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BACKGROUND PAPER



Proposed Federal Securities Regulator

1. Economic Aspects

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***Proposed Federal Securities Regulator –
1. Economic Aspects
(Background Paper)***

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PROPOSED FEDERAL SECURITIES REGULATOR – 1. ECONOMIC ASPECTS*

1 INTRODUCTION

Over the years, a number of interests have promoted the creation of a federal securities regulator. Others, while working towards a greater harmonization of rules, have maintained that the current system of securities regulation is preferable.

Most recently, the federal government proposed legislation to establish a federal regulator responsible for implementing a single Canadian securities statute, and in December 2011, the Supreme Court of Canada ruled that the legislation was unconstitutional. A few months later, in the 2012 Budget, the government restated its economic arguments in support of creating a single regulator.¹

This publication summarizes those economic arguments, as well as views in support of the current system. It also describes the current state of securities regulation and the actions taken by the federal government and other stakeholders regarding the proposed federal body.

2 CURRENT STATE OF SECURITIES REGULATION IN CANADA

2.1 SECURITIES TRADING IN CANADA: BACKGROUND

Securities trading in Canada has been overhauled several times since it first began in 1832, when shares of Canada's first railroad were traded by a small group of brokers at the Exchange Coffee House in Montreal.²

Today, the securities industry enables businesses and governments to raise debt and equity capital, essential for expanding the economy. The securities industry is made up of three types of firms: integrated firms, institutional firms, and retail firms. The integrated firms – which, for the most part, are subsidiaries of the six major Canadian banks – account for the largest share of the industry's revenues.³

Canada's capital markets were reorganized in 1999. The Toronto Stock Exchange became the sole exchange for the trading of senior equities, and the Montreal Stock Exchange became the sole exchange for the trading of derivatives. The Canadian Venture Exchange (CDNX), created through a merger of the Vancouver and Alberta (and later Winnipeg) stock exchanges, handled the trading of junior equities.⁴

In 2001, the Toronto Stock Exchange acquired the CDNX, which was renamed the TSX Venture Exchange in April 2002. It became part of the TSX Group, which also includes the Toronto Stock Exchange. In 2008, the Montreal Stock Exchange and the TSX Group combined to form the TMX Group.

2.2 THE PASSPORT SYSTEM

Canada has a “passport system” that aims to provide market participants with a single window of access to Canadian capital markets.⁵ It operates in an environment where every province and territory has a securities regulator, established under their constitutional jurisdiction over property and civil rights.⁶ The first step in its establishment occurred on 30 September 2004, when the provincial and territorial ministers responsible for securities regulation, with the exception of the minister from Ontario, signed a *Provincial/Territorial Memorandum of Understanding Regarding Securities Regulation*.⁷

Phase one of the passport system was implemented in September 2005 by the Canadian Securities Administrators (CSA) through rule and policy changes, but its scope was limited by a lack of harmonized securities regulations. In the years that followed, the passport jurisdictions implemented harmonized securities regulations designed to support a fully operational passport system and complement the instruments developed by the CSA.⁸ On 17 March 2008, the passport system was established, when new multilateral and national instruments regarding securities issuers came into force.⁹ The new national registration rule,¹⁰ the final phase of the passport system implementation,¹¹ came into effect on 28 September 2009.

Under this passport system, market participants can secure approval of a prospectus, obtain a discretionary exemption or register as a dealer or an advisor by obtaining a decision from the securities regulator of their province or territory (the “principal regulator”), and have this decision apply in all other participating passport jurisdictions. Participants may also access the Ontario market through an interface system in which the Ontario Securities Commission (OSC) makes its own decision, but generally relies on the review by the principal regulator. In return, the passport regulators accept the OSC’s decisions regarding Ontario participants.¹²

This mutual recognition system resembles that suggested as the basis for a possible system of free trade in securities with the United States and other G7 countries,¹³ which would establish a form of international recognition of registration requirements for securities issuers. This approach is also similar to the mutual recognition system in place in the European Union, which does not have a single securities commission.¹⁴

3 TOWARD A PROPOSED FEDERAL SECURITIES REGULATOR

3.1 PAST PROPOSALS FOR FEDERAL SECURITIES MANAGEMENT IN CANADA

Since 1935, several committees and working groups have been created and tasked with studying securities regulations with a view to potentially creating a federal regulator.

- In 1935, the Royal Commission on Price Spreads recommended the formation of an investment securities board to oversee the issuance of securities by companies incorporated under federal legislation.

- In 1964, the Royal Commission on Banking and Finance (the “Porter Commission”) recommended uniform legislation for and administration of the Canadian securities industry under a new regulatory body, based on cooperation between the federal and provincial governments.
- In 1967, the OSC proposed establishing a single, highly decentralized national securities regulator, based on voluntary participation by the provinces.
- In 1979, the federal Department of Consumer and Corporate Affairs envisioned a federal securities commission that involved cooperation with provincial and foreign commissions.
- In 1994, the Atlantic premiers asked the federal government to establish a national securities regulator as part of a draft memorandum of understanding between the federal government and participating provinces.
- In 2002, Harold MacKay, a lawyer who had chaired the Task Force on the Future of the Canadian Financial Services Sector in 1997–1998, recommended that the federal Minister of Finance establish a committee to review securities regulations in Canada and make recommendations for improving the current system, which he said was costly and ineffective.
- In 2003, the Wise Persons’ Committee recommended adopting a comprehensive scheme of capital markets regulation for Canada, combined with provincial legislation incorporating the federal law by reference and delegating administrative powers to the newly established “Canadian Securities Commission.”¹⁵
- In 2005, the Government of Ontario established the Crawford Panel on a Single Canadian Securities Regulator, which endorsed the adoption of uniform Canadian securities regulation and released the 2006 *Blueprint for a Canadian Securities Commission*.¹⁶
- In 2006, the Investment Dealers Association of Canada (IDA) commissioned a task force to look at modernizing securities legislation in Canada and enhancing the competitiveness of Canada’s capital markets. In its final report, the task force wrote, “While we have not directly tackled the issue of regulatory fragmentation in our Report, we do add our voice to the chorus demanding that immediate steps be taken to ameliorate the inefficient, out-dated and duplicative securities regulatory structure that currently exists in Canada.”¹⁷
- In 2008, the federal Minister of Finance Jim Flaherty formed an Expert Panel on Securities Regulation. In its 2009 report, the panel recommended the creation of a federal securities regulator and submitted a draft federal Securities Act,¹⁸ which would go on to pave the way for the Proposed Canadian Securities Act (the proposed Act).

3.2 THE CANADIAN SECURITIES TRANSITION OFFICE

In July 2009, the Department of Finance established the Canadian Securities Transition Office.¹⁹ It was created under the *Canadian Securities Regulation Regime Transition Office Act*²⁰ to hold consultations with the Advisory Committee of Participating Provinces and Territories²¹ on developing draft federal securities

legislation – which would be the subject of a Supreme Court reference – and coming up with a plan for the transition to a federal securities commission.²²

The Transition Office then drew up the Transition Plan for the Canadian Securities Regulatory Authority,²³ which was submitted to the federal Minister of Finance and participating provinces and territories. This transition plan was the first step in the process for creating a Canadian Securities Regulatory Authority, which was to begin operations on 1 July 2012.

3.3 THE PROPOSED CANADIAN SECURITIES ACT

On 26 May 2010, Minister Flaherty released the *Proposed Canadian Securities Act*,²⁴ which was drafted to establish a federal regulator responsible for implementing a single Canadian securities statute.²⁵ As the same time, he submitted the Securities Act reference to the Supreme Court.²⁶

The scope of the proposed Act was similar to provincial and territorial securities legislation and covered all applicable regulatory aspects. Provision for the following was found in the proposed Act:

- creation of a federal regulator, the Canadian Securities Regulatory Authority, which would include an administrative tribunal, the Canadian Securities Tribunal;
- recognized entities and designated entities;
- registration, prospectus requirements and derivatives;
- disclosure and proxies;
- take-over bids, issuer bids and market conduct;
- administration and enforcement, which would include criminal offences and related punishment;
- civil liability and civil liability for secondary market disclosure; and
- transitional regime for participating provinces.

The creation of new criminal offences under the proposed Act would have led to the repeal of *Criminal Code* provisions pertaining to capital markets. Examples include sections 382 to 384, which deal with the fraudulent manipulation of stock market transactions, prohibited insider trading, tipping and other prohibited conduct, and section 400, which deals with false prospectuses.

In April 2012, Minister Flaherty said he was allowing for one more year to establish a federal securities regulator.²⁷ In the 2012 Budget, he repeated his argument that “[a] common securities regulator would give Canada a competitive advantage by reducing unnecessary compliance costs for issuers, strengthening our ability to respond to financial instability, enhancing enforcement and better serving the needs of all Canadians.”²⁸ It was with this in mind that he tabled an order dated 27 March 2012 setting 12 July 2013 as the date of dissolution of the Canadian Securities Transition Office.²⁹

4 ECONOMIC ISSUES: ARGUMENTS ON BOTH SIDES

4.1 COST OF REGULATION AND COMPLEXITY OF THE CURRENT SYSTEM

In its report, the federally commissioned Expert Panel on Securities Regulation stated that securities regulation within the current structure is ineffective and inefficient, since “[r]esources must be devoted to keep 13 separate securities regulators operating,” and duplication of effort “results in unnecessary costs, overstaffing, and delays.”³⁰ The Expert Panel argued that:

Canadians, in turn, are afforded different levels of investor protection depending on the jurisdiction in which they reside or invest. Second, market participants will continue to be burdened with undue compliance costs, even with the full implementation of the passport system. Market participants will still have to pay fees in up to 13 jurisdictions. They will still have to deal with the general inefficiencies associated with differences between provincial statutes and regulations, the ongoing use of local rules, and variations in the interpretation of national rules.³¹

The Organisation for Economic Co-operation and Development (OECD) sees Canada’s 13 securities regulators as hampering optimization and increasing the risk of businesses choosing to go outside Canada for financing. According to the OECD, having a national regulator would do away with the inefficiencies stemming from the limited enforcement powers of provincial regulators.³²

At the same time, an OECD study of securities market regulation in OECD member countries showed that Canada ranks second, behind New Zealand. The evaluation used the *Doing Business Database* (2005) of the World Bank.³³ The OECD’s overall indicator of securities market regulation has four components: contract enforcement, access to credit, investor protection, and bankruptcy procedures. According to this evaluation, Canada ranks higher than Norway, the United States, Great Britain, Japan and Australia.³⁴

Other sources have also been positive about the current system. One analysis of regulatory costs shows that:

there is little evidence to indicate that the current regulatory structure leads to significant costs for investors or issuers. ... The direct costs of regulatory authorities are lower than those incurred in other countries, when expressed on the basis of the number of reporting issuers.³⁵

The authors conclude that arguments to the effect that a federal regulator would generate substantial savings are not persuasive.

4.2 COST OF CAPITAL

The securities regulation system has an undeniable impact on the cost of capital. In theory, this cost is higher in markets governed by deficient regulations, since shareholders demand a higher premium to offset the risk, costs and regulatory burden stemming from these shortcomings.³⁶ If, as some observers contend, the current securities regulation system is deficient compared with those of other

countries, the cost of capital in Canada would be higher than in those countries. However, the results of one study estimating the cost of capital for corporations in about 40 countries in terms of level of disclosure, effectiveness of securities regulation and overall quality of the legal system suggests that the cost of capital in Canada is one of the lowest in the world and is very similar to the cost of capital in the U.S.³⁷

On the other hand, some observers are of the opinion that the relevant question is not how the cost of capital in Canada compares to the cost in other countries, but rather whether this cost would be lower under a single regulator.³⁸ It should be noted that there is little empirical evidence to either support or reject the notion that creating a federal securities regulator would lower the cost of capital in Canada.

4.3 COST OF INITIAL PUBLIC OFFERINGS

According to a number of studies, in recent years Canada has performed well compared to other industrialized countries when it comes to initial public offerings, whether for initial public offerings as a whole or for offerings of “junior” companies.³⁹ The financial costs of initial public offerings may even be lower in Canada than in the U.S.⁴⁰ According to one study,

[t]he direct costs of offerings are lower than those in the United States for offerings of the same size, time frames and shorter than those in the United States and, in particular, the cost of financing for small issuers, measured by the returns earned by investors, is favourable to issuers.⁴¹

As with the cost of capital, it would be difficult to comment on the cost of new offerings without knowing what the cost would be were there a single regulator. The question is not so much how Canada compares with the U.S., but instead whether the costs would be lower if there were a single regulator.

4.4 PARTICIPATION IN INTERNATIONAL MARKETS

In 2010, the International Monetary Fund (IMF) welcomed the progress toward establishing a federal securities regulator in Canada. According to the IMF, creating such a regulator:

will both bridge potential gaps in the supervision and regulation of what are essentially national markets, and create a venue for bringing securities regulation into the ambit of national coordinating initiatives for promoting financial stability.⁴²

However, the IMF has already recognized the quality of Canada’s securities regulation system and the progress made under the passport system toward further harmonization of regulations,⁴³ and it has confirmed that the Canadian system complies with the International Organization of Securities Commissions (IOSCO) principles.⁴⁴ Nevertheless, the IMF points out that a single regulator would be better positioned to address the identified shortcomings.⁴⁵

As some observers have pointed out, Canada is the only developed or industrialized country without a single securities regulator.⁴⁶ Supporters of a federal regulator argue that this means that Canada is unable to speak with one voice or have any real influence on international securities policies. They also believe that there are fewer opportunities to participate in international markets or to take part in lucrative international transactions.⁴⁷

Those who support the current system argue that the regulators in the CSA have joined together to align their regulations and provide a single window for market participants. Others suggest that retaining the current system may be in Canada's best interests. Proponents of the existing arrangement note that Canada is currently one of only three countries – the others being China and the United States – to be represented by two voting members at the IOSCO.⁴⁸ Creating a federal regulator could result in Canada's losing a seat, which would probably not contribute to expanding its influence.

Still other commentators suggest that the adoption of the proposed Act might not lead to a single securities regulator, because a number of provinces may choose not to join a voluntary system. This would lead to a parallel system, where participants in provincial systems would continue to be regulated by provincial authorities.⁴⁹

4.5 REGIONAL ECONOMIES

Supporters of the current system assert that one of its advantages is the support it gives to regional economies. It provides an appreciable number of high-quality jobs in the regions – the financial sector is a major direct employer with salaries above the average in other industrial sectors.⁵⁰ In addition, according to one study, each direct job in the financial sector helps support another job in a wide array of industrial sectors, a high proportion of them in the value-added professional services sector.⁵¹

Another point raised by the current system's proponents is the support the system provides for listed companies with a small market capitalization ("small-cap companies"), which are a strong presence in Canada's capital market. Supporters suggest that the relationships between these companies and their local securities regulator allow the regulator to closely monitor and act in the interests of the companies. Furthermore, supporters of the current system believe that mid- and small-cap companies, which make up the majority of registered issuers in Canada, have needs that may not be adequately met by a national regulator.⁵² For instance, would British Columbia's small-cap mining and technology companies be just as well represented within a federal regulator, and would they have just as good a chance of survival? Would small oil and gas companies based in Alberta continue to thrive?

Certain authors have addressed the potential place for regional economies and their unique character within a national regulator.⁵³ The Transition Plan prepared by the Canadian Securities Transition Office seems to take this consideration into account. According to the plan, the Authority would have an office in each participating province and provide regulatory services in each participating territory.⁵⁴ However, the location of the headquarters of the national regulator is not known – neither the Transition Plan nor the proposed Act specifies where the headquarters of the

Canadian Securities Regulatory Authority would be. It has been suggested that this is not an inconsequential matter, because the province and city where the CSRA would be headquartered would stand to reap unquestionable benefits.⁵⁵ Several proponents have already lobbied on behalf of Ontario and Toronto.⁵⁶

Several Quebec commentators fear that a loss of decision-making power resulting from the creation of a federal regulator would have negative economic consequences for Quebec and would weaken Montréal as a financial centre.⁵⁷ Another source of concern lies in the requirement in Quebec for issuers to have corporate information destined for public distribution translated into French. The proposed Act did not address this sensitive issue, and it is not certain that this requirement would survive under the responsibility of a federal regulator.⁵⁸

5 CONCLUSION

There are strongly held views regarding the creation of a federal securities regulator in Canada. What is more, at times, the same data and even the same empirical studies are used to bolster opposing arguments. Some support the continued harmonization of provincial and territorial regulations and the operation of a passport system, as agreed to by the CSA regulators; others believe that a single national securities regulator should be created.

The choice is not simple, because both solutions have their difficulties. On the one hand, the passport system cannot claim to provide a complete harmonization of securities rules across Canada as long as Ontario is not part of the system. On the other hand, there is no evidence that a federal securities regulator would incur fewer costs and be more efficient than the current system. The solution to these economic and political questions may lie in some form of cooperation between the federal and provincial governments, as suggested by the Supreme Court in *Reference re Securities Act*.

NOTES

- * This paper is one of two in a series about a proposed federal securities regulator. The companion paper examines the constitutional aspects regarding the regulator that were reviewed by the Supreme Court in *Reference re Securities Act*. See Maxime-Olivier Thibodeau, *Proposed Federal Securities Regulator – 2. Constitutional Aspects*, Publication no. 2012-29, Parliamentary Information and Research Service, Library of Parliament, Ottawa, 17 May 2012.
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- 2. Canada's first stock exchange, the Montreal Stock Exchange, was incorporated in 1874, followed by the Toronto Stock Exchange in 1878. See Department of Finance Canada, [Canada's Securities Industry](#), January 2005, p. 2; and Montréal Exchange, [Historical Highlights](#).

PROPOSED FEDERAL SECURITIES REGULATOR – 1. ECONOMIC ASPECTS

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5. Provincial-Territorial Securities Initiative, [Improving Securities Regulation in Canada](#).
6. [Constitution Act, 1867](#) (UK), 30–31 Victoria, c. 3, reproduced in R.S.C. (1985), App. II, No. 5, s. 92(13).
7. Provincial-Territorial Securities Initiative, [A Provincial/Territorial Memorandum of Understanding Regarding Securities Regulation](#).
8. Ibid.
9. [Regulation 11-102 respecting Passport System; Regulation 41-101 respecting General Prospectus Requirements](#); and [Regulation 62-104 respecting Take-Over Bids and Issuer Bids](#).
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18. Expert Panel on Securities Regulation, [Creating an Advantage in Global Capital Markets](#), Final Report and Recommendations, January 2009.
19. The [Canadian Securities Transition Office](#) was established by the [Canadian Securities Regulation Regime Transition Office Act](#), S.C. 2009, c. 2, s. 297, which came into force on 13 July 2009.
20. The [Canadian Securities Regulation Regime Transition Office Act](#) was enacted by the [Budget Implementation Act, 2009](#), S.C. 2009, c. 2.
21. Canadian Securities Transition Office, “[Participating Jurisdictions](#).”
22. The Canadian Securities Transition Office received \$5.4 million in 2009–2010, \$13.2 million in 2010–2011 and \$14.3 million for the period ending July 2012.
23. Canadian Securities Transition Office, [Transition Plan for the Canadian Securities Regulatory Authority](#), 12 July 2010.
24. Department of Finance Canada, [Proposed Canadian Securities Act](#), May 2010.

25. The Department of Finance released the following documents on 26 May 2010: [“Government of Canada Moves to Protect Canadian Investors,”](#) News release; [Fact Sheet on Proposed Canadian Securities Act](#); [“Backgrounder: A New Canadian Securities Regulatory Authority”](#); [Fact Sheet on Reference to the Supreme Court of Canada on the Proposed Canadian Securities Act](#).
26. [Reference re Securities Act](#), 2011 SCC 66, para. 134. The Supreme Court of Canada reference and opinion are presented in Thibodeau (17 May 2012).
27. Tim Kiladze, [“Flaherty sets one-year goal for national regulator plan,”](#) *The Globe and Mail* [Toronto], 27 April 2012.
28. Department of Finance Canada (2012), p. 128.
29. [“Order Setting July 12, 2013 as the Date of Dissolution of the Canadian Securities Regulation Regime Transition Office,”](#) P.C. 2012-341, in *Canada Gazette*, Part I, Vol. 146, No. 14, 7 April 2012.
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51. Ibid.
52. Carpentier and Suret (2009), p. 52.
53. Lortie (2010), *Le projet de commission nationale*, p. 13.
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56. Ibid.; Denis (2010), p. 11.
57. Denis (2010), p. 13.
58. Pierre Lortie, [*The National Securities Commission Proposal: Challenging Conventional Wisdom*](#), 24 May 2010, p. 25.