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Passports, Politics and Path Dependency: Comments on Anand and Klein "Inefficiency and Path Dependency In Canada's Securities Regulatory System: Towards a Reform Agenda"

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**PASSPORTS, POLITICS AND PATH DEPENDENCY:
COMMENTS ON ANAND AND KLEIN
“INEFFICIENCY AND PATH DEPENDENCY
IN CANADA’S SECURITIES REGULATORY SYSTEM:
TOWARDS A REFORM AGENDA”**

*Mary Condon**

1. INTRODUCTION

The argument of this thought-provoking paper is that Canada’s system of securities regulation is inefficient in various ways, particularly with respect to the costs involved for market participants in using it. Further, the primary reason for this inefficiency has to do with “path dependent” features of the way the system is structured. The specific path dependent elements of the system that are causing inefficiency and blocking convergence to national or international regimes of regulation are (i) the legacy of Canadian constitutional jurisprudence that has accorded primacy to the provincial role in the regulation of securities markets and (ii) philosophical and institutional differences in the approach to regulation by individual provincial regulators. The article considers the prospects for the “passport system” proposed by most provinces and territories to alleviate some of these inefficiencies. It concludes that while a passport system will not produce significantly enhanced cost efficiency, it may provide greater opportunities for the achievement of dynamic efficiencies because of the possible presence of competition among provincial regulators.

**II. THE NORMATIVE GOALS OF CANADIAN
SECURITIES REGULATION**

Let us start with some motherhood about the goals of securities regulation. The premise of the article is that it is extremely problematic that the current system for delivering regulation of securities markets in Canada is inefficient. Indeed, as the authors suggest,

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many of those making submissions to the Wise Persons' Committee's¹ deliberations in 2003 singled this out as a defining issue. We know that, substantively speaking, provincial securities regulators in Canada are supposed to be achieving a variety of objectives. One is efficiency in the operation of capital markets, but others are investor protection and fairness. For example, it is unlikely that an elaborate set of rules for public enforcement of securities law would exist if the efficiency of the capital markets were the only objective being pursued. Anand and Klein's useful distinction between the substance and structure of regulation is relevant here. The argument would be, even if there are a variety of substantive goals being achieved by securities regulation, should the system for achieving those goals not be efficiently designed? However it may be that system inefficiency is likewise only one of a number of competing goals for one regulatory structure in Canada. What are other possible normative goals for a decentralized regulatory system? One might be provincial government control over the local economy, of which the capital raising process is a significant component. Another, related, normative goal of decentralization might be to maintain a robust role for regionalism. Political scientist Janine Brodie has argued that

questions of where people live and how economic development, state activity and political power are distributed across geographical space often carry more weight in Canadian politics than other potentially loaded questions such as what people do or how well they live. In other words, Canadians seem to be preoccupied more often with the 'where?' of politics than with who gets what, when, and how.²

Acknowledging the possibility of normative contestation here would require a more elaborate justification for prioritizing system efficiency before moving to the more instrumental debate about whether or not centralization of regulation will or will not contribute to that efficiency.

III. THE EVIDENCE OF INEFFICIENCY

One of the strengths of Anand and Klein's paper is a heightened level of precision about the various meanings of efficiency. In

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1. See Wise Persons' Committee Report: Committee to Review the Structure of Securities Regulation in Canada, *It's Time* (Ottawa, Department of Finance, 2003).
 2. See Janine Brodie, "The New Political Economy of Regions" in Wallace Clement, ed., *Understanding Canada: Building on the New Canadian Political Economy* (Kingston, McGill-Queen's University Press, 1997), pp. 240-41.

particular the authors make an important distinction between various forms of cost inefficiency on the one hand, and the idea of dynamic inefficiency on the other. In relation to cost inefficiencies, the article argues that there is little empirical evidence available to assess the existence or otherwise of cost inefficiency in the structure of Canadian securities regulation. Indeed the authors' own study for the Wise Persons' Committee, conducted in 2003, is the only example cited.³ Interestingly, the results of that study are rather equivocal. It showed that "registrants are more likely to incur material incremental costs than issuers who, by and large, do not incur such costs as a result of the existence of multiple securities regulators in Canada".⁴ This suggests the need to explore further the political implications of who might be bearing the costs of inefficiency. Anand and Klein's Cost Study in 2003 did report a high level of concern among market participants "with the current state of uncertainty in Canada's regulatory regime",⁵ which was said to detract from participants' ability to manage their businesses. While it is not clear that this uncertainty translated directly into an increased cost of doing business, it does raise the issue of assessing what one might call the "dark figure" of the costs of securities regulatory inefficiency. In other words, does the decentralized nature of Canadian securities regulation deter potential capital raisers or investors, especially from outside the country, from venturing into the field? This is of course a difficult calculation to make, but it might render the cost inefficiency argument more compelling and generalizable.

The paper also makes a contribution by developing the concept of dynamic efficiency. The idea here is that an important indication of the dynamism of a regulatory system is whether it is capable of continuing to regulate effectively a market or markets that themselves change over time. The authors rely heavily on the findings of Carpentier and Suret⁶ that a centralized securities regulatory system

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3. See Anita I. Anand and Peter Klein, "The Costs of Compliance in Canada's Securities Regulatory Regime" in A. Douglas Harris, ed., *Committee to Review the Structure of Securities Regulation in Canada: Research Studies* (Ottawa, Department of Finance, 2003), p. 517.
 4. See Anita I. Anand and Peter Klein, "Inefficiency and Path Dependency in Canada's Securities Regulatory System: Towards a Reform Agenda" (2005), 42 C.B.L.J. 41 at p. 46.
 5. *Ibid.*, at p. 48.
 6. See Cécile Carpentier and Jean-Marc Suret, "The Canadian and American Financial Systems: Competition and Regulation" (2003), 29 Can. Pub. Policy 433.

would be unsuitable for Canada because of the high degree of concentration of its securities industry — which might lead to regulatory capture — and because of capital markets that are smaller and shallower than those in the United States. While Anand and Klein acknowledge that their conclusions here are speculative, there is a worrisome lack of empirical support for the claims advanced in this part of the article. Thus, whether or not there would be more or less regulatory capture with a single national regulator as opposed to multiple provincial regulators is not in my view an easy issue to predict, and not necessarily an issue on which the American experience is likely to be a conclusive guide. For one thing, much depends on the legislative protections put in place to ensure public accountability and transparency. This view also seems to assume that existing provincial regulators are not currently in a state of capture. A detailed review of Carpentier and Suret's original arguments here is beyond the scope of this comment. But it is worth noting that for Carpentier and Suret, a crucial manifestation of the concentrated nature of the Canadian securities industry (banks, brokerages and insurance companies) is the ability of a small number of large industry players to capture an increasingly concentrated set of self-regulatory organizations (SROs), the Investment Dealers Association, RS Inc. and the Toronto Stock Exchange, which capture they purport to document in their paper. Their acknowledgment of the key role of SROs in accomplishing securities regulation in Canada is helpful, but it raises another set of questions. Not least of these is, what are the relative capacities of multiple provincial regulators as opposed to a monopolistic single regulator to effectively oversee the activities of nationalized SROs? The experience of the evolution of U.K. securities regulation from being organized around a mosaic of SROs to a centralized Financial Services Authority may be instructive here.

Finally, Anand and Klein agree with Carpentier and Suret's proposition that a securities regulatory system that allows the participants to choose which system governs them "better aligns the incentives of [capital market] participants and regulators"⁷ and thus supports the maintenance of decentralization. Of course, only some versions of a decentralized regulatory system, not including the passport system currently being advanced by provinces and territories other than Ontario, would allow participants to have robust

7. See Anand and Klein, *supra*, footnote 4, at p. 51.

choices about which province would regulate them. But even where participants do get to choose, it is not clear that all participants equally get to choose. That is to say, while securities issuers might be able to choose which Canadian province would regulate their issuances, or registrants offering investment services might also be so enabled, the retail investors who buy the securities or registrant services offered might not be in a similar position. In other words, one should not lose sight of the partiality of choice in a “regulator-select” model of decentralized regulation. Now Carpentier and Suret argue that “issuers will be drawn to the regime preferred by investors to lower their cost of capital, and regulators will be able to discern the efficiency of their regulatory choices by the flow of firms into and out of jurisdictions”.⁸ This claim about the relative bargaining power of investors and issuers again requires close empirical assessment in the Canadian context.

IV. REASONS FOR THE INEFFICIENCY OF THE CURRENT STRUCTURE

As indicated above, Anand and Klein explain the persistence of a decentralized securities regulatory regime in Canada by means of the path dependency hypothesis. The authors point to two features of the historical legacy of policy development to explain why the current system may well prove impervious to radical change. These features are (i) constitutional doctrines that have accorded pre-eminence to provincial autonomy in this field and (ii) institutional and philosophical differences among key provincial regulators. They make a persuasive argument that, despite the optimism of the Wise Persons’ Committee, the weakness and uncertainty associated with the doctrine of paramountcy in Canadian constitutional law, from a federal perspective, makes it an unlikely tool for replacing provincial powers with a strong federal presence. Of course, resort to constitutional contestation might not be necessary if key provinces were attracted to the idea of a single regulator in Canadian securities markets. Anand and Klein explain the lack of persuasiveness of this idea in terms of the desire of provincial regulators to retain their power over regulation and in terms of philosophical differences in the approach to provincial regulation that militate against consensus here. As a sometime student of the role of interests and ideas in

8. See Carpentier and Suret, *supra*, footnote 6, at p. 437.

Canadian securities regulation,⁹ I have no quarrel with this general approach. However, a serious look at the role of established interests in maintaining the institutional status quo would arguably have to go beyond the multi-faceted interests of government regulators themselves and take into account those of key SROs, issuer, financial industry and investor repeat players, new stakeholders and relevant provincial government departments. More specifically, theorists of path dependency identify “the costs of reversal” as a key driver of the policy process. This is the idea that “when set-up or fixed costs are high, individuals and organizations have strong incentives to identify and stick with a single option”.¹⁰ Focusing the analysis of current securities regulatory structures on the issue of identifying and calculating the “costs of reversal” of those arrangements might generate useful insights, especially for reformers who wish to make alternatives more palatable to interests favouring the existing arrangements. Interestingly, Anand and Klein do suggest the possibility of a “catalyst” that might unlock the current status quo, as occurred, they argue, in Australia as a result of a series of financial scandals. This possibility raises a broader issue about the limits of the path dependency hypothesis. Is this literature adequately specific about just what it takes to overturn a path dependent trajectory?

V. CRITIQUE OF THE PASSPORT SYSTEM

Possibly the strongest aspect of this article is its thorough-going critique of the passport system as it is currently conceived of by the Steering Committee of provincial and territorial ministers that proposed it. Anand and Klein usefully analyze the elements of the passport system proposal in terms of the various components of cost inefficiency that they identify in their paper. Thus they argue that the passport proposal does not completely solve the problems of lack of harmonization of substantive law or the implementation of law. Nor does it completely address the duplication of rules problem and indeed may exacerbate it by introducing another decision-making body into the field, a Council of Ministers designed to

9. See Mary G. Condon, *Making Disclosure: Ideas and Interests in Ontario Securities Regulation* (Toronto, University of Toronto Press, 1998).

10. See John Myles and Paul Pierson, “The Comparative Political Economy of Pension Reform” in Paul Pierson, ed., *The New Politics of the Welfare State* (New York, Oxford University Press, 2001), 305 at p. 312.

oversee the ongoing effectiveness of the passport system once it is introduced. While prospects for improvement are somewhat better in relation to opportunity cost risk, there remains the major hurdle that Ontario has not signed on to the proposal, so that market participants will have to deal with two regulatory structures where there is an Ontario connection to a multi-provincial transaction. In relation to the uncertainty problem, they astutely point to the ambiguities surrounding the handling of enforcement issues under a passport system as a major stumbling block. The language of the passport system proposal concerning enforcement appears to create some potential for overlap and duplication of effort among provinces on the one hand, and lack of coverage of enforcement issues on the other. In any event, it retains significant discretion for individual provinces in relation to enforcement action. However, it should be noted that the proposal is accompanied by an “action plan” for moving the initial agreement forward.¹¹ This contemplates increased efforts at coordination of enforcement priorities and practices among provincial regulators, as well as harmonization of sanctions, remedies and maximum penalties.¹²

However, Anand and Klein sound a more positive note in relation to the dynamic efficiency prospects of the passport model. This perspective is premised on the claim that a passport system would provide a “greater degree of regulatory competition, and thus flexibility over time” than a single regulator because competition will better align the incentives of market participants and regulators.¹³ Yet they also acknowledge the possibility that the “path dependent nature of the regulatory environment may prevent . . . sufficient openness among provincial regulators”.¹⁴ Again their optimism might be more persuasive if it were accompanied by an acknowledgement that introducing robust competition among provincial regulators might require a different version of regulator selection than that proposed currently, which is based on the relatively limited criterion of the location of the issuer’s head office. As indicated earlier, their preference for provincial regulatory

11. See Provincial/Territorial Securities Initiative, *Action Plan to Improve Canada’s Securities Regulatory Framework*, online at <http://www.securitiescanada.org/2004_0930_action_plan_english.pdf>.

12. See Mary G. Condon, “The Use of Public Interest Enforcement Powers by Securities Regulators in Canada” in Harris, *supra*, footnote 3, at p. 411.

13. See Anand and Klein, *supra*, footnote 4, at p. 71.

14. *Ibid.*

competition might also be assisted by a somewhat more nuanced account of the respective interests of regulators and market participants in this process, taking the variation in the latter category into account. However, in the end a major achievement of Anand and Klein's article is that it may open the way for a serious and contemporary debate about the issue of regulatory capture in Canadian securities markets. Such a debate might address whether or not it currently exists, who exercises it if it is present, and the prospects for avoiding it in future regulatory arrangements. That debate is one that is timely and very much worth having.