations take is not a determinative factor in creating NewCo. However, it is noted that such associations play a useful and healthy role in advocating their members' interests to regulators and it would be in NewCo's interest for appropriately representative trade associations to continue to exist.

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<sup>22</sup> For example, the OSC Investor Advisory Panel commented that the "proposal from IIROC is not the way to create significant changes to the regulatory structure. Rather, as the Expert Panel on Securities Regulation recommends, changes in the regulatory landscape require a broader and comprehensive approach that considers all levels. IIROC and the MFDA are one part of the bigger picture." *Response to IIROC White Paper*, supra note 10 at p.2.

# Part V

## The SRO Experience – Benefits, Concerns and Trends

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Self-regulation has been recognized as an effective and efficient form of regulation for securities markets and this has been acknowledged in Canada and internationally. While it is recognized that there are many benefits with self-regulation, it is also recognized that there are real and/or perceived weaknesses or concerns with self-regulation.

These benefits and concerns are discussed in more detail below. It should be noted that self-regulation can cover both member regulation which focuses on business conduct and prudential regulation and market regulation governing activities on exchanges and ATSS. For the purposes of the discussion below, the focus is on self-regulation in general without noting differences among particular SRO models or aspects of securities regulation.

### 1. Benefits of Self-Regulation

#### 1.1 Increases Overall Level of Regulatory Resources

Many countries rely on self-regulation because significant resources are required to regulate and supervise securities markets effectively, especially in large and complex markets (see the U.S. for the most extensive example.)<sup>23</sup> The demands on regulators after the 2008/2009 global financial crisis have put even more pressure on regulatory resources. Statutory regulators are often subject to various constraints that limit their ability to obtain the necessary resources (e.g. expert human capital and technology) required to regulate effectively, even if the statutory regulator is funded directly by market participants. The ability of even a well-funded regulator to fully oversee all aspects of modern, complex markets is limited and, therefore, more “cops on the beat” are helpful.<sup>24</sup>

#### 1.2 Allows for More Effective Dedication of Resources

An appropriate division of labour between the SRO and statutory regulator can make best use of the expertise and resources of each, allowing each to fulfil its mandate for the benefit of investors and the market as a whole. As the U.S. Securities and Exchange Commission (SEC) noted in its 2005 Concept Release, SROs play an important role in “maximizing the Commission’s limited resources.”<sup>25</sup> It has been argued that the statutory regulator should best spend its time considering

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<sup>23</sup> SEC, *Concept Release Concerning Self-Regulation*, Release No. 34-50700, File No. S7-40-04 (SEC Concept Release), March 8, 2005, online: <<https://www.sec.gov/rules/concept/34-50700.htm>>.

<sup>24</sup> John Carson, *Self-Regulation in Securities Markets*, (Carson), World Bank Policy Research Working Paper No. 5542, January 2011, online: <<http://documents.worldbank.org/curated/en/337711468340157842/pdf/WPS5542.pdf>>.

<sup>25</sup> SEC Concept Release, supra note 23.

big-picture policy matters, which include: market structure and innovation issues, developing broad investor protection mechanisms, and encouraging fair and efficient markets.<sup>26</sup> A statutory regulator that tries to do all things may lack the resources to focus on the larger issues in its mandate, including those of system-wide risk and financial stability, competition, and transparency, that are not suited to being addressed by SROs.

### 1.3 Ensures Necessary Expertise

SROs have a thorough knowledge of their industry and the regulatory framework within which they operate. This specialized and in-depth knowledge is very beneficial in the development of an appropriate set of rules as well as the development, implementation and monitoring of effective compliance programs.<sup>27</sup> Regular and direct contact with the industry keeps that level of expertise current. Further, SRO rules are often developed with input from market participants who have in-depth knowledge of the industry, market operations and specialized products. A capable SRO will have qualified staff and it will generally be more efficient to rely on an SRO's extensive knowledge, experience and expertise (with industry input) for member regulation rather than trying to reproduce it within the statutory regulator(s). This is particularly true when there is more than one statutory regulator involved.

### 1.4 Cost Efficiency

Self-regulation can be more cost effective for all concerned than direct regulation by the statutory regulators.<sup>28</sup> An efficient division of responsibility between statutory regulators and SROs is likely to also be cost effective. Industry members pay the regulatory fees and investors share in both efficiencies and inefficiencies. Higher costs at the intermediary level inevitably are borne by investors through higher fees and charges.

The ongoing costs of rule development at the SRO level are lower than at the CSA level, as a committee representing (up to) 13 jurisdictions does not have to reach consensus on each point. In addition, when SRO members pay fees to the SRO, the connection between those fees and actual regulatory activities are easier to identify and justify. Fees paid to securities commissions by intermediaries may or may not be reflected in the resources devoted to intermediary regulation. Where the statutory regulator is not self-funding and fees are paid to the government, the connection is even harder to draw.

Self-regulation allows for greater control and ability to resource regulatory activities, particularly as circumstances change. SROs do not require government approval for their budgets and are able to develop budgets based on their regulatory objectives that are fully funded by members.

### 1.5 Fosters Robust Culture of Compliance

Self-regulation works where there is a strong business incentive to operate a fair, reputable, financially sound and competitive industry. Reputation and competition can be powerful motivating forces for proper behaviour which, when coupled with a sense of responsibility stemming from direct involvement in developing standards, can promote a culture of compliance among members. Self-

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<sup>26</sup> Linda Rittenhouse, *Self-Regulation in The Securities Markets: Transitions and New Possibilities* (CFA 2013), CFA Institute, August 2013, at p.12, online: <<https://www.cfainstitute.org/-/media/documents/article/position-paper/self-regulation-in-securities-markets-transitions-new-possibilities.ashx>>.

<sup>27</sup> IOSCO, SRO Consultative Committee, *Model for Effective Regulation* (IOSCO SRO Report), May 2000, at p.4, online: <<https://www.iosco.org/library/pubdocs/pdf/IOSCOPD110.pdf>>; Ministry of Finance, *Five Year Review Committee Final Report: Reviewing the Securities Act* (Ontario), (Five Year Review 2003), March 2003, at p.109, online: <[https://www.osc.gov.on.ca/documents/en/Securities/fyr\\_20030529\\_5yr-final-report.pdf](https://www.osc.gov.on.ca/documents/en/Securities/fyr_20030529_5yr-final-report.pdf)>.

<sup>28</sup> Ibid, IOSCO SRO Report at p.5.



regulation can also enhance members' reputation for quality and reliability by requiring members to acquire and maintain expertise and ethical standards.<sup>29</sup>

## 1.6 SRO Requirements often Exceed Government Regulation

SROs may set standards that exceed those imposed by statutory regulators, such as detailed business conduct or capital standards. In addition, SRO rules are often more detailed and focused than the statutory rules (e.g. capital formula, suitability, supervision and books and records requirements).<sup>30</sup>

## 1.7 Greater Ability to Respond Quickly to Changes in the Industry

Self-regulation offers greater ability to adapt requirements to changes in the marketplace and SROs may be able to respond more quickly than statutory regulators. SRO rules are also easier to amend than statutes or subordinate legislation.<sup>31</sup>

Familiarity with the industry, breadth of membership and constant interaction with market participants mean that SROs are likely to see an emerging trend that may give rise to a need for new rules before it comes to the attention of the statutory regulator. The SRO and industry may also have a greater ability to access and assess, in a timely and efficient manner, relevant market information. This informational advantage is critical to the effective regulation of increasingly complex financial markets and activities.<sup>32</sup>

An SRO may also be an effective forum for bringing emerging issues to the attention of the various statutory regulators and performing valuable coordination and information-sharing functions for the industry and the regulators.

## 1.8 Fit-For-Purpose Approach to Compliance

SROs have greater ability to take into consideration the various business models and operational realities of their members in setting and enforcing compliance requirements. The SRO rules and compliance approach can be tailored to fit the characteristics of the registrant business model, investors, investment products and the registrant/investor relationship. The practical experience and expertise of SROs may also result in the efficient resolution of disputes and incidents of non-compliance earlier in the process.

## 1.9 Common Level of Direct Regulation Across all Industry Members

In Canada, an SRO operating across the country provides a uniform level of regulation and supervision of its members, which is more difficult to deliver at the statutory regulator level with 13 separate provincial and territorial authorities. The CSA has made significant progress towards developing common requirements for market participants in Canada, but the standards are not always fully harmonized or applied consistently. Further, the level of direct supervision applied to registered firms by the securities commissions will continue to vary from jurisdiction to jurisdiction depending on the resources and priorities of the individual statutory regulators. An SRO applies a single set of rules to its members, no matter where they are located, and generally allocates its

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<sup>29</sup> Ibid.

<sup>30</sup> For example, the general books and records requirements under NI 31-103 consist of two paragraphs; the equivalent minimum records requirements under the MFDA and IIROC Rulebooks run several pages.

<sup>31</sup> Given the steps and timelines built into the statutory rule making process, even the simplest routine amendment to a National Instrument takes at least 18 months to come into effect after its first publication for comment.

<sup>32</sup> Saule T. Omarova, *Rethinking the Future of Self-Regulation in the Financial Industry*, Brooklyn Journal of International Law, 35:3 (2010), at pp.670-71, online: <<http://scholarship.law.cornell.edu/cgi/viewcontent.cgi?article=2489&context=facpub>>.

resources to the direct supervision of members based on an informed assessment of perceived risk to investors and the market, not geographical location. Also, a nationally recognized SRO will be able to deal more efficiently with members' actions that take place across provincial borders.

## 1.10 Potential Greater Scope of Authority

The authority of the statutory regulator is set by its government and is limited both by the legislation and by the jurisdiction of that government. This poses impediments to regulating financial market activities that increasingly operate across borders and financial sectors. The authority that an SRO exercises over its members (at least in Canada) is derived not only from the delegation of authority from the statutory regulators but also from its contractual relationship with its members. This contractual authority may extend beyond geographical boundaries and to activities outside the ambit of the statutory regulator's authority. This is important in today's environment where markets operate without regard to provincial or national boundaries and where large, multi-national financial institutions dominate the markets.<sup>33</sup>

## 2. Concerns with Self-Regulation

The benefits of self-regulation must be weighed against concerns or weaknesses that have been identified with the SRO model.

### 2.1 Conflicts of Interest

Many of the strengths of SROs flow from the direct involvement of the SRO's members in regulation. However, this involvement is also the source of the primary criticism of SROs; that member involvement brings with it material conflicts of interest. Members may have an interest in setting rules that favour their interests over those of other market participants, such as competing non-member dealers and the public. SROs may also favour market participants who generate significant revenues for the SRO or who pay a higher share of the costs of operating the SRO. For-profit exchange SROs may not invest sufficient resources to carry out their regulatory tasks as they prefer to devote those funds to profit-making activities or they may compromise standards to increase revenues.<sup>34</sup>

SROs are funded by their members, not from government resources. This direct financial tie has been cited (most often in U.S. critiques of self-regulation) as exacerbating the conflicts of interest. The SRO is viewed as being less likely to pursue members for wrongdoing if those members contribute a substantial proportion of the SRO's budget.<sup>35</sup> This can be a particular concern if SRO membership is voluntary or the intermediary can choose which SRO to join.<sup>36</sup> It also becomes a greater concern as concentration in the industry increases. In other words, the risks of conflicts increase as the number of members decreases and the SRO becomes more dependent on fewer and larger members for its funding.

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<sup>33</sup> IOSCO SRO Report, *supra* note 27 at p.12.

<sup>34</sup> IOSCO, Technical Committee, *Discussion Paper on Stock Exchange Demutualization*, December 2000, online: <<http://www.iosco.org/library/pubdocs/pdf/ioscopd112.pdf>>; IOSCO, Technical Committee, *Regulatory Issues Arising from Exchange Evolution, Final Report*, November 2006, online: <<http://www.iosco.org/library/pubdocs/pdf/ioscopd225.pdf>>.

<sup>35</sup> Steven Irwin, Scott Lane, Carolyn Mendelson, and Tara Tighe, *Self-Regulation of the American Retail Securities Markets: An Oxymoron for What is Best for Investors?*, (Irwin) U. of Pennsylvania Journal of Business Law, 14:4 (2012), online: <<https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=1421&context=jbl>>.

<sup>36</sup> SEC Concept Release, *supra* note 23.

Even if conflicts of interest are avoided, mitigated or managed to the satisfaction of the statutory regulators, the public perception of conflicts may nonetheless undermine confidence in the effectiveness of self-regulation.<sup>37</sup> The concerns about conflicts of interest are the primary reason why IOSCO states that SROs must be subject to an effective system of oversight by the statutory regulator to ensure the public interest is met.<sup>38</sup>

An SRO system of rule making and enforcement that is transparent and for which the SRO is accountable, both to the statutory regulator and the public, helps alleviate this conflict concern. A governance structure with a significant presence of independent, non-industry representation,<sup>39</sup> such as the requirement in the by-laws of both the MFDA and IROC that 50% of the Board members be independent, also helps to alleviate this concern. The presence of statutory regulator nominees on the Board would provide additional protection against conflicts being acted upon.

## 2.2 Regulatory Capture

Specific industry focused regulators, both statutory and SROs, must guard against the phenomenon of regulatory capture, which is the “process by which regulatory agencies eventually come to be dominated by the very industries they were charged with regulating. Regulatory capture happens when a regulatory agency, formed to act in the public’s interest, eventually acts in ways that benefit the industry it is supposed to be regulating, rather than the public.”<sup>40</sup> Causes of this problem have been explained in more direct terms as follows:

“There’s one competing interest that’s unique to enforcing institutions, and that’s the interest of the group the institution is supposed to watch over. If a government agency exists only because of the industry, then it is in its self-preservation interest to keep that industry flourishing. And unless there’s some other career path, pretty much everyone with the expertise necessary to become a regulator will be either a former or future employee of the industry with the obvious implicit and explicit conflicts. As a result, there is a tendency for institutions delegated with regulating a particular industry to start advocating the commercial and special interests of that industry. This is known as regulatory capture, and there are many examples both in the U.S. and in other countries.”<sup>41</sup>

It has been suggested that SROs may be more susceptible to industry capture than statutory regulators and that conflicts of interest issues may be more acute in a single segment SRO than one that regulates a broader swath of the industry. Factors that have been noted as contributing to the risk of SRO regulatory capture include:

- past industry employment or future industry employment opportunities;
- the SRO funding model based on industry fees;
- industry domination of SRO governance;

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<sup>37</sup> CFA 2013, *supra* note 26, at p.9; SEC Concept Release, *supra* note 23.

<sup>38</sup> IOSCO, *Methodology, for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation*, (IOSCO Assessment Methodology), revised May 2017, at p.55 see Principle 9, online: <<https://www.iosco.org/library/pubdocs/pdf/IOSCOPD562.pdf>>. This is echoed in most papers that discuss self-regulation in the securities industry. For example, see CFA 2013, *supra* note 26 at p.37.

<sup>39</sup> *Ibid.*

<sup>40</sup> Investopedia Dictionary, *sub verbo* “Regulatory Capture” accessed December 2019, online: <<http://www.investopedia.com/terms/r/regulatory-capture.asp>>. See also, Ernesto Dal Bo, *Regulatory Capture: A Review*, Oxford Review of Economic Policy, 22:2 (2006), at p.203, online: <<https://www.jstor.org/stable/23606888?seq=1>>.

<sup>41</sup> Bruce Schneier, *Liars & Outliers: Enabling the Trust that Society Needs to Thrive*, John Wiley & Sons, New York, 2012, at p.204.

- regulatory staff becoming too close to those they regulate; and
- the payment of high salaries to senior SRO staff and executives by the industry they regulate.<sup>42</sup>

In a study prepared by the U.S. SEC's Division of Investment Management on the feasibility of outsourcing the investment adviser examination function to FINRA or a newly created SRO for investment advisers, SEC staff noted:

“Multiple SROs could focus expertise and better accommodate industry diversity, but also could more likely lead to SRO “capture” by the discrete industry group from which SRO staff are drawn and to which they may return after their service. Even a single SRO, because it is not only funded by the industry it oversees, but also may include industry representatives in its governance structure or otherwise have a different relationship with industry than an independent government regulatory agency, could possibly have enhanced susceptibility to industry capture.”<sup>43</sup>

## 2.3 Public Confidence, Trust and Expectation

A concern that is becoming more apparent in many jurisdictions is public and investor dissatisfaction with or lack of confidence in regulation. Dissatisfaction may arise because market transgressions or crises, including losses by investors, are often viewed as ineffectively punished or as outright regulatory failures (i.e. “if the regulator was doing a good job the failures would not have happened”). The growth in media coverage of market abuses and the ease of access to information also means that investors are more aware of market failures wherever they have occurred, further colouring their view of the fairness of the markets and effectiveness of regulators.<sup>44</sup>

Related to the public confidence and trust concern is the public's expectation that the government statutory regulators (vs. an industry SRO) are “protecting” them from market abuses. This public expectation of statutory regulators perhaps explains the inconsistency between the severe level of outrage expressed and directed by the U.S. public and politicians at the SEC for its failure to detect and prevent the Bernard Madoff fraud as compared to the relatively muted criticism and lack of attention focused on the industry SRO, FINRA, for the same regulatory failure. When asked why he repeatedly complained to the SEC and not FINRA, whistleblower Harry Markopolos effectively testified that he trusted the SEC as the government regulator and he did not trust FINRA as an industry SRO.<sup>45</sup>

<sup>42</sup> Thaya Knight, *Transparency and Accountability at the SEC and FINRA*, (Knight), The Heritage Foundation, February 28, 2017, at p.173, online: <[https://www.heritage.org/sites/default/files/2017-02/11\\_ProspersityUnleashed\\_Chapter11.pdf](https://www.heritage.org/sites/default/files/2017-02/11_ProspersityUnleashed_Chapter11.pdf)>.

<sup>43</sup> SEC Staff of the Division of Investment Management, *Study on Enhancing Investment Adviser Examinations*, (SEC Examination Study), 2011, at p.33, online: <<https://www.sec.gov/news/studies/2011/914studyfinal.pdf>>.

<sup>44</sup> Grant Robertson and Tom Cardoso, *Easy Money: How fraudsters can make millions off Canadian investors, get barely punished and do it again*, The Globe and Mail, December 16, 2017, online: <<https://www.theglobeandmail.com/news/investigations/easy-money-canadian-securities-fraud/article37350705/>>.

<sup>45</sup> U.S. House of Representatives, Committee on Financial Services, Testimony of Harry Markopolos before the U.S. House of Representatives Committee on Financial Services, February 4, 2009, at p.24, online: <<http://online.wsj.com/public/resources/documents/MarkopolosTestimony20090203.pdf>>. See Also: Investor Lawyers Blog, *Fraud Investigator Publicly Mocks Securities Regulators SEC and FINRA in Hearing Before U.S. Congress*, February 6, 2009, online: <<https://www.investorlawyers.net/blog/fraud-investigator-publicly-mocks-securities-regulators-sec-and-finra-in-hearing-before-u-s-congress/>>. In his February 4, 2009 testimony Mr. Markopolos, when asked to compare the SEC with FINRA said, “I never thought the SEC was corrupt ... FINRA is definitely in bed with the industry.”

## 2.4 Additional Costs/Duplication of Regulation

Self-regulation is often a second layer of regulation. It may simply add costs for little added value when layered on top of a complete regulatory system that includes active supervision by the statutory regulator. If the respective roles and responsibilities of the regulatory authorities are not clearly laid out to minimize overlap, there is a potential for increased inefficiency and confusion, as the requirements and work of the SRO may duplicate those of the statutory regulator and vice-versa. It also runs the risk of introducing significant delays in policy actions as extensive discussions and debates likely will have to take place between the SRO and the statutory regulator. It can also produce conflict, and even competition, over roles and policy. The greater the degree of overlap in issues and initiatives, the more time and resources that must be devoted to coordination, rather than regulatory action.<sup>46</sup>

Even if the respective responsibilities of the SROs and the statutory regulators were laid out to minimize overlap and duplication, the continued presence of several SROs in the regulatory framework will result in greater compliance costs, at least to firms with related companies that are members of different SROs. Depending on how the SROs' responsibilities are divided, this model also carries with it a higher risk that a single firm (or affiliates within a financial services group) may have to be a member of more than one SRO and, therefore, be faced with potentially conflicting SRO rules, interpretations and inspection programs. The greater the degree of overlap in membership among SROs, the greater the likelihood of inefficiencies.<sup>47</sup> In these circumstances, self-regulation may simply add more costs without any offsetting benefit.<sup>48</sup>

## 2.5 Less Effective Enforcement Powers

An SRO may not have access to as broad a range of enforcement powers as does a statutory regulator, thereby hampering the effectiveness of the SRO's enforcement activities. For example, it may not have the ability to obtain information in the course of an investigation or at a disciplinary hearing from persons other than SRO members and their approved persons, except on a voluntary basis. Also, SROs do not have the power to prosecute quasi-criminally.

## 2.6 Less Transparency and Accountability than the Statutory Regulator

An SRO, as a private, non-governmental organization, is not subject to the same level of public transparency or accountability applicable to government agencies. The issue of whether FINRA should be considered a "state actor" like the SEC has been the subject of considerable debate in the U.S.<sup>49</sup> The issue of SRO oversight and accountability has also been the subject of concern in Canada.<sup>50</sup> For example, SROs are not subject to freedom of information legislation that allows the public to require the production of information. The disclosure of information about enforcement proceedings is under the control of the SRO and may be less extensive than that provided by the statutory regulator. An SRO is also not accountable directly to the government.<sup>51</sup>

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<sup>46</sup> Carson, *supra* note 24 at p.14.

<sup>47</sup> SEC Concept Release, *supra* note 23 at p.12.

<sup>48</sup> This is one of the arguments that has been put forward in the U.S. in response to a proposal by the SEC that investment advisers should be required to be members of an SRO. See SEC Examination Study, *supra*, note 43.

<sup>49</sup> David R. Burton, *Reforming FINRA*, (Burton), The Heritage Foundation, February 1, 2017, Backgrounder No. 3181, online: <<https://www.heritage.org/sites/default/files/2017-02/BG3181.pdf>>. A state actor is a governmental agency and is subject to the federal legislation that provides for due process, transparency and regulatory review. However, as discussed in the referenced article, these protections are not present in FINRA's context.

<sup>50</sup> Ken Kivenko, *Comment letter in response to OSC Notice 11-777 – Statement of Priorities for Financial Year to end March 31, 2018*, April 2, 2017, online: <[https://www.osc.gov.on.ca/documents/en/Securities-Category1-Comments/com\\_20170402\\_11-777\\_kenmark.pdf](https://www.osc.gov.on.ca/documents/en/Securities-Category1-Comments/com_20170402_11-777_kenmark.pdf)>.

<sup>51</sup> Irwin, *supra* note 35 at p.1071.

### 3. Trends

Influenced by the benefits and concerns discussed above as well as the Canadian and International Perspective discussed in Part VI, following are some trends and observations that deserve comment.

#### 3.1 Declining Use of SROs

Canada and the U.S. are unique with their significant reliance on SROs. Internationally, there is a declining reliance on SROs, particularly “exchange” SROs due in large part to a combination of (i) the stock exchange demutualization trend, and (ii) increased commitment and resources by statutory regulators to conduct frontline securities regulation.

#### 3.2 Divergent Members – Risk of Erosion of “Commonality of Member Interests”

Self-regulation works best if there is an identifiable community of participants in a well-defined marketplace. If that is present, there is strong “commonality of member interests” and the participants know that their reputations are bound together. A loss of investor confidence in one will negatively affect them all. They, therefore, have a strong incentive to police the behaviour of their colleagues and to discipline those who damage the reputation of the industry and market as a whole. If there is not such a commonality of interests, the incentives among members will be reduced. In today’s rapidly evolving financial services landscape where business models are increasingly affected by such factors as technology, evolving products and the need for scale, the principle of “commonality of member interests” as a key success factor for an effective SRO model has been eroded. Indicators of this fact include the dominance of large, institutional multi-product members over the affairs of Canadian SROs and the diminished participation of representatives of all members in the activities of the SRO. This risk may be addressed in part by ensuring a level playing field among all registrants offering like services regardless of their registration or financial sector category.

#### 3.3 Systemic Risk Focus

Since the 2008/2009 global financial crisis, there has been a greater impetus to expressly address systemic risk and financial stability in financial regulation. Systemic risk has arisen for many reasons with scale, globalization, market connectivity and complexity and product complexity being contributing factors. Accordingly, financial regulation is increasingly focused on identifying sources of systemic risk and mitigating that risk. Further, systemic risk needs to be assessed on a market-wide basis taking into account activities taking place across all financial sectors. However, not all financial services organizations pose systemic risk and so may warrant a different approach, a fact recognized by the Financial Stability Board, IOSCO and various other international standard setting bodies.<sup>52</sup> For example, as it relates to MFDA members, retail distribution of financial services products such as mutual funds in cash accounts is unlikely to give rise to systemic risk. In contrast, certain market trading activity (e.g. types of products or algorithmic trading systems) may have systemic risk implications and are more appropriately overseen by the statutory regulators responsible for systemic risk monitoring and mitigation rather than an industry SRO.

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<sup>52</sup> Financial Stability Board and IOSCO, *Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions*, March 4, 2015, online: <<http://www.fsb.org/wp-content/uploads/2nd-Con-Doc-on-NBNI-G-SIFI-methodologies.pdf>>.



In 2017, reflecting this trend toward identifying “systemic risk” as a key securities regulatory purpose, the *Ontario Securities Act* was amended to add as a third purpose “to contribute to the stability of the financial system and the reduction of systemic risk”.<sup>53</sup> This is IOSCO’s third objective of securities regulation. Addressing systemic risk is also a key purpose of the proposed CMRA.<sup>54</sup>

### 3.4 Comprehensive/Integrated Regulator

Another identified trend is the development of comprehensive financial market regulation that treats similar products or business models alike regardless of the financial sector or form of firm involved. For example, under this model, all investment fund products, whether offered by banks, insurance companies, securities firms or fund managers, would be subject to similar disclosure and conduct rules. The tests are focused on the investor and “what does the investor see” rather than the sector of the registrant. This results in more uniform protection for investors as like investors buying like products are treated alike. The most extensive example of this approach can be seen in the “twin peaks” model in Australia where the regulation and supervision of conduct of all market participants and the relevant disclosure for all products and services is the responsibility of ASIC.

In Canada, this comprehensive regulator model is also reflected in varying degrees in the provinces of Quebec, New Brunswick, Saskatchewan and Manitoba.

### 3.5 Need for Statutory Regulators to have Full Market Visibility

In 2010, recognizing its responsibility and need to have a full view of all trading in the markets, the Australian Government decided that it would, through the statutory regulator ASIC, take over control of the supervision and surveillance of its securities markets and direct market participants. The change allowed for what the Chairman of ASIC at the time described as a “whole of market” approach to market surveillance and participant supervision in response to market fragmentation. At the time, the government noted that it was more “appropriate” that supervision of trading on the exchange and other trading venues be conducted directly by the statutory regulator.<sup>55</sup> By virtue of a broader mandate, many statutory regulators in other countries apply this whole of market approach and conduct surveillance across multiple markets and market types. This gives them a greater ability to identify problematic behaviour and possible systemic risks.<sup>56</sup>

This need for full market visibility in light of market fragmentation was also a driver behind the SEC’s request of FINRA to begin work on the “consolidated audit trail” project after the “flash crash” of May 6, 2010.<sup>57</sup>

In Canada, the IMF FSAP Reports in 2014 and 2019 recommended that the capacity to conduct Canada-wide market surveillance be strengthened. The Reports noted that there are several inter-agency coordination forums at the federal level to address systemic risk issues in addition to the Heads of Agencies Committee for federal–provincial coordination largely on issues related to securities markets. However, the IMF suggested improvements to the current system by establishing a single body with a clear mandate and appropriate powers to address systemic risk issues.<sup>58</sup>

<sup>53</sup> *Securities Act*, R.S.O. 1990, c. S.5, Section 1.1 (c).

<sup>54</sup> A revised consultation draft of the *Capital Markets Stability Act* was released on May 5, 2016. See Cooperative Capital Markets Regulatory System, *Statement on the Release of a Revised Consultation Draft of the Capital Markets Stability Act*, (CCMR Statement) May 5, 2016, Section 6(1)(b), online: <<http://ccmr-ocrmc.ca/statement-release-revised-consultation-draft-capital-markets-stability-act/>>.

<sup>55</sup> Australian Media Release, *supra* note 16.

<sup>56</sup> Janet Austin, *Government to the rescue: ASIC takes the reins of the Stock Markets*, (Austin), *Company and Securities Law Journal*, 28 (2010) at p.445. online: <[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1690982](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1690982)>.

<sup>57</sup> SEC Historical Society, *The Institution of Experience: Self-Regulatory Organizations in the Securities Industry, 1792-2010*, (SEC Historical Society), online: <<http://www.sechistorical.org/museum/galleries/sro/>>.

<sup>58</sup> IMF Country Report No. 19/177, *supra* note 11 at pp.8 and 25.

### 3.6 Amplifying the Public Director and Statutory Regulator Presence in SRO Governance

When looking at the evolution of SROs in Canada and the U.S., a trend toward a greater public director presence in SRO governance is clear. Recognizing that the National Association of Securities Dealers (NASD) and the IDA began as industry trade associations, it is not surprising there was little or no public director presence in SRO governance for decades. It was not until the U.S. securities legislative amendments in 1975 and again in 1996 (in response to market abuses) that greater public director presence was mandated. In Ontario, it was not until the IDA was formally recognized as an SRO in 1995, that significant public director participation in governance was formally mandated under the terms and conditions of recognition. Today, 13 of 23 directors on the FINRA Board are required to be public and at least 50% of MFDA and IIROC board members are required to be public. In addition, the CEO of each of the MFDA, IIROC and FINRA is a board member.

In recent years, concerns have been expressed regarding the previous industry employment or background of some public directors of SROs.<sup>59</sup> This concern has led some stakeholders to suggest that the power to appoint public directors of SROs be assigned to other public/government bodies. In the U.S., the Public Company Accounting Oversight Board (PCAOB) has been cited as an illustrative example with all five PCAOB board members and the Chair being appointed by the SEC.<sup>60</sup> In adopting this new governance structure, the U.S. Congress considered and rejected the governance models of existing SROs because it viewed an SEC appointed Board as a more effective means of addressing industry conflicts of interest.<sup>61</sup> Similarly, in Canada, the Chair, Vice-Chair and board members of the Canadian Public Accountability Board (CPAB) are appointed by a six member Council of Governors made up of the respective Chairs of the CSA, OSC, AMF, the Superintendent of Financial Institutions, another governor appointed by the CSA and a professional accountant with audit regulatory oversight experience.<sup>62</sup>

Citing the PCAOB governance model, it has also been suggested in the case of FINRA and potential reforms, that public directors could be selected by such bodies as the SEC, North America Securities Administrators Association and Departments of Justice and Labour, as well as by investor association bodies such as the Consumer Financial Protection Bureau.<sup>63</sup> Finally, in response to such public directors not having the desired level of industry knowledge, it has also been suggested that current and former staff of such bodies be considered.<sup>64</sup>

### 3.7 Greater SRO Oversight by Statutory Regulators

In compliance with IOSCO Principle 9, CSA statutory regulators conduct robust and active oversight of SRO operations in Canada. This oversight includes SRO rule approval, regular reporting of regulatory activity in compliance, enforcement and policy, and regular onsite oversight reviews. The level and scope of active oversight has increased steadily since the MFDA was first recognized with CSA jurisdictions devoting significant staff resources in this area. Similarly, in the U.S., while FINRA was subject to periodic oversight by SEC in the past, this oversight has been formalized and is more visible with the creation of a new oversight department “FINRA and Securities Industry Oversight” in 2016.<sup>65</sup>

<sup>59</sup> Andrew Stoltmann and Benjamin P. Edwards, Report: FINRA Governance Review: Public Governors Should Protect the Public Interest, November 15, 2017, at p.2, online: <<https://piaba.org/system/files/2017-11/PIABA%20Report-%20FINRA%20Governance%20Report%20%28November%2015%2C%202017%29.pdf>>.

<sup>60</sup> Benjamin P. Edwards, *The Dark Side of Self Regulation*, (Edwards), Cincinnati Law Review, 85 (2017) 573 at p.615, online: <<https://scholars.law.unlv.edu/facpub/1117>>.

<sup>61</sup> SEC Examination Study, supra note 43 at pp.35-36.

<sup>62</sup> Canadian Public Accountability Board Webpage, “Governance Structure”, accessed August 23, 2019, online: <<http://www.cpab-ccrc.ca/en/About/GovernanceAccountability/GovernanceStructure/Pages/default.aspx>>.

<sup>63</sup> Edwards, supra note 60 at p.616.

<sup>64</sup> Ibid at p.621.

<sup>65</sup> Sarah E. Aberg, *SEC Launches Dedicated FINRA Oversight Unit: Watching the Detectives*, The National Law Review, October 27, 2016, online: <<https://www.natlawreview.com/article/sec-launches-dedicated-finra-oversight-unit-watching-detectives>>.



# Part VI

## SRO Reliance – Canadian and International Perspective

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### 1. Canadian Perspective

Most readers of this Paper will have a general understanding of the Canadian financial services regulatory landscape. However, some commentary and general observations are in order as they relate to the role of SROs in Canada. A more detailed overview is included in Schedule 3.

#### 1.1 Current Landscape: Multi-Jurisdictional

The fact that securities regulation in Canada is conducted on a multi-jurisdictional basis is important to bear in mind in assessing the effectiveness of SROs in Canada because SRO operations are conducted within such framework. Constitutionally, aspects of securities regulation that affect capital markets and the distribution of financial services products are shared by the federal and provincial governments. In addition, at the provincial level there are 13 separate provincial and territorial authorities each of which have assumed jurisdiction, to varying degrees, over the activities of MFDA and IIROC as SROs. The provincial and territorial authorities coordinate their regulatory activities through the CSA structure.

In addition, the regulation of other financial services and products at both the federal and provincial level is conducted through other multiple authorities. This circumstance exacerbates the potential for investor confusion and regulatory duplication and creates opportunities for regulatory arbitrage. At a minimum, the structure requires a high degree of cooperation and coordination. A knowledgeable and objective view of this situation from outside Canada was expressed by the IMF in its FSAP Report of Canada in March 2014 which stated as follows: “Within the current framework, several different regulatory agencies and SROs are in charge of the supervision of different components of the securities markets, which make it challenging to have a ‘full’ view of risks. The regulators have developed arrangements for coordination; however, it is key that such arrangements continue to be further strengthened to ensure that a two-way communication exists.”<sup>66</sup>

Although the present response to Canada’s multi-jurisdictional system is directed to achieving effective coordination, many have suggested that Canada should go further and put in place more simplified and unified regulatory structures. The proposed CMRA is intended to be such a unified structure. There have also been other expressions by various provincial government authorities and review panels that new and more comprehensive approaches should be considered. A recent example

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<sup>66</sup> IMF Country Report No. 14/73, *supra* note 11 at p.5.

is the March 2016 Review of the Mandates of the Financial Services Commission of Ontario, the Financial Services Tribunal and the Deposit Insurance Corporation of Ontario<sup>67</sup> that led to the establishment of the Financial Services Regulatory Authority in June 2019.

In its 2019 FSAP Report, the IMF observed that while there are several inter-agency coordination forums for financial sector oversight in Canada, the responsibility for systemic risk oversight is not explicitly assigned to any specific body. The IMF recommended that Canada establish a single body with a clear mandate and appropriate powers to address systemic risk.<sup>68</sup>

## 1.2 SROs are Subordinate Regulators

SROs under current provincial securities legislation are subordinate regulators in the sense that they require CSA statutory regulator approval to operate. This approval is known as “SRO recognition” and can only be granted if the CSA statutory regulator believes it to be in the public interest. Recognized SROs are subject to robust oversight regulation by CSA, which includes detailed terms and conditions of recognition that govern all material aspects of their operations. A recognizing CSA statutory regulator also has the power to make any decision with respect to any rule, policy, procedure or practice of the recognized SRO if it believes it would be in the public interest.<sup>69</sup>

## 1.3 Evolution of SROs in Canada

In assessing the current and future role of SROs, it is helpful to be aware of the basis on which SROs have evolved in Canada.

First, SROs have come into existence and evolved in many different steps and circumstances over the years. The first SROs were stock exchanges, the earliest of which was established in the 19th century. IIROC began in 1916 as a bond trading forum within a private business organization (the Toronto Board of Trade), and has developed over the years by expanding its functions to include member business conduct and prudential regulation, sponsoring an investor compensation plan, divesting its industry/trade association function and assuming market surveillance activities of several stock exchanges – to name a few of the steps. The MFDA has had a much shorter history and while its regulatory framework was modelled closely on the form of the IDA (IIROC’s predecessor) at the time, a few critical differences are noteworthy: MFDA was created at the instance of the CSA, not the industry; MFDA was created as a pure regulator without any industry trade association role; and MFDA performs business conduct and prudential regulation and does not have a registrant registration or market regulation or surveillance role.

A second observation is that in Canada and elsewhere the SRO model predated most securities legislation and formal statutory regulatory policy development. The result has generally been that legislation and policy have followed or attempted to “catch up” with the evolution of SROs. A key driver motivating statutory regulator reliance on SROs has been a practical consideration, specifically lack of resources (personnel, expertise and money) at the statutory regulator.

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<sup>67</sup> George Cooke, James Daw, Lawrence Ritchie. Review of the Mandates of the Financial Services Commission of Ontario, Financial Services Tribunal, and the Deposit Insurance Corporation of Ontario, Final Report, March 31, 2016, online: <<https://www.fin.gov.on.ca/en/consultations/fsc-dico/mandate-review-final-report.pdf>>.

<sup>68</sup> IMF Country Report, No. 19/177, supra note 11 at pp.8 and 25.

<sup>69</sup> For instance, see s.21.1 of *Securities Act*, R.S.O. 1990, c. S.5.

## 1.4 The MFDA Experience – A New Type of SRO

The MFDA was created in 1998 at the initiative of the CSA statutory regulators after consideration of the seminal 1995 Stromberg Report that recommended creation of a “strong, independent and effective” SRO for mutual fund dealers.<sup>70</sup> The CSA decision to accept and implement the Stromberg Report recommendation to create a new SRO was bold and following this decision through to the formal SRO recognition of the MFDA in 2001 required ongoing support and resolve by CSA members as well as industry members acting in the broader public interest.

This observation of the CSA statutory regulators being bold and displaying resolve is made in light of three key factors that existed at the time and are discussed below.

First, the international trend was not toward creating new SROs, rather it was the opposite. In the U.K., in response to securities regulatory concerns, the government decided to eliminate all of the existing SROs and create one single statutory regulator, the Financial Services Authority (FSA). Also in 1998, in Australia as recommended by the Wallis Commission review, the government adopted a new regulatory structure for the whole of its financial industry known as the “twin peaks” model with two statutory regulators.

Second, in the U.S., the experience with SROs was not a solid endorsement for SRO reliance. As a result of a serious stock market scandal in the mid 1990’s, the NASD was subject to investigation by both the SEC and the U.S. Department of Justice. In 1996, this investigation culminated in a Section 21A Report under the *Exchange Act* which concluded that the NASD suffered from “undue influence” by its NASD Automated Quotation System members.

Third, the CSA decision to create the MFDA was not fully supported by the industry. In fact, there was strong industry opposition to the creation of the MFDA. MFDA was a new type of SRO unfamiliar to the industry. It did not reflect the historical evolution of SROs like NASD and IDA that began as associations created and controlled by industry and which over time began to conduct regulatory functions under the oversight of statutory regulators. In contrast, the MFDA was created at the instance of CSA statutory regulators, not the industry. MFDA membership was not voluntary, rather it was mandatory. In addition, the MFDA never had a trade association function, rather it was a pure public interest regulator with its initial staff coming from CSA statutory regulators and not the industry.

## 1.5 IMF Reviews

The current SRO structure in Canada is largely working well within the regulatory framework. This view is borne out by independent observers. In September 2010, the IMF made it mandatory for jurisdictions like Canada with systemically important financial sectors to undergo assessments by the IMF every five years. In 2014, the IMF assessed the Canadian securities regulatory regime as part of its FSAP review of Canada.<sup>71</sup> The SROs were assessed as part of that review. The IMF assessment had only a few minor criticisms of the operations of the SROs and none on the reliance placed on the SROs by the securities commissions. In particular, it is worth noting that the IMF assessor commented positively on the substantial resources the SROs devote to active supervision programs

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<sup>70</sup> Glorianne Stromberg, *Regulatory strategies for the mid-’90s : recommendations for regulating investment funds in Canada*, Ontario Securities Commission, (Stromberg Report), 1995, at p.45, online: <[http://faircanada.ca/wp-content/uploads/2010/10/Stromberg\\_RegulatoryStrategies\\_Feb95.pdf?ac95e7](http://faircanada.ca/wp-content/uploads/2010/10/Stromberg_RegulatoryStrategies_Feb95.pdf?ac95e7)>; Standing Committee on Finance and Affairs, Financial Services Statute Law Reform Amendment Act, 1993, Bill 134, Committee Transcripts, Legislative Assembly of Ontario, May 12, 1994, Mr. Donald Grant at p.1130–1140. online: <[https://www.ola.org/en/legislative-business/committees/finance-and-economic-affairs/parliament-35/transcript/committee-transcript-1994-may-12#P368\\_110351](https://www.ola.org/en/legislative-business/committees/finance-and-economic-affairs/parliament-35/transcript/committee-transcript-1994-may-12#P368_110351)>.

<sup>71</sup> IMF Country Report No. 14/73, *supra* note 11. For a survey of regulatory and legislative responses in certain G20 countries, see Carson, *supra* note 24.

and judged the examination and enforcement activities of the SROs as effective, while noting the securities commissions needed to do more active supervision of non-SRO firms.<sup>72</sup>

In June 2019, the IMF issued its most recent five year FSAP Report of Canadian financial markets. A key finding of the Report was the need to strengthen institutional arrangements for systemic risk oversight in order to ensure Canada's capacity to manage systemic risk going forward. The IMF also noted that the capacity to conduct Canada-wide market surveillance should be strengthened and supported by continued efforts to address data gaps. Observing the spread of systemic risk oversight responsibilities over multiple government layers and across sectoral boundaries in Canada, the IMF recommended the establishment of a single body with a clear mandate and appropriate powers to address systemic risk.<sup>73</sup>

## 1.6 Initiatives for Change: The Challenge of Practical Realities

The ability to design and execute up-to-date and responsive regulatory structures has been, and continues to be, a challenge for Canada. This results from the complexity of the issues, different public policy objectives and many uncontrollable dynamics such as the key features of globalization, technological advances, and business and financial product evolution. This is in contrast to permitting controllable factors such as commercial and political agendas, regulatory turf and less principled excuses to stand in the way of improvement. Accordingly, while identification of a common legislative or policy objective or structure design principle may be a necessary prerequisite for change, it may not be sufficient to actually effect and implement change.

For instance, in the case of the SROs in Canada and their relationship with their respective CSA statutory regulators, the challenge is not defining the common objective; rather, it is implementing and executing an effective securities regulatory regime on a practical and timely basis. This observation is not an imaginary barrier or inconvenience. It reflects the actual experience of regulatory developments with SROs in Canada. As an example, it was six years from the release of the Stromberg Report in 1995 that recommended the creation of an independent SRO for mutual fund dealers to the commencement of business of the MFDA in 2001.

The foregoing comment with respect to the practical aspects of turning regulatory policy objectives into a working regulatory system, integrated among all relevant parties, underlines the need for an efficient design process in which the planning and implementation can take place. (See *Part VIII – The Way Forward for MFDA and SROs in Canada*.)

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<sup>72</sup> IMF Country Report No. 14/73, *supra* note 11. Discussion of Principles 9 and 12 starting at pp.71 and 87, respectively.

<sup>73</sup> IMF Country Report No. 19/177, *supra* note 11 at pp.8 and 15.

## 2. International Perspective

In assessing SRO effectiveness and planning for the future, it is important to refer to the international perspective and experience regarding the use of SROs including the views of IOSCO. A more detailed overview is included in Schedule 4.

### 2.1 Diverse Approaches – No Standard Blueprint for Optimal Structure Design

A scan of various foreign jurisdictions shows that there are many different approaches to both statutory securities regulatory structures and the role of SROs. The level of reliance placed on SROs by the statutory regulators varies from virtually none to extensive.<sup>74</sup> Not only are the models different at any given time but the manner in which they have evolved into their current forms is often different as well. These differences reflect the circumstances of the various jurisdictions in which SROs play a role. For instance, certain political and economic features may favour or preclude the participation of SROs.

### 2.2 Impact of Practical Realities

The important distinction referred to in Section 1.6 of this Part VI between the theory of SRO design and the practical realities of such design and implementation for Canadian purposes is important to bear in mind when reviewing the international experience. The reality is that regulatory models, including SROs, may have evolved in one jurisdiction in a way that may not be possible to implement in another jurisdiction because of differing circumstances. However, this should not be used as an excuse to avoid examining the experience of the other jurisdictions. The key is to learn from these jurisdictions and adopt better regulatory principles unless there are legitimate barriers to doing so.

### 2.3 Be Bold and Commit to Change

One thing that is clear from the jurisdictions that have implemented significant changes to their securities regulatory structures is the need to be bold and commit to change to ensure successful implementation. Further, recognizing that there is no standard blueprint for optimal securities regulatory structure design, actual experience over time with a new model may prove to not generate the results originally hoped for and thus require additional change. The experience of the U.K. is demonstrative of this need to be bold, commit to change and then be prepared to change again if necessary. The U.K. eliminated SROs and adopted a single statutory regulator model in 1998 and then changed again in 2010 to a “twin peaks” statutory regulator model when the integrated model proved to have significant weaknesses. (See *Section 2.2.1 of Schedule 4 for U.K. discussion.*)

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<sup>74</sup> Anthony Ogus, *Rethinking Self-Regulation*, Oxford Journal of Legal Studies, 15:1 (1995), at p.97; Asia Securities Forum, *4th Comparative Analysis of Asian Securities Regulators & SROs and Market Characteristics*, December 2013. online: <[http://www.asiasecuritiesforum.org/pdf/2013/4thCOMPARATIVEANALYSISOFASIANSECURITIESREGULATOR\(final\).pdf](http://www.asiasecuritiesforum.org/pdf/2013/4thCOMPARATIVEANALYSISOFASIANSECURITIESREGULATOR(final).pdf)>

# Part VII

## Benefits of NewCo – An SRO Built for the Future

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### 1. Forward Looking and Modern

The NewCo model reflects a forward looking and modern approach to securities regulation influenced by several key factors.

- The NewCo model is a fresh blank page approach that preserves and builds on the “good” of what exists today and it avoids or addresses the “bad”.
- It is based on the proposition that the assessment and development of the role of SROs in Canada for the future should be based primarily on expected developments and needs of Canada and not constrained by current models.
- The NewCo model reflects and/or addresses other key factors such as:
  - SRO governance best practices;
  - The ongoing evolution and improvement of securities regulation in Canada and internationally;
  - The need for statutory regulators to have full market visibility and direct and real time access to market data; and
  - Public and investor expectations of statutory regulators.

## 2. Issues and Concerns Addressed/Resolved by NewCo

Following is a summary of issues and concerns relevant to the current SRO model in Canada from the perspective of the three core stakeholder groups – public/investors, industry, CSA statutory regulators – that would or could be addressed or resolved with the NewCo model.<sup>75</sup>

### 2.1 Public/Investor Perspective

#### 2.1.1 Confusion

Investors are not clear on the role of the SRO or the relationship between the SRO and the statutory regulator. Most investors assume that the statutory regulator is “on the job” and is the frontline regulator. This concern is exacerbated in Canada with two national SROs that seem to have overlapping regulatory responsibilities and dual platform members. Ultimately, the confusion is simply “who is doing what?” and “where does the investor go to for help?”.

#### 2.1.2 Conflicts of Interest and Regulatory Capture

Concerns regarding industry conflicts (real or perceived) and the risk of regulatory capture have led to several changes to the SRO model, including:

- Increased public director presence on SRO boards;
- Increased SRO oversight by statutory regulators;
- Requirements for SRO rules to be published for public comment and approved by statutory regulators;
- Amendments to legislation to allow statutory regulators to make any decision regarding operations of the SRO; and
- Enhanced reporting requirements by SROs to statutory regulators.

Notwithstanding these enhancements, the conflicts of interest and regulatory capture concerns remain and have been raised by investors and other public stakeholders.

#### 2.1.3 Lack of Accountability

Concerns have been expressed regarding the lack of accountability of SROs to a higher public interest authority. Other than requirements for the number of public directors versus industry directors, SRO governance is largely independent from any influence by government or statutory regulators. In the event the SRO fails to satisfy any expectations or request of a statutory regulator, the remedies available to the statutory regulator are limited, and include remedial orders with respect to decisions and the ultimate remedy of “de-recognition”. The de-recognition remedy is an impractical solution given the significant resources the statutory regulator would need to deploy in a relatively short time frame to ensure the same level of regulation continues.

#### 2.1.4 Lack of Protection Fund Coverage for Clients of non-SRO Registrants

Only clients of MFDA and IIROC members have direct protection fund coverage. Clients of other registrants do not have similar coverage.<sup>76</sup> This difference in coverage is often only discovered by

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<sup>75</sup> It is noted that several of the issues and concerns have been expressed by more than one of the stakeholder groups, however for the ease of reader accessibility, they have been mentioned only once.

<sup>76</sup> In Quebec, the Fonds d'indemnisation des services financiers compensates victims of fraud in relation to financial products and services offered by representatives, firms, independent representatives, independent partnerships, mutual fund dealers or scholarship plan dealers.



investors after a failure has occurred. While both the MFDA IPC and CIPF require members to tell their clients about coverage, there is no obligation on other registrants to warn their clients about the lack of direct coverage. A transparent review as to whether the public interest warrants such protection being made available for clients of such non-SRO registrants has not occurred.<sup>77</sup>

### **2.1.5 Lack of Active Regulation**

Many PMs, EMDs and SPDs deal with the investing public in Canada in the same manner as do MFDA and IIROC members, but they are not subject to the same level of active regulation reflected by detailed SRO rules and regular in-depth compliance examinations. This difference in active supervision between SRO and non-SRO registrants is even more concerning when many PMs and EMDs may engage in activity that involves more client risk (i.e. PMs usually have discretionary authority and EMDs are generally selling higher risk products).

### **2.1.6 Concern that SROs are also Trade Associations**

Notwithstanding that the SROs today have an exclusive public interest regulatory mandate, there continues to be a perception/concern among some stakeholders that the SROs function as industry trade associations rather than public interest regulators.

### **2.1.7 Governance – Public Director Ties with Industry**

Concerns have been raised with the blurring of the distinction between public directors and industry directors as some public directors were previously employed in the industry. The concern is that if public directors have a strong industry connection or background, there may be a risk that they may act in ways that benefit the interests of industry over the public.

### **2.1.8 Governance – Lack of Investor Representation**

Concerns have been expressed regarding the lack of investor representation in the SRO governance model.

### **2.1.9 Perception of Weak Enforcement Record**

There is a perception expressed by some stakeholders that MFDA and IIROC SRO disciplinary measures and sanctions are lax. Some stakeholders have also been critical of SRO cases where the SRO only disciplines the individual registrant and not the corresponding firm that was responsible for supervising the individual. A perceived weak SRO enforcement record has also been cited as an indicator of regulatory capture.<sup>78</sup>

## **2.2 Industry Perspective**

### **2.2.1 Duplication of Regulation, Regulatory Burden and Inefficiency**

CSA statutory regulators and SROs may impose similar but not identical regulatory requirements on the same registrants, which may result in duplicate and inefficient regulation and unnecessary regulatory burden.

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<sup>77</sup> MFDA did an extensive analysis of this issue in its paper: *Regulatory Gap in Canada – Fund Managers: The Need for a Compensation Fund*, November 20, 2008, MFDA Bulletin 0469-P, issued March 10, 2011, online: <<https://mfda.ca/bulletin/bulletin0469-p/>>.

<sup>78</sup> Knight, supra note 42; and M.E. Lokanan, *Regulatory Capture of Regulators: The Case of the Investment Dealers Association of Canada*, International Journal of Public Administration, 2017 at p.3. online: <[https://viurrspace.ca/bitstream/handle/10613/5140/IDA Enforcement Manuscript Capture IIPA Revised.pdf?sequence=1&isAllowed=y](https://viurrspace.ca/bitstream/handle/10613/5140/IDA%20Enforcement%20Manuscript%20Capture%20IIPA%20Revised.pdf?sequence=1&isAllowed=y)>.

### **2.2.2 Barrier to Innovation and Evolution of Business Models**

The current two separate SRO system in Canada, with limitations on the business relationships that can exist between members of different SROs represents a barrier to innovation and business model evolution.

### **2.2.3 Fragmentation**

Separate registration categories and SROs exacerbate fragmentation of markets and can cause market inefficiencies and unnecessary regulatory burden. Regulatory arbitrage can also result.

### **2.2.4 Blurring of Registration Categories**

Having separate SROs for separate registration categories is less logical in light of a convergence of financial advice activities, services and product innovations and the engagement by different types of firms in the same activities (i.e. different categories of securities registrants engaging in the provision of general financial advice and dealing with products that are similar).

### **2.2.5 Importance of “Self” in SRO**

Meaningful industry participation in governance, policy development and the enforcement processes are key features necessary to ensure an effective SRO with buy-in from industry participants.

### **2.2.6 Business Conduct/Prudential Regulation and Market Regulation Different**

Business conduct and prudential regulation is different than market regulation and surveillance. This difference involves not only different rules and requirements but also different regulatory staff expertise and systems capabilities. Combining both types of regulation in the same SRO poses three key concerns:

- Lack of commonality of member interests as not all members directly trade on markets;
- Fee cross-subsidization; and
- Dilution of regulatory expertise and focus of the SRO.

## **2.3 Statutory Regulator Perspective**

### **2.3.1 Philosophical View Questioning Reliance on SROs**

Some statutory regulators have questioned the continued reliance on SROs and have asked the question “Why are we not doing this regulation ourselves?”

### **2.3.2 Lack of Statutory Regulator Resources Less of a Reason for SRO Reliance**

In 1995, when creation of the MFDA was initially proposed and when the IDA was formally recognized (under the new SRO provisions in the *Ontario Securities Act*), a key driver behind this reliance on SROs was a lack of resources at the statutory regulators to conduct the level of regulation felt necessary in the public interest.<sup>79</sup> Today, with many CSA jurisdictions now having self-funding status, lack of resources is less of a limiting factor. Industry member fees levied to finance industry regulation could be paid directly to the CSA statutory regulator instead of an SRO. A main concern for industry members is the avoidance of fee cross-subsidization – comfort that the fees they pay are

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<sup>79</sup> Stromberg Report, supra note 70 at p.22; Standing Committee on Finance and Affairs, *Financial Services Statute Law Reform Amendment Act*, 1993, Bill 134, Committee Transcripts, Legislative Assembly of Ontario, May 12, 1994, Mr. Donald Grant at p.1130-1140.

going to regulation of their business (and firms in a similar business) and not being diverted to pay for regulation of some other business activity or some other initiative unrelated to the regulation of their business.

### 2.3.3 Lack of Visibility Regarding Full Market Activity and Risk

CSA statutory regulators are responsible for regulation of all trading markets – which includes recognizing organized markets as well as regulating activity on the markets. Currently, the CSA recognizes the markets (exchanges and ATSS) and allows frontline market supervision and surveillance functions to be performed by IIROC. Issues associated with allowing these market regulation and surveillance functions to be conducted by an industry SRO include:

- **Lack of Visibility:** CSA does not have a full or direct view of all trading on all markets.
- **Lack of Expertise Development (human and systems):** Relying on an industry SRO to perform market surveillance and regulation prevents CSA from developing this expertise in house. Arguably this concern increases as markets and trading activity become more sophisticated and the expertise gap at CSA grows.
- **Systemic Risk/Financial Stability Relationship:** The 2008/2009 global financial crisis demonstrated the need for a system-wide approach to financial regulation and oversight, to mitigate the build-up of systemic risk. One of the lessons derived from the 2008/2009 global financial crisis was the need for securities regulatory authorities to contribute more to overall market integrity, through more robust monitoring and regulation of systemic risk. The global financial crisis demonstrated that the failure of markets and market regulation and surveillance can potentially have system-wide risk and financial stability implications.<sup>80</sup>
- **More Appropriate Role for Statutory Regulator:** This type of regulation is more properly the purview of government regulators rather than industry SROs.<sup>81</sup>

### 2.3.4 MFDA Member Approval of Rules

MFDA Members currently continue to have the power to approve (or not) MFDA Rules. Concerns have been expressed regarding the MFDA's ability to get Rules approved by Members. It is noted that neither IIROC or FINRA members have a similar rule approval power.

### 2.3.5 SRO Power to Grant Rule Exemptions without prior CSA approval

Consistent with the goal of CSA statutory regulators to conduct effective and robust SRO oversight, all SRO rules are subject to approval by the CSA statutory regulators before they can become effective. However, inconsistent with this CSA SRO rule approval requirement, SROs have the ability to grant exemptions to their rules without having to obtain prior CSA statutory regulator approval.

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<sup>80</sup> IOSCO, Technical Committee, *Mitigating Systemic Risk – A Role for Securities Regulators*, February 2011, at p.6, online: <<https://www.iosco.org/library/pubdocs/pdf/IOSCOPD347.pdf>>; Mary Condon, *Canadian Securities Regulation and the Global Financial Crisis*, UBC Law Review, 42:2 (2010), online: <[http://digitalcommons.osgoode.yorku.ca/cgi/viewcontent.cgi?article=1706&context=scholarly\\_works](http://digitalcommons.osgoode.yorku.ca/cgi/viewcontent.cgi?article=1706&context=scholarly_works)>; Anita Anand, *Is Systemic Risk Relevant to Securities Regulation?*, University of Toronto Law Journal, 60 (2010), online: <<https://www.law.utoronto.ca/documents/anand/UTLJ-2010-11-systemicriskrelevant.pdf>>.

<sup>81</sup> Australian Media Release, *supra* note 16.

# Part VIII

## The Way Forward for MFDA and SROs in Canada

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### 1. Principles Applicable to Moving Forward

The successful design and implementation of NewCo will depend on the acceptance and adherence to certain principles in order that the processes be disciplined and focused.

#### 1.1 CSA Directed

The initiative for and supervision of NewCo's development must ultimately be directed by the CSA statutory regulators. This could include retention of a notable expert or formation of a committee of notable experts, in securities regulation to provide profile, independence and credibility to the initiative. The diversity of interests affected by NewCo make it unrealistic to expect an orderly and timely process of design and implementation without firm direction from the CSA and active CSA participation in exercising its regulatory authority. However, this principle does not preclude - and it would be expected to include - the active and meaningful participation of all affected interests including the existing SROs, industry representatives, protection funds, investor groups, public interest forums and governmental bodies and agencies with related jurisdiction.

#### 1.2 Clear Mandate

The design and implementation process should be based on clarity and acceptance of the basic features of NewCo as outlined in this Paper or otherwise adopted as consistent with the model. While there are many details to fill in and relationships to define, the process should not invite or tolerate reconsideration or subversion of the structure of NewCo and the principles on which it is based and would be expected to operate.

#### 1.3 Experienced Participants

NewCo builds on and consolidates many of the existing regulatory structures which govern the securities industry and is expected to continue regulatory functions currently carried out by the CSA members and the SROs. Accordingly, the leadership and participants in the design and implementation of NewCo should consist primarily of individuals with direct experience in such functions - and not general policy experts or others who do not have such direct experience.

## 1.4 Effective Project Management

The complexity of implementing NewCo and responding to the many interest groups affected require that tight project management processes be imposed. The experience in more than one initiative in Canadian securities regulatory reform or improvement in recent years has been that the projects have been compromised or often abandoned because of project management processes that (i) have been overly ambitious in terms of participant inclusion, (ii) tolerant of relaxed timelines, and/or (iii) have vague outcome expectations.

## 2. Process

Until the level of interest and acceptance of the concept of the NewCo model is determined, it would be premature for this Paper to propose specific processes for moving forward with its design and implementation. However, some comment on the main features of a successful process may be made.

### 2.1 Focused Consultation

Wide and open consultation on the NewCo model will contribute to its adoption, as improvements would likely be expected to be identified in the process. However, the scope of consultation should be focused on the basic features of NewCo and not invite wholesale redesign or advocacy for entirely different approaches. As indicated, NewCo should be a CSA directed initiative and, as such, the decision to consider the model belongs to the CSA. How the CSA makes its own determinations in that regard is not for comment by the MFDA, but the belief of the MFDA is that the respective members of the CSA are in an informed and sound position to manage the process with confidence.

### 2.2 Steering Group and Design Teams

It would be expected that a small steering group would be established to oversee the implementation process for NewCo. The composition of the steering group would be led by a CSA representative or appointee and reflect the main stakeholder interests affected. As indicated above, the determinative characteristic of the members of the steering group (and design teams) would be direct experience in securities regulatory activities. Separate design teams would be established under the direction and coordination of the steering group to assess and recommend the steps and features of implementation including: the regulatory operating structure and functions of NewCo; transitioning of functions from the CSA members and SROs; preparation of any necessary changes to CSA rules, regulations and policies; internal organization features of NewCo including personnel, funding and governance. The work of all such teams would be coordinated to the extent necessary with related but non-NewCo initiatives such as the assumption of market regulation and surveillance activities by the CSA.

### 2.3 Timing

The nature and status of NewCo is relatively simple, but the securities regulatory needs that it is intended to serve are broad and more complicated. This situation suggests a transitional or scalable approach to implementation with the early establishment of NewCo as an organization and the staged transition of functions to it. Discipline will be required to ensure that the process of transition is as tight as is practicable and that the complete establishment and operationalizing of NewCo is achieved in a timely manner.

# Schedule 1

## Alternative Models

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As noted in the Introduction of this Paper, in considering how the public interest regulatory objectives of all securities regulators (statutory or SRO) can best be achieved, there are many approaches and options to consider. Several possible models, including considerations and observations associated with each model are described below.

The SRO models identified and commented upon have been selected because they (i) have arisen for discussion in the current Canadian context, (ii) are based on aspects of the MFDA's structure and operations that have made it successful, or (iii) they reflect the experience in other jurisdictions from which Canadians may learn. It is noted, however, the models discussed are representative, not exhaustive, and there are others that may be identified.

It is also important to recognize that it is simplistic to categorize regulatory models as having discrete and absolute features. In fact, all regulatory structures are hybrids of different features and circumstances. However, for the purposes of this Paper it is convenient to identify and discuss the possibilities with reference to their primary and commonly understood features. Further, it must also be kept in mind that all of the models discussed below will be influenced by decisions of governments or CSA statutory regulators as to what areas of regulation should be performed by them as frontline regulators.

### 1. No SROs

One of the regulatory models to be considered is the elimination of SROs as a feature of Canadian securities regulation. Many jurisdictions around the world operate without SROs. It is also pertinent to remember that the SRO model did not develop historically as a matter of statutory directive or regulatory policy; rather, it pre-dated modern securities legislation in many jurisdictions, including Canada and the U.S. Securities legislation eventually took into account the SRO market feature largely as a practical solution to address resource constraints. (See *Part VI and Schedules 3 and 4 for some background*).

Some considerations in the “No SRO” approach are:

- The regulatory structure could be simplified somewhat and any inefficiency resulting from the duplication of regulatory efforts by SROs and statutory regulators would be eliminated.
- The practical likelihood of any material operational/administrative efficiencies or cost savings through consolidating SRO functions into statutory regulators is low.
- Concerns of industry self-interest or conflicts of interest would be eliminated.



- Better coordination and harmonization of various aspects of financial services markets (both policy development and regulation) by one (or more) regulators under one governmental authority, and an increase in both (i) the ease with which the statutory regulators can see the whole of market, and (ii) their expertise in markets and participants.
- The framework would align the Canadian regulatory regime more closely with other developed countries – other than the U.S., Switzerland and Japan.
- Assumption by CSA statutory regulators of market regulation and surveillance would provide CSA with full market visibility and better enable it to identify systemic risk issues associated with the markets.
- Statutory regulators (and their governments) would have to substantially increase resources in terms of personnel, expertise and administration dedicated to securities regulation. Additional funding from the public or industry would have to be secured. Self-funding status now possessed by many CSA statutory regulators could address this.
- The benefits of the SRO model such as industry expertise, member/participant responsibility and buy-in, and private sector efficiency would be lost – unless replaced with comparable expertise and structures that engage the same level of industry involvement.
- The role and future of the SRO sponsored compensation funds (MFDA IPC and CIPF) would have to be considered.
- The implementation of such a complex transformation of the structure would require a significant investment of time, resources, expertise, coordination of interests and cost, thus impeding delivery of statutory regulators' strategic objectives.
- Direct oversight of all registrants by the statutory regulators would require continued coordination among all CSA statutory regulators.

## 2. Status Quo

A status quo approach to contemplating the appropriate future regulatory structure and role of SROs in Canada has different aspects and implications. There are at least three variations of this approach which are referred to below but there are a couple of overriding principles that apply to them all:

- ***SROs are working well.*** There is no immediate public interest concern or risk that is evident in the SROs continuing to perform their roles for the immediate future.
- ***No action may be high risk.*** In the longer term, to assume that the current SRO model will continue to serve Canada well, given the rapid pace of change, may be high risk. A changing environment would likely require changes to the model.

The variations of a status quo approach include:

- (i) ***Assume the status quo is acceptable indefinitely.*** This is the approach of no planned change or review of SROs for the indefinite future. There are various arguments that would support this position, including that: existing SROs are effective regulators at present; there are other regulatory priorities; the CMRA statutory regulatory direction is not settled; and the current complexities are too challenging. In the view of the MFDA as noted above, this strategy may be high risk.

**(ii) Status quo with random ad hoc change.** This approach adopts the status quo to the extent no formal review or planned redesign of the SRO system in Canada would occur. It is based on the assumption that changes to regulatory structures and operations would occur as a matter of course over time. Examples of random ad hoc change include discrete legislative or policy amendments, rule exemptions (i.e. proficiency upgrade exemption) as well as a merger of the existing SROs.

In the view of the MFDA, a strategy of ad hoc and unplanned long term regulatory change is not responsible and liable to lead to less than optimal results – with the real risk of ultimately reducing investor protection and confidence.

**(iii) Plan for Change now and Implement in Future.** The prudent and likely most successful approach when considering the broader public interest is to begin planning for change now (i.e. the NewCo model discussed in Part III) that could be implemented at the appropriate time in the future. The logical and reasonable time during which the status quo could be maintained is until the statutory regulatory structure (with or without the CMRA) is determined and settled.

### 3. Merger of Existing SROs

The matter of merging the MFDA and IIROC has been considered several times since the MFDA was established, including in the context of proposals by IIROC relating to employment of mutual fund restricted IIROC advisors and elimination of the proficiency upgrade requirement.<sup>82</sup> Considerations relevant to the merger of the existing SROs today include:

- A single SRO in respect of the distribution of similar investment products is attractive in many respects including common standards, reduced client confusion and expectations, streamlined regulatory structure, less fragmentation and concentrated expertise.
- The membership and business models of the two SROs are different – with most MFDA members serving only retail customers – and the synergy of a common membership would not likely be achieved absent the “level playing field” benefits associated with the regulation of other retail client facing registrants.
- While some increased critical mass in a combined SRO membership may be positive, unless the respective interests of the member groups are aligned there may be little benefit in efficiencies or regulatory effectiveness.
- While it is recognized that there would be a need to minimize cross-subsidization of separate regulatory areas (i.e. market regulation and dealer functions), such a structure inevitably introduces inefficiencies.
- Actual efficiency gains or identifiable, material cost savings for the SROs appear to be slight, if any.
- MFDA’s singular regulatory focus on the retail investor would likely be diluted in a combined model.
- The role of IIROC as a market surveillance regulator is a concern in terms of commonality of member interests, regulatory functions and objectives, and fee cross-subsidization.

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<sup>82</sup> SRO consolidation was raised by stakeholders as a “consequence” of eliminating the proficiency upgrade requirement, rather than a solution. The solution to this issue would require a revision to existing dealer registration categories and related proficiency requirements.

- The integration of the two sponsored protection plans – MFDA IPC and CIPF – would require detailed consideration in light of the differences in risks they underwrite (and for which they charge assessments).
- The successful integration of two different corporate cultures, influenced in part by MFDA’s history as a pure regulator and IIROC’s previous history (through the IDA) as an industry trade association, could prove challenging.
- MFDA and IIROC firms, in many respects, are direct competitors for the same clients. A merger may be viewed by many, including smaller independent MFDA members, as an IIROC “takeover” of MFDA intended to facilitate the takeover of MFDA firms and/or “poaching” of top advisors of MFDA firms.

In October 2005, the MFDA Board of Directors met to discuss a specific merger proposal with the then IDA. The MFDA Board concluded that a merger was not in the public interest and would raise a number of complex and difficult issues and concerns that, on balance, did not make a merger attractive. Although the circumstances of MFDA, IIROC and the securities industry have changed since then, many of the issues remain relevant today. The issue of SRO consolidation has also been the subject of comment in periodic MFDA Member surveys and consultations, including 2011, 2014 and 2018. The consensus view of MFDA Members and the MFDA Board of Directors has been that consideration of any redesign of the current two SRO system in Canada should include a larger review of the role of self-regulation in Canada. Such review would take into consideration all relevant factors including other relevant registration categories, the evolution of the CMRA, and the role of CSA statutory regulators.

The view is that a merger of MFDA and IIROC essentially perpetuates the existing regulatory model with little benefit to MFDA Members, Canadian investors or the Canadian capital markets; it raises the possibility of negative features being introduced (such as increased costs and dilution of regulatory focus); and it provides little in the way of real change to meet the future needs of Canada. In essence, the view is that a two SRO merger is too narrow and simply perpetuates the status quo and a broader more thoughtful review is needed in the public interest.

## 4. Multi-SRO Model

The successful experience of the MFDA demonstrates the particular benefits of the SRO model when it applies to concentrated memberships where there is a common interest of the members and focused regulatory expertise.<sup>83</sup> The corollary of this observation is that multiple SROs with particular market focus may be beneficial. The creation of the MFDA itself is an example of this view. The following are some of the considerations relevant to a multi-SRO model:

- The prospect of focused expertise and regulatory activities is attractive and has been suggested in the past for some types of securities businesses.
- A focused SRO may give greater opportunities for members to be directly involved in the development of policy at the SRO, which leads to greater buy-in and higher levels of compliance with requirements. It also harnesses the industry expertise of the members in the development of regulatory requirements.
- The costs of establishing a new SRO are considerable.

<sup>83</sup> MFDA has consistently met the SRO oversight expectations of CSA statutory regulators, most recently evidenced by clean CSA oversight reports in 2018 and 2019 with no material findings or deficiencies.

- The multi-SRO model creates greater regulatory fragmentation that can, in turn, increase investor confusion, reduce regulatory harmonization and, likely, increase inefficiencies among regulators and market participants resulting from duplication of members and regulatory efforts.
- A multi-SRO model potentially increases disparate regulation of similar activities as well as opportunities for regulatory arbitrage.
- The oversight role and resource investment of CSA statutory regulators necessarily increases under this model.
- Both the risk of regulatory capture and the potential for conflicts increase with a smaller more focused regulator under this model.
- Smaller more focused SROs may lack the critical mass to be sustainable in the long term and are subject to the risk of market developments rendering the particular business model or product becoming obsolete or different which may undermine the effectiveness, relevance and viability of the SRO.
- As a practical matter and in view of the several reviews and initiatives in Canada that stress the need for greater regulatory simplicity, integration and harmonization, it is difficult to support the proliferation of smaller, focused SROs.

## 5. Separate Regulatory Function Model

A developing trend in structuring financial services regulation at the statutory regulator level is to divide responsibilities for regulation by regulatory function, rather than by type of firm. This is the so-called “twin peaks” model of financial services regulation which separates consumer protection/ business conduct regulation (often along with market regulation) from prudential regulation which concerns itself with solvency and, to a degree, systemic risks. This regulatory approach has been used by statutory regulators in the U.K., the Netherlands, South Africa and Australia.<sup>84</sup>

The rationale is that different kinds of regulation are appropriate or necessary for different kinds of regulatory and market risks and concerns. Such different risks may require different expertise and regulatory approaches. Further, combining conduct and prudential regulation in one regulator may give rise to conflicts at the regulator on actions to be taken. This model also allows for the development of common requirements across various types of financial services organizations.

A challenging design issue for this model is how to define the scope of each regulator’s responsibilities so as to ensure proper coverage while minimizing potential overlap. For example, a number of existing requirements fall into both business conduct and prudential regulation, such as some of the internal control and supervisory requirements. In addition, market regulation does not fall neatly into either category. It is defined in different ways by different jurisdictions and the responsibilities for regulating various aspects may fall to the statutory regulator, an SRO and/or an exchange, whether or not the exchange is recognized as an SRO.

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<sup>84</sup> It should be noted that in Australia, and to a lesser degree in the U.K., the prudential oversight of the securities industry lies with the conduct regulator – ASIC or the FCA – not with the prudential regulator.

Considerations relevant to the model that separates SRO responsibilities by regulatory function include the following:

- The division of consumer protection/business conduct regulation from prudential regulation more easily accommodates the inclusion of other registration categories dealing with retail investors and the benefit of commonality of member interests would be preserved.
- The theory of twin peaks regulation is not always easy to apply because distinguishing between issues or conduct that affect consumer protection/business conduct alone and not prudential matters that may affect financial markets as a whole (or vice versa) can be difficult. Further, consumer protection may be put at risk by financial weakness of the firms providing services. This is particularly so in the Canadian SRO context where the respective compensation funds (MFDA IPC and CIPF) have a role and interest in ensuring robust compliance in both business conduct and prudential matters.
- The proper place or fit for market regulation and surveillance functions may be problematic to determine. For instance, the appropriate regulatory division among SROs, statutory regulators or governments must be determined. In addition, from the point of view of regulatory focus and commonality of member interests, market regulation and surveillance activity is peripheral to the MFDA's core regulatory focus of consumer protection/business conduct and the business of its Members.
- The focus on business conduct and prudential matters, respectively, by different regulators may result in regulatory overlap with other regulatory structures dealing with similar subject matter. For instance, a very high percentage of the Canadian securities distribution business is owned or controlled by federally regulated financial institutions that are subject to federal prudential and systemic risk oversight by the Office of the Superintendent of Financial Institutions.

## 6. New Comprehensive SRO

The design and development of a new single comprehensive SRO entails a broader “blank page” approach of identifying what SRO model best serves regulatory and investor protection needs. Ultimately, this approach should not only assess the objectives and capabilities of the current securities industry SROs, but should also identify other financial services segments that could be better served by inclusion or by greater harmonization. The often cited example of the similarity of insurance segregated funds and mutual fund products and the view that they should be regulated in a similar manner illustrates the “comprehensive” aspect of the approach. The Segregated Funds Working Group Position Paper of the Canadian Council of Insurance Regulators<sup>85</sup> released in December 2017 illustrates further commitment in this regard. Considerations relevant to the development of a new comprehensive securities industry SRO model include the following:

- The compelling rationale of this approach is that the protection of investors should be the overriding objective and this should not be subject to restrictions resulting from regulatory structures, jurisdictional turf, historical happenstance and industry self-interest.
- A comprehensive approach may be simpler, more effective and consistent with financial regulation in other jurisdictions such as Australia and the U.K.

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<sup>85</sup> CCIR, Segregated Funds Working Group, *Position Paper*, December 2017, online: <<https://www.ccir-ccra.org/Documents/View/3369>>.

- The broader range of members of a larger SRO with more comprehensive regulatory scope brings with it distancing in engagement by its members. This, in turn, may reduce the effectiveness of the policy and rule development process and result in reduced member buy-in and compliance with rules. It may also be more difficult to develop a single set of rules that would apply appropriately across a disparate membership. However, issues resulting from a broad membership may be mitigated in large measure by a level playing field.
- A single overall set of rules for like conduct and businesses would create a more level playing field as the same standards would apply to the same activity, regardless of the type of intermediary carrying on the activity. It would reflect the principle that “like conduct should be subject to like regulation” and it would be less confusing for clients who often do not understand the differences between registration categories or particular financial sectors. Further, a single SRO with one set of rules and processes would make it easier for clients to understand their rights and know where to address their complaints. The opportunity for regulatory arbitrage would also be reduced.
- The comprehensive SRO would benefit from exposure to a broader range of regulated entities and activities that would enhance the quality of regulation and regulator visibility of registrant conduct. In addition, the risk of dominant members creating conflicts of interest or regulatory capture is reduced.
- The foregoing rationale may not be sound if the resulting SRO’s complexity, increased size and cost compromise its effectiveness and ability to protect investors.
- As with the separate regulatory function model, the proper place or fit for market regulation and surveillance in a comprehensive SRO model is problematic and is considered a better and more appropriate fit with CSA statutory regulators.
- The criteria for determining the scope of mandate and authority of a comprehensive SRO model may be difficult to establish both as a matter of policy and practicality. The risk of engagement in theoretically well-founded discussions which have little chance of practical success may temper consideration of the comprehensive SRO approach. Accordingly, an inclusive and clear design, implementation and decision process would be critical.



# Schedule 2

## Market Regulation and Surveillance by CSA

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Supplementing the discussion in Section 4.1 of Part IV, following is additional discussion of factors supporting CSA assumption of market regulation and surveillance responsibilities.

### 1. More Efficient Investigation and Enforcement of Market Abuse

To be effective, the supervision of market activity to combat market manipulation, insider trading and other abusive behaviour requires the regulator to have full access to information about all related trading taking place in the markets – both on exchanges (and other authorized marketplaces such as ATSS) and in the over-the-counter (OTC) markets. The CSA's current Business Plan recognizes the importance of having the necessary access to complete market data along with the capability to analyze that data effectively (data analytics). Direct data access and data analytics capabilities will increase the effectiveness of the CSA's surveillance and enforcement activities. Initiatives under strategic goals 3, 4, 7, 8 and 9 of the (2019-2022) CSA Business Plan are supportive of this outcome.

Accurate identification and full assessment of suspicious transactions may require access to information from other domestic and foreign regulators or from persons other than securities registrants. The ability of SROs to access these sources is limited. Information sharing arrangements are largely between statutory regulators and some jurisdictions will not provide information directly to SROs.

Finally, the only power to take action for market abuse where the defendant is not a registrant lies with the statutory regulators and the courts, not with the SROs.

### 2. Reduction of Overall Infrastructure Costs and Related Regulatory Burden

If the responsibilities for market supervision and surveillance are fully assumed by the CSA, the duplication of efforts between the CSA and the marketplaces in this area is eliminated. The overall costs of establishing and maintaining state-of-the-art surveillance and data analysis systems should be reduced as multiple systems should not be needed. This should result in a reduction of the regulatory burden on market participants.

### 3. Financial Stability/Systemic Risk – Centralized Supervision

The markets must operate (and be seen to operate) efficiently, fairly and transparently or there will be a risk of erosion of market trust, undercutting the markets' effectiveness and putting stability at risk. A regulatory framework of strong investor protection standards, transparency requirements, risk monitoring and robust enforcement are important regulatory tools that buttress financial stability. The statutory regulator is primarily responsible for establishing and enforcing the appropriate regulatory framework. Further, direct risk-based supervision of all of the regulated markets, together with a more targeted surveillance and enforcement approach by the statutory regulator contribute to ensuring that markets remain fair and efficient.

Reducing systemic risk is one of the three IOSCO core objectives of securities regulation. Statutory securities regulators have an important and unique role to play in identifying, monitoring, mitigating, and managing systemic risk owing to the central role that derivatives and securities markets play in the overall financial system. It is generally agreed that these markets have the capacity to both generate and transmit risks throughout the system.

Systemic risk in the securities markets may result from sudden negative events, but more often results from a prolonged build-up of risk over time. It may also result from a gradual erosion of market trust owing to market misconduct, that undercuts the markets' ability to efficiently price and allocate risks to willing investors.<sup>86</sup>

Globally, systemic risk monitoring and mitigation is the responsibility of government ministries, central banks, and statutory regulators and supervisors. Securities regulators are expected to contribute to those activities by putting in place internal processes and contributing to arrangements with other responsible entities to identify, monitor, mitigate and manage potential systemic risks. IOSCO expects the securities regulators to be able to contribute to the systematic and robust analysis of entities, products, markets, market infrastructures and activities across securities markets that could be the source of systemic risk using accessible, reliable and good quality data. Securities regulators are also expected to contribute to a broad understanding of the financial markets environment in which they operate and on which assessments of systemic risk can be made. The regulators should understand the interconnections between different products, markets, market infrastructures and activities across securities markets.<sup>87</sup>

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<sup>86</sup> IOSCO, Assessment Methodology, Principle 6, *supra* note 38.

<sup>87</sup> *Ibid.*

# Schedule 3

## Canadian Regulation

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Supplementing the discussion in Section 1 of Part VI, following is additional discussion of the Canadian securities regulatory landscape.

### 1. Current Canadian Landscape

SROs currently play a prominent role in the regulation of aspects of the Canadian securities marketplace. They are the frontline regulators of the two categories of market intermediaries that serve the majority of the retail investing public: investment dealers and mutual fund dealers.

The framework for regulation of market intermediaries and markets in Canada is more complicated than in most other countries. The responsibilities for regulation of market intermediaries and markets is spread across 13 statutory regulators, three non-exchange SROs (IIROC, MFDA and the CSF) and the Bourse de Montréal (MX). The frontline regulation of registrants is divided between the CSA statutory regulators, MFDA, IIROC and the CSF in Quebec.

The CSA statutory regulators are ultimately responsible for the regulation and supervision of both markets and registered firms. They act directly by:

- Setting baseline requirements that apply to all registrants or markets, such as National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103), National Instrument 21-101 *Market Place Operations*, and National Instrument 23-101 *Trading Rules*;
- Registering intermediaries and recognizing markets in accordance with those baseline requirements;
- Conducting on and off-site supervision of investment advisers/PMs (other than those carrying on business within IIROC members), EMDs, SPDs and investment fund managers;
- Overseeing the operations of the SROs and exchanges, through rule reviews and oversight examinations; and
- Investigating and taking enforcement action for breaches of the securities laws, regulations and rules.

In response to the current fragmented regulatory framework, the CSA has made significant progress over the past several years in producing a harmonized regime to govern market intermediaries through the Registration Reform Project in 2009 and most recently, the NI 31-103 Client Focused Reforms in October 2019. However, the system is still not fully harmonized and the CSA is working to make its rule-making process more timely and effective through ongoing collaborative efforts, which can be challenging with changing priorities and political environments. Further, there continues to be material differences between the regimes imposed on members of MFDA and

IIROC versus those that apply to other market intermediaries who offer similar services to investors (who may also be clients of these SRO members) further complicating the task of implementing a cohesive regime.

## 2. Intermediary Regulation

The standards that dealers, advisors and investment fund managers in Canada are required to meet differ depending on the category of registration of the firm and the jurisdiction in which it operates. Investment dealers and mutual fund dealers (outside Quebec) must be members of IIROC or the MFDA (respectively). The SROs often set higher standards for their members and their rules generally are more detailed than those of the CSA. Firms registered solely in one or more of the other categories of registration (i.e. EMD, PM, SPD) are not required to be members of an SRO.

MFDA and IIROC oversee a wide range of activities and have established rules regarding capital adequacy, business conduct, sales practices, proficiency and market conduct rules applicable to their members. Each conducts disciplinary proceedings where there has been a breach of those rules and imposes sanctions.

### 2.1 IIROC

The regulation and supervision of investment dealers and market surveillance of the bond market and all equity markets in Canada is the responsibility of IIROC. IIROC is recognized by the securities regulators of Alberta, British Columbia, Manitoba, New Brunswick, Newfoundland and Labrador, Northwest Territories, Nova Scotia, Nunavut, Prince Edward Island, Ontario, Quebec, Saskatchewan and the Yukon and operates in all Canadian jurisdictions.

IIROC was formed in 2008 from a merger of the two SROs that were responsible for regulation of investment dealers – the IDA and RS. The IDA was an SRO and trade association that began in 1916 as the Bond Dealers Section of the Toronto Board of Trade. In 2006, its trade association functions were transferred to a separate company: IIAC. RS commenced operations in 2002. RS was created to be an independent and neutral body to monitor and enforce compliance with trading rules on Canadian equity markets, including stock exchanges, quotation and trade reporting systems and ATSS. It was responsible for market surveillance, trade desk supervision, investigation, and enforcement functions.

### 2.2 MFDA

The regulation and supervision of mutual fund dealers falls to the MFDA outside Quebec. The MFDA is recognized by the securities regulators of Alberta, British Columbia, Manitoba, New Brunswick, Nova Scotia, Ontario, Prince Edward Island and Saskatchewan, and operates in all Canadian jurisdictions. Applications for SRO recognition have been filed and are currently being considered in Newfoundland and Labrador, Nunavut, the Yukon and the Northwest Territories. In Quebec, the AMF supervises the mutual fund dealer firms, while CSF is responsible for the education and supervision of individuals who act for mutual fund dealers and scholarship plan dealers within the province. The MFDA, CSF and AMF have entered into a cooperative agreement to govern the regulation of MFDA Members with operations in Quebec and elsewhere in Canada by providing for similar standards and oversight to apply and to coordinate inspection programs and enforcement responsibilities.

The MFDA was established at the initiative of the CSA in response to the rapid growth of mutual funds in Canada in the late 1980s and recognition by the CSA that the mutual fund industry and investors would benefit from more direct, and therefore more effective, regulation and supervision of mutual fund dealers and their representatives. The MFDA was incorporated in 1998 and was first recognized as an SRO in 2001.

Many MFDA Members are also registered in other categories under securities legislation as EMDs, SPDs or investment fund managers. Virtually all of MFDA's 81,000 Approved Persons are dually employed as they are registered to sell insurance or employed with a financial institution such as a bank or credit union. In addition, many Approved Persons also have a recognized financial planning designation (i.e. CFP, PFP) and offer services in that area.

The MFDA's business conduct rules (i.e. duty to act fairly, honestly and in good faith, complaint handling, conflicts) apply to all Member business and activities of Approved Persons in this area. Similarly, MFDA prudential rules apply to all activities carried on by MFDA Members.

### 3. Market Regulation

Responsibility for market regulation and surveillance is shared between the CSA statutory regulators, six exchanges (one of which is also recognized as an SRO) and IIROC. The framework may become more complex with the advent of the federal *Capital Markets Stability Act* that, among other things, considers whether trading in certain securities or derivatives would transmit risks through the capital markets or the financial system and thereafter authorizes the federal government to set a wide array of requirements, prohibitions and restrictions.<sup>88</sup>

#### 3.1 The Role of CSA Statutory Regulators

The CSA statutory regulators are responsible for: regulating the capital markets as a whole, authorizing new exchanges and other marketplaces, setting baseline requirements with respect to entry standards for marketplaces, trading rules and other matters with general effect on the marketplace,<sup>89</sup> overseeing how the recognized exchanges and other marketplaces operate through rule review and on-site examinations, and for taking enforcement action regarding offences such as insider trading and other breaches of securities legislation.

#### 3.2 The Role of IIROC

IIROC oversees all trading activity by its members in debt instruments in Canada. It also regulates trading conduct of its members and other institutions and individuals that participate directly in a Canadian equity marketplace for which IIROC is the regulation services provider (RSP), which includes all equity exchanges and ATSS. Any marketplace that retains IIROC as its RSP to regulate equity trading activity must become a Marketplace Member of IIROC. All firms operating as ATSS must become Dealer Members, in addition to being Marketplace Members.

Trading on marketplaces for which IIROC acts as RSP is subject to rules administered and enforced by IIROC called the Universal Market Integrity Rules (UMIR), a common set of equity trading rules designed to ensure fairness and maintain investor confidence. Each Canadian equity marketplace has retained IIROC to:

- Administer and enforce UMIR and provide guidance regarding the application of UMIR;
- Monitor and review trade desk procedures of persons accessing the Canadian equity marketplaces;
- Conduct surveillance of trading activity on and across all stock exchanges and ATSS to ensure compliance with UMIR; and

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<sup>88</sup> CCMR Statement, *supra* note 54.

<sup>89</sup> See for example, National Instrument 21-101 – *Marketplace Operations*, and National Instrument 23-101 – *Trading Rules*.

- Impose trading halts or delays relating to market integrity matters and coordinate halts or delays with other marketplaces.<sup>90</sup>

Marketplaces regulated by IIROC are: NEO Exchange Inc., Canadian Securities Exchange, Instinet Canada Cross Limited (ATS), Liquidnet Canada Inc. (ATS), Nasdaq CXC Limited (Exchange), Omega ATS, TMX Group, TriAct Canada Marketplace – Match Now (ATS).<sup>91</sup>

The other Canadian exchange, the MX, a derivatives market, is also recognized as an SRO by the AMF. The MX regulates trading by participants on its trading facilities, conducts market surveillance, inspects member firms for compliance and takes enforcement action where breaches have been found.

## 4. Cooperative Capital Markets Regulatory System

While no national securities regulator yet exists, significant progress in establishing a single regulatory system has taken place. The proposed formation of the Cooperative Capital Markets Regulatory System (the Cooperative System) and the CMRA will bring new parties to the table and with them, additional uncertainties. While the proposed capital markets legislation at the provincial and territorial level continues the current legislative regime governing the establishment, recognition and oversight of SROs, it is not clear how the new regulatory authority will apply that framework. How oversight will work in practice, given the new dynamic between the non-participating CSA members and those that are part of the Cooperative System, is also unclear.

The emergence of the CMRA as an operating part of the Canadian regulatory environment is moving forward with six provinces and one territory signed on to the Memorandum of Agreement with the federal government as of April 2019. Of the other six jurisdictions, at least two have stated definitively that they will not be participating. On May 5, 2016, the Department of Finance Canada released for public comment a revised consultation draft of the *Capital Markets Stability Act*.<sup>92</sup> On July 22, 2016, the participating jurisdictions in the CMRA announced the initial Board of Directors for the CMRA and a Chief Regulator was appointed on November 17, 2016.

Legal challenges with respect to the CMRA appear to have been exhausted with the November 9, 2018 Supreme Court of Canada decision confirming the constitutionality of key elements of the Cooperative System. However, with respect to implementation, the participating jurisdictions in the Cooperative System have not yet provided an anticipated launch date for the CMRA.

Given the current participation levels of the provinces, there will continue to be several separate statutory securities regulators for the foreseeable future. As many public commenters have observed, the first set of published materials regarding the Cooperative System contained little or no guidance on how the Cooperative System will coordinate its regulatory activities with the remaining members of the CSA.<sup>93</sup> The second draft of the provincial/territorial *Capital Markets Act* provides no greater guidance. The commentary to the Initial Regulations states the Authority “expects that an interface will be agreed upon with non-participating jurisdictions.”<sup>94</sup> Inevitably, there will be transition issues to be worked out.

<sup>90</sup> IIROC webpage, *Equity Marketplaces We Regulate*, accessed December 10, 2019, online: <<http://www.iiroc.ca/industry/Pages/Equity-Marketplaces-We-Regulate.aspx>>.

<sup>91</sup> Ibid.

<sup>92</sup> See CCMR Statement supra note 54.

<sup>93</sup> Canadian Foundation for Advancement of Investor Rights, *Letter to Minister of Finance (Canada) et al. on the Cooperative Capital Markets Regulatory System – Governance and Legislative Framework*, December 8, 2014, online: <<http://faircanada.ca/wp-content/uploads/2011/01/141208-FAIR-Canada-final-comments-on-draft-CCMR-legislation.pdf>>.

<sup>94</sup> Cooperative Capital Markets Regulatory System, *Commentary re: Draft Initial Regulations for the Cooperative Capital Markets Regulatory System*, August 25, 2015, at p.6, online: <<http://ccmr-ocrmc.ca/wp-content/uploads/commentary-draft-initial-regulations-en.pdf>>.



# Schedule 4

## International Perspective

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Supplementing the discussion in Section 2 of Part VI, following is additional discussion of the international perspective and experience regarding the use of SROs.

### 1. Concept of SROs

Several international organizations have, in varying degrees, commented on the use of SROs including IOSCO, the World Bank and the International Council of Securities Associations (ICSA). The commentary differs in that IOSCO provides standards that organizations characterized as SROs and their regulators are to comply with whereas the World Bank and ICSA provide a more general viewpoint, contextualizing what each organization considers an SRO to be and what contribution they may make to securities regulation. The perspectives are summarized in further detail below.

#### 1.1 IOSCO – Principles and Standards

According to IOSCO, the core objectives of securities regulation are: (1) the protection of investors; (2) ensuring that markets are fair, efficient and transparent; and (3) the reduction of systemic risk.<sup>95</sup> IOSCO expressly states that SROs can be a valuable complement to the achievement of the objectives of securities regulation in a jurisdiction<sup>96</sup> but does not require their use.

IOSCO sets out detailed Principles that relate to specific areas such as the regulation of secondary markets, market intermediaries and issuers and sets particular standards that the regulator itself must meet. IOSCO Principle 9 states that:

“Where the regulatory system makes use of SROs that exercise some direct oversight responsibility for their respective areas of competence, such SROs should be subject to the oversight of the Regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.”<sup>97</sup>

IOSCO’s definition of SRO is flexible to accommodate the various models used by its members. The threshold requirements to be considered an SRO under IOSCO Principles are if the non-government organization:

- Establishes rules of eligibility that must be satisfied in order for individuals or firms to participate in any significant securities activity;
- Establishes and enforces binding rules of trading, business conduct and qualification for individuals and/or firms engaging in securities activities; and/or

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<sup>95</sup> IOSCO Assessment Methodology, *supra* note 38 at pp.10-11.

<sup>96</sup> *Ibid.* at p.53.

<sup>97</sup> *Ibid.* at p.55.

- Establishes disciplinary rules and/or conducts disciplinary proceedings that enable the SRO to impose appropriate sanctions for non-compliance with its rules.

The authority of the SRO to carry out its activities may come from specific statutory provisions<sup>98</sup>, a delegation of power from the statutory regulator, or a contract between an SRO and its members. Under the IOSCO Principles, SROs should be subject to authorization by the statutory regulator (after meeting standards with respect to resources, fit and proper management, appropriate governance, etc.) and the statutory regulators must have in place an effective active oversight program to ensure the SRO's continued compliance with these standards.

Any SRO that continues to exist should meet both international standards and best practices with respect to its activities and governance. IOSCO standards state that an SRO should have:

- Sufficient powers and capacity to carry out its responsibilities and enforce compliance by its members with its standards;
- An appropriate governance structure;
- Fair and transparent processes that provide for due process and rights of appeal;
- Requirements to ensure the confidentiality of supervisory information; and
- Policies and procedures to adequately address any potential conflicts of interest.<sup>99</sup>

It should be noted that the IOSCO Principles also apply many of these expectations to statutory regulators.

Many jurisdictions have one or more organizations that meet IOSCO's definition of an SRO as they exercise some authority over an aspect of the securities market or its participants and they set standards and requirements with which their members are expected to comply. These include member regulation organizations, stock exchanges, and trade or professional associations that set standards for members and/or provide training.

## 1.2 World Bank – Models of Regulatory Structures

A World Bank paper on Self-Regulation in Securities Markets<sup>100</sup> divided global regulatory structures into four models based on the degree of reliance and type of SRO. These four basic models are:

- 1. Government (Statutory) Model** - A public authority is responsible for securities regulation. Exchanges are usually responsible for very limited supervision of their markets but are not considered to be SROs and there are no free standing SROs. Examples: most European Union countries.
- 2. Limited Exchange SRO Model** - A public authority is the primary regulator. It relies on exchanges to perform certain regulatory functions tied to operation of the market (for example, market surveillance and listing). Examples: Hong Kong (Hong Kong Exchanges and Clearing), Singapore (Singapore Stock Exchange) Sweden (Nasdaq OMX Stockholm), U.S. (NYSE).
- 3. Strong Exchange SRO Model** - A public authority is the primary regulator. It relies on exchanges to perform extensive regulatory functions that extend beyond their market operations, including

<sup>98</sup> This is often the case for stock exchanges created by statute (as was the Toronto Stock Exchange) or where the general securities legislation includes provisions giving specified regulatory duties to particular entities.

<sup>99</sup> IOSCO Assessment Methodology, *supra* note 38, at pp.48-52.

<sup>100</sup> Carson, *supra* note 24.

regulating members' business conduct. Examples: Japan (Japan Exchange Group: Tokyo and Osaka Securities Exchanges), Malaysia (Bursa Malaysia), U.S. (Chicago Mercantile Exchange Group).

- 4. Independent Member SRO Model** - A public authority is the primary regulator. It relies extensively on an independent SRO (a member organization that is not a market operator) to perform extensive regulatory functions. Examples: Canada (IIROC and MFDA), Japan (Japanese Securities Dealer Association), South Korea (Korea Financial Investment Association), U.S. (FINRA) and the National Futures Association (NFA)) and Colombia (Autorregulador del Mercado de Valores).

Of course, other arrangements are possible that lie between these points. For example, a slightly less developed version of Model 4 relies on industry associations that function mainly as industry advocacy bodies but also set standards or rules for specific securities market activities. The International Capital Markets Association and the Brazilian Financial and Capital Markets Association fall into this category. Further, even under Model 1, industry associations may play a role in setting standards, as in France where regulations provide that firms have a duty to implement standards set by associations such as the Association française des marchés financiers where those standards have been recognized as professional standards by the regulator.<sup>101</sup>

### 1.3 International Council of Securities Associations Definition

The ICSA, a group of securities industry SROs and trade associations, has defined SROs as sharing certain core characteristics regardless of their jurisdiction.

“SROs can be defined as non-governmental organizations that: (1) share a common set of public policy objectives including the enhancement of market integrity, market efficiency and investor protection; (2) are actively supervised by government regulators; (3) have statutory regulatory authority and/or authority delegated by the government regulator(s); (4) establish rules and regulations for firms and individuals subject to their regulatory authority; (5) monitor compliance with those rules and regulations; (6) have the authority to discipline firms and individuals that violate their rules and regulations; (7) include industry representatives on their Boards or otherwise ensure that industry representatives have a meaningful role in governance; and (8) maintain structures, policies and procedures intended to ensure that conflicts of interest between their commercial and regulatory activities are appropriately managed.”<sup>102</sup>

## 2. International Use of SROs

Internationally, the use of SROs varies from jurisdiction to jurisdiction. As discussed, SROs are flexible – they can be designed to suit a range of regulatory environments. International trends related to SROs and the use of SROs and models of financial services regulation in various jurisdictions are described in further detail below.

### 2.1 Decline of Exchange SROs

The most frequently seen form of SRO around the world has been the securities exchange. Globally, their role as SROs has declined in recent years, but many of them still have primary responsibility for surveillance of their own market and retain extensive authority over listing standards and supervision of listed companies. Virtually all of them continue to set some or all of their own trading rules. The

<sup>101</sup> Ibid. at p.17. See also IMF, *France: Financial Sector Assessment Program-Detailed Assessment of Observance of IOSCO Objectives and Principles of Securities Regulation*, IMF Country Report No. 13/182, June 2013, at p.61, Principal 9, online: <<https://www.imf.org/external/pubs/ft/scr/2013/cr13182.pdf>>.

<sup>102</sup> International Council of Securities Associations, *Self-Regulation in Financial Markets: An Exploratory Survey*, September 2006, at p.3, online: <<https://icsa.global/sites/default/files/Self-RegulationFinancialMarkets.pdf>>.

decline in reliance on exchanges as SROs can be linked to two factors: (1) demutualization of the exchanges to become for-profit businesses; and (2) increased availability of resources at the statutory regulators.

European Union countries generally rely on SROs to a lesser extent than many other countries. This can be ascribed to a number of factors. In many European countries, regulation is viewed as a government function, not something that should or can be carried out by industry. Also, in civil law countries, the legal system may not permit the statutory regulator to delegate functions to the SRO or it may preclude a non-governmental organization from taking enforcement action. Finally, the regulatory changes in aid of the formation of a single European Union capital market resulted in the assumption by statutory regulators of certain regulatory and supervisory functions that had been performed by the exchanges.<sup>103</sup>

Despite the aforementioned, there are several countries that continue to rely on SROs. For instance, Switzerland has a long history of making use of self-regulation of several types – voluntary self regulation (such as industry codes of conduct); self-regulation that is recognized by the statutory regulator as a minimum standard; and compulsory self-regulation based on a statutory mandate.<sup>104</sup> Also, several emerging markets with large capital markets have taken action in recent years to strengthen their SRO systems, including China, Brazil, Colombia and India.<sup>105</sup> Further, some international agencies such as the World Bank have recognized that self-regulation may provide significant benefits, particularly in developing countries.<sup>106</sup>

## 2.2 Models of Financial Services Regulation Used Around the World

Jurisdictions around the globe have discussed and considered the best structure for financial services regulation, particularly after the global financial crisis that started in 2008 where failures in regulation bore some of the blame, such as the bankruptcies of Lehman Brothers and Northern Rock. The discussions are dynamic and the factors stated to be determinative tend to change with both market conditions and experience. There are also fashions in play. For example, starting in 1986, there was a proliferation of integrated/single financial services regulators (i.e. Norway, Denmark, Sweden, Germany, U.K. in 1997-2010). Recently, the trend has been towards the twin peaks model (where regulation is separated by regulatory objective – prudential vs. consumer protection), particularly after the global financial crisis (i.e. Australia, Netherlands, South Africa and the U.K.).

### 2.2.1 United Kingdom

The financial services landscape in the U.K. has undergone several changes and serves as an example of the shifting needs of the industry and associated impact on the regulatory framework. In 1997, the U.K. government announced its decision to reform financial services regulation in the U.K. and the creation of a new integrated statutory regulator. At the time, the regulatory structure in the U.K. was highly fragmented, with overlapping regulatory responsibilities and there were concerns about its effectiveness. Many securities firms were subject to regulation by multiple SROs and by the statutory regulator. The government decided to eliminate all SROs and create a comprehensive single statutory regulator, the FSA.

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<sup>103</sup> John W. Carson, *Managing Conflicts of Interest in TSX Listed Company Regulation*, July 23, 2010, at p.26, online: <<http://faircanada.ca/wp-content/uploads/2008/12/TSX-Listings-Conflicts-final-report-23-Jul.pdf>>.

<sup>104</sup> IMF, *Switzerland: Detailed Assessment of Implementation IOSCO Objectives and Principles of Securities Regulation*, IMF Country Report No. 14/266, September 2014, at p.51. online: <<https://www.imf.org/external/pubs/ft/scr/2014/cr14266.pdf>>.

<sup>105</sup> CFA 2013, *supra* note 26, at pp.23-25. The article provides short descriptions of the structure and use of SROs in several jurisdictions outside North America.

<sup>106</sup> Carson, *supra* note 24 at p.50.

The newly created FSA took on the regulatory roles of the SROs, the bank supervision role of Bank of England and the markets and intermediary regulation roles of the Securities and Investment Board.<sup>107</sup> The FSA also assumed responsibility for insurance and mortgage regulation from departments of the government. In 2010, as a result of perceived failures (largely in banking supervision owing to the overall “light-touch” approach to regulation) during the global financial crisis, the U.K. government announced another regulatory restructuring. The responsibilities of the FSA were distributed to the Bank of England and to two new successor statutory regulator bodies: the Prudential Regulatory Authority (part of the Bank of England) and the Financial Conduct Authority, following the twin peaks model of regulation first adopted in Australia in 1998.

### 2.2.2 Australia

In Australia, the twin peaks statutory regulator model was adopted in 1998 following the Wallis Commission report recommendations. The Wallis report resulted from an inquiry established to examine the results of the deregulation of the Australian financial system and the forces driving further change, particularly technological, and recommended changes to the regulatory system to ensure an “efficient, responsive, competitive and flexible financial system to underpin stronger economic performance, consistent with financial stability, prudence, integrity and fairness.”<sup>108</sup> The Wallis report recommended that the best structure for Australia at that time would involve two statutory regulators: one responsible for prudential regulation of any entity that needed to be prudentially regulated; and one responsible for market and disclosure regulation of any financial products being offered to Australian consumers.

In 2010, another regulatory structure change occurred in Australia with the statutory regulator, ASIC, assuming control from the ASX of the supervision and surveillance of securities markets and market participants. This change represented a widening of ASIC’s powers as well as a fundamental shift away from the co-regulatory model where there is heavy dependence on SROs/exchanges monitoring the markets under the oversight of a government regulator. The change was done in part to allow for “whole of market” approach to supervision and surveillance in response to increasing market fragmentation and cross-border trading. It was also done with the intention of allowing ASIC staff to be closer to the market, more accessible and flexible with respect to emerging trends and a number of senior staff with market experience were hired from ASX.<sup>109</sup> Explaining the rationale for the statutory regulator taking over the market supervision function, the Minister of Financial Services, Superannuation and Corporate Law, stated as follows:

“As part of the Government’s drive to improve regulation of the financial industry, the Government has decided to transfer supervisory responsibility for Australia’s financial markets to ASIC, as it is more appropriate for an agency of the Government to perform this important function”.<sup>110</sup>

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<sup>107</sup> Eric J. Pan, *Structural Reform of Financial Regulation*, Cardozo Legal Studies Research Paper No. 250, January 1, 2009, online: <<http://dx.doi.org/10.2139/ssrn.1333385>>.

<sup>108</sup> Stan Wallis, *Financial System Inquiry (The Wallis Inquiry)*, Australia Government – The Treasury, (1995-1997), online: <<https://treasury.gov.au/review/financial-system-inquiry>>.

<sup>109</sup> Austin, *supra* note 56 at p.454.

<sup>110</sup> Australian Media Release, *supra* note 16.

### 2.2.3 United States

The U.S. is the closest comparator to Canada with respect to its reliance on SROs. FINRA is the frontline regulator for broker-dealers in the U.S. FINRA was created in 2007 through the merger of the NASD and the member regulation and enforcement operations of the NYSE. NASD can trace its roots back to 1912 when it began as a trade association as the Investment Bankers Association of America. NYSE has an even longer history and can trace its roots back to 1792.

The formal regulatory partnership between industry and statutory regulators in the U.S. began in 1934 with the promulgation of the *Securities and Exchange Act of 1934* (the “Exchange Act”). The Exchange Act did three key things: it established the SEC; it provided for the recognition of Exchange SROs; and it provided that such SROs would be subject to statutory regulator oversight by the newly created SEC. NYSE was recognized as an “exchange” SRO in 1934. Five years later the Exchange Act was amended to provide for the recognition of “association” SROs and the newly named NASD was recognized under the Exchange Act as an association SRO in 1939. Effectively, the rules of the private clubs were co-opted by the statutory regulator who would focus on SRO oversight while allowing the SROs to continue to enforce their own rules as well as the federal securities law.<sup>111</sup>

As noted in the 1963 SEC Special Study of Securities Markets, “self-regulation was originally advanced and adopted as a feature of Federal control on the *ground of practicality*” [emphasis added]. A key practical motivator for SRO reliance was lack of government resources to fund direct regulation as well as the related factor of not using taxpayer dollars to fund regulation.<sup>112</sup>

Over the next four decades, the SEC was generally willing to let the SROs take the lead in supervising their members and regulating markets, but in the early 1970s, Congress grew increasingly weary of repeated market abuses and crises. In response, the 1975 amendments to U.S. securities laws granted the SEC increased authority over SROs by requiring SEC approval of new SRO rules and rule amendments. The securities legislation amendments also required at least two public members on the NASD Board, thus formalizing the federal government’s reach into SRO governance.<sup>113</sup>

In response to continued stock market abuses, further SRO reforms were implemented in the late 1990s. In particular, in 1996, in the aftermath of a price fixing scandal, the SEC and the U.S. Department of Justice launched investigations into NASD and NASDAQ practices. Following the investigation, the NASD undertook to: (1) separate its market activities from its self-regulatory function; (2) provide for greater non-industry representation on its board and policy committees; (3) spend \$100 million to enhance its systems for market surveillance and to increase its staffing in the areas of examination, surveillance, enforcement and internal audit; and (4) seek direct public comment on the rules it proposes.

In 2007, as discussed above, FINRA was established through the consolidation of the NASD and the member regulation, enforcement and arbitration operations of the NYSE. The consolidation was intended to help streamline the broker-dealer regulatory system, combine technologies and permit the establishment of a single set of rules governing membership matters with the aim of enhancing oversight of U.S. securities firms and assuring investor protection.

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<sup>111</sup> SEC Historical Society, *supra* note 57.

<sup>112</sup> SEC, *Report of Special Study of Securities Markets of the SEC*, 88th Cong., 1st Sess. (1963), H. R. Doc. No. 95, Pt. 4 at Chapter XII p. 501, online: <[http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1960/1963\\_SSMkt\\_Chapter\\_12\\_1.pdf](http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1960/1963_SSMkt_Chapter_12_1.pdf)>; Eric J. Pan, *Understanding Financial Regulation*, Cardozo Legal Studies Research Paper No. 329, January 1, 2011, online: <<http://dx.doi.org/10.2139/ssrn.1805018>>.

<sup>113</sup> Joel Seligman, *Cautious Evolution or Perennial Irresolution: Stock Market Self-Regulation During the First Seventy Years of the Securities and Exchange Commission*, *The Business Lawyer*, 59:4 (2004) at p.1363, online: <[www.jstor.org/stable/40688239](http://www.jstor.org/stable/40688239)>; SEC Historical Society, *supra* note 57.



Since its creation in 2007, concerns have been expressed by various stakeholder groups with respect to FINRA's structure, governance and operations, such as:

- FINRA is subject to regulatory capture and is too influenced by the industry it is mandated with overseeing;<sup>114</sup>
- Many of FINRA's Public Governors should not be considered Public since they have material ties to the industry;<sup>115</sup>
- Concerns include the lack of transparency with respect to FINRA's finances and lack of accountability to its members and the public;<sup>116</sup>
- FINRA is not subject to adequate government accountability as it operates with substantial independence from the SEC;<sup>117</sup> and
- Concerns suggesting that FINRA is a quasi-government regulator and does not act like a true SRO.<sup>118</sup>

Stakeholders have suggested various ways FINRA could be reformed to address the concerns noted above. These reform solutions include:

- Incorporate FINRA into the SEC where FINRA's regulatory functions would be discharged directly by the SEC;
- Increase congressional oversight of FINRA to ensure more independent accountability;
- Establish FINRA as a true SRO with an industry majority on its Board of Governors; and
- Have public directors appointed by the SEC or other similar agencies, similar to the governance process in place at the PCAOB.

In 2017, FINRA launched its FINRA 360 initiative, being a comprehensive self-evaluation. Since the inception of the project, FINRA has made many changes to its organization and the way it operates, including:

- Enhancing transparency of its operations, processes and activities;
- Increasing training of staff; and
- Integrating programs in the areas of risk monitoring, examinations and enforcement.

The FINRA 360 process is continuing.<sup>119</sup>

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<sup>114</sup> Edwards, *supra* note 60 at pp.606-607.

<sup>115</sup> *Ibid* at p.588.

<sup>116</sup> *FINRA: Who's Watching the Watchdog?*, InvestmentNews, September 2, 2017, online: <<https://www.investmentnews.com/finra-whos-watching-the-watchdog-72102>>; Hester Peirce, *The Financial Industry Regulatory Authority: Not Self-Regulation after All*, Mercatus Working Paper, January 2015, at pp.19-24, online: <[https://www.mercatus.org/system/files/Peirce-FINRA\\_0.pdf](https://www.mercatus.org/system/files/Peirce-FINRA_0.pdf)>.

<sup>117</sup> *Ibid*.

<sup>118</sup> Burton, *supra* note 49 at pp.1 and 11.

<sup>119</sup> See FINRA, Progress Report on FINRA 360, June 2019, online: <<https://www.finra.org/sites/default/files/finra360-progress-report.pdf>>.



# Schedule 5

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