SIDE-PAYMENTS, OPT-INS AND POWER: CREATING A NATIONAL SECURITIES REGULATOR IN CANADA

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I. INTRODUCTION

Canada is the only developed economy that does not have a national securities regulator.\(^{1}\) Instead, each province and territory has its own securities regulator. All but one province co-operators through a "passport" system which allows issuers to choose a regulator. The exception, a large one, is that Ontario has not signed on to the passport system. The absence of a national regulator has led to decades of debate about the necessity and value of a single securities regulator. Spurred on by the 2009 Report of the Expert Panel on Securities Regulation,\(^ {2}\) the federal government established a "Transition Office" and passed legislation providing the Office with a mandate to establish a Canadian Securities Regulator.\(^ {3}\)

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2. Expert Panel on Securities Regulation, Final Report and Recommendations (Ottawa, Department of Finance, 2009) [The Expert Panel’s Report or the Report]. Regarding the federal government’s support for a national securities regulator, see the budget that followed the release of the Report in March 2009. See Department of Finance Canada, Budget 2009: Canada’s Economic Action Plan (Ottawa, Department of Finance, 2009), online: Department of Finance Canada <http://www.budget.gc.ca/2009/plan/bpc3a-eng.html>. The Expert Panel’s Report uses the terms “national securities regulator” and “single securities regulator” (more often) throughout the report. We use both of these terms here.
With these initiatives, the federal government has moved closer to the creation of a national securities regulator. Yet despite numerous reports on the benefits of a national model, it faces resistance from a number of provinces (in particular Alberta, Québec, Manitoba and to some extent, British Columbia and Saskatchewan). To overcome this opposition, the federal government appears to be employing a combination of “sticks” and “carrots.” First, the federal government has brought a reference to the Supreme Court of Canada seeking a decision on the constitutionality of such a regulator based on a proposed Canadian Securities Act. Alberta and Québec have also brought references to their respective courts of appeal on the constitutionality of the federal proposal.


government’s position is successful in these references, it may impose a national model on reluctant provinces. Second, the proposed Canadian Securities Act includes a carrot of sorts, since its opt-in structure allows reticent provinces to join the federal scheme over time. Third, federal funds have been set aside to compensate the provinces for loss of revenue from fees in the transition to a national regulator.

This article examines whether the federal government is likely to succeed in establishing a national securities regulator given an array of strategies comprised of both carrots and sticks. The analysis turns in part on the basis for the provincial resistance to the proposed federal model. One possibility is that the hold-out provinces believe that the federal plan will harm them in welfare terms — that is, the respective provinces and their residents will be worse off in some sense such as economic growth. The federal government would then need to either convince the provinces that a national regulator is in fact in their long term interests, compensate individual provinces harmed by the federal plan or force hold-out provinces to accept the national system despite legitimate welfare concerns. (The latter option would raise considerable political concerns for the federal government.)

Another possibility is to examine provincial resistance in political economy or public choice terms. On this approach, the resistance stems not from a perceived loss of provincial welfare but from potential losses to important parties within each province. The parties central to the creation of a national scheme include not only provincial legislators but also securities regulators, issuers and the investing public at large. We argue that the incentives of these parties vary across provinces and this variance in part explains the


8. See A. Anand and A. Green, “Why is this Taking So Long? The Move Towards a National Securities Regulator” (2010), 60 U.T.L.J. 663 (examining the implications of assuming that the provinces are resisting a national regulator in an attempt to maximize their social welfare). For example, Alberta argues that its market is arguably different from other Canadian securities markets; as Alberta Premier Ed Stelmach has said, “[s]mall oil and gas companies want Alberta to keep the provincial regulator, because they want to work with a body that understands the operations of companies involved in high-risk exploration projects ... The national companies ... large companies, pipeline companies ... they’re doing business around the world. It doesn’t matter to them.” See Ed Stelmach, quoted in “Canada Doesn’t Need National Securities Regulator: Stelmach,” CBC News, January 14, 2009, online: Canadian Broadcasting Corporation <http://www.cbc.ca/canada/edmonton/story/2009/01/14/edm-stelmach-regulator.html>.
resistance to the federal plan. The federal proposal may be successful if it is able to undermine the incentives of these players by making provincial regulatory monopolies less attractive.

Part II analyzes recent reform initiatives that have spurred the debate about a national securities regulator. Part III then probes two different explanations of provincial resistance — welfare and political economy — and argues that the political economy perspective points to co-operation between the provincial regulators being conditional on maintaining provincial jurisdiction over securities regulation. Part IV turns to the issue of whether either of these explanations is likely to break the conditional co-operation that underlies the passport model. We argue that the federal government must overcome this provincially-based co-operation to create a successful national securities regulatory scheme. Part V concludes.

II. RECENT REFORM INITIATIVES

One significant factor that differentiates the current push towards a national regulator from previous proposals is the financial crisis that enveloped the global economy at the very time the Expert Panel’s report was being written and released. The economic crisis was a catalyst for the federal government’s initiative as well as the Report despite the fact that the crisis was not at its core about the necessity of a national securities regulator.9 In this section, we discuss recent reform initiatives, including the Expert Panel’s report and the federal constitutional

9. The federal government has referred to the global credit crisis of 2008 as a reason for forming a national securities regulator. See for example Michaëlle Jean, Speech from the Throne, “Protecting Canada’s Future,” Government of Canada, November 19, 2008, online: Government of Canada <http://www.sft-ddt.gc.ca/eng/media.asp?id=1364>. “The credit crisis has also underlined the dangers of a fragmented financial regulatory system. To further strengthen financial oversight in Canada, our Government will work with the provinces to put in place a common securities regulator.” However, while the regulation of certain securities (such as over-the-counter derivatives) was one aspect of the crisis, the crisis was also about a host of issues outside the realm of securities law, including the availability of mortgages and mortgage insurance, the availability of credit and banks’ capital adequacy ratios. Nevertheless, Finance Minister Flaherty argued (perhaps successfully) that this was the time to implement a national securities regulator. See Anita Anand, “Is Systemic Risk Relevant to Securities Regulation?” (2010), 60 U.T.L.J. 941. See also Kevin Carmichael, “Securities Regulator Law Coming in ‘Days’: Flaherty,” The Globe and Mail, May 3, 2010, online: The Globe and Mail <http://www.theglobeandmail.com/report-on-business/securities-regulator-law-coming-in-days-flaherty/article1555578/?cmpid=rss1>.
reference, both of which were conceived during the financial crisis and its immediate aftermath.

1. Expert Panel’s Report

In early 2009, the Expert Panel on Securities Regulation released its Final Report and Recommendations. The Report identifies several difficulties with the current system of 13 separate securities regulators, including increased transaction costs and inefficiencies due to multiple regulatory bodies, reduced ability to react quickly to changes in financial markets, and inability to respond uniformly to national and international issues in capital markets. The Report recommends the creation of a Canadian Securities Commission (CSC). ¹⁰

The defining features of the regulatory model proposed in the Report are threefold. First, the Report recommends a decentralized approach within the federal model, in which vice-chairs are distributed across regional centres and provinces have representation at various levels of decision-making. ¹¹ Decentralization is to be achieved via the creation of regional offices in major centres along with a series of smaller regional offices. ¹² The regional offices will “be responsive to the distinct needs of regionally-based sectors and local market participants.” ¹³ The offices will also support local enforcement actions and will be a first point of contact for complaints of misconduct. The Report does not recommend a geographical location for the CSC’s head office, but suggests that it be in one of the four largest provinces: British Columbia, Alberta, Ontario or Québec.

Second, the Report recommends that the national securities regulatory regime operate with a two-pronged opt-in mechanism. Under the first prong, provinces can choose to forego provincial

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¹⁰. Expert Panel’s Report, supra, footnote 2. The Expert Panel’s Report is not alone in its critique of the status quo; the International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD) have criticized the current regime as being fragmented and inefficient. See Anita I. Anand, “Another look on the Lortie report,” Investment Executive, December 2010, p. 46. See also Ontario Ministry of Finance, Five Year Review Committee Final Report, supra, footnote 4, at p. 36. See also Anita Anand and Peter Klein, “Inefficiency and Path Dependency in Canada’s Securities Regulatory System” (2005), 42 C.B.L.J. 41, which is based on a report, prepared by these authors, entitled “Costs of Compliance in Canada’s Securities Regulatory System” in Harris, supra, footnote 4.


¹². Ibid.

¹³. Ibid., at p. 43.
regulation and voluntarily join the national regulatory model over time. That is, they can choose to participate in the national regulatory model at a later date even if they did not join upon its inception. Under the second prong, until all provinces have adopted the national model, market players, such as issuers and registrants, can voluntarily choose to be regulated under the federal model even if their home province has not yet opted in. In other words, these players can forego being regulated at the provincial level (and thereby be exempt from provincial law) and instead be regulated by the CSC and federal securities law alone.\(^\text{14}\)

The rationale, it appears, is that although some provinces may be hold-outs, enough provinces and issuers will opt in to the national model that they will bleed the benefits that any holdout provinces may obtain by opting out.\(^\text{15}\)

Third, the Report recommends the creation of new institutions. First would be a separation between the adjudicatory and regulatory arms of the federal agency, with the regulatory arm still adjudicating certain matters such as discretionary exemptions and contested takeover bids. The Report notes that the Commission should retain the administrative power because the regulator has the “policy expertise and the quick response capability to properly address these matters in a more timely fashion, which . . . outweigh the benefits of referring these decisions to an independent tribunal.”\(^\text{16}\) The regime would also have an independent investor panel and a small issuers panel. A council of ministers, composed of the federal Minister of Finance and a minister designated by each participating jurisdiction, would be formed to discuss emerging issues and supporting distinct regional and industry-specific needs.\(^\text{17}\)

## 2. Proposed Federal Securities Act

While Ontario responded positively to the Expert Panel’s Report, not all provinces support the creation of a CSC. Alberta, Québec, Manitoba and Saskatchewan in particular are opposed to the idea of a single national regulator, either that proposed in the

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\(^\text{14}\) Ibid., at p. 91 which states: “Issuers and registrants who make such an election [i.e., to be regulated under the federal regime only] would then, for securities laws purposes, be regulated in Canada by the federal regime only, and would not be regulated by the non-participating jurisdictions.”

\(^\text{15}\) See Anand and Green, supra, footnote 8.

\(^\text{16}\) The Expert Panel’s Report, supra, footnote 2, at p. 30.

\(^\text{17}\) Ibid., at p. 45.
Expert Panel’s Report or in any form beyond a passport system. As noted above, Alberta and Québec have been particularly vocal and have each filed constitutional references in their respective courts of appeal. They are not participating in the processes established by the Transition Office to develop an implementation plan for a national securities regulator.

Perhaps in response to this forceful opposition, the federal government referred the matter to the Supreme Court of Canada and appended a proposed Canadian Securities Act as part of its reference. Following on from the Expert Panel’s Report, the Act contains a number of provisions that incorporate concerns about regional representation. It contemplates the creation of a Council of Ministers composed of the federal Minister of Finance and provincial ministers to “facilitate consultations and the exchange of information.” Further, the new Canadian Securities Regulatory Authority (the “Authority”) is to be controlled by a Board of Directors appointed by the federal Cabinet on the recommendation of the Minister of Finance and in consultation with the Council of Ministers. The Minister must both take account of the expertise of the potential Board members and “have regard to the importance of having a board of directors that is representative of the various regions of Canada.”

The Board makes policies and regulations for the Authority. The Act also contemplates regionalization of other aspects of the Authority’s institutional framework. The Act proposes a Regulatory Division for the Authority under the responsibility of a Chief Regulator. The Board must also appoint a Deputy Chief Regulator for each region, with the regions fixed by the Board of Directors. In addition, the Act would create a Canadian


19. Proposed Canadian Securities Act, supra, footnote 6. The case is set to be heard in April, 2011.

20. Ibid., at ss. 11 and 12.

21. Ibid., at s. 19(3)(b).

22. Ibid., at s. 18(2)(h) and (c): “(2) The board of directors (b) establishes policies with respect to the Chief Regulator’s powers and duties; and (c) exercises the Authority’s power to make regulations.”
Securities Tribunal, which is to have adjudicative functions and be independent from the Authority. As with the Board of Directors, the Minister is to recommend individuals to the Cabinet for appointment to the Tribunal, taking into account both expertise and the importance of regional representation. Further, the Act proposes a policy advisory body called the Regulatory Policy Forum that would have regional representation through the Deputy Chief Regulators.

The final important element of the proposed Securities Act is the provincial opt-in. The proposed statute states that the principal provisions of the Act will not apply in a province unless Cabinet designates it as a participating province. The Cabinet may only make such a designation with the consent of the province. In addition, the Minister of Finance must recommend the designation to Cabinet and may only do so if he or she is satisfied that the national regime will apply in the province. Unlike the proposal of the Expert Panel, the proposed Securities Act does not include a separate opt-in for issuers and registrants.

III. SOCIAL WELFARE, PRIVATE INTEREST AND REGULATION

Given these two policy initiatives (the Expert Panel’s Report and the proposed Securities Act), the question arises as to how the federal government can persuade reluctant provinces to join a national securities regulatory scheme. We argue that the federal government can utilize a variety of policy levers which we call “carrots” and “sticks.” The effect of the carrots and sticks will depend on reasons for which different actors make particular choices. In general, economic analysis assumes that individuals are rational, with rationality meaning maximizing something (utility, welfare, wealth) based on a set of preferences. The focus is on the outcomes of various choices that the decision-maker could take. These decision-makers are usually assumed to be self-interested and self-centered — that is, they care about maximizing their own welfare, which is assumed to be unaffected either by the welfare of others or by other factors such as fairness.

This basic assumption

23. Ibid., at s. 23.
24. Ibid., at s. 28.
25. Ibid., at s. 29.
26. Ibid., at s. 50.
27. Ibid., at s. 250. Note that there is no “opt-out” feature, suggesting that once provinces opt in, this decision cannot be reversed.
of rationality is made whether the decision-maker is an individual, entity or group, such as a regulatory body, or even a state. It is, of course, more difficult to assess how choices are made where the decision is ostensibly made by a group or organization. In this part, we examine two very different sets of assumptions about the nature of the group decision-maker and what it seeks to maximize.

1. Social Welfare Maximization

One approach is based on the assumption that the group (such as a securities regulatory body or the political leaders and bureaucrats involved) makes decisions in order to maximize social welfare. Social welfare could be viewed in terms of economic growth (e.g., measured in terms of GDP) or a broader notion of social welfare, which includes other factors, such as the level and distribution of wealth, health and education. The assumption of self-interest implies that there can be a difference between the welfare of the decision-maker and that relating to broader groups. For example, if the decision-maker is the provincial government, even assuming that it aims to maximize social welfare, there may be a difference between a policy that maximizes the welfare of the province and a policy that maximizes the welfare of Canada as a whole (let alone global welfare).

Group decision-making raises concerns about the policy process even where all individuals within the group are assumed to be making decisions on the basis of maximizing social welfare. First, the process of decision-making within a group will impact policy choices in part by determining who has the power within the group and therefore whose preferences are likely to count. Within a province, for example, there will be differences in views on the appropriate notion of social welfare: is it the politician’s view of welfare that counts, a subset of politicians, the executive (such as a regulatory body) or the electorate? The preferences of different sub-groups may conflict — such as preferences over what should be the goal of policy (economic growth versus some other notion of social welfare) and the weight to be given to various factors, such as equity and fairness. Determining the process for decision-making and for checks on decision-makers is important for the resulting policy choices because it can determine whose preferences prevail.

Second, even if it is clear whose preferences count, there may be a principal-agent problem if those individuals are not the ultimate
decision-maker. This is true even if the decision-maker is attempting to faithfully base decisions on the preferences of others. In particular, the decision-makers (the agents) may make mistakes about the preferences of those whose preferences are to be satisfied (the principal). An obvious example is the case of a regulatory body which is attempting to make policies which accord with the preferences of the citizens of the jurisdiction. If the regulatory body cannot determine the preferences of the citizens (or cannot do so within their existing budget), it may make incorrect assumptions about those preferences. The processes and administrative structure are therefore important as they aid in determining if the ultimate decision-maker has the ability to determine the underlying relevant preferences.

In the case of securities regulation, the more positive social welfare story on the provincial side would be that the provincial politicians or regulatory officials who do not want a national securities regulator believe that local regulation is more advantageous in terms of provincial welfare. Provincial regulation may not be as beneficial nationally as centralized regulation since there may be negative externalities imposed on other provinces from local regulation. However, the interests of local officials focus on provincial welfare and therefore do not take these externalities into account. Moreover provincial welfare — defined by either the politicians or potentially the regulatory officials — may focus on aspects of provincial welfare (such as narrowly on economic growth or government revenues) that do not accord with the preferences of the majority of provincial residents. In this way, the provinces may not want a national securities regulator because they believe that it is disadvantageous to provincial welfare. The social welfare argument for the federal government would be that a national securities regulator is necessary to overcome the negative externalities or efficiency concerns with provincial regulation.29

2. Public Choice, Provincial Interests and National Regulation

The story behind provincial and federal interests is important because it relates to the potential impact of different policy choices by the federal government. For example, if provincial decisions on the appropriate regulatory jurisdiction (provincial or federal) are based on welfare concerns, some provinces may agree that a

29. See Anand and Green, supra, footnote 8.
federal securities regulator enhances national welfare but differ on
the appropriate form of implementing this model. Some provinces
may want a national regulatory scheme which favours small
venture capital firms while others may want to favour senior
issuers. Different forms of national regulation would lead to
different distributions of the benefits of such regulation. In such a
case, there may be the opportunity for side payments (carrots)
which take into account the loss of welfare by some provinces from
a federal model. A federal government which unilaterally imposes
a national regulatory structure may be viewed as acting unfairly
without such accompanying side payments. Put differently, side
payments can level the playing field in terms of provincial
willingness to join the federal model.

However, a main focus of this article is on a different story
about policy decisions: a political economy story where the central
assumption is that the decision-makers are rational but that they
seek to maximize their own welfare rather than social welfare. For
example, politicians may make decisions based on maximizing
their own prospects for re-election (which may be a function of
which group is willing to finance a re-election bid) or on increasing
their potential job opportunities after their political career is over.
Similarly, bureaucrats (such as members of a regulatory agency)
may seek to enhance the size of the bureaucracy or to further their
own future career opportunities. In this way, the decisions that
result from public bodies, such as legislatures or regulatory
agencies, can be viewed as the outcome of a maximization of
some individually or narrowly defined self-interest. These
individuals will make choices which may not maximize social
welfare.

In the current provincial regulatory model, provincial regulators
are central to the political economy story. This story assumes that
regulators wish to augment their power and importance, both of
which will increase with the number and size of the firms within
their jurisdiction as well as the volume of trading. In Canada,
provincial regulators have been able to maintain or augment their
importance through monopolies over securities regulation. Each
controls the type and scope of regulation within its own province

30. Ibid. For a discussion of the possible coordination game underlying provincial
opposition to national regulation.
31. Frederick Tung, "From Monopolists to Markets? A Political Economy of Issuer
Choice in International Securities Regulation" (2002), Wis. L. Rev. 1363, at p.
1381.
32. See Tung, ibid.
and, to some extent, each has been able to rely on the fact that issuers have tended, at least historically, to rely on local capital markets.

Tung notes that securities regulators may set a “price” for issuing in their jurisdiction — with the “price” being the difference between the level of regulation that would be ideal for a particular type of firm and the level actually set by the regulator.33 He argues that some jurisdictions, such as the United States which has a deep market accessed by a large number of firms, are “price setters.” In such cases, the regulator sets a high price by over-regulating which in turn allows them to increase the size of their bureaucracy while maintaining a large number of issuers. Other jurisdictions, however, are “price-takers” in that they cannot set a high regulatory price for entry as they need to ensure that firms either stay in or are attracted to their markets. They face pressure to weaken regulation to maintain the number of firms or volume of trades at the expense of the opportunity to increase the number or complexity of the rules (and hence the size of the bureaucracy).

Issuers in Canada do have some choice regarding their securities regulator. Under the passport system of regulation, issuers choose a principal regulator which reviews all necessary documentation relating to the transaction. All other provincial and territorial regulators defer to the decision of the principal regulator.34 Ontario has not signed on to the passport system; however, since all other jurisdictions have agreed to defer to its decisions, the province therefore participates by default. Ontario is without question a price-setter. Issuers would likely wish to enter Ontario’s markets. Other provinces, particularly the smaller provinces such as New Brunswick or Prince Edward Island, would likely to be less able to set a high price for entry.

Not all regulation is over-regulation. Most firms would likely want some set of regulation, relating to common disclosure obligations, for example, to increase investor confidence.

33. Ibid; Robert Cooler, “Prices and Sanctions” (1984), 84 Colum. L. Rev. 1523, at p. 1525 (who defined a price as a payment in money that is required to do what is permitted); Roberta Romano, “The Need for Competition in International Securities Regulation” (2001), 2 Theor. Inq. L. 387, at p. 399 (who observed that the SEC has lowered the price for foreign investors while raising the price for domestic ones).

Differences between price-takers and price-setters would not be regulation versus no regulation but rather would be on the margin. The fact, therefore, that there is considerable commonality between the securities regulation across provinces points to some tendency towards a minimum set of (perhaps efficient) regulations. The differences arise around this minimum — there could be over-regulation where a jurisdiction is a price-setter and under-regulation where it is a price-taker. These differences could arise in the substance of the regulations (such as less strict regulations for certain types of firms in some provinces) or in the strength of enforcement.

Advocates of allowing issuers the choice of jurisdictions view such differences in regulation as beneficial. Their argument is that such diversity allows tailoring to different types of investors. However, such diversity may also have a social cost to the extent that there is under- or over-regulation of issuers or that there are other transaction costs or welfare costs to having multiple regulators. One report has indicated that the Canadian economy bears the costs of such diversity due to higher regulatory costs and possibly less efficient capital markets. Other reports have argued that the costs do not outweigh the benefits.

Why then has this system of provincial monopolies continued? One possibility is a welfare story: provincial regulators recognize that there are inefficiencies from not having a national regulator and wish to co-operate on a single regulator. However, while they may wish to co-operate, they cannot agree on the form of cooperation — that is, there is a coordination problem that hinders the creation of a national securities regulator. There are different sets of rules that may be efficient and the distribution across provinces of gains from a national system depends on which set of rules is chosen. Lack of agreement on the appropriate set of rules, and therefore the distribution of gains and losses from moving to the national regulator, have delayed creation of a national system.


36. Note that some studies favour the retention the current system: see Pierre Lortie, “Securities Regulation in Canada at a Crossroads” (2010), 3 U. Calg. School of Pub. Pol. srp Research Paper 5. For a response to this paper, see Anita Anand’s article in the Investment Executive, supra, footnote 10.


38. See Anand and Green, supra, footnote 8, for a discussion of the welfare story for the lack of agreement on a national regulator.
In this article, however, we propose a different reason for the absence of a federal system of securities regulation. It is not that the provinces cannot agree on what all see as a national welfare enhancing regime; some provinces obstruct the development of a national regulatory scheme because they do not want to lose their rents from the current system, including the power and importance they are able to garner from local monopolies. The move to a national regulator may mean dismantling local securities regulatory bodies, and the local professional networks that they have engendered, or at least a loss of local power over securities regulation.

In game theory terms, the current regime from the public choice perspective could be seen as a “stag hunt” game for securities regulators. In the stag hunt game, individuals have to decide whether to take one of two actions — hunt rabbits on their own which provides a low pay-off or to hunt a stag which results in a higher pay-off but only if they work together. No one individual can hunt a stag successfully on its own — such a strategy yields nothing. The players must choose whether to hunt rabbits or stag without knowing the choices of the others (or at least without knowing the other’s strategy for certain). They do, however, have expectations of what the other player will do. There are two equilibria — both hunt stag together or both hunt rabbits separately.

In the case of securities regulation in Canada, the conditional co-operation is the maintenance of the current system of provincial regulatory monopolies. Provincial regulators benefit if all provinces follow the same strategy as they each are able to protect their markets. They keep the regulatory price somewhat high and collect fees as issuers must continue to pay these to each separate regulator despite the passport system. Issuers in Canada


40. These equilibria are Nash equilibria. A Nash Equilibrium is a set of strategies that the two players play in which neither player has an incentive to deviate from it — that is, no player can do better by choosing a different strategy given the strategy of the other player(s). Douglas G. Baird, Robert H. Gertner and Randal C. Picker, Game Theory and the Law (Cambridge, Harvard University Press, 1994).
have no choice but to bear the cost of provincial regulation (though, as noted above, the price may vary across provinces).

While co-operation in terms of provincial regulation is beneficial to provincial regulators, however, the co-operative state is tenuous as it may be difficult for provinces to maintain their individual monopolies if other provinces opt for a national regulator. Provinces could choose to register with the national regulator in which case their issuers have access to the capital markets of all provinces which are part of the national system. Alternatively, issuers could choose a principal regulator in a hold-out province under the passport system which would provide local capital market access to its investors. While some issuers may be tied to local markets, others may choose to undertake a cost-benefit analysis of staying with the hold-out province. The cost of registering in the hold-out province may be the same before and after the creation of the national regulator but the benefits of registering may be reduced because the national regulator provides access to additional capital. If they can meet their capital acquisition needs via a national regulator, they may be unwilling to bear the regulatory cost of remaining as a reporting issuer in the hold-out province alone. It may then be that as more provinces opt for the national regulator, hold-out provinces will be less able to maintain sufficient volume of issuers to remain viable. Moreover, to attract or maintain issuers, regulators in the hold-out provinces may have to drop their “regulatory price” significantly. The resulting regulation may not be sufficiently strict to maintain the confidence of investors (i.e., a race-to-the-bottom type argument).

Provinces then face two choices or equilibria — either they all (or almost all) co-operate in the sense of maintaining the provincial monopolies or they all join the federal model. If each province expects the others to maintain the provincial regulatory system, then it will also maintain the system. If, on the other hand, it expects the others to join the national regulatory system, it will also do so.

However, while provincial regulation may be beneficial to provincial regulators, it is still not clear why it would be maintained if a national securities regulator is welfare-enhancing (nationally and/or provincially). Why are provincial regulators able to maintain provincial regulatory monopolies if they reduce welfare? It would seem at first as if the legislators would step in and move to the national regulatory system if it enhances provincial (and possibly national) welfare. However, there are a number of
reasons why such legislative action may not occur. First, the regulators would oppose any such a transition since they would not want to lose their power. They may have strong influence on the legislators to the extent that there are informational asymmetries between the legislators and the regulators — in essence a principal-agent problem. Legislators do not have the expertise to evaluate the impact of the change in regulatory structures on provincial welfare and therefore rely on securities regulators. Regulators, however, may have an incentive to push for the maintenance of provincial monopolies as discussed above. 41

Second, as Tung argues in the context of international issuer choice models, the political economy story behind whether a jurisdiction will change its regulatory model will depend not only on whether regulators favour the change but also on the constellation of interest groups for or against the change. 42 In the case of the regulatory monopolies, such decisions may depend on whether the jurisdiction is a price-setter or price-taker. Issuers will consider whether the price for entry to the monopoly jurisdiction is relatively high and the nature of the likely change in price given the adoption of a national regulatory structure. If the change in regulatory structure is likely to lead to a significant reduction in the regulatory price, issuers may push legislators to agree to the change. Conversely, the smaller the likely change in price, the less pressure there will be for change and of course if the price is likely to rise, issuers that will suffer from this change in price will likely seek to influence legislators to resist the change.

Ontario may, for example, be more of a price-setter than some other provinces, setting a higher regulatory price. It has a large number of senior issuers. The extent to which these issuers would oppose the creation of a national securities regulator would depend on the change in price as a result of the transition. Given that Ontario likely already charges a fairly high price, Ontario issuers may not foresee a large price difference from the move to the national system and therefore voice less opposition. In fact, they may gain if the rules essentially stay the same but the overall transaction costs are reduced because of efficiencies in the new system. Moreover, their competitors in “low price” provinces may face an increase in regulatory price from moving to a national

41. See, for example, Tung, supra, footnote 31, discussing information asymmetries between legislators and securities regulators.
42. Ibid.
regulator, which would make the transition even more attractive to Ontario issuers.

Smaller provinces, on the other hand, may be price-takers — unable to set as high a regulatory price because they need to attract and retain issuers. In fact, they may not be in competition for most senior issuers as these issuers have already gravitated to larger markets. However, smaller provinces may be able to attract and retain smaller firms if they set the regulatory price low — perhaps through favourable rules or weaker enforcement. The degree of opposition of these firms to a national securities regulator would depend on the regulatory price under the national system.

The various provinces then fall along a spectrum with Ontario at one end, as home to the largest capital market, and with provinces with smaller markets that may not be able to afford a significant securities regulator at the other end. In the latter instance, even if the securities regulators argue against a national system, legislators may not be willing to listen since they would realize significant savings from moving to a national regulator (that is, low switching costs or even savings). In between are provinces such as Alberta and British Columbia where regulators may hold some sway in legislative and other debates over moving to the national regulator.

There may also be other interest groups that have a stake in the existence of provincial regulators versus a national regulator. Securities regulators in each province gives rise to a need for lawyers and law firms to provide at least minimal advice for issuing securities in that province. The “local opinions” may be an important source of income for such lawyers and firms and they may be lobby to retain this income. Moreover, some groups may develop an expertise in a particular industry which may provide them with a competitive advantage in providing services to issuers in these industries.

Along these lines, Puri argues that “local infrastructures for capital raising” or LICRs have developed in different provinces for particular industries. An LICR is “a geographic region where there is a critical mass of issuers of a certain industry type or level of market capitalization; this allows local securities regulators and professionals (such as investment bankers, lawyers and accountants) to develop an expertise and respond to the needs of these investors.” She finds that Alberta hosts an LICR in oil and

43. Ibid. (discussing the interests of securities lawyers and accountants in maintaining an existing regime in which they have made specific human capital investments).
gas, British Columbia in mining and technology, Ontario in mining, technology, financial services, communications and media and life sciences and Québec in communications and media and life sciences. These LICRs may seek to lobby for maintenance of the existing provincial regulators if at least part of the source of their advantage stems from their relationship with the local securities regulator.

These other interest groups, including securities lawyers and other professionals, in the non-dominant provinces may then favour the current system. The move to a national regulator would risk a decrease in demand for their services as they lose out on their developed expertise in the province's securities law. For the dominant provinces, such as Ontario, these groups would push for a national regulator if they believed either that the national rules would be similar to their rules so they have an immediate saleable expertise or that they would be involved in the creation of the rules.

If such a political economy story is behind provincial opposition to national regulation, Canadians may view unilateral national legislation as fair and legitimate. The rents obtained by provincial officials from provincial regulation (to the extent they can be shown to be such) would provide a strong basis for the exercise of federal power. The federal government in this case would need the trust of Canadians that the politicians and/or bureaucrats will not also use these powers for their own self-interest, such as favouring certain interest groups in other parts of the country. Further, if the federal government were to use any carrots to foster provincial buy-in to the national regulator, these carrots would, under the political economy story, need to be tailored to purchasing the acquiescence of provincial officials (whether political or bureaucratic) as well as local professionals as in the form of local offices for the national regulator. They would likely be different in both form and level than carrots aimed at overcoming provincial concerns about a loss of welfare.

**IV. ANALYSIS OF POTENTIAL POLICY OUTCOMES**

In this section, we consider the public choice implications of the federal government's policy approach and the likelihood of its

44. Poonam Puri, "Local and Regional Interests in the Debate on Optimal Securities Regulatory Structure" (Research Study Prepared for the Wise Person’s Committee, October 7, 2003), in Harris, *supra*, footnote 4, at p. 209.

success. The core obstacle to a national regulator from a public choice perspective is that provincial securities regulators cooperate to provincial regulatory monopolies. These regulators hold sway with provincial legislators provided other interest groups do not significantly oppose them. The main feature of this co-operation that is beneficial to the federal government and its plan for a national regulator is that the provinces are engaged in "conditional co-operation." Each province needs to trust the other provinces (or most of the other provinces) to maintain its provincial monopoly or the current system ceases to make sense for them to do so as well.

One option then that the federal government could take (and seemingly has taken) in response is to "divide and conquer," an approach which is used in many areas of the law.46 Posner et al. define a "divide and conquer" approach as one in which a unitary actor (in this case, the federal government) "follows an intentional strategy of exploiting problems of coordination or collective action among . . . multiple actors" (the provinces).47 They could seek to break up the conditional co-operation such that the provinces move from the expectation of one equilibrium to another — that is, they would move from the expectation that each would maintain their provincial securities regulators to the expectation that the others would sign on to the national system.

The clearest elements of the federal plan that tie into a "divide and conquer" approach are the opt-in provisions. As noted above, the Expert Panel’s Report contemplated two types of opt-in: an issuer opt-in and a provincial/territorial opt-in. In terms of issuer opt-in, the Report proposed allowing issuers from non-participating provinces to voluntarily opt in to the national regulator. Such an opt-in has the potential to bleed issuers from hold-out provinces. Any issuers who face lower costs (including regulatory and capital costs) by joining the national system would leave the hold-out provincial systems. The reduction in the number of firms may reduce the viability and political gains from holding out. Such reductions may induce some provinces to agree to the national regulator. Moreover, it would undermine the expectations of the remaining provinces about the likelihood of maintaining the existing system. Each effect would increase the probability of a shift to the new (non-conditional co-operative) equilibrium.48

47. Ibid., at p. 2.
48. Note that the issuer choice literature posits that if issuers and registrants were
The actual federal proposal, however, does not include an issuer opt-in provision but only a provincial opt-in. It provides provinces that are initially reluctant to join with the ability to opt-in to the federal regulatory regime if their position should change. The holdout provinces could never then be certain that their fellow holdouts will remain outside a national system. If such a system becomes operational, there will be a continual threat that more provinces will join, thereby eliminating the benefit of maintaining provincial monopolies. Such threat may be sufficient to undermine the trust or probability estimates at the core of the conditional co-operation.

Why would any provinces opt into the federal model? If the regulators would lose from the national system and they have an informational advantage over the legislators, it would seem unlikely that the federal government could break the conditional co-operation without legal force. However, the federal plan has other elements aimed at bringing at least some provinces on side — the "carrots" or positive incentives for signing on to the system. Posner et al. note that the conditional co-operation underlying the stag hunt game may be overcome with either non-discriminatory incentives or discriminatory incentives. Non-discriminatory incentives would require the federal government to offer the same level of incentive to each province. The level of the incentive could be less than the amount that completely compensates the province for shifting to the new system as provinces may be willing to accept the slightly lower incentive if there is any doubt that the current system would continue (that is, the incentive changes the expectations of the provinces and makes them willing to play safe and accept the incentive).

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given the choice to choose their regulatory regime, competition would result in a break-up of existing monopolies and would allow individual investors to choose an optimal degree of regulation (see Romano, supra, footnote 35). Others have argued that if the market is not efficient with respect to pricing regulatory regimes, then a market may emerge in these provinces to cater to a "race to the bottom clientele" (see Merritt B. Fox, "The Issuer Choice Debate" (2001), 2 Theor. Inq. L. 563; James D. Cox, "Regulatory Duopoly in U.S. Securities Market" (1999), 99 Colum. L. Rev. 1200; and John C. Coffee, Jr., "Racing Towards the Top? The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance" (2002), 102 Colum. L. Rev. 1757). But note that while the current system in theory allows for a race to the bottom, this has not occurred, given a basic level of harmonization in terms of securities law, and there is no reason to assume that any such market will develop.

49. Posner, Spier and Vermeule, supra, footnote 39, at p. 7. Posner et al. refer to these incentives as "bribes."
One aspect of the federal plan could be seen as a non-discriminatory incentive — the centrality of regional representation for key governance positions including on the Board of Directors, the Deputy Chief Regulators and the Tribunal. To the extent provincial regulators claim that their issuers will face welfare losses from a centralized national system, the federal government could assert that these losses are reduced by such regional representation in the federal model.

Moreover, these regional bodies may reduce the opposition of other interest groups to the adoption of a national regulator. For example, to the extent they preserve a lower regulatory price for issuers in certain regional issuers, they may reduce their fear of higher regulatory prices. Further, regional securities lawyers or accounting firms may believe that there would not be as significant a decrease in demand for their services if they can specialize in the regional application of the national rules. Finally, the governance structure may even reduce opposition from provincial regulators to a certain extent given the emphasis on regional representation on the main policy and adjudicative bodies. Regulators in each province would have at least some hope that they would obtain positions in the Authority.

The incentives to overcome conditional co-operation in a stag hunt game can also be discriminatory — that is, different incentives for the different players. If one player (or a sufficient number of players) is given incentives to stop co-operating, the expectations of all parties change and there is a shift to the uncooperative equilibrium.\(^50\) In the case of the Canadian national securities regulator, the necessary incentives would likely vary for different provinces. For provinces with small capital markets, it is likely a sufficient carrot that the federal government will assume the cost of securities regulation and will likely make compensation for lost revenue from fees, at least where the administrative costs of running the provincial regulatory body are lower than the revenue gained from fees. There may continue to be opposition from securities regulators in those provinces as well as from issuers that face a significant increase in their regulatory price from the move to a national market. However, it is likely sufficiently costly and inefficient in those small provinces to run an independent securities regulator that legislators would be willing to withstand such opposition to the change to the national regulator. Further,

\(^{50}\) Ibid., footnote 39.
smaller jurisdictions could also be compensated for loss of revenues from filing fees.

Larger provinces may rely more on the expertise of their securities regulators as to the relative value of maintaining the provincial regulatory system. Additional carrots would therefore be required. Choosing commissioners and/or the head of the federal commission from a province or locating the head office in a province could be potentially significant carrots. The location of the headquarters of the regulator brings a benefit since:

\[\text{[r]egulators generate positive spin-offs for the economy and the sector. They employ highly qualified individuals. They also procure high value products and professional services. Further, the presence of a regulator's head office can influence the location decisions of new market players.}\]

The Wise Persons’ Committee and the Expert Panel alluded to carrots of this sort.\(^5^2\)

Ontario may have agreed to the national model because of a belief by members of its securities regulators that they will have control over the national body. It would likely prefer to have the principal office located in Toronto. Given that Ontario is the largest capital market, it may have the greatest likelihood of success in this regard.\(^5^3\) Moreover, as noted above, Ontario is more of a price-setter than other provinces, and is able to set a high regulatory price. Its issuers then would not likely face a significant increase in a regulatory price from a move to a national regulator and possibly would gain due to decreased transaction costs. Further, as noted above, securities lawyers and accountants may see the adoption of a national regulator as an opportunity to increase demand for their services. The provincial government then faces some pressure to adopt the national model (or at least less pressure to continue to hold out from both the securities regulators and core issuers).

In terms of other provinces, the federal government’s plan could be viewed as relying on such carrots. It is prepared to offer compensation for lost revenue as discussed above. Placing the head

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52. See The Expert Panel’s Report, supra, footnote 2, at p. 43 where the option of side payments is possibly being suggested (e.g., the Expert Panel proposed that the Head Office be located in one of the four largest provinces (British Columbia, Alberta, Ontario and Québec)).

53. For a defense of Toronto for the headquarters of the federal regulator, see Hjartarson, supra, footnote 51.
office in Alberta or Québec and ensuring that these provinces are home to a regional office would also be carrots. However, securities regulators in other provinces may not be convinced of the likelihood of such a move given the depth of Ontario’s capital markets. Moreover, not only may the securities regulators be opposed, but issuers in other provinces would be opposed. If these provinces had been price-takers (in the sense of setting a low price to attract and retain their issuer base), the issuers in those provinces would face a significant regulatory price increase from the adoption of a national regulator. The lack of likely carrots for provinces and opposition by issuers may explain the continued opposition of a number of provinces.\(^5\)

The issue for the federal government would then be whether it had offered sufficient carrots to break the conditional cooperation. This need to foster the break-up of the conditional cooperation leads to another element of the federal strategy to bring about the national regulator — the reference to the Supreme Court of Canada. The outcome will be key to the success of the federal government’s plan: if the federal government is successful in the reference, it could force a federal model. Moreover, the outcome of the reference will change the likelihood of a voluntary shift in the equilibrium away from the current cooperation on provincial regulatory monopolies. In particular, a key question in the constitutional reference is whether the court will find paramountcy obtains which would permit the federal government to regulate exclusively in certain areas (e.g., securities offerings).\(^5\) A paramountcy clause could effectively prevent provincial regulation in certain areas and would be a significant stick.

\(^{54}\) Posner et al. also speak of the sequencing of offers. In the context of the present argument, it may be that if the federal government asserts a take-it-or-leave-it offer to a province (or set of provinces), and the others know that they will lose the conditional cooperation of that province, then whichever the federal government contacts first with the offer of the carrot will likely take it. The province knows that if it does not accept the offer, another will do so. For example, if the federal government approaches Alberta with the offer of the Chair of the national securities regulator or headquarters, it will take it if it believes that Ontario or some other province would take it if it refused and that then the conditional cooperation would break down.

\(^{55}\) See Jeremy Fraiberg, “Taking Sides on a Single Securities Regulator,” The Globe and Mail, October 27, 2009, who states that “[u]nder the paramountcy doctrine, whenever there is a so-called operational conflict between valid federal and provincial law or where the provincial law is contrary to the purpose of the federal law, federal law prevails.”
There are two related results if the federal government is successful in the reference. First, it would reduce the size of the carrots that the federal government would need to provide to the provinces and/or the provincial regulators to implement the transition. If the federal government does not need the support of the provinces, it is in a better bargaining position — although this bargaining position also depends on how willing the federal government is to take any political cost that may result from implementing a policy that it is legally entitled to take but to which there is resistance in different provinces or regions.

The other result of federal success in the constitutional references is that it may change the expectations of the provinces about the likely continuation of the current system of provincial regulatory monopolies. *Ex ante* the Supreme Court decision, if provinces believe there is some probability that the Court will find the federal legislation unconstitutional, they may have a higher expectation that they will be able to maintain the status quo *ex post*. By contrast, a finding that the federal government has the power to implement national securities legislation *ex post* may be sufficient to tip the equilibrium to abandoning the conditional co-operation of the current system. The decision may even have such a large effect on these expectations that the federal government can reduce the size of the carrots to an even greater extent. It could mean that the federal government obtains Constitutional support that it could force national regulation but it does not actually have to do so because the conditional co-operation collapses on its own.

The federal plan then has a number of elements which may be useful in reducing the continuation of the conditional co-operation at the core of the current regulatory structure. The federal government has not adopted what is likely the most effective tool — issuer choice — possibly because it was uncertain about its probability of success in the reference as issuer choice may have been seen as more difficult for the Supreme Court to accept.

V. CONCLUSION

The federal government's success at creating a national securities regulator may hinge on its undermining the conditional co-operation of the provinces via a voluntary opt-in and other carrots. The incentives to accede to the federal plan differ across provinces. For Ontario, in particular, the carrots take the form of jobs and control for current provincial regulators. Issuers in
Ontario may not be as concerned with the move (and may be in favour of it) as the regulatory price is unlikely to change. The smaller provinces seem likely to agree to the federal model in order to relieve themselves of the burden of running their own regulatory structure (despite the fact that they receive some fees from doing so). They would have an incentive to ignore the regulators as well as any small issuers that they would face a significant increase in regulatory price.

The recalcitrant provinces are key. Regulators in these provinces are unlikely to favour the federal model, as they would lose their positions without much hope of carrots. Their main base of issuers is likely to face a significant regulatory price increase. In turn, legislators suffer from information asymmetries and face significant interest group opposition along with the standard collective action problem for small investors. They may benefit from the implementation of a national regulatory model but cannot organize themselves sufficiently. The provincial legislators then may not see a benefit, either in welfare or political terms, in making such a transition.

The opposing provinces need continued trust and cooperation among a substantial core in order to successfully prevent the creation of a national securities regulator. This need explains the continual and increasing lobbying of each province by those in opposition to the national plan — they need a majority to hold the line in the face of federal pressure, or the base of their opposition falls apart. On the one hand, federal success in the reference(s) would lower the expectation of each province that the others will stay with the provincial monopolies and, correspondingly, increases the probability that the conditional co-operation will fall apart. On the other hand, provincial success in the reference(s) increases the ability of the provinces to retain the conditional cooperation equilibrium. The almost simultaneous launch of the provincial and federal references may be an attempt by the provinces to have a favourable decision by provincial courts of appeal prior to the Supreme Court reference, given the importance of the outcome.

The federal government may not impose a national securities regulatory model, even if it succeeds at the reference, because of the regional politics behind the national regulator debate. The nature of Québec politics may effectively prevent the provincial government from signing on to a national endeavour of this sort. Regarding Alberta, the historical reluctance of Western Canada to
endorse federal initiatives such as the National Energy Program may play a role in its opposition. It would then be politically very difficult for the federal government to impose the national plan on either western provinces or Québec.

A victory at the Supreme Court, along with the carrots to some provincial regulators, may go some way towards breaking down the conditional co-operation underlying the maintenance of provincial monopolies. The federal government then would not have to force its preferred position in the absence of backing from the Supreme Court of Canada. Without question, public choice considerations in part explain the federal government’s reluctance to move more forcefully (i.e., with sticks and not carrots) at this stage and adopt stronger provisions such as the issuer opt-in. Stick-based strategies seem more directly targeted at undermining provincial regulators and therefore would raise political costs for the federal government.