UNIVERSITY OF TORONTO
FACULTY OF LAW

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Anita Anand, B.A., B.A. (Juris), LL.B., LL.M.
J.R. Kimber Chair in Investor Protection
and Corporate Governance
Professor, Faculty of Law
e-mail: anita.anand@utoronto.ca
tel: 416-946-4002 / fax: 416-978-7899
84 Queen's Park
Toronto, Ontario M5S 2C5

VIA E-MAIL: comment@ccmr-ocrmc.ca

Dear Sirs / Mesdames:

Re: Revised Consultation Draft *Capital Markets Stability Act (Canada)*

Thank you for the opportunity to comment on the revised consultation draft for the *Capital Markets Stability Act* (Canada) (the "CSMA" or the "Act"). By way of background, I have researched and taught in the area of corporate governance and capital markets for almost twenty years. I am a Professor of Law at the University of Toronto, where I hold the J.R. Kimber Chair in Investor Protection and Corporate Governance. Prior to my employment at the University of Toronto, I was a tenured professor at Queen's University. I am cross-appointed to the School of Public Policy and Governance. I serve on the academic advisory board of the Canadian Coalition for Good Governance and I am also a fellow-in –residence at the C.D. Howe Institute in the area of economic performance and corporate governance. I have written extensively on Canada's securities regulatory structure.

General Approach

At root, the debate over whether Canada should have a cooperative securities regulator (or some version thereof) stems from questions about the appropriate institutional supervisory structure for Canada's financial system. While a specific question is whether securities regulation should be dispensed provincially or federally, a larger question pertains to the optimal regulatory structure for Canadian financial markets and the institutions that are required for such regulation.

Historically, prudential regulation and securities regulation have been separate beasts. The financial crisis, and particularly the causes of the crisis, highlight that a complete separation between these two areas of law is no longer tenable.[1] To name but one example, OTC derivatives issued or traded by a financial institution give rise to concerns relating to both securities law

[1] See also Anita Anand, "Is Systemic Risk Relevant to Securities Regulation?" (2010) 60 UTLJ 941 and Anita Anand (ed), *Systemic Risk, Institutional Design and the Regulation of Financial Markets* (Oxford: Oxford University Press, 2016 (forthcoming)).

(with respect to disclosure) and prudential regulation (with respect to counterparty exposure). A legal regime in which regulators in each sphere are uncoordinated will be unable to anticipate and respond comprehensively to systemic risks stemming from the trading of OTC derivatives as they may arise. Understanding the coordinated approach that it is at the heart of the Act is, therefore, crucially important to the development of Canada's financial markets.

Defining "Systemic Risk"

The term "systemic risk" inspires ambiguity despite the volumes of writing in the area.[2] Most commentators agree that there is no universally-accepted definition of the term.[3] An examination of the literature suggests that the term systemic risk has itself evolved over time. While originally conceived as a term that applies to the failure of one financial institution which in turn causes the failure of others in domino-like fashion, "systemic risk" now generally describes the possibility of financial meltdown. Moreover, while many agree that systemic risk is defined with reference to the interconnectedness of financial institutions (such that the failure of one may lead to the failure of others), they disagree about specifics, including the extent to which the risk should be crystallized and/or whether the contemplated collapse relates only to financial institutions or the entire economic system.[4] Thus it comes as no surprise that a main criticism lodged against those who promote the regulation of systemic risk is that the term defies precise definition and, further, "if we cannot define it, how can we regulate it?"

Notwithstanding these definitional issues, two aspects of systemic risk consistently arise in the literature which are pertinent when drafting legislation. The first relates to the chain of negative economic consequences to the financial sector that results from the realization of a systemic risk.[5] This domino-like effect has been described as follows:

> For banks, this effect may occur if Bank A, for whatever reason, defaults on a loan, deposit, or other payment to Bank B, thereby producing a loss greater than B's capital and forcing it to default on payment to Bank C, thereby producing a loss greater than C's capital, and so on down the chain."[6]

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[2] This writing is reviewed and discussed in Steven Schwarcz, "Systemic Risk" (March 2008), online: Duke Law School Legal Studies Research Paper No. 163 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1008326>. See also Anand, *supra* note 1; Miquel Dijkman, "A Framework for Assessing Systemic Risk" (April 2010), online: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1596492>; Olivier de Bandt and Philipp Hartmann, "Systemic Risk: A Survey" (November 2000), online: European Central Bank Working Paper No. 35 <https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp035.pdf>; George G. Kaufman and Kenneth E. Scott, "What Is Systemic Risk, and Do Bank Regulators Retard or Contribute to It?" (Winter 2003), online: 7(3) The Independent Review 371 <https://www.independent.org/pdf/tir/tir_07_3_scott.pdf>; John B. Taylor, "Defining Systemic Risk Operationally" in G. Shultz, K. Scott, and J. Taylor (eds.), *Ending Government Bailouts As We Know Them* (California: Hoover Press, Stanford University, 2003) at 33-57; J.A.C. Santos, "Bank Capital Regulation in Contemporary Banking Theory: A Review of the Literature" (September 2000), online: Bank of International Settlements Working Paper No. 90 <http://www.bis.org/publ/work90.pdf>; Seraina N. Gruenwald, "Financial Crisis Containment and its Implications For Institutional and Legal Reform" (December 2009), online: Social Science Research Network <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1516700>.

[3] Taylor states, "The recent crises show how far away we are from defining and agreeing on systemic risk […].": Taylor, *supra* note 2 at 47.

[4] See Kaufman and Scott, *supra* note 2.

[5] See Schwarcz, *supra* note 2 at 197.

[6] Andrew Crockett, "Why Is Financial Stability a Goal of Public Policy?" in *Maintaining Financial Stability*

Thus, a central concept underlying the term "systemic risk" has traditionally related to the failure of financial institutions to meet their obligations under contractual relationships between and among themselves.

The second aspect is the presence of some initial triggering event that occasions the fall of the first domino.[7] This triggering event can come in the form of a default by a fundamentally important market participant or an exogenous system shock to the economy.[8] It should be noted, however, that definitions of systemic risk may also include references to the potential for substantial volatility in asset prices, corporate liquidity, bankruptcies, and efficiency losses brought on by economic shocks.[9]

A definition of systemic risk that includes both these components – a triggering event followed by a domino-like failure of financial institutions – accords with the understanding of the term in the Bank for International Settlements, which defines the term as "the risk that the failure of a participant to meet its contractual obligations [specifically, counterparty risk in the case of credit default swaps used primarily in synthetic collateralized debt obligations] may in turn cause other participants to default with a chain reaction leading to broader financial difficulties."[10]

This understanding of systemic risk also seems to be the view held by the Supreme Court of Canada, which defined the term as "risks that occasion a 'domino effect' whereby the risk of default by one market participant will impact the ability of others to fulfill their legal obligations, setting off a chain of negative economic consequences that pervade an entire financial system."[11] It is this broad conception of systemic risk that should form the basis of prospective regulation.

The question arises as to whether the existence of systemic risk is knowable ex ante (i.e., before the risk arises) or only ex post (i.e., after the risk has become evident because of a financial system breakdown). Developing policy relating to the mitigation of systemic risk depends on the ability to make and understand the validity of predictions. For instance, there were moments pre-crisis in the United States when regulators could have intervened in advance of the realization of a systemic risk: The former chair of the Commodity Futures and Trade Commission (the

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in a Global Economy (Kansas City: Federal Reserve Bank of Kansas City, 1997) at 7–36.

[7] See Claudio Borio, "Towards a Macroprudential Framework for Financial Supervision and Regulation" (2003) 49 CESifo Econ Stud 181. See also Schwarcz, *supra* note 2, who states that, in defining the risk, it is not clear whether the trigger event must occur or whether it merely has the potential to occur. See also BIS/Central Banks of the Group of Ten Working Group, *Recent Developments in International Interbank Relations* (Basel: BIS, 1992) at 61, which defines systemic risk as "the risk that a disruption (at a firm, in a market segment, to a settlement system, etc.) causes widespread difficulties at other firms, in other market segments or in the financial system as a whole."

[8] George G. Kaufman, "Bank Failures, Systemic Risk and Bank Regulation" (1996) 16 Cato J 17.

[9] See also Schwarcz *supra* note 2 at 196-197, citing Paul Kupiec and David Nickerson, "Assessing Systemic Risk Exposure from Banks and GSEs Under Alternative Approaches to Capital Regulation" (2004) 48 J Real Estate Fin Econ 123 at 123.

[10] Bank for International Settlements (BIS), *64th Annual Report* (Basel: BIS, 1994) at 177.

[11] *Reference re Securities Act*, 2011 SCC 66 at para 103. This definition is drawn from the expert evidence of Michael Trebilcock and is consistent with the Bank for International Settlements definition, which is the "risk that the failure of a participant to meet its contractual obligations may in turn cause other participants to default": BIS, *64th Annual Report* (BIS: Basel, Switzerland, 1994) at 177 and cited in Kaufman and Scott, *supra* note 2 at 372.

"CFTC"), Brooksley Born, is widely acknowledged to have predicted the crisis in the OTC derivatives market prior to the 2007 crash. And yet, Congress moved to enact legislation that prevented the CFTC from taking any pre-emptive regulatory action.[12]

If we agree that systemic risk warrants regulation, then we move into the sphere of "macroprudential regulation," which refers to a definite intention by regulators to respond to systemic risk (above and beyond merely identifying it). The Group of Thirty has declared that "macroprudential policy is concerned not only with systemic risk but also with developing the appropriate responses to those risks in order to strengthen the financial system and avoid similar crises in the future."[13] The focus is on "the interconnectedness of financial institutions and markets, common exposures to economic variables, and procyclical behaviors [that] can create risk."[14] The reforms contemplated by the Act modify this concept by seeking to ensure that any regulatory response to the crisis takes into account the fact that historically separate legal spheres are more effective when they coordinate and share information with one another.

Systemic Risk and Materiality

Comments on the initial version of the Act related to potentially broad interpretations of "systemic risk." In an effort to specify the term's meaning in the Act, section 3 states:

> 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 <u>material adverse effect</u> on the Canadian economy [emphasis added].

While separating material from immaterial market occurrences is necessary, the term "material adverse effect" is ambiguous, especially when used in the context of identifying systemic risk.

Materiality is a complex concept. The term relates to an issuer's disclosure obligations. As found in the *Securities Act* (Ontario), the definitions of "material fact" and "material change" are centered on the effect that the information would have on the market price or value of the security and, specifically, whether that piece of information could reasonably be expected to have a significant effect on market price. Case law suggests that these concepts are difficult to interpret and apply.[15]

Given the difficulties that have plagued the interpretation of securities laws, one can reasonably conclude that applying the term "material adverse effect" in a context that does not relate to disclosure of information will likely lead to unnecessary confusion – especially when coupled

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[12] Pat Garofolo, "Former CFTC Chair Who Predicted the Derivatives Crisis Endorses Dodd-Frank Financial Reform Bill" ThinkProgress (2 July 2010), online: <http://thinkprogress.org/economy/2010/07/02/173371/brooksley-born-endorse/?mobile=nc>.

[13] Group of Thirty Report, "Enhancing Financial Stability and Resilience: Macroprudential Policy, Tools, and Systems for the Future" (October 2010), online: <http://www.group30.org/images/PDF/Macroprudential_Report_Final.pdf>.

[14] Macroprudential regulation does not seek to remove economic shocks but it does aim to identify and address a financial system's exposure to such shocks ex ante so that they can be addressed and the market's ability to resist such shocks can be established.

[15] See *R v Felderhof*, [2002] OJ No 4103.

with the ambiguity inherent in the term systemic risk discussed above. I have written extensively on this ambiguity, which would only be compounded if a concept of materiality were embedded in the definition of systemic risk in the Act.

Role of the Authority and Material Adverse Change

The responsibilities of the Capital Markets Regulatory Authority (the "Authority") also raise concerns. Section 4 outlines the purposes of the Act. This sections asserts that, among other purposes, the Act is designed to "promote and protect the stability of Canada's financial system." Section 6 highlights the duties of the Authority, stating that its mandate is to "detect, identify and mitigate systemic risk related to capital markets." These two provisions lead to some confusion: they appear to overlap or least introduce some ambiguities in respect of the Authority's responsibilities under the Act.

The previous draft of the Act raised concerns amongst stakeholders who worried that it contained too many exceptions from the obligation of the Authority to keep confidential information obtained under the Act. Under the latest draft of the Act, the Authority is permitted to provide information to other financial sector regulatory authorities and infrastructure entities. Section 15 further allows the Authority to "disclose any information obtained under this Act …for the purpose of promoting and protecting the stability of Canada's financial system through the management of systemic risk related to capital markets." This once again raises the question of how the Authority determines whether information will be disclosed. Problematically, concerns over the Authority's obligations vis-à-vis disclosure of information bleed into the issues raised above in respect of "material adverse effect."

Purposes and Effects of Enforcement

Section 33 establishes that the purpose of administrative monetary penalties ("AMPs") levied pursuant to the Act is to "promote compliance with this Act and not to punish." I understand that this may be language that is typically used with regard to AMPs in federal legislation. But case law suggests that securities commissions' public interest power is to prevent future harm and to protect capital markets on a prospective basis.[16] From the standpoint of securities legislation, then, is the stated purpose of the new AMP consistent with this prospective goal and therefore with case law? Promoting compliance is arguably a more narrow goal than preventing future harm and protecting capital markets on a prospective basis.

Part 4 of the Act outlines the punishments for contraventions of the Act. For proceedings by way of indictment, the punishment is a fine up to $5 million and/or imprisonment up to five years for an individual, or a fine up to $25 million for a person other than an individual. For proceedings by way of summary conviction, the punishment is a fine up to $250,000 and/or imprisonment up to one year for an individual, or a fine up to $5 million for a person other than an individual. Once levied, these punishments are likely to have a penal and possibly a deterrent (both specific and general) effect.

[16] See *Committee for the Equal Treatment of Asbestos Minority Shareholders v Ontario (Securities Commission)*, 2001 SCC 37.

The key question, however, is whether enforcement stemming from these provisions will be effective *in practice*. This is the challenge for the new Authority; Canada has for too long suffered under a fragmented enforcement regime and national and international expectations will be running high for an effective body to lead the enforcement of financial market crimes pursuant to the Act.

Criminal Offenses

Usefully, certain rarely-used provisions of the *Criminal Code*, such as those relating to the issuance of a false prospectus, have not been included in the Act. Criminal offenses caught by the Act include: fraud relating to securities and derivatives; deceitfully affecting market prices; market manipulation; benchmark manipulation; insider trading; misrepresentation; criminal breach of trust by dealers and investment fund managers; forgery of securities or derivatives-related documents; threats and retaliation against employees who comply with the Act; and conspiracy to commit an indictable offence under the Act.

The Act states in section 67 that the "Attorney General of Canada of the Attorney General or Solicitor General of a province may commence and conduct proceedings in relation to an offence." To some extent, the Act imitates the way in which securities-related offences are currently handled. And yet, the current enforcement regime raises numerous concerns. It remains to be seen how enforcement will improve in practice under the new Act and regulatory infrastructure.

The Opportunity to be Heard

Section 18 of the Act deals with the Authority's power to define systemically important benchmarks, and the procedures that must be followed after a benchmark has been set. One such procedure requires the Authority to give "any person that the Authority considers would be directly affected by the order an opportunity to be heard" [emphasis added]. Section 24 raises the same issues in dealing with urgent orders and states that "the Authority must, as soon as feasible after making the order, give any person that the Authority considers would be directly affected by the order an opportunity to be heard" [emphasis added]. The provision is useful and should remain in the Act. However, the Act does not specify how the Authority will determine who is "directly affected" or what "as soon as feasible" means. These terms should be specified in subordinate legislation or in guidance.

Overlap with other Legislation

The CMSA is a complex piece of legislation. It contains provisions relating to the monitoring and managing of systemic risk and criminal law enforcement. A key question is the extent to which it overlaps with legislation in other areas. For example, is the jurisdiction of the Authority going to overlap with the responsibilities of the Financial Transactions and Reports Analysis Centre of Canada under the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act*? Overlapping legislation is by no means optimal and should be avoided, especially when separate regulatory bodies are enforcing such legislation and can interpret similar legal obligations differently.

Please feel free to contact me via telephone at 416-946-4002 or e-mail at

anita.anand@utoronto.ca should you have any questions or comments in respect of these submissions.

Yours very truly,

Anita Anand
J.R. Kimber Chair in Investor Protection and Corporate Governance
University of Toronto