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The Cooperative Capital Markets Regulatory System
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Ladies and Gentlemen,

We welcome this opportunity to provide comments on the draft consultation *Capital Markets Stability Act* ("CMSA" or the "Act"). This uniquely Canadian legislation has the potential to reduce systemic risks in the capital markets and improve enforcement against securities violations. We congratulate the policy makers and drafters of the Act for having developed a thoughtful and innovative approach to the emerging field of systemic risk regulation in the capital markets.

Gowling Lafleur Henderson LLP is a national law firm. Our Corporate Finance and M&A Practice Group represents various interested parties in securities matters, including issuers, investors, registrants and regulators, and defendants/respondents in securities-related proceedings. This letter reflects the personal views of the undersigned and should not be taken as the views of the group's members or the firm as a whole.

I offer the following limited comments on certain key aspects of the CMSA for your consideration.

Systemic Risk

Section 3 of the CMSA defines systemic risk related to capital markets. This is the most important section of the Act because it circumscribes the powers of the Authority to detect, identify and mitigate systemic risks and to designate various systemically important aspects of the capital markets for regulation and oversight.

Subsection 3(1) contains four elements.

1) The first is a threat to the "stability or integrity" of Canada's financial system. All of subsection (2) is devoted to explaining what integrity means in this context. The proposed *Canadian Securities Act* which was referred to the Supreme Court of Canada used the expression "integrity and stability" suggesting a linkage. There are several references to this expression in its decision on the reference, but no discussion of what integrity means in that context. I would suggest for consideration that using the expression "integrity and stability" might provide more

context to integrity and may remove the need for all of the explanations of structural integrity found in subsection (2).

2) The threat must affect "Canada's financial system", suggesting that the threat might have to target the whole financial system. I would suggest for consideration revising this to refer to "Canada's financial system or a significant part of it." The purpose of this would be to allow a threat to the capital markets alone to trigger the systemic risk threshold because of the importance of the capital markets within the financial system.

3) The threat must originate in, be transmitted through or impair the capital markets. This element is adequately addressed in the definition.

4) The threat must have the "potential to have an adverse effect on the Canadian economy". The link to the real economy might be difficult to prove in legal proceedings challenging a systemic risk determination. Such a case would undoubtedly include expert testimony from economists for the challengers and would allow the courts, through those experts, to overturn a decision of the regulator that a threat meets the statutory threshold. The IOSCO definition sets up the economic impact as a presumption with the expression "adverse effect on the financial system **and, in consequence, on the economy**" [emphasis added]. I would suggest for consideration a revision of this nature.

Enforcement of Insider Trading and other Trading Violations

The successful prosecution of trading violations proportionately to the prosecution of other forms of crime should be an important objective of the cooperative system.

Insider trading is an egregious trading violation that has been particularly difficult to successfully prosecute in Canada. Insider trading is dealt with in sections 66 and 67 of the CMSA and section 66 of the *Provincial Capital Markets Act* ("PCMA"). The PCMA provisions largely reproduce existing law.

The CMSA rephrases the offence of insider trading using elements from the existing offence in section 382.1 of the *Criminal Code*. The new wording continues to place the bar quite high for the successful prosecution of insider trading under the criminal provision. In particular:

- The requirement that knowledge of a material fact be used by the accused creates a fairly significant hurdle. Although the court can infer that knowledge was used, the provision leaves a lot of discretion in the hands of the court with no instructions on how to apply it. Will judges or juries be able to bring themselves to a conclusion beyond a reasonable doubt that information known to the accused was used?

- Trading with knowledge of a material fact should be sufficient, but even if a "use" test is required for *mens rea* it could be less stringent. The section could set up an absolute presumption that information known is information used, or alternatively a rebuttable presumption to this effect.

- The requirement that the offender have knowledge of the non-disclosure of the material fact introduces an additional hurdle for successful prosecution. Knowledge of negatives is difficult to prove. Consider whether it could be sufficient that the material fact had not been disclosed, without regard to the belief of the accused?

The duplication of trading offences under the federal and provincial acts reflects the status quo. Most of the criminal offences under sections 62 to 74 of the CMSA have counterparts in the market conduct offences described in sections 59 to 66 of the PCMA and, as such, would constitute offences under section 112 of the PCMA. With a single regulator, the need for parallel and substantially similar criminal/penal offence regimes is not obvious. Consider whether it might be useful to harmonize the two regimes and make them more complementary. The starting point could be to put the criminal/penal provisions in the CMSA and place matters that can be dealt with through the "public interest" mandate in the PCMA.

The mandatory minimum sentence for serious fraud in section 62 of the CMSA is likely to render this section less useful than intended because of public and judicial aversion to mandatory minimum sentences. This could drive prosecutions for securities fraud to the PCMA. An alternative would be to remove the mandatory minimum from section 62, bearing in mind that the corresponding fraud provision of the *Criminal Code* does have a mandatory minimum and remains available for use in the most serious cases. The result would be three levels of fraud provisions: first the *Criminal Code* with its mandatory minimum; secondly the CMSA without mandatory minimum but a serious crime nevertheless, and thirdly, the PCMA.

The Authority and the Chief Regulator

The responsibilities of the Chief Regulator as suggested by the title of that office, and those of the Authority acting through its board of directors, are not clearly delineated throughout the Act. The Act appears to confer regulatory responsibilities on both of them. A statutory delegation from the board to the Chief Regulator in section 6 (somewhat along the lines of section 8 of the *Bank of Canada Act*) might be considered.

While there are pros and cons as to who should have responsibility for making systemically important determinations and urgent orders, placing this responsibility with the Chief Regulator would seem to offer certain advantages in terms of the perception of impartiality. Based on the intention that the board will be broadly representative of the regions of Canada (section 7.1 of the Memorandum of Agreement), I expect that the board is where the different regions of Canada will be given a voice. The regional and multi-skilled eligibility requirements for board members would seem to lend themselves better to balanced regulation-making and oversight than to making actual regulatory decisions, which could become more politicized at the board level than if left mainly with the Chief Regulator.

These changes would essentially vest regulatory discretion and direction of regulatory staff exclusively with the Chief Regulator and oversight and regulation-making with the board of directors, consistent with section 7.2 of the Memorandum of Agreement.

Harmonization of the CMSA and PCMA

The two statutes are quite well harmonized but there remain some similar definitions and substantive provisions that should be equivalent but do not contain identical wording. I query whether this could result in problems when the Authority is conducting enforcement activities in which both the CMSA and the PCMA are being invoked. One case in point is inquiries or investigations under section 38 of the CMSA, subsection 103(4) of the PCMA and section 104 of the PCMA, which all have slightly different tests for entering a place to investigate.

If not already done, a comprehensive technical review of opportunities for additional harmonization might be beneficial.

Miscellaneous Comments

Definition of "*benchmark*" – This definition reflects IOSCO's recently adopted *Principles for Financial Benchmarks*. To better align the Canadian provision with IOSCO's recommendations and international benchmark regulation, consider replacing the references to *security* or *derivative* in the benchmark definition with *financial contract or instrument*. The same benchmarks, such as CDOR in the case of Canadian interest rates, will serve equally as references for securities and derivatives as for other financial instruments and contracts. The present wording suggests that there could be more than one regulator of the same benchmark for different purposes.

Definition of "*security*" – The hallmark of Canadian securities regulation has been the flexibility of the term *security* and its ability to grow as a result of regulatory determinations, endorsed by the courts, that novel instruments should be treated as securities when it makes sense to regulate them as such. The current wording of the CMSA might not reflect this concept. The definition of security requires that the instrument be "*commonly known as a security*" which would limit *securities* to instruments recognized as such under the PCMA or other laws. At a minimum, investment contracts could be added to the federal definition.

Section 4 refers to the "*management of systemic risk*". Consider whether it would be preferable to repeat the expression used elsewhere in the Act – *detecting, identifying and mitigating systemic risk*. It is not clear that the Authority "manages" these risks.

Sections 13 and 14 – Confidentiality and Disclosure of Information. The default position under section 13 is that any information that is not publicly available is confidential. This is a very high standard, and one that might be improved by adding some materiality or subjective criteria into the determination. The threshold for disclosure in paragraph 14 (b) is equally high and a target for challenge on the basis of the competing interests not having been properly weighed by the Authority. Together these two provisions might give the Authority a bias towards secrecy rather than openness. A more flexible standard might be preferable. Rather than weighing the private interest in keeping the information confidential against the public interest in disclosure, consider allowing disclosure where the Authority believes it is in the public interest, without an explicit need to weigh the divergent interests. A stricter regime could apply to identifiable individuals.

Sections 18-29 – Systemically important entity designations. The right of an entity to make representations before being designated as systemically important, and the requirement to notify the Council of Ministers of the impending designation, are currently contained in the same subsection. This could be interpreted as suggesting a political element in the designation process, which I assume is not the intention. As a drafting matter, consider separating these two elements.

Section 23 – Designation of Systemically Important Credit Rating Agencies. Consider whether the reference to the *activities* of the credit rating agency is sufficient to capture all the criteria that will be considered in making a determination.

Section 24 – Credit Agency Methodologies. Paragraph 24(1)(e) allows the regulations to prescribe policies, procedures and standards for the development of the methodologies for determining credit ratings, whereas subsection 24(2) prohibits the Authority from regulating the content of such methodologies. In order to enforce the regulations establishing the standards for credit agency methodologies, the Authority may need to judge the contents of the methodology, in the same way that a bank regulator reviews the content of comparable prudential methodologies adapted by banks. The current language would appear to prevent the Authority from effectively engaging in this level of scrutiny.

Section 38 – Inquiry. The test to launch an inquiry – that the Chief Regulator be "*satisfied that the exercise of the powers is appropriate in the circumstances*" – is quite vague and could end up having the opposite effect than that intended, which seems to be to provide full discretion to the Chief Regulator. In order to determine that the Chief Regulator's "satisfaction" and judgment about "appropriateness" were reasonable, the court would have to put itself in the shoes of the Chief Regulator. If, as the language suggests, some regulatory consideration is required, a more concrete test might in fact provide more flexibility, such as *necessary* or in the *public interest* or some other test that the courts could more easily adjudicate than the absolute discretion suggested by the current language.

Thank you for your kind attention. If you have any questions concerning the foregoing comments, please contact the undersigned.

Yours very truly,

Guy David
Partner