

Keep securities regulation decentralized



by **Hugh MacIntyre**

Canada is unusual among developed nations in that it does not have a national securities regulator. Instead, each of Canada's thirteen jurisdictions has its own regulatory body. Each province and territory has its own provincial securities legislation and regulatory bodies in each jurisdiction have prescribed powers to create rules and adopt policies. This has created concern in some quarters that a patchwork of different regulations will disadvantage Canada. For instance, a report produced for the Minister of Finance by the Expert Panel on Securities Regulation (EPSR) called *Creating an Advantage in Global Capital Markets: Final Report and Recommendations* recommends creating a national securities commission. The EPSR claims that the current decentralized system is too

burdensome for both investors and governments alike.

There are, however, some advantages to having a decentralized policy process that are overlooked by the EPSR. Also, the disadvantages outlined in the report are greatly exaggerated and in some cases are not really disadvantages at all. Though it is important for the various regulatory bodies to coordinate on some issues, Canada is better served by keeping the current decentralized system.

Benefits of decentralization

One of the advantages inherent in a federal state is that it allows citizens greater choice in which policy environment in which they will work and live (Tullock, 1994). A provincial government that offers superior policy at a lower cost is more likely to attract the most capable immigrants and the most investment. In the case of security regulations, companies can choose into which provinces they will raise capital. This is commonly referred to as “voting with your feet,” and, in a limited way, it creates competition between governments that is similar to the competition in a market place. This competition adds a constraint on government power that is complimentary to the democratic system and, “the addition of voting with your feet to voting with a ballot is a significant improvement” (Tullock, 1994: 34).



A second advantage to a decentralized system is that it allows greater policy experimentation and thus more policy learning. Policy making is almost always experimental (Freeman, 2006). Academics and policy makers have theories on what the effect of a policy will be, but the only way to know definitively is to first implement that policy. The obvious danger of such experimentation can be mitigated by learning from other jurisdictions (Freeman, 2006). For example, if Quebec is considering a reform, they can learn from what has or has not worked in Ontario. If the federal government dictated policy for both provinces, there would be no way to learn from differences that could improve government policies.

The third way that a decentralized system is advantageous is that it allows for a greater voice of regional differences and interests. Canada is

not a homogeneous country and the economies of the provinces vary greatly. This is reflected in the differences in approach to regulating securities (Mohindra, 2002). The EPSR recognizes the importance of a regional voice and recommends that a “Council of Ministers” be included in the structure to represent each province’s interests (EPSR, 2009: 53). The flaw with this solution is that for the national securities regulator to have any coherence or meaning, it will have to produce a single set of policies for all provinces. Therefore, some provinces are bound to have their interests better served than other provinces. The only way to ensure that provincial interests are all protected is by allowing provinces to create their own policy (Mohindra, 2002).

EPSR concerns with decentralization

Despite the advantages outlined above, the EPSR presents three points—which can be better divided into five arguments—against the current decentralized regulatory system. The first is that it is difficult for securities regulators to act quickly in a coordinated manner. The second is that it is difficult to fit the different regulatory bodies into a “national systemic risk management team” (EPSR, 2009: 40). The third is that there is a duplication of effort across the provinces. The fourth is that there is variation in the levels of protection enjoyed by investors.

The fifth and final point is that having to comply potentially with thirteen separate regulations leads to a high compliance cost (EPSR, 2009).

The EPSR refers to Canada's delay in restricting short-selling in September 2008 as an example of a case in which Canada acted too slowly (EPSR, 2009). The underlining assumption is that this interference in the market was beneficial and needed to occur quickly. Without making a judgment in this particular case, swift action on the part of a regulator is not necessarily positive. Public policy is difficult to get right, and hasty actions are often damaging. This is especially true when dealing with issues of property rights—an integral part of most securities regulation. Any decentralized system



is valuable if it slows down public policy, makes arbitrary rule making more difficult, and allows for greater debate. In this way the very disadvantage presented by the EPSR is in fact actually an advantage.

The second point that the EPSR makes also puts too much importance on the swiftness of response. It is a dubious claim that a coordinated "management team" would be able to produce an instant regulation that would have a positive impact on the economy and securities markets. Especially considering that much of the delay is due to the consultation process of some provinces, not coordination problems (for example, see Part V of the *Ontario Securities Act*). If a proposed regulation has merit and requires coordination, then the regulatory bodies should be able to negotiate with each other. Negotiations between government agencies are common in any governing structure (Tulloch, 1995) and it is certainly common among Canada's securities regulators (Mohindra, 2002). Furthermore, coordination is simplified through the Canadian Standards Association by developing universal standards. The merit of speeding up that process is not outweighed by the risks involved in creating hasty and harmful regulations.

The complaint that there is a duplication of effort is common in any federal system. The assumption is that economies of scale in a combined system would save on



costs, but the reality is that inefficiencies created by consolidating into large monolithic organizations often outweigh the efficiencies of economy of scale (Tulloch, 1995). At the same time, the inefficiencies of duplication have been partially alleviated by cross-jurisdictional agreements. Combining organizations would lead to difficult political decisions such as where should jobs be cut and which organizational model should be used. The path of least resistance would be to retain redundant jobs, and to latch together a mismatch of organizations. In fact, the Canadian Securities Transition Office has already committed itself to offering a position to all staff in participating regulators (CSTO, 2010), which makes it highly probable that there will be redundancies and thus inefficiencies.



Variation in levels of investor protection is not inherently a negative trait and it is only one of several factors that must be balanced when creating securities regulation; compliance cost, for example, is another important factor. The importance given to certain factors differs among Canada's securities regulators depending on circumstances and philosophy (Mohindra, 2002). There is no guarantee that a single monolithic body would be more able to handle the complexity of securities regulation (Tullock, 1995). In fact, a monolithic regulator would be at a disadvantage because it would not allow policy experimentation to discover the best balance of the various factors.

Cost of compliance would not necessarily decline with a single securities regulator. Harmonization so far has only led to the increase

in the complexity of securities regulations and thus has made it more difficult for firms to comply (Mohindra, 2002). This is partly because a single regulator or more harmonized regulatory system faces less competitive pressure to keep compliance costs low. The EPSR is simply assuming that a monolithic regulator would keep costs low, but experience has demonstrated that the opposite is more probable.

Conclusion

There is no overwhelming advantage to a centralized securities regulator, but there are several advantages to keeping it decentralized. A decentralized system forces regulators to compete to create better regulation, it allows for more policy experimentation, and it is more able to incorporate regional diversity. The EPSR exaggerates the importance of quick policy making and it makes flawed assumptions about the greater efficiencies and lower compliance costs of a monolithic system. Finally, it ignores the disadvantage of harmonizing investor protection, and it does not consider that a decentralized system would be better able to handle complex policy problems.

References

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