

Commentary on the *Capital Markets Stability Act*

I. Overview

The Cooperative Capital Markets Regulatory System will include two pieces of platform capital markets legislation:

- 1) Uniform *Capital Markets Act*, which will replace existing securities legislation in participating provinces and territories; and
- 2) Complementary federal *Capital Markets Stability Act* (CMSA), which will address systemic risk related to capital markets and criminal enforcement matters.

These proposed pieces of legislation address matters within the constitutional jurisdiction of the respective participating jurisdictions. Administration of the legislation will be delegated to the Capital Markets Regulatory Authority (the Authority), which is to be jointly created by the participating jurisdictions.

The proposed CMSA would be a new component of Canada's capital markets regulatory framework and would apply throughout Canada because systemic risk related to capital markets is a matter of national scope requiring Canada-wide analysis and response. The proposed CMSA would provide for:

- national data collection to identify potential risks;
- powers to regulate systemically important products and benchmarks, and systemically risky practices, subject to robust criteria and due process considerations;
- an urgent order making power to address serious and immediate threats; and
- administration and enforcement, including criminal enforcement.

The proposed CMSA is intended to complement the existing provincial-territorial capital markets regulatory frameworks. It is not intended as a substitute for the existing regulatory framework.

II. Responding to stakeholder input

The majority of the submissions on the August 2014 consultation draft of the CMSA (the August 2014 draft) supported the objectives of the Cooperative System and offered constructive feedback on ways to improve the proposed federal legislation. Stakeholders were largely supportive of efforts to address capital markets-related systemic risk, provided that the new powers would be used judiciously and in coordination with other regulators to avoid undue burden on market participants. The enhanced measures to strengthen enforcement were also welcomed, but stakeholders underscored the importance of having clear procedural protections for market participants affected by CMSA-related regulatory decisions. Finally, stakeholders raised questions about how the Authority would interact with regulators in non-participating jurisdictions given the national scope of the proposed CMSA.

A central concern of many commenters on the August 2014 draft was that the new national data collection power and the potential measures to address capital markets-related systemic risk could result in duplication and unnecessary regulatory burden. To address these concerns, the revised consultation draft CMSA now includes requirements for the Authority to consider the extent to which data collection and systemically important benchmarks, products and practices are already regulated before implementing new requirements. There is also an overarching legislative requirement that the Authority make efforts to coordinate its regulatory activities, including data collection, with other federal, provincial and foreign financial regulatory authorities. This provides legislative direction to the Authority to administer the CMSA in a way that promotes efficient capital markets, achieves effective regulation and avoids imposing an undue regulatory burden.

The input from stakeholders has been carefully considered and where appropriate, is reflected in the revised consultation draft CMSA. This commentary provides an overview of the proposed CMSA while reviewing the principal stakeholder concerns and explaining how the August 2014 draft has been revised to address them. A blackline version of the revised consultation draft CMSA tracking the revisions against the August 2014 draft is also available.

III. Revisions to the *Capital Markets Stability Act*

The phrase ‘systemic risk related to capital markets’ is used throughout Parts 1 and 2 of the proposed CMSA as a threshold for exercising regulatory powers relating to information collection and systemic risk.

The revised consultation draft CMSA removes the phrase “or integrity” and adds a materiality threshold to the definition of systemic risk related to capital markets in section 3:

In this Act, systemic risk related to capital markets means a threat to the stability of Canada’s financial system that originates in, is transmitted through or impairs capital markets and that has the potential to have a material adverse effect on the Canadian economy.

(emphasis added)

The definition is tailored to align with the purposes of the proposed legislation, namely to monitor activity in national capital markets and detect, identify and mitigate systemic risks related to capital markets on a national basis. Accordingly, the definition is limited to threats to financial stability that originate in, are transmitted through or impair capital markets.

The addition of a materiality threshold to the definition responds to the views of some stakeholders that the magnitude of the potential impact on the economy was unqualified in the August 2014 draft. The revised definition limits the scope of the Authority’s regulatory powers to threats to financial stability that are sufficiently large to potentially have a material adverse effect on the Canadian economy.

This approach is consistent with definitions espoused by international regulatory organizations, such as the Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO).

The phrase “or integrity” has been removed from the definition along with the associated definition in subsection 3(2) of the August 2014 draft, which states that “integrity” refers to the structural integrity of the financial system. The previous definition of integrity referred to structural concepts such as the continuous and orderly operation of the financial system and avoiding its structural impairment. With the removal of the power to designate market infrastructure entities (e.g. trading facilities and clearing houses) in the revised consultation draft, the notion of structural integrity is no longer needed.

Information collection and disclosure

Part 1 of the proposed CMSA enables the Authority to make regulations regarding information and record collection and retention and the provision of information or records to the Authority or a designated trade repository for the purposes of monitoring capital markets activity or detecting, identifying or mitigating systemic risk. The information collection and disclosure provisions also allow the Chief Regulator to make requests of market participants on a case-by-case basis in the absence of regulations, if necessary. The Authority may share information with other regulatory authorities as long as the disclosure is consistent with:

- promoting and protecting the stability of Canada’s financial system through the management of systemic risk related to capital markets, or
- assisting in the administration of capital markets or financial legislation in Canada or elsewhere.

Stakeholders expressed concerns that these powers were too broad in the August 2014 draft and that there were too many exceptions to the obligation for the Authority to keep information confidential.

The Authority is required to treat confidential information accordingly, but is permitted to share information with other financial sector regulatory authorities and certain market infrastructure entities to promote and protect the stability of Canada’s financial system. Information may also be shared if the disclosure is consistent with the specific purposes for which the information was obtained. For example, information obtained for the purposes of conducting policy analysis may be shared for the purpose of undertaking that work. The confidentiality restrictions do not prevent sharing information with law enforcement agencies as long as the disclosure is not otherwise prohibited by law.

To further strengthen confidentiality requirements, and in response to stakeholder concerns about the number of exceptions, the revised consultation draft CMSA eliminates former paragraph 14(b), which would have permitted the Authority to disclose information if it considered that the public interest in disclosure outweighed the private interest in keeping the information confidential. Additionally, the previously proposed power to change the confidentiality requirements through regulations has been eliminated from subsection 13(1).

Stakeholders were also concerned that additional reporting requirements would add to their regulatory burden. As with its regulatory activities more generally, the Authority must coordinate, to the extent practicable, its information collection with other domestic and foreign financial sector regulatory authorities to avoid imposing an undue regulatory burden. In addition, new provisions have been added to the revised consultation draft CMSA requiring the Authority to consider

whether the keeping of records and information is already required by other legislation and the extent to which it is practicable to seek information from existing sources before making new data collection regulations (s. 9(2)) or requesting records and information from market participants (s. 10(2)).

Overall, the proposed CMSA balances the need to monitor capital markets for emerging threats with limits on information collection and disclosure. Furthermore, regulations in respect of ongoing data collection requirements would be developed in consultation with stakeholders, according to the Authority's normal regulation-making process, and subject to approval by the Council of Ministers.

Overview of the capital markets-related systemic risk provisions

Part 2 of the revised consultation draft CMSA sets out the framework for the Authority to address systemic risk related to capital markets. The Authority could designate a benchmark (ss. 18-19) as systemically important after taking into account a variety of factors assessing the benchmark's systemic importance and providing affected persons an opportunity to be heard. The Authority could also prescribe a product to be systemically important (ss. 20-21) or a practice to be systemically risky (ss. 22-23) following a similar consideration of factors to determine whether a product or practice could pose a systemic risk related to capital markets.

As a corollary step, the Authority would then make regulations to address the systemic risk posed by a systemically important benchmark or product, or a systemically risky practice. The factors to be considered by the Authority in making a designation and the respective regulation-making authorities provided in the proposed CMSA are tailored to reflect the specific characteristics of benchmarks, products and practices and are consistent with internationally recognized assessment criteria.

What is a benchmark?

A benchmark is a price, estimate, rate, index or value that is used for reference in a security, derivative or other financial contract.

In Canada, the Canadian Dollar Offered Rate, or CDOR, is commonly used as a benchmark for Canadian dollar floating rate notes and interest rate swaps, as well as for calculating the final settlement price for Canadian Bankers' Acceptance (BAX) futures contracts traded on the Montreal Exchange.

Part 2 of the proposed CMSA also provides an urgent order making power to address a serious and immediate systemic risk related to capital markets. Section 24 allows the Authority to make a temporary order of national application to prohibit a person from engaging in a practice or activity related to the risk, suspend or restrict trading in a security or a derivative, or suspend or restrict trading on a trading facility. In response to comments that the previous scope of the Authority's order-making power under paragraph 24(2)(a) was too broad, the phrase "or do anything else" has been eliminated.

Section 25 enables the Minister of Finance of Canada, after consultation with the Authority and the members of the Council of Ministers representing the major capital markets jurisdictions (presently British Columbia and Ontario), to direct the Authority to make, amend or repeal a section 24 urgent order if, in the Minister's opinion, the direction is necessary to address an immediate and serious systemic risk related to capital markets.

Revisions to systemically important entity designation categories

The August 2014 draft included provisions for designating systemically important trading facilities, clearing houses, credit rating organizations, benchmarks and capital markets intermediaries. Stakeholders raised concerns that some of these designation provisions captured types of entities that might not be considered "systemically important" under current international guidance and that their potential designation would expose them to regulations that could hinder their competitiveness if similar regulations were not applied in other jurisdictions.

Furthermore, international best practices have shifted away from entity-based regulation towards assessing the systemic risks posed by entities' activities and the products they trade in. For these reasons, the revised consultation draft CMSA no longer includes the power to designate trading facilities, clearing houses, credit rating organizations and capital markets intermediaries as systemically important.

Potential regulations in respect of systemically important products and systemically risky practices will apply to anyone who deals in those prescribed products or engages in such practices.

Enhanced regulatory coordination

Stakeholders expressed concerns about the potential for additional regulatory burden as a result of the national data collection powers and measures to address systemic risk related to capital markets contemplated in the August 2014 draft. As noted above, the proposed CMSA is intended to complement the existing regulatory framework by providing supplemental powers to address potential regulatory gaps. In addition to the overarching requirement that the Authority coordinate its regulatory activities with other regulators, the revised consultation draft CMSA includes the following specific requirements to ensure coordination and avoid unnecessary duplication:

- In making a regulation regarding the provision and retention of records and information, the Authority must consider whether such requirements already exist and the extent to which it is practicable for the Authority to obtain the records and information from another source (s. 9(2)).
- Before the Chief Regulator requests information, the Chief Regulator must consider the extent to which it is practicable to obtain the information in a timely manner from another source (s. 10(2)).
- In determining whether to designate a benchmark as systemically important, the Authority must consider whether and how the benchmark is already regulated (s. 18(2)(g)).
- In making a regulation regarding a class of systemically important securities or derivatives, the Authority must consider whether and how the securities or derivatives within the class are already regulated (s. 20(2)(h)).

- In making a regulation regarding a systemically risky practice, the Authority must consider whether and how the practice is already regulated (s. 22(2)(f)).
- As soon as feasible after the Authority is of the opinion that an urgent order is necessary to address a serious and immediate systemic risk related to capital markets, it must notify the capital markets regulator in each non-participating province or territory about the nature of the risk (s. 24(7)). The Authority must also notify them after the order is made (s. 24(8)).

Procedural fairness

The revised consultation draft CMSA includes a number of changes to address stakeholder concerns about issues of procedural fairness. Stakeholders indicated that they preferred the term “opportunity to be heard” over “opportunity to make representations” as the former term is used in existing securities legislation. The revised consultation draft CMSA reflects this preference, except in the provisions respecting administrative monetary penalties (ss. 33-35) where the term “making representations” is retained in order to be consistent with other federal administrative monetary penalty regimes.

In the case of an urgent order made under s. 24, if no opportunity to be heard is given before the order is made, the revised consultation draft CMSA includes a new provision requiring the Authority, as soon as feasible after making the order, to give any person that the Authority considers would be directly affected by the order an opportunity to be heard (s. 24(6)).

The administrative monetary penalty provisions have also been revised in response to stakeholder input to allow for notices of violation to be contested directly before the Tribunal rather than having to be contested first before the Chief Regulator as had been proposed in the August 2014 draft.

It should also be noted that the common law rules of procedural fairness generally entitle persons to participate in the making of administrative decisions that impact them.

IV. Administration and enforcement

Part 3 of the proposed CMSA provides the Authority with the necessary tools to assess compliance with the Act and inquire into possible non-compliance. Sections 27 to 32 enable the Authority to conduct reviews to verify compliance with the Act and hold an inquiry into any matter relating to compliance with the Act. These provisions include requirements to provide records and information to specially designated members of the Authority and powers of entry to conduct their inquiry.

Sections 33 to 38 set out provisions for assessing administrative monetary penalties for contraventions of the Act, except for the criminal offence provisions. The purpose of the proposed CMSA’s administrative monetary penalties is to promote compliance with the Act rather than punish wrongdoing. The maximum amount of a penalty is the sum of the amounts obtained or losses avoided as a result of the contravention, plus \$1 million in the case of an individual, or \$15 million in the case of any other person. In assessing the amount of the penalty, a number of factors must be considered, including the frequency and duration of the contravention and the actual or anticipated profits of the contravention. Upon receipt of a notice of violation, a person may either pay the penalty or make representations to the Tribunal; whereupon the Tribunal must decide whether the person committed the violation and if so, whether to impose, reduce or eliminate the

proposed penalty. The amounts proposed for the penalties are consistent with other federal administrative monetary penalty regimes, such as those in the *Competition Act* and the anti-spam legislation.

Section 39 sets out a number of order powers for the Tribunal. If the Tribunal considers it necessary to address a systemic risk related to capital markets, it may, after a hearing, make one or more orders requiring that a person comply with the Act, that trading cease in respect of any security or derivative, that a person cease trading in securities or derivatives, or that issuers of systemically important securities, or parties to systemically important derivatives, make changes to their practices and procedures.

Section 40 provides the Tribunal the power to issue a freeze order if the Tribunal considers such an order expedient for the administration of the proposed CMSA, or to assist in the administration of a foreign jurisdiction's capital markets legislation.

Part 4 of the proposed CMSA includes a general offence for contraventions of the Act. Proceedings by way of indictment may result in a fine of up to \$5 million and/or imprisonment for up to five years for an individual found guilty of an offence and a fine of up to \$25 million in the case of a person other than an individual. Summary convictions carry a fine of up to \$250,000 and/or imprisonment for not more than a year for an individual and a fine of up to \$5 million for a person other than an individual.

V. Criminal enforcement

Securities fraud and other forms of capital market abuse erode investor confidence and undermine the integrity of Canada's capital markets. They also impose a significant financial and emotional burden on their victims, affecting families and communities. Securing Canada's long-term prosperity requires a strong system of enforcement that protects Canada's capital markets and the investors that place their confidence in them. The proposed CMSA will provide structural and legislative enhancements that support stronger criminal enforcement in Canada's capital markets.

While many cases of misconduct can be adequately addressed through administrative proceedings, the most serious cases must be dealt with by criminal prosecution. Part 5 of the proposed CMSA moves existing offences from the *Criminal Code* and updates them. It also adds new offences to reflect modern capital markets.

Criminal offences under the proposed CMSA include fraud relating to securities or derivatives (s. 52), deceitfully affecting market price (s. 53), market manipulation (s. 54), benchmark manipulation (s. 55), insider trading (ss. 56-57), misrepresentation (s. 58), criminal breach of trust by dealers and investment fund managers (s. 59), forgery of securities or derivatives-related documents (s. 60-61), threats and retaliation against employees who comply with the Act (s. 63) and conspiracy to commit an indictable offence under the Act (s. 64). The Attorney General of Canada and the Attorney General of a province or territory will have concurrent jurisdiction over the prosecution of these offences, as is currently the case for securities-related offences in the *Criminal Code*.

To assist in the investigation of criminal offences under the proposed CMSA, the proposed legislation provides enhanced criminal investigative tools:

- *Production order (names)*: Investigators would be able, on the basis of reasonable suspicion, to obtain a court order to compel a trading facility, clearing house, or a self-regulatory organization to provide a list of dealers, other than individuals, who purchased or traded a security or derivative during a specified period. A court order could also be obtained to compel a dealer, other than an individual, to produce a document that contains the names of all persons on whose behalf the dealer purchased or traded a specified security or derivative during a specified period as well as the time and date of the purchase or trade. In addition, trade repositories could be compelled to produce a document that contains the legal entity identifiers or other identifying information for all persons that traded in a security or derivative during a specified period (s. 43). These powers would provide investigators with the information required to build cases involving trading misconduct, such as market manipulation and prohibited insider trading.
- *Production order (written statement)*: Investigators would be able, on the basis of reasonable belief, to obtain a court order to compel an issuer, a capital markets intermediary that is not an individual, or a party to a derivative that is not an individual to produce copies of records or provide a written statement setting out in detail information required by the order (s. 44). The power would provide a new avenue for investigators to obtain evidence and could help to reduce the resources and time required to investigate offences.
- *Civil Immunity*: The proposed CMSA would provide immunity from civil action to persons who cooperate and disclose information to regulatory or criminal investigators that they reasonably believe is true (s. 68). This measure is meant to protect people in order to promote greater rates of voluntary witness cooperation in capital markets offence-related investigations.

The inclusion of criminal offences and additional production order powers in the proposed CMSA will better position the Authority to contribute to the investigation of capital markets criminal offences.

VI. Regulations

The regulation-making process under the proposed CMSA is similar to that contained in the proposed provincial and territorial *Capital Markets Act*, with both statutes empowering the Authority to make regulations for carrying out the purposes and provisions of the legislation. Part 6 sets out a detailed public consultation and approval process that the Authority must undertake before making a regulation.

To promote transparency, the regulation-making provisions include a mandatory notice and comment period, a requirement to republish when a material change has been made to a proposed regulation and oversight by the Council of Ministers. There are also provisions for urgent regulation-making, and the proposed CMSA contemplates that the Council of Ministers may request that the Authority consider making a regulation on a particular subject.

VII. Conclusion

The revised consultation draft CMSA responds constructively to public comments received during the initial consultation in 2014. It provides the Authority with the capacity to address capital markets-related systemic risk on a national basis in a manner that complements existing provincial-territorial capital markets regulatory frameworks with safeguards to avoid undue regulatory burden. Work to implement the Cooperative System, including finalizing the appointments to the Authority's board of directors and Tribunal, will continue.

VII. Comments

The governments of British Columbia, Ontario, Saskatchewan, New Brunswick, Prince Edward Island, Yukon and Canada invite comments on the revised consultation draft CMSA until July 6, 2016. Comments can be submitted on the website for the Cooperative System at www.ccmr-ocrmc.ca.

Please note that we cannot keep submissions confidential. It is important that you state on whose behalf you are making submissions. All comments will be posted on the Cooperative System website.

The governments of British Columbia, Ontario, Saskatchewan, New Brunswick, Prince Edward Island, Yukon and Canada continue to invite other provinces and territories to participate in the Cooperative System.