Self-regulation in Canada – time for a change in changing times?

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Throughout the history of the securities industry in Canada, the industry itself has played a critical role in the regulation and oversight of the conduct of its members. For nearly 20 years, securities trading activities have been regulated by two industry-led self-regulatory organizations (SROs). These are the Investment Industry Regulatory Organization of Canada (IIROC), which oversees all investment dealers and trading activity on debt and equity markets in Canada, and the Mutual Fund Dealers Association of Canada (the MFDA), which is responsible for oversight of mutual fund dealers in Canada (except in Québec). Both IIROC and the MFDA are recognized as SROs and are overseen by the Canadian Securities Administrators (CSA) under applicable securities regulation. IIROC and its predecessor, the Investment Dealers Association of Canada, have been regulating investment dealers as a recognized SRO since 1995, although the IDA's origins and operations date back much earlier to 1916. Calls to reform the SRO structure have risen occasionally through the years, both from within the structure itself – such as the debates over the regulation of mutual fund distribution that led to the creation of the MFDA in 1995 – and from external parties such as the C.D. Howe Institute, which issued a report on SRO reform in October 2019.

The most recent wave of discussion spurred consideration of SRO reform from the CSA, the MFDA, IIROC and the Ontario government's Capital Markets Modernization Taskforce (the Task Force), each of which have published a report or consultation paper on this topic. This bulletin provides an overview of the contents of each of these reports and an analysis of common points and discrepancies between the proposals.

The CSA

In December 2019, the CSA announced that it would undertake a review of the regulatory framework for IIROC and the MFDA, after which it met with various stakeholder groups to better understand the benefits, challenges and issues of the current framework. This initial consultation effort led to the publication of CSA Consultation Paper 25-402 *Consultation of the Self-Regulatory Organization Framework* on June 25, 2020 (the CSA Consultation Paper).

Rather than explicitly making recommendations on the reform of the SRO framework, the CSA Consultation Paper instead outlines the history and current regulatory

landscape, highlights comparable SROs in the United States and United Kingdom, and sets out what it perceives to be the key benefits and issues of the current framework as identified by stakeholders. These perceived benefits include the national scope and specialized industry expertise of SROs, the ability of the two-SRO system to address unique member needs, and the effective performance of market surveillance by IIROC. The issues with the current framework identified by stakeholders were as follows:

- Duplicative operating costs for dual-platform dealers, which are ultimately borne by investors and which inhibit scalability;
- Product-based regulation, including converging registration categories and regulatory arbitrage;
- Regulatory inefficiencies, such as inefficient distribution of products caused by limited access to back-office systems;
- Structural inflexibility, which can create succession-planning issues among dealers and can be slow to address investor preferences and needs;
- Investor confusion surrounding topics such as regulatory overlap and the complaint resolution process;
- Lack of public confidence in the regulatory framework, namely regulatory capture, lack of transparency in SRO compliance/enforcement practices and insufficient accountability of SROs to the CSA; and
- Concerns regarding separation of market surveillance from statutory regulators, including the ability of regulators to monitor systemic risk and the potential for conflicts for an SRO tasked with the surveillance of its members and the capital markets as a whole.

MFDA

The MFDA's report on self-regulation in the securities industry (the MFDA Report), released in February 2020, proposes the creation of a new, purpose-built SRO responsible for the prudential regulation of registrable activity in the securities industry. Citing a lack of coordination among the various regulatory and governmental authorities, the MFDA Report submits that creating a "blank page" SRO is the most effective way of demonstrating to statutory regulators and the investing public that meaningful improvements are intended and are being achieved. The MFDA Report goes on to suggest that reforms of this magnitude are necessary due to declining public trust in the traditional SRO model, regulatory capture and real or perceived industry conflicts of interest. In order to combat these concerns and to restore public confidence in SROs, the MFDA proposes an enhanced governance structure that would include a board of directors consisting of public directors, industry directors and representatives of the CSA, a cooling-off period for public and independent directors coming from the industry, and greater participation by CSA members in the governance of the new SRO.

The MFDA's proposed new SRO would have a mandate including registration, business conduct standards, prudential matters, policy and rule development, and enforcement. Notably, this mandate would include oversight over all firms required under securities law to register in order to trade or advise in respect of securities. The MFDA suggests that market surveillance responsibilities should be consolidated under the authority of the statutory regulators. For the first time, portfolio managers (advisers), exempt market dealers and scholarship plan dealers would be required to be members of the new SRO, along with investment dealers and mutual fund dealers. The new SRO would be these registrants' principal regulator.

IIROC

IIROC's report on improving the self-regulation framework (the IIROC Report), released in June 2020, proposes the consolidation of IIROC and the MFDA as divisions of a new SRO. IIROC suggests that rather than creating a new rulebook from scratch, it would be beneficial to both industry participants and the investing public to permit dual-platform dealers and representatives the flexibility to consolidate all of their regulatory oversight under one set of rules. This would have the practical effect of creating a "one-stop shop" investing experience, which would enable retail investors to access a full shelf of products at one point of service, without having to open multiple accounts or sign contracts with multiple entities. The IIROC Report also states that this proposal could be achieved without disrupting existing business models or regulatory fee structures.

The IIROC Report acknowledges several specific regulatory obstacles to a "one-stop shop" investor experience, but suggests that these can be surmounted through an end to the structural separation of IIROC and the MFDA. With oversight of investment and mutual fund dealers housed under one roof, mutual fund dealers could provide greater access for their clients to products such as ETFs, and dual-platform dealers could avoid the unnecessary duplication of back-office services.

The IIROC Report suggests that, once approved by the CSA, the streamlined nature of its proposal could allow the MFDA and IIROC to consolidate within three months, and that the new SRO could be operational within a year.

On August 25, 2020, IIROC released a report from Deloitte LLP assessing the benefits and costs of IIROC's proposal (the Deloitte Report). The Deloitte Report estimates that the consolidation of IIROC and the MFDA would provide dual-platform firms with cost savings between approximately $380 and $490 million (over a ten-year period), primarily reflecting savings in systems and technology, staffing costs and corporate costs; however, the Deloitte Report does not consider the impact of consolidation on IIROC-only or MFDA-only firms. Deloitte also suggests, among other points, that SRO consolidation could encourage greater investor choice, the arrival of new market participants and innovation within the securities industry.

Capital Markets Modernization Task Force

Established by the Ontario government in February 2020 with a mandate to review and modernize Ontario's capital markets, the Task Force released its initial consultation report in July 2020 (the Task Force Consultation Report). Although the primary focus of the Task Force Consultation Report is not on the investment industry, the report makes two key recommendations:

- To significantly increase OSC oversight of IIROC and the MFDA; and
- To create a new single SRO that regulates both investment dealers and mutual fund dealers, as well as other registrants.

The Task Force suggests that the current SRO framework does not consistently align with the OSC's public interest mandate and proposes several amendments to the OSC's recognition orders for both IIROC and the MFDA to rectify this. These include an OSC veto on SRO publications, guidance or rule interpretations and on appointments of

key personnel, implementing requirements for independent directors akin to the requirements for independent directors of public companies, and a requirement that statutory regulators appoint up to half of the directors of any SRO.

The Task Force also proposes the immediate creation of a new, single SRO that absorbs the mandates to regulate investment dealers, mutual fund dealers and registrants such as exempt market dealers, portfolio managers and scholarship plan dealers, with the latter being phased in to the new SRO's mandate within 12 to 18 months of its creation. This new SRO would conduct national market surveillance, and would be tasked with carrying out statutory registrant regulation functions on behalf of the OSC (including the registration of firms and individuals). Underpinning this new regulatory framework would be the principle that regulatory oversight must be commensurate with a market participant's size and sophistication. The Task Force suggests that this move would lead to non-duplicative regulatory oversight, while minimizing disruption to SRO-regulated firms and enhancing accountability to statutory regulators and the investing public.

The upshot

There appears to be consensus among the various reports that the current two-SRO framework should be revisited, and that both IIROC and the MFDA should be replaced in the future by a single pan-Canadian SRO with a mandate to regulate at the very least both investment dealers and mutual fund dealers. Issues such as the convergence of services and products offered by different categories of registrants, the duplicative regulatory burden for dual-platform dealers, and a confusing and inconsistent investor experience were highlighted in each report as critical shortcomings of the existing system.

However, that is where the "common ground" ends. The reports offer conflicting visions as to whether the new SRO will be a consolidation and continuation of IIROC and the MFDA under a new umbrella organization, or whether it will be a "blank page" and purpose-built SRO. The MFDA Report contends that a consolidation of IIROC and the MFDA would not address the larger public interest concerns and weaknesses with the existing framework, while the IIROC Report rejects the "blank page" approach as not feasible and as a potential source for greater uncertainty for investors and market participants. The Task Force Consultation Report calls for a "new, single SRO".

Similarly, both the MFDA Report and the Task Force Consultation Report call for the inclusion of exempt market dealers, portfolio managers and scholarship plan dealers under the regulatory authority of the new SRO, while the IIROC Report views the assumption of this mandate as "practically impossible" in the medium term, as it would involve extensive consultations with a vast number of stakeholders, taking years to accomplish and in the meantime continuing the status quo. The Task Force Consultation Report takes a different view of the time that it would take to accomplish this transfer of oversight, proposing that it could be done within 12 to 18 months.

The IIROC Report and the Task Force Consultation Report each call for the continuation of national market surveillance activities under the new SRO, which are currently within IIROC's mandate. The CSA Consultation Paper notes that several stakeholders have identified that market surveillance conducted by IIROC works well, but also suggests that other stakeholders have raised concerns about possible

information gaps and fragmented market visibility resulting from surveillance functions being separated from statutory regulators. As noted above, the MFDA Report suggests that market surveillance activities should be assumed by the statutory regulators instead of continued under the new SRO, as it views market surveillance as more appropriately under the purview of government regulators than industry.

We anticipate that a fundamental discussion point going forward will be the extent to which “self” regulation is both necessary and desirable for registrants and in respect of market surveillance – and the advantages and disadvantages of such regulation. It will be important to consider the enhancements needed to ensure appropriate SRO oversight by the CSA and achievement of appropriate investor protection. For instance, from a governance perspective, both the MFDA Report and Task Force Report propose the participation of CSA representatives on the board of the proposed SRO, while IIROC does not. Although we understand the inherent attractiveness of ensuring a system of regulation that is consistent for all registrants and including all such registrants in a single SRO, we believe it will be important to articulate the reasons why “self” regulation is better than the status quo, while also recognizing the significant differences amongst the business models and client services of each of these registrants. The on-going role of the members of the CSA will need to be highlighted and understood going forward.

Nothing is impossible, but strong leadership, commitment and thoughtful policy development at all levels will be critical for both industry and regulators going forward if the shortfalls of the status quo are to be properly addressed for these changing times and a changing industry.

Comments

Written submissions addressing questions set out in the Task Force Consultation Report, or on issues not reflected in the Task Force Consultation Report, are due by September 7, 2020. Written submissions addressing questions set out in the CSA Consultation Paper are due by October 23, 2020. We would welcome comments from our clients and industry participants and would be pleased to work with you on any submissions you wish to make.

If you would like to discuss how these proposals might affect your business and operations, or if you would like to discuss your comments on these proposals, please contact the authors of this Bulletin or your usual lawyer in BLG’s Investment Management Group.

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