THE INVESTMENT FUNDS INSTITUTE OF CANADA
L'INSTITUT DES FONDS D'INVESTISSEMENT DU CANADA
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July 9, 2003

Mr. Michael Phelps (Chair)
Wise Persons Committee to review the structure of securities regulation in Canada
P.O. Box 10026
700 West Georgia Street
Vancouver, B.C.
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Dear Mr. Phelps

Re: Restructuring the Regulatory Framework of the Securities Industry in Canada

1. General

The Investment Funds Institute of Canada ("IFIC") appreciates the opportunity to offer comments to the Wise Persons Committee ("Committee") on behalf of its members with respect to this important initiative.

IFIC is the member association of the investment funds industry in Canada and its membership includes 69 fund management companies sponsoring 1,995 mutual funds, 93 dealer firms selling mutual funds, and 57 affiliates representing law, accounting and other professional firms.

IFIC members currently manage assets representing almost 100% of all open-end mutual funds in the country. IFIC member funds manage $387.74 billion in assets (representing nearly 95 per cent of the industry) in over 51 million unit-holder accounts.[1]

The convening of the Committee to consider the regulatory framework of the securities industry in Canada represents a significant opportunity for the Committee to recommend meaningful and desperately needed change.

In our view, the most important criteria for any potential solution is that it be structured so as to accurately reflect market reality. We urge the Committee to remain cognizant of the fact that the mutual funds industry in Canada is national and needs to be regulated nationally and on a uniform basis.

[1] Note: figures representing membership and assets under management by IFIC members are current as at May 31, 2003.

The ultimate goal of any restructuring of the regulatory framework of our industry must be to institute one set of rules that can be consistently interpreted and applied across Canada. There are many models that could achieve this objective.

We are very conscious of jurisdictional concerns and issues of political will that, practically speaking, are likely to render the implementation of certain proposals improbable. We do not wish to squander this opportunity for the reformation of our regulatory framework by suggesting that its multiple problems have their solution in only one model.

In making recommendations to the Minister of Finance we encourage the Committee to consider the experience of the U.S. in implementing the National Securities Markets Improvement Act of 1996 ("NSMIA"). NSMIA is federal legislation[2] that curtailed both federal and state jurisdiction in an effort to achieve a more streamlined regulatory framework.

The U.S. Congress recognized that uncoordinated state regulation[3] that also overlapped with federal jurisdiction was a serious threat to the efficient operation of the U.S. capital markets. The U.S. markets are much larger than Canada's and U.S. efforts at fostering more coordinated administration of their legislative framework had to contend with reconciling the interests of federal and 50 state regulatory authorities. The U.S., however, was able to negotiate these significant challenges. NSMIA amended federal securities laws in order to promote efficiency and capital formation in the financial markets, while also amending the Investment Company Act of 1940 ("1940 Act") to promote more efficient management of mutual funds, protect investors, and provide less burdensome regulation.

In light of the success of the U.S., we believe that there is no longer any continued justification for a regulatory model that results in much greater fragmentation of Canada's much smaller capital markets.

[2] NSMIA was passed by the U.S. congress in response to the significant problems of duplicative federal/state legislation and the failure of individual states to uniformly regulate certain types of national securities offerings. The introduction of NSMIA saw the implementation of a federally imposed set of rules designed to create one uniform code that could be followed by both companies and regulators.

[3] The U.S. Securities and Exchange Commission ("SEC") is the main enforcement agency for U.S. securities laws. However, each of the 50 states also has its own securities regulatory authorities and state securities laws ("Blue Sky" laws) and this results in the securities industry in the U.S. being made subject to the concurrent oversight of both federal and state regulatory regimes. While most states model their laws after the Uniform Securities Act of 1956 ("USA - 1956"), these laws vary widely with little uniformity among states. Where statutory language is identical for specified types of activity, the statute itself is often subject to differing interpretations between states.

2. The Existing Model and General Observations on Current Proposals for Regulatory Reform

Our existing regulatory framework is a patchwork that is the product of years of individual regulators launching multiple and uncoordinated initiatives. The current model is cost inefficient and results in excessive direct and transactional expenses. Being subject to multiple regulatory authorities that are poorly coordinated also renders it unjustifiably difficult to know and fulfill regulatory obligations as legislation is neither interpreted nor applied consistently across jurisdictions. In addition, current regulation is too prescriptive and the process of regulatory reform is unacceptably slow.

We have made these comments on numerous occasions and have attached as Appendix "A" to this letter various submissions that include IFIC's remarks on the state of our current regulatory model.

The mutual funds industry in Canada has recently been subject to a flurry of regulatory activity. The industry finds itself in an unfortunate middle ground where the pace of proposed change with the introduction of new proposals is enormous but the rate at which actual change is implemented is unconscionably slow. It is better, in our view, to focus on developing a regulatory structure that would allow the industry and regulators to focus on the efficient implementation of key changes as opposed to being perpetually engaged in launching and responding to multiple proposed initiatives.

Uniform Securities Legislation Project ("USL")

We support, in concept, the efforts of the Canadian Securities Administrators ("CSA") to streamline securities regulation across Canada and think that the USL project might have a role to play in reforming our regulatory framework. However, we remind the Committee that the goal of one set of rules applied and interpreted consistently across Canada is more akin to word for word uniformity adopted by all jurisdictions on a mandatory basis. The type of legislative uniformity that we believe would be necessary thus goes further than "harmonized" legislation that jurisdictions have the ability to opt out of as currently contemplated by the USL project.

3. The Regulatory Passport Model - Government of Alberta Discussion Paper

The Minister of Revenue for the Government of Alberta recently released a discussion paper entitled "Securities Regulation in Canada: An Inter-Provincial Securities Framework" ("Discussion Paper"). The Discussion Paper is an inter-provincial initiative, led by Alberta that was developed by a Steering Committee of Ministers from the provinces of Alberta, British Columbia, Saskatchewan, Manitoba, Ontario and Quebec.

The Discussion Paper proposes a regulatory passport system that would give regulated market participants access to the capital markets of all participating provinces and territories, with the approval of their primary jurisdiction.

The passport system would authorize, but not require, jurisdictions to enter into agreements that would enable a host jurisdiction's regulator to rely on a primary jurisdiction's regulator to perform its supervisory duties regarding market access rules. The Discussion Paper states that the passport system would enable streamlined and simplified regulation and would be relatively simple to implement as it would build upon the existing regulatory structure and the Mutual Reliance Review System ("MRRS"). The Discussion Paper states that adoption of the passport system would encourage harmonized regulatory development.

However, the Discussion Paper also notes that provinces and territories participating in the passport framework would need to build on the existing base of harmonized law to ensure that investors and other market participants benefit from consistent rules in each participating jurisdiction. The Discussion Paper recognizes that the degree to which securities laws are harmonized across participating jurisdictions would be a key factor in determining the extent to which the passport system would be adopted. If securities laws were not substantially harmonized, there would be a stronger incentive for jurisdictions to decline to join or withdraw from the passport framework because of dissatisfaction with the application of different laws.

Note at the outset that this proposal would not introduce any measure of regulatory uniformity but rather presupposes and is dependent upon such uniformity to work. In addition, and in our view, it does little more than preserve the status quo by allowing too much local variation in provincial/territorial securities laws.

We believe that a passport model, as articulated in the Discussion Paper does not go far enough. We are of the view that a necessary precondition for the effective operation of any passport model is the implementation of some form of uniform securities legislation that is, as we have already indicated, closer to being the same on a word for word basis rather than just being similar. In addition, and for a passport model to be serviceable as more than an interim solution, we believe that it must foster greater regulatory certainty by removing the ability of jurisdictions to opt-out.

The current proposal is premised upon the notion that the structural inefficiencies and competing interests inherent in a regulatory model administered by 13 separate regulators can be meaningfully ameliorated through voluntary agreements. The experience of our industry, however, does not bear out the efficacy of voluntary agreements in fostering more consistent cooperation among jurisdictions, uniformity of decisions or regulatory clarity.

4. <u>The Current Regulatory Structure Negatively Impacts the International Competitiveness of Canadian Capital Markets</u>

The Canadian capital markets represent approximately 2% of world capital markets and, as the Committee has noted, this figure is trending downwards. One possible explanation for this trend is straightforward. Our capital markets are extremely small by international standards and, as a result of our grossly inefficient regulatory model, must bear costs that are completely out of proportion to any potential benefit that can be derived from participating in the Canadian market. The unfortunate combination of small size and high regulatory compliance and transactional costs[4] is inherently unattractive as it renders the cost of raising capital prohibitively high. As a consequence, many international and large domestic issuers have a powerful incentive to simply bypass Canada in search of more efficient capital markets and this causes reduced liquidity and efficiency of the Canadian market. Note also that this avoidance of the Canadian market has particularly negative consequences for "trapped" smaller Canadian investors and issuers who cannot afford to access foreign markets.

5. NSMIA[5]

We think that it would be useful for the Committee to have a general understanding of how NSMIA works and the following section provides a brief overview of the legislative impact of NSMIA on other U.S. securities laws.

Capital Markets Efficiency Provisions - Preemption of State Regulation

NSMIA simplifies the prior system of dual federal and state regulatory oversight by exempting a wide range of securities from state regulation. Most notably NSMIA

1. preempts state regulation of the registration and qualification of securities which are or will become covered securities [6];

[4] In its 2002/2003 Annual Report, the Financial Services Authority ("FSA") of the United Kingdom estimated the overall costs of regulatory models for various jurisdictions relative to the size of their respective markets. Among the jurisdictions considered by the FSA were Canada, France and Germany. The estimates made by the FSA show that Canada is among the most expensive securities regulatory models relative to the size of its capital markets. **Canada:** the FSA estimates the total costs of Canada's regulatory model to be £84.4 million, employing 1,655 staff and covering a market with £452.6 billion in banking assets, total equity market capitalization of £389.5 billion and total insurance premiums of £30.1 billion. The FSA notes that as a result of Canada's "dual level of jurisdiction and the numerous regulatory entities at both levels, it is not possible to present the full costs of regulation". **France:** total regulatory costs are estimated at £77.1 million, employing 888 people. Total banking assets are estimated at £1,508.8 billion (more than triple the banking assets in Canada) and total equity market capitalization is estimated at £962.7 billion (more than twice the size of the Canadian market). Total insurance premiums are estimated at £86.9 billion (more than twice Canada's). **Germany:** the total amount spent on regulation is estimated at £35 million, while employing 901 staff. Total estimated banking assets are £2,658.1 billion (more than five times the banking assets in Canada), with a total equity market capitalization of £432.9 billion (representing only a marginally larger equity market than Canada) and estimated total insurance premiums of £94.7 billion (more than 3 times Canada's).

[5] NSMIA overview in this section excerpted from Shearman & Sterling LLP (C.N.-10/96).

[6] NSMIA created a class of federal "covered securities" that are offered on a national basis and can no longer be subjected to merit review and other registration requirements by the states. **Covered securities are defined as**:

- securities listed, or authorized for listing, on the New York Stock Exchange or the American Stock Exchange, or listed on the Nasdaq National Market; (B) securities listed, or authorized for listing, on

2. preempts state regulation of offering documents prepared by or on behalf of an issuer that are used in connection with covered securities; and
3. preempts state regulation of proxy statements, reports to shareholders, and other disclosure documents filed with the SEC or a national securities exchange relating to covered securities or the issuer thereof.[7]

State Regulation of Broker-Dealers

While NSMIA does, in certain respects, limit the regulation of broker-dealers by individual states, it preserves state power to require broker-dealer registration with each state. Individuals that act as agents of broker-dealers are also required to be dually registered. In addition, broker-dealers remain subject to antifraud enforcement action by individual states. The preservation of this ability fundamentally recognizes the necessity for state regulation of local market conduct accompanied by civil and criminal enforcement of the law in state courts.

Investment Company Act Amendments

NSMIA creates a national securities market and firmly establishes federal authority over the investment funds industry by implementing a number of amendments to the 1940 Act that are intended to render the 1940 Act more responsive to market reality. Most notable among these changes are amendments to the regulation of private investment companies, qualified purchaser funds and fund of fund structures.

Investment Advisers Supervision Coordination Provisions

NSMIA also created a model to address local and national concerns through the amendment of the Investment Advisers Act of 1940 (the "Advisers Act") to eliminate dual regulation of investment advisers by the SEC and the various states.

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other SEC approved exchanges; or (C) a security of the same issuer that is equal or senior to a security described in (A) or (B) (collectively, "Listed Covered Securities").

- Securities issued by investment companies registered with the SEC under the 1940 Act.
- Securities sold to "qualified purchasers".
- Securities sold by persons other than issuers, underwriters or dealers in transactions exempt under Section 4(1) of the Securities Act of 1933 ("1933 Act"), so long as the issuer is a reporting company pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 ("1934 Act").
- Securities exempt from registration under Section 3(a) of the 1933 Act, except that securities issued by non-profit organizations, securities of an in-state issuer which are sold only to in-state investors, and municipal securities offered or sold in the home state of the issuer remain subject to state securities regulation.
- Securities sold by dealers in transactions exempt under Section 4(3) of the 1933 Act, so long as the issuer is a reporting company.
- Securities sold in brokers' transactions exempt under Section 4(4) of the 1933 Act.
- Securities exempt from registration pursuant to a rule or regulation issued under Section 4(2) of the 1933 Act. This would include securities offered pursuant to Rule 506 of Regulation D.

[7] Note, however, that the issuer's state of incorporation retains the ability to continue to regulate such disclosure documents.

The Act provides for bifurcated regulation whereby investment advisers with at least $25 million in assets under management and investment advisers of mutual funds are regulated by the SEC with all other investment advisers being regulated by the states. This delineation of regulatory oversight permits states to regulate "smaller" investment advisers that might avoid SEC scrutiny, while removing many of the burdensome and duplicative requirements imposed by dual regulation. Notwithstanding this division of oversight, all investment advisers remain subject to state antifraud laws, and states may still collect fees and require notice of all filings made by any investment adviser with the SEC.

Reducing the Cost of Saving and Investment

Another section of NSMIA, titled "Reducing the Cost of Saving and Investment," contains a number of amendments to the 1940 Act and other securities laws. The general purpose of these amendments is to revise duplicative or overly burdensome regulation, update provisions of the law in order to reflect current market realities and/or exempt from regulation certain companies whose investors may not need the protections afforded by the 1940 Act.[8]

The 2002 Uniform Securities Act

The 2002 Uniform Securities Act ("USA – 2002") operates in a manner that is complimentary to NSMIA. A substantial objective of the USA – 2002 was to coordinate federal and state regulation by providing state securities regulators with enforcement powers that minimized duplication of regulatory resources and that blended with federal regulation and enforcement to result in a more efficient system.[9]

With NSMIA, the U.S. congress instructed the SEC to coordinate their regulatory oversight with state regulators so as to maximize uniformity in federal/state regulatory standards and minimize interference with capital formation. This initiative mandates the sharing of information regarding the registration or exemption of securities issues and

[8] These provisions notably:

- Exempt from most provisions of the 1940 Act industrial development companies, which promote the economic, business or industrial development in a state by providing financial and managerial assistance to enterprises doing business or proposing to do business in that state.
- Amend the capital structure provisions pertaining to business development companies and
- Make it easier for intrastate closed-end investment companies, which offer and sell their securities only to residents of the state in which they are organized, to avoid registration and regulation under the 1940 Act.

[9] The USA – 2002 was drafted in recognition of the fact that a meaningful reduction of duplication of regulatory oversight could only be achieved by legislation that was uniform among the individual states while also operating in a manner that was coordinated with federal law. The USA – 2002 provides a platform for coordination of regulatory oversight to occur at the state level. The USA – 2002 is an effort to address the fundamental challenge of drafting legislation that achieves the basic goal of uniformity among states and with applicable federal law while attempting to acknowledge and reconcile decades of state experience with locally evolved solutions to numerous securities law issues.

development of uniform securities forms and procedures. The USA – 2002 responds to NSMIA by adopting a provision that contains a reciprocal instruction from the state legislature to its securities administrator. With the enactment of the USA – 2002, both federal and state regulatory authorities were given the same instructions in their respective pieces of legislation and thereby better equipped to coordinate their efforts so as to make securities regulation as efficient as possible.

6. In Closing

Our industry operates across Canada and requires nationally uniform regulation. The form of a new regulatory framework must be dictated by and subject to the achievement of this objective. We urge the Committee to focus on this fundamental goal and not to become distracted by trying to select the best form among competing regulatory models. Once a general approach has been settled upon, we are confident that the Committee in consultation with the industry is capable of developing various models that would satisfy the primary objective of uniform regulation while fitting into a national or pan-Canadian framework.

Our discussion of NSMIA and the USA-2002 anticipates the Committee's consideration of these issues and is for the purpose of bringing useful legislative concepts to the attention of the Committee. With a significantly larger capital market, 50 different state regulatory authorities and little uniformity among state securities laws, the U.S. has had, in many respects, to grapple with problems that were far more formidable than Canada's in trying to achieve a more unified regulatory framework.

NSMIA and the USA – 2002 in our view, demonstrate the significant role that federal and provincial/territorial legislation could play in the development of regulatory standards that operate in a uniform and reciprocal manner. We are of the view that the U.S. experience is instructive and encourage the Committee to engage in a detailed review of these pieces of legislation as part of the inquiry into the reformation of the regulatory framework for the securities industry in Canada.

Should you have any concerns or questions, please do not hesitate to contact either John Mountain, Vice-President – Regulation at (416) 363-2150 x 271 / jmountain@ific.ca or Aamir Mirza, Legal Counsel at (416) 363-2150 x 295 / amirza@ific.ca.

Yours truly,

ORIGINAL SIGNED BY THOMAS A. HOCKIN

Hon. Thomas A. Hockin
President and Chief Executive Officer