INVESTOR ADVISORY PANEL

February 17, 2022

Capital Markets Act Consultation
Capital Markets and Agency Transformation Branch
Ministry of Finance
Frost Building North
95 Grosvenor Street, 4th Floor,
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Re: Consultation – Capital Markets Act

On behalf of the Ontario Securities Commission's Investor Advisory Panel (IAP), I wish to thank you for this opportunity to comment on the draft Capital Markets Act (CMA) as presented in conjunction with the Ontario Ministry of Finance publication *Capital Markets Act – Consultation Commentary, October 2021* (the Consultation Paper).

The IAP is an initiative of the Ontario Securities Commission (OSC) to ensure investor concerns and voices are represented in the Commission's policy development and rulemaking process and to comment on legislative developments. Our mandate is to solicit and articulate the views of investors on regulatory initiatives that have investor protection implications.

GENERAL COMMENTS

The IAP strongly supports the urgency of modernizing Canada's financial regulatory framework in order to respond to disruptive forces in our rapidly evolving financial markets and to robustly protect retail investors. While the proposed CMA does not address the critical issue of Canada's siloed approach to regulation, it is a first step in modernizing securities legislation in Ontario and is long overdue.

Timely Response to Market Developments

The Consultation Paper emphasizes that the CMA's platform approach "*promotes regulatory flexibility, allowing the OSC to respond to market developments in a timely manner and appropriately tailor its regulatory treatment of various entities and activities*." We believe this approach is sensible and necessary. In our *Horizon Project: Initial Report*, we expressed deep concern over the common theme heard from delegations we engaged with, who characterized "*financial regulation as overly reactive and chronically slow-footed, unable to catch up to what's actually happening on the ground in today's rapidly changing world*." [p. 11] We also recommended that the OSC take leadership and "[s]*peed up OSC policymaking and rulemaking*".

It concerns us, however, that the CMA's platform approach may be insufficient to streamline the regulatory process. No amount of legislative renovation will accomplish this unless, at the same time, the OSC's specialized expertise is acknowledged and consistently utilized as the most appropriate, even-handed resource for addressing rapidly evolving capital markets and the growing complexity of investment products.

Moreover, as noted by the Auditor General in her recent report on the OSC [*Value for Money Audit: Ontario Securities Commission, Office of the Auditor General for Ontario December 2021 (Audit Report)*], the pre-clearance process instituted by the Ministry of Finance (Ministry) inhibits the adoption of new rules, policies and practices in a timely manner.

The Audit Report goes on to indicate that "*pre-clearance has required additional time, averaging 93 days for rules before public consultation, 91 days for rules after public consultation but before sending the rules to the Minister for final approval, and 54 days for staff notices*" [p. 23]. In reply, the Ministry has pledged to work with the OSC so it can continue to "*respond to capital markets developments and exercise its statutory rule-making authority in an effective and timely manner*." Follow through on this pledge is critical if the OSC is to remain an effective and modern regulator.

Transparency

On a related theme, the Consultation Paper notes that the approach under the proposed CMA aligns with the "*government's regulatory principles of responding to a clearly identified need for streamlined regulation, developing and implementing legislation in a transparent manner*." We would point out, however, that the pre-clearance process is far from transparent. It obscures from public view how long rules and staff notices have been in development. More troubling, pre-clearance also obscures from public view any barriers preventing particular issues from being addressed altogether – leaving the public to wonder whether the resulting inaction is due to regulatory failure or indifference, or whether it is the result of political interference.

This opacity and blurring of accountability risks undermining public confidence in the regulation of Ontario's capital markets. It also may jeopardize the competitiveness of our markets in comparison to others where regulation is more clearly insulated from partisan influence.[1]

We urge the government to address this crucial issue. Part of the solution may lie in adding more transparency to the statutory framework for oversight of the OSC. For example:

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[1] In its *Objectives and Principles of Securities Regulation*, the International Organization of Securities Commissions (IOSCO) sets forth 30 principles of securities regulation, including that "*[T]he regulator should be operationally independent from external political or commercial interference in the exercise of its functions and powers and accountable in the use of its powers and resources*." [p. 10] It defines the term "interference" as meaning a formal or informal level and method of contact that affects day-to-day decision making and is unsusceptible to review or scrutiny. We are concerned that the pre-clearance process, and the lack of transparency that accompanies it, does not meet this standard and could negate many of the benefits of the CMA.

- Where the Minister rejects a proposed rule or returns it to the OSC for further consideration under CMA section 269 (3), we think it important that the legislation should require the Minister to provide reasons for doing so in all cases. The CMA also should require the OSC to promptly publish notice of the fact that the rule has been rejected or returned to it for further consideration, and it should be mandatory for the Minister's reasons to be included in the notice.

- In cases of reconsideration, the CMA should require the OSC to publish its response or notice of any decision to withdraw the proposed rule within 30 days of the matter having been referred back to the OSC by the Minister.

These measures, however, will not fully resolve the problems created by subjecting OSC initiatives to pre-clearance. A more comprehensive answer is needed and should be given urgent priority.

Purposes of the CMA

The OSC's ability to protect investors has been called into question by recent amendments to the *Securities Act* requiring the OSC to "foster capital formation". It is feared the addition of this capital formation mandate will push the OSC to skew its priorities toward business interests and lessen its focus on investor protection, upsetting a carefully considered regulatory balance of those interests essential to maintaining fair capital markets and public confidence in them.

Formerly, this critical balance served as an underpinning for the guiding principles (set out in section 2.1 of the *Securities Act*) that the OSC is directed to consider in interpreting the purposes of its governing statute. Now, applied to a mandate tilted into dis-equilibrium, these same principles (continued in section 2 of the CMA) will tend to further skew the focus of the regulator away from protecting investors.

To address this – and to restore necessary balance recognizing that investor protection is the foundation of sustainable capital formation – we would urge revision of the principles' wording in section 2 of the CMA so that investor protection remains paramount and is not outweighed by other considerations.

SPECIFIC COMMENTS

The Dilemma of Rationalizing Business Interests with Investor Protection - Q11

The Kimber Report [Report of the Attorney General's Committee on Securities Legislation in Ontario, 1965 (Kimber)] noted that public confidence is "[o]*ne of the strongest single forces in the process of raising capital*." [Kimber, par 1.11]. The maintenance of an appropriate balance between business interests and investor protection is the underpinning of public confidence.

The risk that business interests could somehow trump investor protection comes up in the wording of Q11 in the Consultation Paper and is a reason for concern: "[w]*ill these new tools allow the OSC to effectively encourage compliance without unduly burdening market participants*." This seems to us to be oddly phrased. It has never occurred to us that, should compliance be unduly burdensome, it could simply be dispensed with.

While it is arguable that regulation should be 'proportionate', there is a greater risk that rationalizing the burden of compliance with the protection of investors will be resolved in favour of capital formation. This would be to the detriment of investors if it were to remain a purpose under the CMA.

Moreover, it will be detrimental to Ontario's capital markets if lower standards, diminished regulation, and a light touch on compliance are implemented in pursuit of competitiveness. Real competitive advantage, we believe, will be found only by being open for business that commits itself to operating in a manner fully aligned with high market probity standards. The CMA should ensure those businesses aren't saddled with unnecessary compliance requirements. But the statute should not reflect a viewpoint that the appropriateness of regulation is to be gauged largely by the degree to which it impinges on business.

The Need for an Investor Voice

For the proposed CMA to be successful it is critical that, following the introduction of the CMA, the OSC should be seen as being independent and not captive to any one interest.

In its "Methodology for Assessing Implementation of the IOSCO Principles of Securities Regulation" IOSCO states that:

> *While the regulator should be accountable under a jurisdiction's legal and governing structure, the regulator should also be operationally independent from external political or commercial interference. Without such independence investors and other market participants may come to doubt the regulator's objectivity and fairness, with deleterious effects on the market's integrity. Generally, the regulator's independence will be enhanced by a stable source of funding. It also means that the regulator should remain independent from the market participants that it supervises. In some jurisdictions, particular matters of regulatory policy require consultation with or even approval by, a government, minister, or other legislative authority. The circumstances in which such consultation or approval is required or permitted should be clear and the process sufficiently transparent or subject to review to safeguard its integrity. Generally, it is not appropriate for these circumstances to include decision making on day-to-day technical matters*. [p.25]

Independence implies a regulator that operates independently of sectoral interest, and it is for this reason that we strongly recommend the inclusion of three board members who can provide the investor perspective to OSC policy and rule-making. Consideration should be given to candidates with backgrounds in government, professional regulation and financial services, including retired securities regulators, academics with expertise in investment issues and financial journalists.

In fact, the Auditor General in her Audit Report, at recommendation 4, suggested that the Ministry and the Commission's Governance and Nominating Committee identify and recommend for appointment Board members with retail and investor protection experience. That should also be considered for Tribunal members. There is nothing in the new *Securities Commission Act, 2021* (SCA) to address this concern.[2]

We previously commented on this issue in the context of the CMRA initiative, stating [December 21, 2015]: "[w]*e also encourage greater inclusion of retail investor input at all levels of decision- and rule-making...*". We reiterate this suggestion for the CMA, and also recommend that it embed an Investor Advisory Panel as an integral part of the OSC's framework.

Maintaining an Expert Tribunal

The CMRA proposal included a regulatory policy forum by which Tribunal members could be kept informed of securities legislation and policy developments and Board members could be apprised of important decisions made by the Tribunal. This was intended to help ensure expertise would remain current for regulators and adjudicators alike. It may be of interest to note that FAIR Canada, in its comment letter on the CMRA, recommended that two IAP members have seats on this body.

We would endorse the inclusion of a similar regulatory policy forum in the CMA, with participation by investor representatives.

Given the separation of the Tribunal from the regulator under the framework established by the SCA, we also have a concern as to how budgeting decisions will be made as between the Tribunal and the regulator. In particular, we wish to ensure that the Tribunal could not be starved of funding by the regulatory body taking the lead on budget matters. The SCA provides, at section 17, that the Chief Adjudicator shall "*prepare and submit to the Commission's board of directors a proposed budget in each fiscal year containing the estimated amounts required to fund the proper operation of the Tribunal for the next fiscal year*." We recommend that a mechanism be provided either in the CMA or in the SCA to provide confidence to investors that the Tribunal will receive adequate funding through the budgetary process. While it is important that the Tribunal be independent of the regulator, it will need a strong voice to advocate for the resources it needs, and we think that this is something that the Ministry should bear in mind in order for the CMA to be successful.

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[2] By way of interest, the Canadian Foundation for the Advancement of Investor Rights (FAIR) in its White Paper on the Proposed Co-operative Capital Markets Regulator [Anita Anand, 2017] recommended three retail investor representatives be appointed to the Board of the Co-operative Capital Markets Regulatory Authority (CMRA).

Comment Periods – Q10

The move to 60-day consultation periods instead of a 90-day consultation period is, on balance, a good one. It supports rapid response capability – which increasingly is essential for effective market regulation.

Social Media - Q17

Q17 asks whether the scope of the definition of promotional activity is appropriate. We believe that this provision is inadequate for two reasons: First, it might not capture all those who make false statements about an issuer (for example, the falsehood could be posted by someone simply aiming to profit from being a social media influencer, not from trading in the issuer's stock). Secondly, the statutory provision applies only to a statement the person knows or reasonably ought to know is false. To be effective, we recommend that the provision be broadened to apply in situations where the false statement is made carelessly (i.e., without due regard for whether it was true or false).

Disgorgement

Under subsection 120 (7) of the draft CMA, if there is no court appointed administrator, the Commission is to administer and distribute the disgorged amount (or part thereof) according to the rules. If this approach is adopted, the CMA should exempt the OSC from civil liability in the event that questions are raised subsequently about the distribution (for example, by investors left out of the claims process or should issues arise with the amounts distributed). It is likely that this provision will be used for the distribution of relatively small amounts and we are concerned that if there is any risk of liability, the OSC will prefer not to proceed – especially if the records kept by the respondent were poor, destroyed or lost, thereby increasing the risk to the OSC as administrator.

We also are concerned about section 120 (10), which states that the reasonable costs of administering the distribution may be paid out of the disgorged amount. While this makes sense where only a portion of the ordered disgorgement amount can be located and seized, it would unnecessarily shortchange victims' recovery in cases where a greater amount is accessible from the wrongdoer. We believe, therefore, that the CMA should provide the OSC with a full range of tools to do justice in this area, including the ability to impose a surcharge for an amount reasonably required to administer the distribution.

Penalty Limits – Q18

The proposed penalty limits ($5 million for OSC-imposed administrative penalties, $10 million for court-imposed fines) are in our view still too low. Many market frauds and manipulations greatly exceed those amounts today. The penalties should be calibrated in relation to the monetary harm done and adjusted upwards based on the return of a broad-based market index as a measure of the opportunity cost incurred by the investor.

While increased penalty limits may have a deterrent effect, they are not a substitute for robust and capable enforcement. The OSC must still prioritize enforcement and allocate resources accordingly.

Five-year review – Q9

While we think it important that the CMA be subject to regular review, we note there is little difference in substance between the review requirements in draft section 276 of the CMA and section 143.12 in the existing *Securities Act*. To ensure that reviews take place in future, and optimize the outcome, we recommend two measures:

- An independent expert panel should be tasked with continuously reviewing our capital markets regulatory system and reporting every 5 years (or more frequently if necessary). An ongoing mandate is appropriate, given the inherent complexity of regulation in this area and the pace of change impacting it. Additionally, continuous review would avoid concerns about findings and conclusions being rushed.

- The Ministry should consider including a sunset provision in the CMA to compel updating every five years.

Additional Designation Powers – Crypto

While we endorse the statement in the Consultation Paper that

> "[t]*he CMA includes broader designation powers and rule-making authority for the OSC intended to provide regulatory clarity to businesses with unique offerings and appropriate protection to investors*",

we are concerned that the CMA seems to restrict its regulation of crypto or other innovation within the confines of the investor protection provisions of the draft Act, as opposed to increasing protection in certain cases or even prohibiting certain "unique offerings" (or restricting them to certain categories of investors).

Perhaps more importantly, we are unclear about the application of the following statement made at Recommendation 32 [p. 25 of the Consultation Paper]:

> *"While there may be a benefit from OSC regulatory oversight of certain financial assets such as crypto assets that are not already securities or derivatives, there could be other assets or business models that raise fewer investor protection concerns and would not warrant regulatory oversight by the OSC*."

We also ask whether assessment of the need for regulation would be made with or without public consultation. Again, this is where the directives to promote innovation, support business interests and foster capital formation potentially come into conflict with the need to protect investors.

Civil Liability – Q12

We support the changes to civil liability provisions contained at section 183 of the draft CMA, with one caveat: the documents prescribed under this section should encompass every exempt offering provided for in the new legislation.

Secondary Market Right of Action

One aspect of the CMA's secondary market liability provisions potentially dilutes rights to recourse for investors. Subsection 227 (2) sets out the test for leave to commence a secondary market right of action. It is nearly identical to section 138.8(1) of the *Securities Act* except for one important difference: where that section makes it mandatory for the court to grant leave upon satisfaction of the test, section 227 (2) of the CMA appears to offer the court discretion ("may" vs "shall"). The secondary market liability provisions were created after years of consultation with stakeholders, and represent a carefully calibrated balance between all capital market participants. Nothing warrants upsetting this fundamental balance by importing an element of discretion into the test for leave to proceed.

Exchange Traded Funds (ETFs) - Q 28

While technically there is a difference between units of ETFs purchased in the primary versus the secondary market, investors do not see or appreciate that difference. We are of the view that there should be a single right of action that applies to any ETF holder that acquired units during the period of misrepresentation, regardless of whether the ETF was acquired in the primary or secondary market. The right of action should be substantially similar to the right of action for prospectus misrepresentation. Our answer to Q 29 below explains that the policy rationales for many of the restrictions under Part XIII of the CMA, such as the leave requirement and liability limits, do not apply with the same force, if at all, to the proposed right of action concerning ETFs. Accordingly, any liability limit imposed should be substantially higher than the one in section 226 of the CMA.

Exchange Traded Funds (ETFs) - Q 29

Question 29 of the Consultation Paper asks: of the two options set out in the Consultation Paper, which of the two would be more appropriate for Ontario capital markets? In our view, the second option is preferable (secondary market rights supplemented by prospectus rights).

A key policy rationale for imposing liability limits on secondary market claims and not primary market claims is that, in the case of an initial offering of securities, the issuer raises funds when it issues shares and benefits from the misrepresentation. That is not the case for secondary market claims. The issuer obtains no similar benefit when shareholders trade on the secondary market. This is one of the reasons cited for the liability limit and leave test in the background/consultation papers for Part XXIII.1 in the *Securities Act*.

ETFs are unique and do not fit well into either Part XXIII (primary market claims) or Part XXIII.1 (secondary market claims). This is because a purchaser of an ETF has no method of determining whether he or she acquired pursuant to a distribution (which is typically ongoing) or on the secondary market and should be indifferent to the source of the units. If purchasers of ETF units were to care about the source of their units there would almost certainly be market impacts.

Accordingly, the policy reasons for imposing liability limits and other restrictions on secondary market claims do not apply with the same force to ETFs and we would suggest that ETF purchasers should have secondary market claims supplemented by prospectus rights.

Exchange Traded Funds (ETFs) - Q 30

Question 30 of the Consultation Paper goes on to ask: "If Secondary Market Rights supplemented by Prospectus Rights would be more appropriate for Ontario capital markets, please identify the Prospectus Rights that persons or companies who purchased ETF units on an exchange should be deemed to have and explain why." We believe the right of action should include the following features:

1. The purchaser is deemed to have relied on the misrepresentation;
2. The liability limit should be increased as set out in response to Q 28 above;
3. There should be joint and several liability against all defendants; and
4. There should be no preliminary test for leave to assert the ETF misrepresentation claim.

Again, thank you for the opportunity to comment on the proposed Capital Markets Act. Please let us know if you require any clarification of our comments or wish to discuss these matters further.

Sincerely,

Neil Gross,
Chair, Investor Advisory Panel