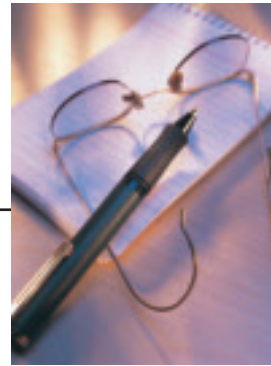


# It's time to reconsider

Has the case for a single securities commission been made?

FIELD NOTES

BY PETER KLEIN AND AIDAN VINING



The Ontario government recently appointed a panel of “knowledgeable and well-respected individuals to advance the design of a common securities regulator.” One of the motivations for establishing the panel is that “Canada is the only developed nation without some form of national regulator to support capital markets and protect investors” (quotes taken from the Ontario Securities Commission’s website, [www.osc.gov.on.ca](http://www.osc.gov.on.ca)).

This announcement closely echoes the federal Wise Persons Committee (WPC), which concluded: “Canada’s securities regulatory structure has become an international outlier. . . only Canada and Bosnia-Herzegovina lack a national or supra-national regulator” (WPC Report [2003]). Accordingly, the WPC recommended a “single Canadian Securities Commission” to replace the current system of provincial regulation.

Given this issue is once again on the public policy agenda, it is important to review the case originally put forward by the WPC. We argue that the case for a single Canadian securities commission has not been made, based on the evidence presented to date.

## AN EFFICIENT REGULATORY SYSTEM

Securities regulation has two major purposes: to allow issuers to raise capital at the lowest cost, and to protect investors. Regulation can protect investors by reducing information asymmetry, which leads to a lower cost of capital and more efficient capital markets. Bhattacharya and Daouk (2002) find that the enforcement of insider-trading laws reduces the cost of equity by about 7%.

Regulatory efficiency has a number of elements. The first is cost efficiency, which depends primarily on economies of scale (EOS) and incentives to minimize costs. Much of the case for centralization rests on EOS, but different regions may have different consumer tastes,

wealth levels and product demands. Centralization is sensible policy for governments if it will achieve minimum efficient scale, and the resulting cost benefits should be an important driver of regulation in countries with small populations, small geography, and/or a small range of industrial sectors. However, EOS is less important where there are big distances, dispersed populations and segmented markets, as in Canada. Furthermore, ongoing technological change may be reducing the importance of EOS in securities regulation.

Cost efficiency is also about the incentives to achieve that efficiency, or X-efficiency; essentially, when it takes effort to minimize costs, individuals and organizations tend to avoid doing so. The evidence certainly suggests that government monopolies—including regulatory monopolies—are prone to X-inefficiency. Regulatory policy analysts have become increasingly aware of the potential value of “regulatory competition” as a check on this form of inefficiency, in particular for financial markets.

The second element—dynamic efficiency—is about efficiency over time. We live in an era of rapid technological and market change, so this kind of regulatory efficiency is critical. But, it is easy to present cases where the inability or unwillingness of regulators to change has cemented regulation which, over time, has become a drag on entrepreneurship, innovation and economic growth.

## THE EVIDENCE ON COST EFFICIENCY

Cost efficiency is the one area where one might expect a strong case favouring a national commission: why have 13 regulators when a single regulator could do the job at lower cost? To address this question, the WPC commissioned studies on both compliance and enforcement costs; the former “examined costs inherent in the current system. . . and compared these to costs. . . under

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## FIELD NOTES

the...passport system of regulation, uniform securities legislation and a single national regulator” (Anand and Klein [2003]). The study concluded that provincial harmonization had already substantially reduced excess costs and that “any of the three alternative regulatory models will reduce or eliminate material incremental costs.” Similarly, the cost of the enforcement study concluded that “many of the considerable problems of the past no longer occur today” and that “the economies of scale savings in enforcement are modest” (Sanderson and Neumann [2003]).

In support of its recommendations, the WPC also argued that “the provincial ministers’ passport proposal and the CSA’s USL Project would continue to require issuers and registrants to pay fees to multiple regulators, even though only one regulator would be responsible for oversight” (WPC Report [2003]). We note, however, that the WPC proposals envision decentralized enforcement with “strong, functionally empowered regional offices in Vancouver, Calgary, Winnipeg, Toronto, Montreal and Halifax” (WPC Report [2003]). Given Ottawa’s overall track record, there is reason to be skeptical that a federal agency with offices spread throughout the country would be able to charge lower fees while still recovering its costs.

### DYNAMIC EFFICIENCY ABROAD

The WPC commissioned three studies that looked at securities regulatory systems in other countries which addressed, to some extent, the issue of dynamic efficiency. The study on Australia concludes that the single regulator model may not have provided the “optimal set of arrangements, in economic or political terms . . . One such model might involve a mix of federal and state regulation—if not the mix characteristic of the U.S. or Canada” (Simmons and da Silva Rosa, [2003]).

The study on the U.S. concludes that “[i]f presented with the opportunity to design a regulatory structure for the United States on a clean slate, I would retain concur-

rent federal-state jurisdiction” (Seligman [2003]). In reaching this conclusion, the author corrects the view that the U.S. system is highly centralized, pointing out that states retain significant regulatory competency in the securities industry and can impose their own regulations.

A third study considered the EU passport system. Again, however, this report does not conclude that a single imposed regulator is the superior model, rather that “[o]ver time, with the single market becoming more integrated, a process toward further harmonization and centralization has developed” (Lannoo and Levin [2003]). The WPC itself acknowledges that “a comprehensive passport system would be a significant incremental improvement over the current system” (WPC Report [2003]).

The WPC research reports spend relatively little time on the issue of investor protection, although three of their studies focused on the related issue of local and regional interests and preferences. These studies also did not express a clear preference for one alternative over another. Puri (2003), for example, concludes that “existing local and regional differences can be accommodated under different regulatory models without appreciable differences in regulatory outcomes.” On the other hand, neither the WPC nor their research presented evidence that a centralized Ottawa bureaucracy would be more responsive to investors.

### IT’S TIME TO RECONSIDER

As we enter into more debate on the appropriate system of regulation for Canada’s securities markets, it’s important to recap the arguments to date. Based on the criteria of cost efficiency, dynamic efficiency or investor protection, we see no compelling evidence to favour a single national regulatory model over others. We agree with the title of the WPC report: it’s time to resolve the current debate on securities regulation in Canada. We conclude, however, that it’s also time to reconsider the evidence upon which the recommendation of a single regulator is based. ■