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BACKGROUND PAPER

Proposed Federal Securities Regulator
2. Constitutional Aspects

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(Background Paper)

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PROPOSED FEDERAL SECURITIES REGULATOR 2. CONSTITUTIONAL ASPECTS*

1 INTRODUCTION

In May 2010, as part of its proposal to create a federal securities regulator, the federal government brought to the Supreme Court of Canada the *Reference re* Securities Act.[1] This was the most recent in numerous efforts over the years to study the possibility of establishing a federal securities regulator. With the stated aim "to provide legal certainty to the provinces, territories and market participants,"[2] the government asked the Court to make a determination on the following question: "Is the annexed Proposed Canadian Securities Act within the legislative authority of the Parliament of Canada"?

In December 2011, the Supreme Court ruled that the Securities Act proposed by the government is not valid because it does not fall under any power vested in the Parliament of Canada by the Constitution.

This publication, which analyzes the constitutional aspects of that decision, contains two parts: a summary of the Supreme Court's opinion, and a description of some reactions to the opinion.

2 *REFERENCE RE* SECURITIES ACT

2.1 OPINION OF THE SUPREME COURT OF CANADA ON *REFERENCE RE* SECURITIES ACT

If it were passed, the Securities Act (the proposed Act) would create a single scheme governing the trade of securities throughout Canada subject to the oversight of a federal regulator. The Supreme Court ruled that "[t]he *Securities Act* as presently drafted is not valid under the general branch of the federal power to regulate trade and commerce under s. 91(2) of the *Constitution Act, 1867*."[3]

In rejecting the federal government's contention that the proposed Act was an exercise of Parliament's general power to regulate trade and commerce, the Court stated that, considered in its entirety, the proposed Act

> is chiefly directed at protecting investors and ensuring the fairness of capital markets through the day-to-day regulation of issuers and other participants in the securities market. These matters have long been considered local concerns subject to provincial legislative competence over property and civil rights within the province. Canada has not shown that the securities market has so changed that the regulation of all aspects of securities now falls within the general branch of Parliament's power over trade and commerce under s. 91(2).[4]

The Court went on to say that, "The proposed *Securities Act* represents a comprehensive foray by Parliament into the realm of securities regulation."[5] It

nevertheless affirmed that the Constitution gives Parliament powers that enable it to pass laws that affect aspects of securities regulation and to promote the integrity and stability of the Canadian financial system.[6]

In the opinion of the Court, "Canada has shown that aspects of the securities market are national in scope and affect the country as a whole."[7] The Court thus raised the prospect of a cooperative approach with the provinces "that recognizes the essentially provincial nature of securities regulation while allowing Parliament to deal with genuinely national concerns."[8]

The issues at play in this matter and the coexistence of the constitutional powers of Parliament and the provinces compelled the Supreme Court to take the tenets of federalism into consideration. According to the Court, "[i]t is a fundamental principle of federalism that both federal and provincial powers must be respected, and one power may not be used in a manner that effectively eviscerates another."[9]

The Court reiterated the need for balance between federal and provincial powers and stated that the national dimension of certain aspects of the securities system is not enough to allow Parliament to regulate the entire securities system.[10]

In its analysis of the proposed Act, the Supreme Court stated that it did not determine what constitutes an optimal model for regulating the securities market because it is not the responsibility of the courts to rule on political matters. The Court wrote, "Accordingly, our answer to the reference question is dictated solely by the text of the Constitution, fundamental constitutional principles and the relevant case law."[11]

After reviewing the proposals for federal securities regulation put forward over the years but never implemented,[12] the Court pointed out that the arguments made in those proposals, and the counter-arguments presented in other studies on the political expediency of either federal or provincial securities regulation, are irrelevant in determining the constitutional validity of the proposed Act.[13]

2.2 CONSTITUTIONAL ARGUMENTS

2.2.1 THE PARTIES' POSITIONS

In the Supreme Court reference, the governments of Canada and Ontario and some other interveners argued that the proposed Act, viewed in its entirety, is an exercise of Parliament's general power under subsection 91(2) of the *Constitution Act, 1867* to regulate trade and commerce.[14]

The Court underlined the fact that the federal government did not invoke other federal heads of power, such as legislative authority in relation to interprovincial and international trade and commerce, which is a separate branch of Parliament's subsection 91(2) authority, or the powers concerning incorporation of companies under federal law or the criminal law (except for some offence provisions, whose constitutionality was not contested).[15]

The Court also pointed out that the federal government did not invoke the doctrine of ancillary powers, whereby the provisions of the proposed Act that might fall under provincial jurisdiction would be valid because they are ancillary to the exercise of federal powers.

Meanwhile, the attorneys general of Alberta, Quebec, Manitoba and New Brunswick and other interveners argued that the scheme falls under the provincial power over property and civil rights set out in subsection 92(13) of the *Constitution Act, 1867*. They took the view that the proposed Act would also encroach on provincial legislative jurisdiction over matters of a merely local or private nature (subsection 92(16)), namely the regulation of contracts, property and professions.[16]

2.2.2 Constitutional Principles

The Supreme Court made the point that under their constitutional powers over property and civil rights, the provinces have jurisdiction to regulate intra-provincial trade in securities. The Court cited Lord Atkin, who wrote in the landmark *Lymburn* v. *Mayland* decision, "If a [company] is formed to trade in securities there appears no reason why it should not be subject to the competent laws of the Province as to the business of all persons who trade in securities."[17]

The principle was reiterated by the Supreme Court more recently in *Multiple Access Ltd.* v. *McCutcheon*:

> It is well established that the provinces have the power, as a matter of property and civil rights, to regulate the trade in corporate securities in the province, provided the statute does not single out federal companies for special treatment or discriminate against them in any way. … Since the decision of the Privy Council in *Lymburn v. Mayland*, [1932] A.C. 318 the provisions of provincial securities acts have been given a wide constitutional recognition.[18]

The Court acknowledged that Parliament has powers under the Constitution that enable it to pass laws that affect certain aspects of securities regulation and promote the integrity and stability of the Canadian financial system.[19] These include the power to enact laws relating to:

- criminal law (subsection 91(27));
- banks (subsection 91(15));
- bankruptcy (subsection 91(21));
- telecommunications (section 91 and paragraph 92(1)(*a*));
- peace, order and good government (section 91); and
- trade and commerce (subsection 91(2)).

The Court stated that the federal power over trade and commerce has two branches: power over interprovincial and international commerce, and the general trade and commerce power that authorizes Parliament to pass laws where "the national interest is engaged in a manner that is qualitatively different from provincial concerns."[20]

After restating these principles, the Court added, "[N]otwithstanding the Court's promotion of cooperative and flexible federalism, the constitutional boundaries that underlie the division of powers must be respected."[21] The Court went on to say that the "dominant tide" of flexible federalism cannot sweep designated powers out to sea or erode the constitutional balance inherent in the Canadian federal state:

> In the delineation of the scope of the general trade and commerce power, courts have been guided by fundamental underlying constitutional principles. The Canadian federation rests on the organizing principle that the orders of government are coordinate and not subordinate one to the other. As a consequence, a federal head of power cannot be given a scope that would eviscerate a provincial legislative competence. This is one of the principles that underlies the Constitution.[22]

The Court then used the test established in *General Motors of Canada* v. *City National Leasing*,[23] where the Supreme Court confirmed that the right of civil action established by a federal law is valid under the federal government's constitutional jurisdiction over trade and commerce.[24] To achieve that result, the Court had reiterated the need to strike a balance between subsection 91(2) and subsection 92(13) of the Constitution, the latter of which gives the provinces jurisdiction over property and civil rights, and it identified five indicators to determine whether a law falls within federal jurisdiction:

1. Is the law part of a general regulatory scheme?
2. Is the scheme under the oversight of a regulatory agency?
3. Is the law concerned with trade as a whole rather than with a particular industry?
4. Is the scheme of such a nature that the provinces, acting alone or in concert, would be constitutionally incapable of enacting it?
5. Would failure to include one or more provinces or localities in the scheme jeopardize its successful operation in other parts of the country?[25]

The Court pointed out that it recently confirmed that approach in *Kirkbi AG* v. *Ritvik Holdings Inc*.,[26] stating that the *Trade-marks Act*, a federal statute, "was concerned with trade as a whole rather than trade within a particular industry, since trademarks 'apply across and between industries in different provinces.'"[27]

2.2.3 Application

In seeking to apply the principles described above, the Court first established that the proposed scheme must be found valid or invalid as a whole. To determine whether the provisions of the proposed scheme fall under the general trade and commerce power, the Court identified the main thrust of the proposed Act and ascertained whether it satisfied the test set out in *General Motors*.

The Court first determined that the main thrust of the proposed Act was "to regulate, on an exclusive basis, all aspects of securities trading in Canada, including the trades and occupations related to securities in each of the provinces."[28] Since that determination was not enough to connect the proposed Act to a provincial or federal head of power, the Court asked whether the legislation, viewed as a whole, addressed a matter that is truly national in importance and scope and that

transcends provincial competence, according to the criteria set out in *General Motors*.

The Court declared that the first two criteria, namely whether the law is part of a general regulatory scheme and whether the scheme is under the oversight of a regulatory agency, were met.[29]

Regarding the third criterion, which consists in determining whether the legislation is concerned with trade as a whole rather than a particular sector, the Court replied that the proposed Act, viewed as a whole, "overreaches the proper scope of the general branch of the trade and commerce power descending well into industry-specific regulation."[30]

As for the fourth criterion in the *General Motors* test, which addresses the constitutional capability of the provinces and territories to adopt a similar scheme in concert, the Court said that the federal government was partly right:

> The provinces, acting in concert, lack the constitutional capacity to sustain a viable national scheme aimed at genuine national goals such as management of systemic risk or Canada-wide data collection. This supports the view that a federal scheme aimed at such matters might well be qualitatively different from what the provinces, acting alone or in concert, could achieve.[31]

The above notwithstanding, the Court concluded that by focusing on the regulation of all aspects of securities in minute detail, the proposed Act exceeded Parliament's legislative interests.

The fifth and final criterion in *General Motors* is whether failure to include one or more provinces or localities in the scheme would jeopardize its successful operation. The Court responded in the negative with respect to lesser regulatory matters, but in the affirmative with respect to genuine national goals.

After analyzing the five criteria that make up the *General Motors* test, the Court asked "the ultimate question – whether the Act, viewed in its entirety, addresses a matter of genuine national importance and scope going to trade as a whole in a way that is distinct and different from provincial concerns."[32] The Court decided that it did not.

2.2.4 Conclusion of Reference

Consequently, the Court concluded that local issues – protecting investors and ensuring market fairness by regulating market participants – are the main thrust of the proposed Act. The Court stated that the doctrine of ancillary powers cannot be applied in this instance because it requires that the proposed Act (viewed as a whole) be valid, which it is not. In the Court's words:

> While the proposed Act must be found *ultra vires* Parliament's general trade and commerce power, a cooperative approach that permits a scheme that recognizes the essentially provincial nature of securities regulation while allowing Parliament to deal with genuinely national concerns remains available.[33]

Similarly, the Court determined that the various proposals advanced over the years to regulate securities in Canada show that the securities sector possesses both central and local aspects.[34] It also made reference to the experience of other federations, where the idea of cooperation is necessary in order to strike a balance between these aspects. In the opinion of the Court, this approach is:

> supported by the Canadian constitutional principles and by the practice adopted by the federal and provincial governments in other fields of activities. The backbone of these schemes is the respect that each level of government has for each other's own sphere of jurisdiction. Cooperation is the animating force. The federalism principle upon which Canada's constitutional framework rests demands nothing less.[35]

In sum, the Supreme Court stated that cooperation is necessary in order to achieve a balance between national and local interests.

3 COMMENTARY

According to one commentator, in *Reference re* Securities Act, the political legitimacy of the Supreme Court was at stake. Indeed, in addition to its economic impact on the securities industry, the Court's opinion would have an impact on the balance of power between the federal Parliament and the provinces. The same analyst asserted that the Supreme Court's opinion could have a major impact on the future of constitutional law in terms of the separation of powers and constitutional evidence. In the wake of the Court's opinion, observers disagree on where things stand and on the merits of the federal government's plan to pursue efforts to create a federal securities regulator.[36]

3.1 PURSUING THE PROJECT OF CREATING A FEDERAL SECURITIES REGULATOR

In *Reference re* Securities Act, the Supreme Court wrote, "The need to prevent and respond to systemic risk may support federal legislation pertaining to the national problem raised by this phenomenon.".[37]

For the purposes of its decision, the Supreme Court used the following definition of "systemic risks":

> risks that occasion a "domino effect" whereby the risk of default by one market participant will impact the ability of others to fulfil their legal obligations, setting off a chain of negative economic consequences that pervade an entire financial system.[38]

Some commentators see *Reference re* Securities Act as authorizing the federal government to put in place a federal scheme that would regulate systemic risk that is clearly within its jurisdiction:

> [T]he federal government should create a financial markets regulatory agency and mandate such a national regulator specifically with the oversight of systemic risks in securities markets, investing it with powers to intervene where particular products or activities threaten financial stability. …

> This would involve the regulation of over-the-counter derivatives, credit rating agencies, record-keeping, short-selling and urgent regulation relating to "substantial risk of material harm to investors or to the integrity or stability of capital markets."[39]

Others have reservations about this approach. One commentator has expressed the view that creating a federal agency to oversee systemic risks would first require that the risks and the manner in which they are addressed be clearly defined:

> My concern with this narrow approach to federal regulation based on systemic risk is that it would create a 14th regulator in the capital markets and not directly address the issues of accountability, duplication, inefficiency and ineffectiveness that cause us concern with the current system.[40]

The same commentator has said that the Court used a formalist analysis of federalism to come to a decision that was very much out of context, indicating a lack of understanding of the evolution and current status of Canadian capital markets.[41] She is of the opinion that by determining that Canadian capital markets are by nature local and ignoring the fact that they are essentially national and international, the Court failed to apply the constitutional principle of the "living tree."[42] She believes, however, that creating a national securities agency is still possible and desirable.[43]

On the subject of the Court's assertion that it is a question of coming up with a solution that would satisfy both the federal government and the provinces by taking a cooperative approach, the same commentator believes that the federal government and the Canadian Securities Transition Office have done exactly that until now.[44] This is the option she prefers.

Finally, some observers believe that the proposed Act is a vehicle that would suffice to ensure that the new Canadian securities regulator will be able to take urgent measures to protect the stability of financial markets.[45] According to this view, there would be greater stability if there were a single body working with federal agencies like the Office of the Superintendent of Financial Institutions and the Bank of Canada to quickly address emerging issues that require some sort of coordination.[46]

3.2 Enhancing the Existing System

Some observers believe that the federal government has a responsibility regarding systemic risk, and that the government already has the means to manage it:

> The Office of the Superintendent of Financial Institutions (OSFI) has the prudential regulatory responsibility to oversee and regulate the securities-related activities of Canadian banks "in a system where all banks, and all of their subsidiaries (including investment banking), are under the scrutiny of a single regulator." … This, of course, is perfectly in line with the powers and duties assigned to the superintendent under the OSFI Act. The federal government's contention that the proposed Securities Act is "squarely aimed at dealing with systemic risk," in view of provisions permitting compelling the production of documents from "market participants" (section 109) and the sharing of information in Canada and abroad (section 224[1]), does not break new ground. These powers are already available to OSFI, and, to the extent it was deemed important to extend its ambit to certain unregulated organizations such as hedge funds and "dark pools," the simple extension of the definition of financial institutions in the OSFI Act to include such "market participants" would accomplish that objective.[47]

Another commentator agrees, saying that any initiative related to systemic risk should target the weaknesses that affect regulation, both federally and provincially:

> [T]he Office of the Superintendant of Financial Institutions and the Bank of Canada are already well-positioned to deal with systemically important situations, such as the six largest Canadian banks. At the provincial level, securities regulators also have existing tools to mitigate the build up of systemic risk. Both levels of regulators also collaborate in the Head of Agencies Committee to exchange information and views, as well as to co-ordinate action on issues of mutual concern.[48]

This analysis shows that cooperation between governments and federal and provincial regulators would ensure that systemic risks are monitored and managed more effectively than would be the case if the government were to act alone.[49]

The same analyst contends that the Supreme Court decision does not allow the government to argue improved management of systemic risk to justify the replacement of provincial securities legislation.[50] Noting that defining the very notion of systemic risk is key to understanding the parameters and primary sources, one observer has said that the definition could not be extended to all aspects of securities.[51]

While other observers acknowledge that "the Bank of Canada has been primarily responsible for the systemic risk oversight of clearing and settlement systems, is involved in international fora and is playing a leading role in the reform of derivatives markets,"[52] they believe that:

> [t]he Office of the Superintendent of Financial Institutions is ill placed to regulate such systemic risk emanating from securities markets (so-called "macro-prudential regulation"). Lumping prudential supervision of securities markets into OSFI's mandate would confuse its specialization and pose a worrisome conflict of interest: Would concern about keeping banks healthy lead to overcautious and ham-fisted interventions in securities markets? Good regulation requires well-co-ordinated but specialized regulators that each have a clear mandate.[53]

Another analyst believes that because there is little chance that provinces like Quebec and Alberta will voluntarily participate, there has never been any hope of creating a truly "national" regulator.[54] The proponent of this view underlines the illusory nature of the notion of the proposed Act's creating a single agency representing Canada with a single voice in international negotiations.[55] He is of the opinion that the Court showed wisdom in properly applying the law to the facts of the matter:

> Those who are disappointed at the Supreme Court's ruling (particularly business interests) might do well to consider the broader implications of a decision favourable to the federal government, both in respect of process issues and the balance of power between the federal government and the provinces.[56]

Yet another observer states that the current passport system – the system that provides participants with a single window of access to Canadian capital markets – cannot be considered truly harmonized throughout Canada because Ontario does not take part. This is another reason that the following might be a solution:

> [T]he best way to bury the constitutional hatchet in securities regulation and move forward would be for Ontario to join the passport system so that the provinces can re-focus their energies on making functional policy improvements, including a more co-operative relationship with the federal government.[57]

4 CONCLUSION

The Supreme Court pointed out in its opinion in *Reference re* Securities Act that securities regulation is an area of provincial jurisdiction, but that the federal government also has a role to play in truly national issues, such as the management of systemic risk and the preservation of the fairness and efficiency of capital markets throughout Canada.

Commentators on the opinion are divided on the course of action to be taken following the decision. Should the existing system be enhanced through increased harmonization across the country of securities regulation, or should the project to create a federal securities regulator that would oversee national issues based on some sort of cooperation with the provinces be pursued?

Whichever path is taken, the nature of the interests and players involved, coupled with the federal government's stated intention of moving forward with its plans to establish a federal securities regulator, mean that the next events will have a decisive impact both on securities regulation in Canada and on the operation of Canadian federalism.

NOTES

* This paper is one of two in a series about a proposed federal securities regulator. The companion paper examines the economic arguments for and against the proposed federal securities regulator. See Maxime-Olivier Thibodeau, *Proposed Federal Securities Regulator – 1. Economic Aspects*, Publication no. 2012-28-E, Parliamentary Information and Research Service, Library of Parliament, Ottawa, 30 April 2012.

1. *Reference re* Securities Act, 2011 SCC 66.
2. Department of Finance, *Fact Sheet on Reference to the Supreme Court of Canada on the Proposed Canadian* Securities Act.
3. *Reference re* Securities Act, para. 134.
4. Ibid., para. 6.
5. Ibid., para. 2.
6. Ibid., para. 46.
7. Ibid., para. 6.
8. Ibid., para. 130.
9. Ibid., para. 7.
10. Ibid.
11. Ibid., para. 10.

12. Ibid., paras. 12–28. These proposals are listed in Thibodeau (30 April 2012).
13. Ibid., para. 127.
14. Ibid., para. 32.
15. Ibid.
16. Ibid., para. 34.
17. *Lymburn* v. *Mayland*, [1932] A.C. 318 (P.C.), p. 324, quoted in *Reference re* Securities Act, para. 43.
18. *Multiple Access Ltd.* v. *McCutcheon*, [1982] 2 S.C.R. 161, quoted in *Reference re* Securities Act, para. 44, which also refers to *Global Securities Corp.* v. *British Columbia (Securities Commission)*, 2000 SCC 21, [2000] 1 S.C.R. 494, para. 40.
19. *Reference re* Securities Act, para. 46.
20. Ibid.
21. Ibid., para. 62.
22. Ibid., para. 71.
23. *General Motors of Canada* v. *City National Leasing*, [1989] 1 S.C.R. 641.
24. *Reference re* Securities Act, para. 80.
25. Ibid., para. 108.
26. *Kirkbi AG* v. *Ritvik Holdings Inc*., 2005 SCC 65, [2005] 3 S.C.R. 302.
27. Ibid., para. 29, quoted in *Reference re* Securities Act, para. 82.
28. *Reference re* Securities Act, para. 106.
29. Ibid., para. 110.
30. Ibid., para. 117.
31. Ibid., para. 121.
32. Ibid., para. 124.
33. Ibid., para. 130.
34. Ibid., para. 131. For a discussion of previous proposals, see Thibodeau (30 April 2012).
35. Ibid., para. 133.
36. In Budget 2012, which followed the Supreme Court's decision in *Reference re* Securities Act, Finance Minister Flaherty restated arguments in favour of a national securities regulator and tabled an order extending the mandate of the Canadian Securities Transition Office by one year, until July 2013.
37. *Reference re* Securities Act, para. 128.
38. Michael J. Trebilcock, *National Securities Regulator Report*, 2010, para. 26, quoted in *Reference re* Securities Act, para. 103.
39. Anita I. Anand and Grant Bishop, "Securities blanket – Ottawa should move now to enact securities regulations in areas that are clearly within federal jurisdiction," *Financial Post*, 9 February 2012.
40. Poonam Puri, "The Supreme Court's Securities Act Reference Fails to Demonstrate an Understanding of the Canadian Capital Markets," *Canadian Business Law Journal*, Vol. 52, No. 2, 2012, p. 196.
41. Ibid., 190–191.

42. Ibid., pp. 193–194.

43. Ibid., p. 191.

44. Ibid., p. 196. The Transition Office was established in 2009 under the *Canadian Securities Regulation Regime Transition Office Act* to hold consultations with the Advisory Committee of Participating Provinces and Territories on developing draft federal securities legislation – which would be the subject of the Supreme Court reference – and coming up with a plan for the transition to a federal securities commission.

45. Thomas Hockin, "Arguments for a National Securities Regulator," in Pierre Lortie, "Securities Regulation in Canada: The Case for Effectiveness," *IRPP Study* [Institute for Research on Public Policy], No. 19, October 2011, p. 32.

46. Ibid.

47. Lortie (2011), p. 22.

48. Stéphane Rousseau, "Endgame: The Impact of the Supreme Court's Decision on the Project to Create a National Securities Regulator," *Canadian Business Law Journal*, Vol. 52, No. 2, 2012, pp. 188–189.

49. Ibid., p. 189.

50. Ibid., p. 188.

51. Ibid.

52. Anand and Bishop (2012).

53. Ibid.

54. Jeffrey MacIntosh, "Politics, Not Law," *Canadian Business Law Journal*, Vol. 52, No. 2, 2012, p. 179.

55. Ibid., p. 180.

56. Ibid., p. 181.

57. Eric Spink, "Reacting to the Status Quo in Securities Regulation," *Canadian Business Law Journal*, Vol. 52, No. 2, 2012, p. 185.