CSA/ACVM

Canadian Securities Administrators | Autorités canadiennes en valeurs mobilières

CSA Notice 24-303

CSA SRO OVERSIGHT PROJECT

Review of Oversight of Self-Regulatory Organizations and Market Infrastructure Entities

Report of the CSA SRO Oversight Project Committee

December 2006

Table of Contents

CSA SRO OVERSIGHT PROJECT
Review of Oversight of Self-Regulatory Organizations and Market Infrastructure Entities

EXECUTIVE SUMMARY

A. Reliance on Self-Regulatory Organizations (SROs) and Market Infrastructure Entities and the CSA SRO Oversight Project

The Canadian regulatory regime has relied increasingly on self-regulatory organizations and market infrastructure entities such as exchanges and clearing agencies to protect investors and to promote fair, efficient and competitive capital markets. The securities commissions[1] enhanced the oversight programs for these entities in 1999. Prior to that, oversight focused on the review and approval of by-laws and rules. Since then, the Canadian Securities Administrators (CSA) have also reviewed the activities and status of these entities including: their resources and financial position, decisions, material changes to operations and reporting on regulatory activities. As the scope of CSA oversight has expanded, generally in line with the increasing regulatory role of the entities, they have become subject to heightened levels of monitoring and scrutiny.

The CSA SRO Oversight Project Committee[2] (Project Committee or we) was struck with a mandate to examine both strategic and operational issues regarding self-regulatory organizations and CSA oversight processes. The project focused on issues related to the current regulatory system and was not intended to be a broader review from first principles of the pros and cons of self-regulation. However, it does not preclude such a review in the future, if needed.

The Project Committee met with board and management representatives of nine SROs and market infrastructure entities[3] to discuss issues that included:

- The major challenges facing SROs and market infrastructure entities from a strategic perspective and the impact of major market changes on the nature of self-regulation;
- Governance, including how an SRO or a market infrastructure entity balances its public interest mandate and the interests of its members or participants;

---

[1] In this paper we use "securities commissions" and "commissions" when referring to the securities regulatory authorities.

[2] Members of the Project Committee are: Elaine Lanouette (AMF); Shaun Fluker (ASC); David McKellar (ASC); Robin Ford (BCSC); Doug Brown (MSC); Susan Wolburgh Jenah (OSC and Chair of the Project Committee); Antoinette Leung (OSC); Randee Pavalow (OSC); Cindy Petlock (OSC); and Ruxandra Smith (OSC).

[3] The SROs are the Investment Dealers Association of Canada (IDA), the Mutual Fund Dealers Association of Canada (MFDA) and Market Regulation Services Inc. (RS). The market infrastructure entities that participated in the project included: exchanges such as the Bourse de Montréal (Bourse) (including its wholly owned subsidiary, the Canadian Derivatives Clearing Corporation (CDCC)), the Toronto Stock Exchange (TSX), the TSX Venture Exchange (TSXV), the Canadian Trading and Quotation System Inc. (CNQ); a clearing agency, The Canadian Depository for Securities Limited (CDS); and an investor protection fund, the Canadian Investor Protection Fund (CIPF).

- The regulatory roles of SROs and market infrastructure entities;
- The role of the industry committees of an SRO or of a market infrastructure entity in the regulatory processes;
- How an SRO or a market infrastructure entity interprets and fulfills its public interest mandate; and
- The division of responsibilities among the SROs and market infrastructure entities, and that between the regulators and the entities they oversee.

This report summarizes the main issues we identified during the discussions and the Project Committee's recommendations to the CSA regarding those issues. The recommendations are not intended to be one-size-fits-all. The structure and functions of each SRO and each market infrastructure entity will impact on how each recommendation is applied.

B. How Do We Determine an Appropriate Level of Reliance?

As a general principle, the Project Committee believes that the CSA should increase the degree of reliance on SROs and market infrastructure entities where they can clearly demonstrate that they meet their public interest mandate and the high level standards in their recognition orders and related documents. Increased reliance might entail, for example, a less hands-on approach to oversight generally or less detailed analysis by the CSA of decisions and submissions (such as rules developed) of SROs and market infrastructure entities.

Public Interest Criteria

SROs and market infrastructure entities should always act either in accordance with, or not contrary to, the public interest. Each SRO and each market infrastructure entity should be able to demonstrate and explain in writing how it meets its public interest mandate when making regulatory decisions and, while they should remain flexible in determining how they meet this mandate, they should consider certain high-level criteria in the process, including:

- The decision would be in the interest of, or would not negatively impact, investors;
- The decision would not inappropriately stifle innovation or competition;
- The decision would not unfairly discriminate against certain types of businesses, participants, products or investors;
- The decision would appropriately balance investor protection and the efficiency of the capital markets; and
- Any other criterion that may be appropriate for the subject of the specific decision.

In addition, the SROs and market infrastructure entities must meet high-level standards covering areas such as governance, rule-making and membership. These standards are generally included in their recognition orders or related documents and include:

- Governance structure – an SRO or market infrastructure entity should have an appropriate governance structure that allows it to manage conflicts of interest and ensure different stakeholders are fairly represented;
- Rule-making and policy development processes – the processes for rule-making and policy development should foster investor protection and promote fair, efficient and competitive capital markets;
- Membership or access – an SRO or market infrastructure entity should have processes and policies for granting membership or access to its facilities or regulation services to prevent unfair discrimination among members and to avoid the creation of undue barriers to entry;
- Systems and controls – an SRO or market infrastructure entity should have systems and internal controls to ensure that it is carrying out its functions effectively and efficiently;
- Fees or costs – an SRO or market infrastructure entity's fee setting process should be fair and the fees proportionate to ensure the entity has adequate financial resources and staffing for performing its functions without creating undue barriers to entry;
- Information sharing and transparency – SROs and market infrastructure entities should, when appropriate, share information with each other and with the securities commissions to the extent possible under applicable laws, to ensure effective oversight, minimize duplications and inconsistencies, and maximize coordination; and
- Accountability to recognizing regulators – an SRO or market infrastructure entity must be accountable to its recognizing regulators by demonstrating that it is meeting its mandate and these high level standards.

Governance and regulatory processes are key areas where performance of SROs and market infrastructure entities can influence the CSA's level of reliance. In this report, we make recommendations in these areas, as well as on enhanced coordination, transparency and accountability.

Governance

Effective governance is, of course, a pre-condition to increased reliance. For this reason, SROs and market infrastructure entities need to demonstrate effective governance in order to allow the CSA to increase reliance on them. Effective governance structures require appropriate representation of independent or public directors on the board or other mechanisms, such as a Regulatory Oversight Committee, to help entities carry out their regulatory responsibilities without undue influence from their members or their commercial operations. The Project Committee also recognizes the importance of the board nomination process, and recommends that the SROs and market infrastructure entities review their existing board nomination and election processes and consider whether modifications are appropriate.

Enforcement Powers

SROs indicated that they currently do not have sufficient enforcement powers to carry out their regulatory functions in the most efficient and effective manner. The IDA,

MFDA and RS made a joint submission to the Ontario Five Year Review Committee to request certain statutory enforcement powers to support their jurisdiction and enforcement process. During the course of the CSA SRO Oversight Project, one SRO renewed its request for the following statutory powers:

- Authority to file disciplinary decisions with the courts;
- Power to compel third parties to produce documents and attend as witnesses during investigations and at hearings;
- Statutory immunity;
- Jurisdiction over current and former non-registered employees of members;
- Jurisdiction over current and former members and approved persons; and
- Power to seek judicial appointment of a monitor.

For jurisdictions where these powers are not already in place,[4] the Project Committee unanimously supports, subject to each jurisdiction's assessment of the appropriate timing for such a recommendation, the granting of the authority to file disciplinary decisions with the courts. Members of the Project Committee, other than BC, also support the granting of statutory immunity to SROs. In BC, statutory immunity already extends to the exercise of statutory functions authorized by the BCSC.

Although the Project Committee is not prepared to recommend that additional statutory powers be granted to the SROs at this time, we acknowledge the rationale for the SROs' request. The CSA will continue the dialogue with the SROs in order to review the appropriateness of these recommendations from time to time.

C. Gaps, Duplications and Inconsistencies

In our regulatory system, multiple SROs and market infrastructure entities have different jurisdictions and may oversee the same or different market participants. Inevitably there are some duplications, inconsistencies and gaps. The SROs acknowledged the increasing regulatory burden faced by their members and some made specific suggestions about how to reduce this burden. The Project Committee was also concerned that there may be a lack of clarity about the roles of the various SROs and market infrastructure entities.

Transparency of Role of SROs and Market Infrastructure Entities and Streamlining
We think that there should be increased cooperation among SROs and market infrastructure entities, and enhanced transparency regarding their roles and responsibilities. They should clarify and make public their respective regulatory roles and describe the processes in place to address duplications, inconsistencies and gaps between them.

SRO Consolidation
During the meetings held as part of the CSA SRO Oversight Project, it was noted that one way to deal with the inefficiencies associated with multiple SROs would be a merger

[4] Some jurisdictions already grant certain of these powers or protections, and did not revisit them in the course of the project.

among the IDA, MFDA and RS. The Project Committee recommends that any merger proposal assess the expected benefits of the merger against its anticipated costs and explain how the merger is in the public interest. In addition, to help guide CSA decisions on mergers, we propose a number of high level evaluation criteria.

D. Improving the Current Oversight Approach

The SROs and market infrastructure entities perform roles and functions that are important to the capital markets specifically, and to the economy generally. Oversight of these entities is necessary to establish and monitor their accountability and compliance with their public interest mandate.

The oversight of SROs and market infrastructure entities operating in multiple jurisdictions is a task that is shared among multiple regulators. The CSA have acknowledged the inefficiencies caused by the involvement of multiple regulators and have established formal memoranda of understanding (MOUs) and informal processes in order to coordinate oversight.

Oversight Reviews

For oversight reviews, which are generally coordinated to some extent, more consistency in the different approaches of the recognizing regulators could be achieved. One option is for staff from different recognizing regulators to work as a team in conducting oversight reviews.

At the same time, the CSA should establish clear, high level qualitative and quantitative performance benchmarks for the evaluation of the entities they oversee. Such benchmarks must be objective and meaningful. This will be a difficult challenge, but we are of the view that adopting such performance measures would improve the quality and consistency of oversight reviews.

For their part, each SRO and each market infrastructure entity should more meaningfully self-assess and document its efficiency and effectiveness in meeting its strategic plan and objectives, regulatory mandate, and any relevant high level standards and benchmarks. They should measure outcomes and not activities. This information would be used by the CSA in conjunction with the results of oversight reviews to evaluate the overall performance of the entities they oversee.

Review of rules

We recommend a more streamlined CSA rule review process, where the CSA would limit their review to material rule proposals. The CSA, SROs and market infrastructure entities would need to agree on criteria for what is “material” and to set out expectations on how the entities would assess and self-certify whether proposed changes to an existing rule or proposed new rules are material. The non-material rule proposals would be deemed approved at the end of a public comment period and there would be a process in place for periodic review of the appropriateness of the classification criteria and procedures.

E. Conclusion

More reliance on the increasingly mature SROs and, as applicable, market infrastructure entities, in carrying out their regulatory functions, may be appropriate. The challenge, however, is achieving a proper balance between reliance and oversight. To the extent that these entities demonstrate effective performance of their respective regulatory mandates, the CSA should take this into account in determining the appropriate level of oversight. The CSA will also review and improve their current oversight processes to streamline them and increase their overall efficiency.

I. ROLE OF SROS AND MARKET INFRASTRUCTURE ENTITIES IN A CHANGING ENVIRONMENT

A. The Principle of Reliance and the CSA SRO Oversight Project

Self-regulatory organizations and market infrastructure entities develop standards of practice and business conduct, monitor their members' or participants' compliance with these standards, and take appropriate enforcement actions against those who violate these requirements.[5]

The Canadian regulatory regime employs government regulation together with self-regulatory organizations and market infrastructure entities such as exchanges and clearing agencies to protect investors and to promote fair, efficient and competitive capital markets. Canadian securities legislation enables securities commissions to recognize self-regulatory organizations, exchanges and clearing agencies,[6] and encourages reliance on SROs.[7] Reliance on SROs is one of the objectives and principles of securities regulation of the International Organization of Securities Commissions (IOSCO), which states that "[t]he regulatory regime should make appropriate use of Self-Regulatory Organizations that exercise some direct oversight responsibility for their respective areas of competence and to the extent appropriate to the size and complexity of the markets".[8]

The SROs, specifically the IDA, the MFDA and RS, are recognized as self-regulatory organizations as defined in various jurisdictions' securities legislation,[9] and some jurisdictions have delegated to them certain powers under their securities legislation, such

---

[5] The current regulatory regime provides for parallel regulation of members and participants of these organizations and entities. For instance, securities commissions make general rules for dealers, while self-regulatory organizations make rules that are consistent but may be more restrictive on the same subject matter; therefore, both securities commissions and self-regulatory organizations may take enforcement actions against members.

[6] Part 4 of the *Securities Act* (Alberta) (ASA), Part 4 of the *Securities Act* (British Columbia) (BCSA), Section 14 of the *Commodity Futures Act* (Manitoba), Section 31.1 of the *Securities Act* (Manitoba), Part VIII of the *Securities Act* (Ontario) (OSA) and Title III of *An Act respecting the Autorité des marchés financiers* (Québec) (AMF Act) authorize the respective securities commissions to recognize self-regulatory organizations, exchanges and clearing agencies.

[7] For example, section 2.1 of the OSA states, in part, that "In pursuing the purposes of this Act, the Commission shall have regard to the following fundamental principles: ... 4. The Commission should, subject to an appropriate system of supervision, use the enforcement capability and regulatory expertise of recognized self-regulatory organizations."

[8] See *Objectives and Principles of Securities Regulation*, International Organization of Securities Commission, May 2003, page 12.

[9] The AMF Act does not define "self-regulatory organization", but states, in section 60, that: "A legal person, a partnership or any other entity may monitor or supervise the conduct of its members or participants...only if it is recognized…as a self-regulatory organization". The OSA defines "self-regulatory organization" as "a person or company that represents registrants and is organized for the purpose of regulating the operations and the standards of practice and business conduct of its members and their representatives with a view to promoting the protection of investors and the public interest." The *Securities Act* (BC) (2004) (not yet in force) defines a "self-regulatory organization" as "a person, other than a marketplace, that sets standards for, or monitors conduct of, its members or participants relating to trading in or advising on securities."

as registration and compliance functions.[10] Market infrastructure entities, which are exchanges, quotation and trade reporting systems, clearing agencies and compensation funds, operate facilities and systems to facilitate trading, reduce risk and improve the efficiency of the capital markets. They also set rules and monitor and enforce participants' compliance with these rules. Examples of market infrastructure entities are the Bourse[11], CNQ, TSX, the Winnipeg Commodity Exchange Inc. (WCE), CDS, CDCC and CIPF. Some of these entities are for-profit organizations, others are not, and some have competitors while others have monopoly positions.

The nature and degree of CSA reliance on SROs and market infrastructure entities varies across entities. Certain SROs (such as the Bourse, IDA, MFDA and RS) are expected to perform a broad range of front-line regulatory functions and identify, through their ongoing regulatory activities, concerns that will be referred to the securities commissions where appropriate (for example, an exchange may identify and refer potential insider trading). Other entities are limited to specific functions.[12]

Securities commissions conduct regular oversight of SROs and market infrastructure entities to evaluate their effectiveness, to confirm that they are acting in the public interest and to ensure that any conflicts of interest between the public and their members/users and any conflicts among members/users are properly managed. IOSCO's *Objectives and Principles of Securities Regulation*[13] and legislation in many jurisdictions[14] outline this oversight responsibility.

This report is the product of a review by the Project Committee to identify ways of improving the CSA oversight regime, to clarify the respective roles of SROs, market infrastructure entities and securities commissions, and to identify and analyze other current issues relating to self-regulation.

Between February 2005 and February 2006, the Project Committee held fact finding meetings with SRO and market infrastructure entity board and management representatives. The topics discussed at the meetings with the SROs and market infrastructure entities included:

- The major challenges facing these entities from a strategic perspective and the impact of major market changes on the nature of self-regulation;
- Governance, including how they balance their public interest mandate and the interests of their members or participants;
- The regulatory role of SROs and market infrastructure entities, as well as the role of their industry committees in the regulatory processes;

[10] The ASC, the BCSC and the OSC have delegated certain registration functions to the IDA; the AMF has delegated registration and inspection functions and powers to the IDA.
[11] We note that the Bourse is also a recognized SRO in Québec.
[12] CIPF performs certain oversight functions over the IDA's financial compliance activities. A proposed change in its role is described later in this paper.
[13] Principles of self-regulation in IOSCO's *Objectives and Principles of Securities Regulation* state that "SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities."
[14] For example, section 2.1 of the OSA.

- How these entities interpret and fulfill their public interest mandate; and
- The division of responsibilities among SROs, among certain SROs and market infrastructure entities, and between the regulators and the entities they oversee.

The CSA SRO Oversight Project covered issues related to the current regulatory system, and was not intended to be a broader review from first principles of the pros and cons of self-regulation or the appropriateness of reliance on SROs and market infrastructure entities. We note, however, that this project does not preclude such a review in the future, if warranted. The CSA will continue to analyze the relationship between the CSA, SROs and market infrastructure entities periodically and, in the process, will review other approaches to regulation.

During the same period, the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) each initiated a review of their self-regulatory system[15] and oversight regime. The CFTC commenced its SRO study in 2003, sought public comments in 2004[16] and 2005[17] and, in February 2006, conducted a public hearing on various aspects of self-regulation. The SEC published for comment, in November 2004, a concept release regarding self-regulation[18] and proposed regulations to improve self-regulation and regulatory oversight.[19] See Appendix A for a summary of the topics covered in the CFTC's and SEC's reviews. Neither the CFTC nor the SEC have concluded their studies at this time.

Recent studies in this area that precede this project include those conducted by the Ontario Five Year Review Committee and the Standing Committee on Finance and Economic Affairs (SCFEA).[20] Both Committees discussed the following topics:

- The potential conflict of interest due to an SRO's dual role as a trade association and a regulator;
- The role of self-regulatory organizations;
- Whether self-regulatory organizations and other market infrastructure entities should be required to be recognized by the securities commission; and
- Whether recognized self-regulatory organizations should have legislated enforcement powers.

See Appendix B for a further description of the issues raised in these reports. We note that other current publications also address some of these issues.[21]

---

[15] We note that the SEC and CFTC studies focused on the self-regulatory organizations that also operate markets.
[16] Release No. 4936-04.
[17] Release No. 5138-05.
[18] Release No. 34-50700.
[19] Release No. 34-50699.
[20] Ontario, Five Year Review Committee (Purdy Crawford, Q.C., Chair), *Five Year Review Committee Final Report: Reviewing the Securities Act (Ontario)*, March 21, 2003; and SCFEA, *Report on the Five Year Review of the Securities Act*, October 2004.
[21] For example, Autorité des marchés financiers, *Regulation of Derivatives Markets in Québec*, May 1, 2006 and *Ontario Commodity Futures Act Advisory Committee Interim Report*, May 26, 2006.

This paper summarizes the main issues we identified during our discussions with the SROs and market infrastructure entities and our recommendations for addressing them. Part II covers issues concerning reliance on and oversight of SROs and market infrastructure entities. Part III discusses gaps, duplications and inconsistencies resulting from multiple SROs and market infrastructure entities. Part IV discusses potential improvements to the CSA's oversight. Lastly, Part V discusses how the Project Committee's recommendations could be implemented.

B. The CSA's Oversight Experience

The CSA carried out a comprehensive review of their oversight programs in 1999. Prior to that, oversight focused on the review and approval of the by-laws and rules of an SRO or exchange. Since then, the CSA have also incorporated the review of a broader range of functions and activities of each SRO and market infrastructure entity into oversight programs. This includes reviewing the entity's resources and financial position, its decisions, any material changes to its operations and its reporting on its regulatory activities. The CSA have also established MOUs among themselves to coordinate their oversight activities to minimize disruptions to the entities they oversee.[22]

As the scope of CSA oversight has expanded, the SROs and market infrastructure entities have become subject to increasing levels of monitoring and scrutiny. Some have raised concerns regarding the nature and burden of the oversight, as well as the potential delays it causes, for example, due to the CSA approval process for rule proposals. There was also a view that the CSA's oversight approach should take into account the quality of the governance of the entities they oversee and, where merited, greater reliance should be placed on the entities' boards.

C. Changes in the Securities Industry and the Scope of the CSA SRO Oversight Project

Sweeping changes have taken place in the securities industry. For example, technological developments have facilitated the creation of new competitive market structures, such as alternative trading systems (ATSs); electronic trading has changed the nature of and access to the markets; and legislative changes have broadened the options available to market participants. To respond to the increasingly competitive environment, many exchanges, such as the Bourse, the TSX and the WCE, have demutualized and become for-profit organizations. In the U.S., the New York Stock Exchange has also demutualized, and questions have been raised about its governance

[22] Examples of these MOUs are the Memorandum of Understanding about the Oversight of Exchanges and Quotation and Trade Reporting Systems among the ASC, the BCSC, the CVMQ (now AMF), the MSC and the OSC, dated September 13, 2002; and the agreement on the Coordination of Oversight of the IDA by the CSA among the IDA, the ASC, the BCSC, the OSC, the NSSC and the SFSC, dated June 5, 2001 (IDA Oversight MOU) (The CVMQ, now AMF, participated in the drafting of the IDA agreement, and is co-operating with the other recognizing regulators in IDA oversight following the terms of this agreement, although it is not a signatory).

and oversight, raising broader issues about the regulatory framework of market self-regulation and pressures to re-examine that framework.[23]

Membership in the IDA and MFDA is no longer voluntary. This development recognizes the increasing importance of the role of SROs for investor protection and market integrity. Both large and small investors depend on the SROs to effectively use their resources in order to monitor the industry's compliance with applicable rules and requirements, and on the oversight by the CSA to monitor how the SROs fulfill their mandate. The CSA have increased their resources in the areas of member and market SRO oversight as the SROs have assumed more significant roles in protecting investors and market integrity. While this paper recognizes that the SROs should have appropriate independence in order to carry out their roles, it also acknowledges that the CSA must maintain an effective oversight role. Effective oversight depends upon clarity of roles, including a common understanding regarding the degree of reliance on SROs and the appropriate exercise by the CSA of their oversight authority.

II. HOW DO WE DETERMINE AN APPROPRIATE LEVEL OF RELIANCE?

In considering which criteria might help us to determine the appropriate level of reliance, the Project Committee considered the standards, oversight processes and mechanisms that would need to be in place, as well as the nature and functions of the entities. In our view, the high level standards that SROs and market infrastructure entities should meet include those set out below. When applying these standards, the CSA would take into account the particular structure and functions of each organization.

(1) Governance structure – an SRO or market infrastructure entity should have an appropriate governance structure that allows it to manage conflicts of interest and ensure different stakeholders are fairly represented;
(2) Rule-making and policy development processes – the processes for rule-making and policy development should foster investor protection and promote fair, efficient and competitive capital markets;
(3) Membership or access – an SRO or market infrastructure entity should have processes and policies for granting membership or access to its facilities or regulation services to prevent unfair discrimination among members and to avoid the creation of undue barriers to entry;
(4) Systems and controls – an SRO or market infrastructure entity should have systems and internal controls to ensure that it is carrying out its functions effectively and efficiently;
(5) Fees or costs – an SRO or market infrastructure entity's fee setting process should be fair and the fees proportionate to ensure the entity has adequate financial resources and staffing for performing its functions without creating undue barriers to entry;

[23] *Reinventing Self-Regulation, White Paper for the Securities Industry Association*, January 5, 2000 and updated by SIA staff on October 14, 2003, section I.

(6) Information sharing and transparency – SROs and market infrastructure entities should, when appropriate, share information with each other and with the securities commissions to the extent possible under applicable laws, to ensure effective oversight, minimize duplications and inconsistencies, and maximize coordination; and

(7) Accountability to recognizing regulators – an SRO or market infrastructure entity must be accountable to its recognizing regulators by demonstrating that it is meeting its mandate and these high level standards.

Generally, these standards are set out in recognition orders and related documents. To the extent SROs and market infrastructure entities are transparent in demonstrating how they meet their public interest mandate and achieve these high-level standards, the CSA can increase reliance and take a less hands-on approach in their oversight.

This part examines certain key factors that influence our views on the appropriate level of reliance, i.e, how SROs and market infrastructure entities interpret their public interest mandate, and the need for appropriate governance and regulatory processes for them to fulfill their public interest mandate. Lastly, this part examines SRO enforcement powers.

A. Public Interest

1. Overview

Although most of the recognition orders of the SROs and market infrastructure entities require them to make decisions "in the public interest", or in some cases, "not contrary to the public interest",[24] they do not have a clear set of criteria to guide them in meeting this requirement.

2. Definition of Public Interest and How SROs Meet the Public Interest

There is no "one-size-fits-all" definition of "public interest". The securities commissions' public interest mandate is generally interpreted in the light of their objectives to protect investors and foster fair and efficient capital markets and confidence in the capital markets.[25]

We recognize that the SROs' and market infrastructure entities' interpretation of their public interest mandate must be based on their objectives and functions. For this reason, the SROs' public interest mandates are the most consistent with that of the securities commissions, because they have the same objectives of investor protection and capital market fairness and efficiency. On the other hand, exchanges indicated that they focus

[24] RS (T&C 4(c) of the recognition order of RS' recognizing jurisdictions), TSX (T&C 3 of the OSC recognition order) and TSXV (T&Cs 4 and 30 of both the ASC and BCSC recognition orders) are required to operate or carry out their functions in or consistent with the public interest. The OSC recognition order for the MFDA states that protection of the public interest is a primary goal of the MFDA. In addition, the recognition orders or rule review protocols for the Bourse, the IDA, RS and TSXV require them to make rules that are not contrary to the public interest.

[25] This interpretation is derived from the mandates of securities commissions (e.g. the BCSC and the OSC) and the objectives of securities legislation in different jurisdictions (e.g. the ASC).

primarily on their participants' interests, the interests of the market and the end users. Similarly, a clearing agency noted its focus on the continuous operation and systemic risk of its clearing and settlement system, and on the safeguarding of its users' deposits. Given these differences, we believe that it is important that there be collaboration between the CSA, the SROs and the market infrastructure entities to ensure that the interpretation of their public interest mandate remains appropriate and appropriately aligned with that of the CSA.

While the board and the professional staff of the SROs and market infrastructure entities have a general understanding of their public interest mandate, our discussions revealed that the entities do not have a clear process in place to specifically evaluate and document whether they are meeting this mandate in their decision making. Some entities believed that they address the public interest through a governance structure that minimizes conflicts and facilitates diverse views and interests. Others stated that they meet their public interest mandate through consultation with the industry and the public.

The Project Committee considered whether all SROs and all market infrastructure entities should be required to meet the public interest mandate in the same manner or apply the same criteria when fulfilling the public interest mandate. However, we noted that different entities are responsible for providing different functions or services. For example, the traditional SROs are responsible for monitoring and enforcing their members' compliance with their rules; exchanges are responsible for operating fair and efficient markets; and clearing agencies are responsible for reducing systemic risk by providing effective clearing and settlement services. While we identified certain high-level criteria that SROs and market infrastructure entities should generally consider, the Project Committee concluded that it is not necessarily appropriate to expect all these entities to have the same objectives or to meet their public interest mandate in the same way.

Recommendations

Each SRO and market infrastructure entity should explain in writing how it ensures that it meets its public interest mandate generally. Going forward, for relevant decisions made (such as rules developed), an SRO or market infrastructure entity should explain how it has taken the public interest into account, and why a proposal for approval by the CSA is in the public interest. The following high-level criteria should be considered by all entities, however, the importance of each factor may differ for each SRO and each market infrastructure entity, and there may be other factors appropriate for the specific decision:

- The decision would be in the interest of, or would not negatively impact, investors;
- The decision would not inappropriately stifle innovation or competition;
- The decision would not unfairly discriminate against certain types of businesses, participants, products or investors;
- The decision would appropriately balance investor protection and the efficiency of the capital markets; and
- Any other criterion that may be appropriate for the subject of the specific decision.

B. Governance

1. Overview

The Project Committee believes that, for a CSA jurisdiction to rely on an entity it oversees, such entity must have a governance structure that ensures its mandate is met and is seen to be met. We considered whether specific elements of governance should be required for SROs and market infrastructure entities to ensure that they are properly addressing their public interest mandate and complying with their recognition orders. This section focuses on three specific governance topics: independent board members, regulatory oversight committees, and the board nomination and election process.

2. Independence

An SRO or market infrastructure entity faces potential conflicts of interest between its members/participants and the public, between different types of members/participants, and in some cases, between its commercial and regulatory operations. It must put in place mechanisms to address these conflicts and to ensure that it can conduct its regulatory functions in the public interest without undue influence from its members/participants or commercial operations. Two mechanisms that have been adopted by a number of entities for these purposes are: (a) independent directors to promote the independent operation of the board, and (b) a Regulatory Oversight Committee that oversees the regulatory functions (where the entity has both commercial operations and regulatory functions).

(i) Independent board directors

In Canada, SROs and market infrastructure entities are required to meet criteria relating to fair representation with respect to their governance structure. They must manage their conflicts properly and act independently of the industry, while taking into account the interests of their members, participants and the public in their decision making. We considered whether there should be a certain number or percentage of independent or public directors on such entities' boards.

For public companies, there is increasing support for a majority of the board to be made up of directors who are independent, and independence in this context generally means being independent from management and free from any interest or business relationship with the company.[26]

---

[26] *The Combined Code on Corporate Governance*, Financial Reporting Council, U.K., July 2003, *National Policy 58-201, Corporate Governance Guidelines*, CSA, June 30, 2005, and *Corporate Governance Listing Standards*, New York Stock Exchange (NYSE), November 3, 2004 (section 303A) contain the requirement for public companies to have a majority of independent directors on the board. This principle is also listed as a best practice in the following publications: *Beyond Compliance: Building a Governance Culture*, Joint Committee on Corporate Governance, November 2001; *Corporate Governance Guidelines for Building High Performance Boards*, Canadian Coalition for Good Governance, November 2005. Some best practices guidelines do not specifically require a board to have a majority of independent directors, but they suggest that a board should have a "sufficient" number or "strong presence" of independent non-executive directors to ensure that the board is capable of exercising objective independent judgement. These guidelines include *OECD Principles of Corporate*

The recognition order of each SRO and market infrastructure entity, other than CDS and the IDA, contains a condition that requires its board to have a majority of, or at least, 50% independent or public directors excluding the CEO. In addition, recognition orders or by-laws of most SROs and market infrastructure entities contain a definition of "independent director" or "public director".[27] An independent director would be a director that does not have a direct or indirect material relationship with the SRO or market infrastructure entity it represents. Generally speaking, a director would have a material relationship with the entity if such a relationship would be reasonably expected to interfere with the exercise of the director's independent judgment. Employees, associates, executive officers and directors of an entity's members or participant organizations are generally not considered to be independent. For TSX Group as a public company, the two concepts of independence, i.e. independence from management and free from any interest or business relationship with the company and independence from its participating organizations, are combined.[28]

The SEC has proposed rules that require a majority of the members of an SRO's board to be independent,[29] and defines an independent director as a director who has no material relationship with the entity or its affiliates that could reasonably affect the independent judgment or decision-making of the director.[30]

Not everyone agrees that a governance structure that requires at least 50% independent directors is necessarily appropriate for a market infrastructure entity that performs specialized functions, and for which directors must have a certain level of expertise in order to understand the operations, to ensure that any risks are properly managed and to provide constructive input to the board. The Project Committee, however, concludes that that an SRO or a market infrastructure entity must have a governance structure that has appropriate public or independent representation. We believe that, generally, the percentage of independent directors should be at least 50%. An independent director, as explained above, would have no direct or indirect material relationship with the entity.

We are, however, of the view that alternative governance structures may be appropriate, as long as the entity can show adequate independence of oversight of the regulatory functions and an effective board, that fair and effective representation of, or input from,

---

Governance, Organization for Economic Co-operation and Development, 2004, *ICGN Statement on Global Corporate Governance Principles*, International Corporate Governance Network, July 8, 2005, and The Commission of the European Communities, *Committee Recommendation of 15 February 2005*, (see http://eur-lex.europa.eu/LexUriServ/site/en/oj/2005/l_052/l_05220050225en00510063.pdf) .

[27] The definitions of public/independent directors are included in the recognition orders of the Bourse, CDS, CIPF, CNQ, MFDA, RS and TSX, and in IDA by-law 10.

[28] Board standards on the independence of directors for TSX Group and TSX are published at (2005) 28 OSCB 7287.

[29] In order to preserve the "self" in self-regulation, the SEC proposed to allow members of an SRO to select at least 20% of the directors.

[30] Proposed SEC Rules 6(a)-5(b)(12) and 15Aa-3(b)(13) contain specific circumstances in which a director would not be considered independent.

all stakeholders is achieved, and that there are mechanisms to ensure the public interest is addressed.

(ii) Regulatory Oversight Committee (ROC)

Another mechanism to enhance the independence of an SRO and the regulatory functions of a market infrastructure entity is to create an independent body within the entity to oversee its regulatory functions; in other words a ROC.

The use of a ROC is common in both Canada and the U.S. for entities that have both commercial and regulatory functions, especially exchanges. The Bourse, the Chicago Board Options Exchange, the Chicago Stock Exchange, the Chicago Mercantile Exchange, the Chicago Board of Trade, the National Stock Exchange, the New York Board of Trade, and the WCE have a ROC or an equivalent committee.[31] The IDA also has a ROC that oversees how the IDA is fulfilling its regulatory obligations.

In general, the mandate of the ROC is to oversee the performance of regulatory functions, ensure the adequacy of resources allocated to these functions, and review regulatory policy proposals. ROC members can be directors or persons appointed by the board[32] and most ROCs are composed of at least a majority of independent or public members.[33] The ROCs of the Bourse and the WCE report to the boards of these entities, and are also accountable to the regulators – they report annually to the AMF and the MSC respectively on regulatory matters.

The SEC has proposed that exchanges and SROs have a ROC that is composed solely of independent members and has certain specified responsibilities, similar to those noted above, with respect to regulation.[34]

We believe that a ROC that is responsible for overseeing the regulatory responsibilities of a market infrastructure entity is valuable when such an entity has both regulatory and commercial operations because of the significant potential conflicts between the regulatory and commercial operations. Since a ROC is charged with overseeing the regulatory responsibilities of an entity, including in most cases its commitment to fund those responsibilities, the ROC can lead to a greater degree of objective decision-making by this entity.

---

[31] The New York Stock Exchange had a ROC which was dissolved after the merger of the New York Stock Exchange and Archipelago Holdings, Inc. NYSE Regulation Inc., a separate legal entity from the exchange, has been set up to conduct regulation functions.

[32] Members of the ROC of each of New York Mercantile Exchange, National Stock Exchange, the Bourse and the WCE are non-board members who are appointed by the board.

[33] The ROCs of the Chicago Board Options Exchange, the Chicago Mercantile Exchange, the New York Board of Trade, and the National Stock Exchange are, and the previous ROC of the New York Stock Exchange was, composed solely of independent members. The ROCs of the Bourse, the Chicago Stock Exchange and the Winnipeg Commodity Exchange comprise a majority of independent members.

[34] Proposed SEC Rules regarding governance, administration, transparency and ownership of SROs that are national securities exchanges or registered securities association (release no. 34-50699), SEC, November 9, 2004.

We considered whether a ROC should be composed of 100% independent members. We recognize that, without industry members, a ROC may not have the right knowledge or expertise about the industry to effectively oversee the regulatory activities of the entity it represents. Also, it may be difficult for some, especially smaller entities, to find independent members that have the right skill set and expertise to participate in the ROC. We therefore do not recommend that a ROC must be 100% independent.

In order to ensure that a ROC has the authority to discharge its oversight function, we are of the view that it should report directly to the board. However, we do not believe it is necessary for the securities commissions to mandate specific responsibilities for a ROC. Each market infrastructure entity should have the flexibility to decide the specific responsibilities of its ROC and how it discharges its mandate.

Recommendations

Each SRO and market infrastructure entity must have effective governance, including processes to identify and manage conflicts of interest appropriately, to allow the CSA to increase their reliance on it. The following are examples of structures that would support effective governance:

(a) The board should generally have at least 50% independent directors, excluding the CEO, and an independent director would be a director that does not have a material relationship with the entity.

(b) A ROC should be established for any market infrastructure entity, such as an exchange or a clearing agency, or for any other entity with both commercial and regulatory operations.

(c) An entity may have an alternative governance structure that does not comply with recommendations (a) and (b); however, it should assess the appropriateness of having 50% independent directors or a ROC, and explain how its alternative governance structure would ensure effective and independent oversight of the entity and management of any conflicts of interest without such tools.

(d) A ROC should be composed of at least 50% independent members, who may be directors of the board or who may be appointed by the board.

(e) A ROC should report directly to the board to afford it with the necessary authority and independence to carry out its responsibilities.

(f) Communication lines should be open to facilitate a ROC's ability to raise any significant matters directly with the CSA.

3. Nomination and Election Process

Another governance issue that was raised related to whether an SRO or market infrastructure entity represents the diversity of interests of different members or participants. Some SRO members, especially regional or smaller members, have expressed concerns that their SROs are dominated by big players in the industry and their views are not properly represented. Most SROs and market infrastructure entities have processes in place to ensure that they do not unfairly disadvantage any member or group of members, or create undue barriers to entry.

One way to accomplish this is by ensuring that the board represents the diversity of their members or participants. The recognition orders of the Bourse, CDS, CNQ, MFDA, RS and TSX include a term and condition that reflects this requirement. For instance, the MFDA is required to select a board that reflects diversity based on the geographic locations of various members, sizes of its members' businesses, types of business, and members' ownership structures (such as small owner-operated firms, large independent fund company dealer groups). RS' board must have directors that represent the Canadian public venture capital market and ATSs.

The Bourse, CIPF, IDA, MFDA, and RS each has a board committee that is responsible for reviewing the qualifications of candidates and recommending candidates for election to the board. The nominating committee of RS is only responsible for nominating independent directors. For the IDA, members may nominate additional candidates for industry director positions. The nominating committees of CIPF, the IDA, the MFDA and RS present a slate of candidates for election.

The Organisation for Economic Co-operation and Development recommends that shareholders should have the right to participate in the nomination and election of board members.[35] The International Corporate Governance Network recommends that shareholders should have the right to nominate, appoint and remove directors on an individual basis.[36] The Canadian Coalition for Good Governance (CCGG) suggests that shareholders should be able to vote "for" or "against" individual directors, allowing the candidate who receives a majority vote to win, or, alternatively, a director should resign from the board if the number of shares withheld exceeds the number of shares voted in his/her favour.[37] The CCGG would also like to see slate voting eliminated eventually.[38]

We also reviewed the board nomination and election process for some not-for-profit member organizations, including the Institute of Chartered Accountants of Ontario (ICAO), the Law Society of Upper Canada (Law Society), and the CFA Institute. For the ICAO and the Law Society, any member can nominate candidates to stand for election. The CFA Institute has a board committee responsible for reviewing the qualifications of candidates and recommending candidates for election to the board; however, its members may nominate additional candidates to stand for election.

Corporate governance publications also provide guidance on how an entity should identify and select candidates. [39]

---

[35] *OECD Principles of Corporate Governance*, Organisation for Economic Co-operation and Development, 2004, page 18.

[36] *ICGN Statement on Global Corporate Governance Principles*, International Corporate Governance Network, July 2005, at page 4.

[37] Canadian Coalition for Good Governance Best Practices: https://www.ccgg.ca/web/ccgg.nsf/web/ccggbestpractices.

[38] Comments by CCGG reported by Janet McFarland in "For activist investors, it's all about who has the power: a priority of a watchdog group is to see slate voting ended in Canada", *Globe and Mail*, October 14, 2004.

[39] See, for example, *Beyond Compliance: Building a Governance Culture*, Joint Committee on Corporate Governance, November 2001; *The Combined Code on Corporate Governance*, Financial Reporting

Whatever system is used, an entity must demonstrate fair representation, address any constraints imposed by its recognition order (e.g. geographic diversity, size of members, etc.) and ensure that input from all members is encouraged and taken into account.

Recommendation
SROs and market infrastructure entities should, if they have not already done so, review their board nomination and election processes to ensure they meet current best practices and consider whether modifications are appropriate. In the process, these entities should review and consider alternative nomination and election processes.

C. Role of Members in the Rule-Making and Policy Development Processes

Members become involved in an SRO or market infrastructure entity's policy process in different ways: by participating in industry committees, through representation on the board, and by commenting on rule proposals.

We recognize the value of obtaining industry input in policy development through industry committees. The sectoral and regional input provided by these committees is at the heart of self-regulation. However, the roles of industry committees have differed and their mandates are not always clear. Some industry committees have only acted in an advisory capacity to provide feedback to either staff or the board on policy proposals, while others have had broader authority, such as setting standards and approving policy proposals. The Project Committee is not currently aware of any industry committees of SROs or market infrastructure entities that have the authority to veto their staff's proposals. However, there may be perceived conflicts where an entity has not made clear the role of its industry committees and demonstrated how it has considered the public interest in deliberations over regulatory matters.

Recommendation
SROs and market infrastructure entities should clarify and document, for both members/participants and the public, how they rely on their industry committees for input in the rule-making and policy development processes.

D. SROs' Enforcement Tools

1. Overview
The SROs made a joint submission to the Ontario Five Year Review Committee to request certain statutory enforcement powers to support their jurisdiction and enforcement processes. The Five Year Review Committee and the SCFEA both

Council, U.K., July 2003; *National Policy 58-201 Corporate Governance Guidelines*, CSA, June 30, 2005; *ICGN Statement on Global Corporate Governance Principles*, International Corporate Governance Network, July 8, 2005; and *Director Independence Policy*, New York Stock Exchange, February 2005.

recommended that the OSC review whether SROs should be given additional powers.[40] One SRO renewed its request for statutory enforcement powers as part of this project and its request was consistent with that made by all SROs to the Five Year Review Committee. Some jurisdictions already grant certain of these powers, and this report should not be construed to mean such jurisdictions are reviewing existing grants of authority.

2. Request for Statutory Enforcement Powers

The following statutory powers and protection were requested:

(a) Authority to file disciplinary decisions with the courts so that they have the same force and effect as if they were orders of the courts;
(b) Power to compel third parties to produce documents during an investigation and at a disciplinary hearing;
(c) Power to compel third party witnesses' attendance during an investigation and at a disciplinary hearing;
(d) Same statutory immunity from civil liability as that of the securities commissions and their staff for the SRO and its directors, officers and employees arising from acts done in good faith in the conduct of their regulatory responsibilities;
(e) Jurisdiction over current and former non-registered employees and agents of members;
(f) Jurisdiction over former members and former approved persons;
(g) Jurisdiction over current members and current approved persons; and
(h) Authority to seek judicial appointment of a monitor where there is risk of imminent harm to investors, the SRO or the industry.

3. Current Status

This section describes the powers that SROs and exchanges generally, and the IDA specifically, have in various jurisdictions. Exchanges and self-regulatory organizations recognized by the Alberta Securities Commission under the *Securities Act* (Alberta) (ASA) already have the following powers in Alberta:

(a) Authority to file disciplinary decisions with the courts so that they have the same effect as if they were orders of the courts;[41]
(b) Power to compel third parties to produce documents at a disciplinary hearing;[42]
(c) Power to compel third party witnesses' attendance at a disciplinary hearing;[43]
(d) Jurisdiction over former members and former approved persons;[44] and
(e) Jurisdiction over current members and current approved persons.[45]

---

[40] *Five Year Review Committee Final Report – Review the Securities Act (Ontario),* Five Year Review Committee, March 21, 2003, pages 114 to 116; and *Report on the Five Year Review of the Securities Act*, Standing Committee on Finance and Economic Affairs, October 2004, pages 19 to 20.
[41] Subsection 69(2) of the ASA.
[42] Subsection 69(1) of the ASA.
[43] Subsection 69(1) of the ASA.
[44] Subsections 63(3) and 64(5) of the ASA.
[45] Subsections 63(3) and 64(5) of the ASA.

In Québec, due to the AMF's delegation of registration and inspection functions, the IDA has certain of the requested enforcement powers and protection with respect to the delegated functions and powers. These include the following:

(a) Authority to file disciplinary decisions with the court – the IDA can request the homologation (i.e. grant of approval by an authority) of a decision rendered by virtue of its delegated powers, such that the decision becomes executory under the authority of the court that has homologated it;[46] and
(b) Statutory immunity from civil liability – this immunity is limited to the persons exercising the registration and inspection functions and powers delegated to the IDA by the AMF, not the IDA and all its directors, officers and employees in general.[47]

In BC, the IDA and any of its officers, servants or agents who perform the registration functions authorized by the BCSC also have statutory immunity with respect to those functions.[48]

4. Evaluation of Request

(i) Authority to file disciplinary decisions with the courts

The authority to file disciplinary decisions with the courts would ensure that the SROs' decisions have the same force and effect as a court decision, and it would increase the likelihood of the payment of penalties and, thus, the SROs' credibility. Since the Canadian regulatory system relies on self-regulation and, in certain jurisdictions, the legislation specifically supports the use of SROs' enforcement capabilities, enhancing their credibility would contribute to the credibility of the regulatory system. Despite these pros, concerns were raised as to whether it is appropriate to grant the SROs this authority, since they are not government bodies and they can impose higher penalties than the securities commissions. We note that each SRO's disciplinary process and the self-regulatory system has built-in protections for firms and individuals affected by their decisions, such as the ability of those affected to appeal to an SRO's board and to the securities commissions. In addition, the CSA's oversight process periodically examines the SROs' disciplinary process. As a result, the Project Committee supports the granting of this authority to the SROs in the jurisdictions where it is not already in place.

---

[46] Section 320.1 of the *Securities Act* (Québec) provides that "Every decision of the Authority or a person exercising a delegated power may be homologated at the request of the Authority by the Superior Court or the Court of Québec, according to their respective jurisdictions, at the expiry of the time prescribed for applying for a review of the decision before the Bureau de décision et de révision en valeurs mobilières, and the decision becomes executory under the authority of the court that has homologated it."

[47] Section 63 of the AMF Act provides that "No proceedings may be brought against an organization recognized by the Authority or any person exercising a function or power delegated by the Authority by reason of acts performed in good faith in the exercise of the function or power."

[48] Subsection 170(1) of the *Securities Act* (BC) (1996) (BCSA) provides immunity to a "designated organization" and its officers, servants or agents who administer the BC Act. The IDA is considered a designated organization because it is authorized under section 184(2)(e) of the BCSA to perform a duty (registration functions) of the executive director.

(ii) Power to compel third parties to produce documents

Without the power to compel documents from third parties, an SRO is not always able to gather the relevant evidence to continue with its investigation or disciplinary proceedings. However, the SRO that had renewed its request for this power acknowledged that for some cases it solicited and received assistance from commission staff to gather these documents without significant difficulties. The ability to compel documents from third parties would confer broad powers to SROs, and there is a concern that this would not be appropriate since they are non-statutory regulators with no direct accountability to the government. As a result, the Project Committee does not support adding the power to compel third parties to produce documents during investigations and at disciplinary hearings, in the jurisdictions where it is not already in place. However, the Project Committee is of the view that the CSA should streamline the process for the SROs to seek assistance, and the SROs should monitor and report to the CSA their enforcement experience to determine if further improvements are necessary.

(iii) Power to compel third party witnesses

As complainants may lose interest in pursuing their complaints and become hesitant to assist with an SRO's investigations and disciplinary proceedings after receiving satisfactory compensation, the lack of witnesses has prevented certain actions from moving forward. While commission staff may assist SROs in interviewing witnesses in order to gather evidence, their involvement leads to time delays in investigations as they need time to understand the case before they can proceed with the interviews. Similar to the power to compel documents from third parties, this power is very broad and raises the issue of accountability. The Project Committee, therefore, does not support the SROs' request for powers to compel third party witnesses during investigations and at disciplinary hearings in the jurisdictions where these additional powers are not already in place. However, we believe that the CSA's process for providing assistance to the SROs should be streamlined. Again, the SROs should monitor and report to the CSA their enforcement experience to determine if further improvements are necessary.

(iv) Statutory immunity from civil liability

In an increasingly litigious environment, there is a greater possibility that regulators, SROs and other market infrastructure entities that perform regulatory functions will need to defend their actions. In *Morgis v. Thomson Kernaghan & Co.*[49], however, the Ontario Court of Appeal held that the IDA did not owe a duty of care to any specific investor. Statutory immunity would avoid a chilling effect resulting from concerns of SRO staff that they could face liability for acts done in good faith. Since securities commissions rely on the SROs to regulate and discipline dealers, the SROs and their representatives should, arguably, have the same protection as the securities commissions and their staff. Members of the Project Committee, with the exception of BC,[50] support granting this immunity to the SROs. These Project Committee members are of the view

[49] *Morgis v. Thomson Kernaghan & Co.* (2003), 174 O.C.A. 104 (*Morgis*).

[50] Although BC does not support granting of broad statutory immunity to SROs and their representatives, it is not reconsidering immunity that is currently available to the IDA and its representatives for the registration functions authorized by the BCSC.

that, to the extent other market infrastructure entities need this protection in performing their regulatory duties, their application should also be considered.

(v) Jurisdiction over current and former non-registered employees and agents

SROs have no jurisdiction over non-registered individuals employed by their members, including those who work in certain key areas such as corporate finance and research. In addition, other non-registered individuals have pertinent information about a member's activities and could assist the SROs in their enforcement actions. Since SRO members are responsible for supervising their employees and agents, whether registered or not, we believe that a viable alternative to granting this power is for the SROs to impose requirements on members to require their employees and agents to submit to the SROs' jurisdiction or to co-operate with the SROs with respect to regulatory matters. As a result, we do not support the granting of this power at this time in the jurisdictions where it is not already in place.

(vi) Jurisdiction over former members and approved persons

The IDA and MFDA currently have jurisdiction over members and approved persons for a period of five years from the date they cease to be members and approved persons, according to their by-laws[51]. The IDA has acknowledged, in its submission to the Ontario Five Year Review Committee that, in a majority of cases, this contractual jurisdiction over its members is sufficient for it to fulfill its mandate.[52] However, this jurisdiction has been challenged. A recent decision of the Saskatchewan Financial Services Commission ruled that the IDA does not have authority over former members or former approved persons.[53] Despite the uncertainty in this area, we feel that the granting of such statutory jurisdiction to the SROs is not necessary at this time, in the jurisdictions where it is not already in place. The Project Committee encourages the other SROs, to the extent that they also have the tools (such as amendments to their by-laws and rules) to achieve these objectives, to use them as the IDA and MFDA have done.

(vii) Jurisdiction over current members and approved persons

Although there is a concern that the SROs' jurisdiction over current members and approved persons may be challenged in an increasingly litigious environment, as noted above, the IDA has indicated that contractual jurisdiction is usually sufficient for it to fulfill its mandate. As a result, we do not support the granting of this power at this time, in the jurisdictions where it is not already in place.

(viii) Authority to seek judicial appointment of a monitor

Current IDA By-law 20 provides the IDA with the authority to impose a monitor.[54] We encourage other SROs, to the extent they have tools (such as amendments to their by-laws and rules) to achieve the same objective, to use them for this purpose.

---

[51] IDA By-law 20.7 and MFDA By-law No. 1, section 24.1.4.

[52] This submission is located at: http://www.osc.gov.on.ca/Regulation/FiveYearReview/fyr_20040324_list_comments.jsp

[53] *MacBain, Neufeld, Smith v. Investment Dealers Association of Canada*, Saskatchewan Financial Services Commission, February 6, 2006.

[54] IDA By-law 20.46.

5. Checks and Balances to Ensure Procedural Fairness and Protections

The Ontario Five Year Review Committee recommended that the securities commissions consider what checks and balances, if any, are necessary to ensure that procedural fairness and protections would be available to those who would be subject to the new statutory powers. For the authority to file decisions with the courts, the protections in the SRO and court processes and the CSA's oversight of the SROs may be argued to be sufficient safeguards against any potential abuses by SROs in enforcing their decisions. For statutory immunity, we note that the current self-regulatory system provides the right for individuals who are affected by a decision of an SRO to appeal to the securities commissions. In addition, the CSA's oversight provides checks and balances on the SROs' processes and decisions. We, therefore, do not recommend additional checks and balances.

6. Application of Powers

We have not considered whether the statutory enforcement powers and protection we have recommended should apply to the other market infrastructure entities in the performance of regulatory functions. We recommend that any future request for additional powers made by market infrastructure entities, e.g. an exchange, be considered separately.

Recommendations

(a) Subject to the legislative priorities of each commission and each provincial government, the Project Committee recommends that the securities commissions recommend to their governments to grant the following statutory authority and protection to the IDA, the MFDA and RS in jurisdictions where they are not already in place:
   (i) The authority to file disciplinary decisions with the courts as decisions of the court; and
   (ii) Except in BC, statutory immunity from civil liability for the self-regulatory organizations and their directors, officers and employees (this presumes that the legislative power to grant immunity to a non-statutory entity for functions/powers that have not been specifically delegated exists).

(b) The securities commissions should streamline the process used to provide assistance to SROs to compel third parties to be witnesses and to compel documents from third parties during investigations and at hearings. The SROs should monitor their enforcement experiences, and report back to the securities commissions to allow the commissions to determine whether further improvements should be considered.

III. GAPS, DUPLICATIONS AND INCONSISTENCIES AMONG SROs

In our regulatory system, multiple SROs and some market infrastructure entities have different jurisdiction over the same or different market participants. Inevitably there are some duplications, inconsistencies and gaps. This section covers the following:

coordination among SROs and market infrastructure entities, duplications in regulation due to CIPF's oversight over the IDA, and the issue of SRO consolidation.

A. Coordination among SROs and Market Infrastructure Entities

1. Multiple SROs

In Canada, SROs have authority over their members or participants that is, for the most part, based on functions (such as member regulation) and products (such as mutual funds). As a result, the following overlapping environments exist:

- The IDA and RS both regulate investment dealers, but in different areas of activity. The IDA is responsible for member regulation generally and regulates the fixed income markets, while RS is responsible for equity market regulation. The distinction between member and market regulation may be unclear to those in the industry and to the public.
- The MFDA and the IDA perform similar types of member regulation, but for different entities and different products. The IDA regulates investment dealers and all types of trading, while the MFDA regulates mutual fund dealers and trading in mutual fund securities and/or exempt securities only.
- The Bourse, in its SRO capacity, and RS perform the same market regulation functions for different products, i.e., derivatives and equity securities respectively.

These overlaps and any resulting duplication or confusion may affect members' businesses and increase their compliance costs. In addition, inconsistencies in the approaches to regulation may exist, or each SRO may be separately dealing with issues where co-operation and coordination might lead to a less costly and more effective result.

The SROs and market infrastructure entities acknowledged the increasing regulatory burden faced by their members and some made specific suggestions or entered into agreements with one another aimed at reducing this burden. We think that, even though some SROs and market infrastructure entities have established MOUs to cover the allocation of duties related to certain regulatory functions, the coordination among them could be improved. During our discussions, some meeting participants also indicated that SROs and market infrastructure entities could make greater efforts to reduce duplication of regulatory activities and expressed their view that more cohesive and coordinated regulation by these entities would be beneficial.

In the past, some SROs and market infrastructure entities paid relatively little attention to processes to assess whether their rulebooks, as a whole, are streamlined and clear, and whether the rules are consistent and continue to be effective without creating any unnecessary burden on their members and participants. Recently, however, most entities have undertaken such analysis. We support this work.

2. Regulatory gaps

The SROs and market infrastructure entities also noted that there are gaps and inconsistencies in regulation. For example, an SRO may experience increased difficulty

in regulating its members as they expand into the distribution of alternative investment products that are either under the jurisdiction of another regulator (such as life insurance products), or distributed under a prospectus or registration exemption (such as hedge funds or guaranteed investment certificates).

Limitation of jurisdiction is also an issue for RS. As the regulation services provider to the equity markets only, and only for the marketplaces it regulates, RS may not obtain a complete and full understanding of the interrelationship of all the market activities (which may include derivatives trading) conducted by investment dealers. This raises concerns about the adequacy and effectiveness of cross-market and cross-product surveillance. The importance of coordinating with other regulators such as the Bourse is obvious.

Finally, inconsistencies may also occur in the regulation of the different participants in the mutual fund industry. For example, even though both mutual fund dealers and fund managers are involved in the distribution of mutual funds to the public, the former are subject to more rigorous oversight by the MFDA.

3. Public transparency regarding role of SROs and market infrastructure entities

Another concern in a system with multiple SROs and market infrastructure entities relates to the lack of clarity and transparency regarding their roles.

4. U.S. Developments

The existence of multiple SROs is also of particular concern in the U.S., where the regulators have implemented rules to deal with the inefficiencies caused by multiple SROs[55] with overlapping jurisdiction.

For example, where a member belongs to more than one SRO, the SEC must designate the responsibility to one SRO (designated SRO) for examining the member for compliance with applicable financial responsibility rules.[56] Similarly, the CFTC rules provide for cooperation among SROs and reserves for the CFTC a role in approving and monitoring this system of cooperation to ensure that it remains appropriate and that it works to strengthen customer protection in the futures markets.[57] Both the SEC and the CFTC rules require the SROs that were relieved of certain regulatory responsibilities by coordination agreements to notify their members of their limited responsibilities, once their coordination plans are approved by their regulators.

The SEC and the CFTC each recently acknowledged that their current system of reliance on a designated SRO needed even further improvement. In February 2004, the CFTC announced that it would begin a review of its designated SRO system, including its

[55] We note that in the US, the definition of an "SRO" includes exchanges.

[56] The *Securities Exchange Act of 1934* (Exchange Act) Section 17(d) and Rule 17d-1.

[57] Specifically, the Rule 1.52 of the *Commodity and Securities Exchange Act* states that the CFTC, after appropriate notice and opportunity for comment may, by written notice, approve such a coordination plan or any part of the plan if it finds that, among others, it: (1) is necessary or appropriate to serve the public interest; (2) is for the protection of customers; (3) reduces multiple monitoring and auditing for compliance with the minimum financial rules of the SROs submitting the plan; (4) reduces multiple reporting; and (5) fosters cooperation and coordination among the contract markets.

cooperative agreements and programs. Furthermore, in its concept release on self-regulation,[58] the SEC requested comments on alternate regulatory models that would help reduce the inefficiencies related to the large number of U.S. SROs. These alternatives, described in more detail in Appendix A of this paper, would entail a drastic restructuring of the U.S. regulatory system. The majority of respondents to the concept release thought that a more appropriate approach would be to continue with the current regulatory system, as long as measures are taken to improve it.[59]

Recommendations

(a) The SROs and, if applicable, the market infrastructure entities, should clarify their respective regulatory roles and describe the processes in place to address duplications, inconsistencies and gaps between them. As part of this process, they should establish, where appropriate, procedures for coordination and sharing of information in order to minimize the disruption and costs to the members, for example, for the purposes of intermarket surveillance, or for coordination of field reviews.

(b) SROs and market infrastructure entities should increase public transparency of their roles and responsibilities. This may include publication of any agreements and MOUs that set out their regulatory roles and the processes to address duplications, inconsistencies and gaps.

(c) SROs and market infrastructure entities should review their rules, by-laws and policies in order to ensure that they are clear and easy to understand, obsolete rules are deleted, and requirements are streamlined to facilitate compliance by members and participants.

(d) SROs and, as applicable, market infrastructure entities should co-operate more closely on substantive issues and regulatory approaches so they can minimize gaps, duplications and inconsistencies, address common operational issues (such as risk-based approaches to regulation or procedures to select firms for field reviews) and related best practices, and develop cost effective regulatory solutions to achieve common goals.

B. CIPF's Oversight Role over the IDA

1. Duplication between CIPF and IDA

Historically, there has been some duplication between the IDA's and CIPF's functions. Specifically, the IDA imposes prudential requirements on IDA members, and both the IDA and CIPF monitor their compliance with these requirements. In addition, both entities perform member examinations, review members' capital and capital calculations, as well as their monthly and annual financial reports.

[58] Release no. 34-50700.

[59] In this regard, the NASD and NYSE Group announced on November 28, 2006 the signing of a letter of intent to consolidate their member regulation operations into a new SRO that will be the private sector regulator for all securities brokers and dealers doing business with the public in the United States. The plan is aimed at increasing the efficiency and consistency of securities industry oversight.

Another area of duplication relates to the review of IDA proposals. CIPF reviews all of the IDA's prudential rule proposals in order to assess their impact on IDA members and on the risks to the fund, as well as to assess any implementation issues. However, the CSA also review the IDA's rule proposals in order to determine whether they are in the public interest by assessing, among other things, whether they might lead to unnecessary regulatory burden on firms or unduly restrict competition.

2. Proposed industry solution

To deal with these overlaps, the IDA and CIPF formed a joint board working committee, which met in January 2006 and reviewed and approved in principle a proposal to eliminate the duplications in regulation and oversight. The proposal addresses duplication in a number of areas, including field reviews of IDA members and rule proposal reviews. It aims to improve coordination on issues, such as risk-based approaches. It was approved by the boards of IDA and CIPF and reviewed by the Project Committee. The two entities are currently working on amending the appropriate documents to reflect this proposal and will make a formal submission to the CSA for review and approval by the securities commissions. It is the view of the Project Committee that this proposal will reduce duplications in the oversight of the IDA's financial compliance and policy functions.

Recommendation

The Project Committee supports the proposal of CIPF and the IDA boards. Once the two entities have finalized their proposal, they should submit to the relevant securities commissions for approval the proposal and consequential amendments to the Memorandum of Agreement between CIPF and the CSA, IDA Oversight MOU, CIPF approval orders and IDA recognition orders, as well as appropriate by-laws.[60]

C. SRO Consolidation

During the meetings with the SROs and market infrastructure entities held between February 2005 and December 2005, it was noted that one way to deal with the inefficiencies associated with multiple SROs would be a merger among the IDA, MFDA and RS. Some meeting participants shared their views regarding the benefits of a merger.[61] These views included:

(a) Consolidation would help streamline the regulatory regime and enhance the effectiveness of regulation;
(b) A merger between the IDA and RS would lead to more effective regulation because member and market regulation would be conducted by one SRO;
(c) Some issues of fragmentation of regulation would be addressed;

[60] At the time of this report, the IDA had submitted for CSA review and approval proposed amendments to by-laws 21 and 41 and Form 1 to reflect changes to CIPF's oversight role.

[61] On April 26, 2006, subsequent to the meetings with the SROs and market infrastructure entities held as part of the CSA SRO Oversight Project, the boards of directors of the IDA and RS announced their approval in principle of a proposal to merge. The two SROs established a joint steering committee that will work closely with the CSA and capital markets stakeholders to develop a detailed merger implementation plan that will be subject to approval by IDA membership, RS shareholders and the CSA.

(d) Firms would have lower compliance costs as a result of dealing with fewer SROs;
(e) There would be more opportunities for development of professional staff in a larger, more diversified organization;
(f) There would be less confusion as firms and investors would be dealing with a single SRO; and
(g) There would be fewer CSA oversight activities.

However, meeting participants indicated that any benefits associated with a merger should be carefully weighed against the costs before a decision is made.

A number of issues associated with a merger were also discussed during the meetings, and they included:

(a) Difficulties in combining SROs that have different regulatory structures, approval processes, governance structures and cultures;
(b) Difficulties in agreeing on an adequate governance structure for a consolidated SRO that has directors with adequate proficiency and expertise in all areas of regulation, and that ensures proper industry representation;
(c) Potential disruptions in the businesses of SROs and potential negative impact on staff morale;
(d) Difficulties in prioritizing issues in an SRO that represents members with different businesses and different cultures (such as investment dealers and mutual fund dealers);
(e) Difficulties in maintaining focus on market integrity issues in an SRO that also regulates dealers and may tend to focus more on dealer-specific issues;
(f) A merged SRO may not be as close to the market, is unlikely to be much cheaper, and might discourage the development and retention of staff with adequate expertise; and
(g) A merger may not be appropriate because the markets are increasingly complex, which means that SRO specialization may be needed for effective and efficient regulation.

Another possible merger discussed during the meetings was a combination of the two main compensation funds that currently exist in Canada - CIPF (for the investment dealer industry) and MFDA IPC (for the mutual fund industry). A merger between these funds would be beneficial since it would reduce confusion regarding the protection available to different investors, there would be efficiencies in the merged entity, and MFDA and IDA members would have an opportunity to consolidate their back office functions and therefore increase business efficiencies.

Recommendation
The CSA should evaluate any merger proposal to determine whether it is consistent with the public interest. The merger should not result in a diminution of the performance of the regulatory functions of the merging entities.

The criteria for evaluation should include whether:

1. The merged entity is able to perform its regulatory functions at least as effectively as the individual entities and ensures the continuing adequacy of services in the various regions and for the various marketplaces;
2. The governance of the merged entity is adequate for effective management and oversight, maintaining independence and addressing conflicts of interest, while also representing the membership or participants;
3. The impact on the costs to the industry, including fees, has been weighed against the benefits;
4. The merged entity would have staff with adequate proficiency to deal with different issues in different areas;
5. The impact of a merger on current service agreements, such as those performed by an SRO for another regulated entity, and those where the SRO outsources regulatory functions to others has been addressed;
6. There is regional accountability; and
7. The merger does not have a negative impact on competition and market structure.

As part of any proposal, the entities should:
1. Assess the expected benefits of the merger against its anticipated costs; and
2. Explain how the merger is in the public interest by addressing the criteria for evaluation identified above and any others considered to be relevant.

IV. EFFECTIVE CSA OVERSIGHT

A. Improving the Current Oversight Approach

1. Current oversight approach

SROs and market infrastructure entities perform roles and functions that are important to the capital markets. Oversight of these entities is necessary to establish and monitor these entities' accountability and compliance with their public interest mandate.

The oversight of SROs and market infrastructure entities operating in multiple jurisdictions is a task that is shared among multiple regulators. To reduce inefficiencies caused by the involvement of multiple regulators, the CSA have established formal MOUs[62] and informal processes[63] in order to coordinate their oversight.

A CSA staff oversight committee is in place for SRO oversight generally, with sub-committees for the IDA, MFDA and RS. An additional committee, the Market Structure and Exchange Oversight Committee, was created to deal with exchange oversight and market structure issues. The IDA, MFDA and RS committees are made up of staff from each recognizing jurisdiction dedicated to the oversight of the specific SRO. The intention of each of these three committees is to provide a single point of contact for the SRO to raise issues or concerns. They hold quarterly conference calls and annual in-person meetings to discuss issues and share information about oversight, with an

[62] See footnote 22.
[63] Staff of recognizing jurisdictions generally coordinate their efforts in reviewing and making recommendations with respect to issues relating to entities for which there are no MOUs in place.

objective of identifying and/or resolving any inconsistent approaches or inefficiencies in dealing with oversight or related regulatory issues. In addition, staff of the recognizing regulators for the IDA, MFDA and RS coordinate their review of the respective SRO's rule proposals, oversight reviews, and review of the SRO's reporting (such as periodic reports). The Market Structure and Exchange Oversight Committee members have annual in-person meetings and ad-hoc calls to deal with any issues that require coordination (such as matters affecting both TSX and TSXV).

2. Oversight review coordination

Staff of the recognizing jurisdictions of the IDA, MFDA and RS coordinate their oversight reviews by:

- developing a common review program;
- evaluating each office of the SRO using this common program;
- resolving inconsistent recommendations for common deficiencies; and
- conducting the review at each SRO office separately, but aiming to issue reports at the same time.

Reviews of entities under the lead regulator model are carried out by the lead regulators. The Exchange Oversight MOU requires the lead regulators to copy the results to the exempting regulators.

3. Rule review and approval

In order to coordinate their review and approval of rule proposals, the recognizing regulators of the IDA, MFDA and RS established joint rule review protocols for each SRO. The oversight of these SROs is carried out under a principal regulator model, whereby the principal regulator coordinates all comments from the other recognizing regulators and communicates them to the SRO. This coordinated process requires the principal regulator to attempt to resolve any inconsistent comments and recommendations with respect to the proposal. The process also provides a mechanism for staff to escalate different views to the commission chairs for resolution. Under the principal regulator model, some recognizing regulators with limited staff resources rely completely on the principal regulator. These recognizing regulators do not comment on or approve SRO rule proposals.

For market infrastructure entities under the lead regulator model (i.e. the Bourse, CNQ, TSX and TSXV), all exempting regulators rely on the lead regulator to review and approve a rule proposal. The exempting regulators do not require that these entities seek their approval, but they have the ability to raise material comments with the lead regulator.

4. Issues and options for improvement of oversight processes

The SROs and market infrastructure entities acknowledged that the efforts aimed at coordination have led to improvements, but they noted that inefficiencies still exist, for example:

(1) the additional time needed to resolve issues raised by different regulators on rule proposals and reviews conducted;

(2) remaining duplication in the oversight process;
(3) overly detailed reviews in some cases; and
(4) different views or different approaches to regulation by the securities commissions.

Entities regulated under a lead regulator model expressed the view that the model has simplified the oversight process and reduced the inefficiencies resulting from the involvement of multiple regulators. In the meetings it was noted that, although some improvements can be made, the lead regulator model works well, as it allows regulators to build expertise in a specific SRO and shorten turnaround times for rule proposals. One SRO, currently overseen under a principal regulator model, also thought a lead regulator model would be beneficial. Another noted that a drawback of the principal regulator model is that, given the coordination among the participating regulators and their efforts to funnel comments through the principal regulators, it is difficult to properly address issues raised without knowing where they originate.

Most CSA jurisdictions involved in oversight do not believe that the implementation of a lead regulator model for IDA, MFDA and RS is appropriate. In their view, as a result of the delegation of certain regulatory functions by the recognizing regulators to these SROs and/or the importance generally of the roles played by these SROs in their jurisdictions (where the major categories of registrants such as investment or mutual fund dealers are required to join one of the SROs), regulators need to retain direct oversight rather than relying entirely on another jurisdiction. Project Committee members agreed that, where the principal regulator model is used, further improvements should be made in order to address the legitimate concerns raised by the SROs.

One option we discussed was a mutual reliance system for oversight. Such a system would incorporate principles similar to those set out in National Policy 12-201 – *Mutual Reliance Review System for Exemptive Relief Applications.* It would not differ significantly from the current principal regulator model, but it would streamline oversight by requiring that the recognizing regulators raise only material comments on filings and applications that require their decisions (such as approval of rule proposals or amendments to the recognition orders) and by imposing strict timelines.

The underlying principles of the mutual reliance system for oversight are:

1. Non-principal regulators would raise only material issues within a specified period of time (for example, 10 business days) and would explain why these matters are material; material issues would be those issues which the non-principal regulators believe that, if unresolved, would be contrary to the recognition order or not in the public interest. Staff of the principal regulator would consider the material issues raised by the other recognizing regulators when recommending whether to approve the application.
2. SROs would deal only with the principal regulator regarding their applications and any material issues.

3. The principal regulator would communicate its decision regarding an SRO's application to the non-principal regulators. The non-principal regulators would have a specified period of time to agree with the decision or to ask for the decision to be escalated (to the Chairs or Vice Chairs) if they disagree with it.
4. Quarterly conference calls and annual in-person meetings of the various CSA oversight committees would continue to provide staff the opportunities to raise issues and share information about SROs and oversight.

In order to ensure that staff at each recognizing jurisdiction maintain their expertise on each SRO, the principal regulator role could be rotated among the recognizing jurisdictions. In determining how rotation could occur, we considered the following criteria:

- the rotation should minimize any loss of continuity of the relationship between SROs and the principal regulator;
- the process for rotation should be simple and clearly understood by SROs; and
- the timeframe should allow the different recognizing regulators to build expertise in overseeing SROs.

We also considered whether the principal regulator role could be rotated on an activity-by-activity basis (e.g. oversight reviews or rule reviews).

An appropriate rotation period for all activities might be five years, as this timeframe is long enough that it minimizes disruption while still allowing the recognizing regulator acting as principal to build expertise. Recognizing jurisdictions that have limited staff resources could opt to rely on other jurisdictions for oversight and not participate as a principal regulator. In addition, jurisdictions could opt for full reliance on the principal regulator, on a case-by-case basis.

The following sections of the paper describe the specific issues raised by the entities on the current oversight process. They include:

- oversight reviews;
- the process for conducting rule reviews;
- the approaches to regulation and policy interpretation taken by the securities commissions;
- issues related to the division of responsibilities between SROs or market infrastructure entities and regulators; and
- transparency of our oversight.

We also raise for discussion proposed options to address these issues. Where appropriate, we make specific recommendations.

B. Oversight Reviews

1. Nature of Oversight Reviews

Reviews are important tools for effective oversight, as they provide regulators with an opportunity to visit the places of business of the entities they oversee, meet with their personnel, ask questions, listen to their views and concerns, and examine files. The review findings are documented in reports, which constitute working documents for the use of the regulated entities' management, as they create a record of the findings brought to management's attention.

However, oversight reviews have limitations: in particular, they do not cover all areas or address all risks pertaining to the entities reviewed. Even though the reviewers try to get a thorough understanding of their operations, oversight reviews assess the performance of SROs and market infrastructure entities and how they meet their regulatory obligations mainly by reference to their terms and conditions of recognition.

The SROs and market infrastructure entities raised concerns about oversight reviews. They said that these reviews tend to focus more on detailed file reviews than on an entity's achievement of regulatory performance objectives. They suggested that the regulators should, instead, evaluate how the entities meet higher level performance standards. They also recommended that the criteria or benchmarks used to evaluate the SROs and market infrastructure entities be articulated and shared with them in order to clarify the regulators' expectations.

As self-regulation and regulatory oversight have matured, the nature of reviews should evolve accordingly. We agree that the CSA should establish clear, high level qualitative and quantitative performance benchmarks for evaluation. Such benchmarks must be objective and meaningful. This will be a difficult challenge, but we are of the view that adopting such performance measures would improve the oversight process. In fact, the IDA is currently working with a consultant to establish qualitative benchmarks for its performance. We expect that they will share the results of that work with us.

Another way to enhance oversight and address the limitations of reviews is by improving the other oversight tools already available and our use of such tools. For example, while some SROs prepare annual self-assessments and file them with their recognizing regulators, the usefulness of the information contained in these documents is limited. The focus is often on activities rather than outcomes and, while there is a limited assessment of the adequacy of an SRO's processes and procedures, there is no assessment, based on qualitative criteria, of the effectiveness of the SROs in meeting their regulatory mandates in general, and their recognition orders in particular. Furthermore, self-assessments do not report on how an SRO achieved its own strategic goals, nor do they show important year-to-year trends.

The Project Committee is of the view that, if enhanced, the information included in self-assessments would complement the oversight reviews and help regulators get a clear and complete picture of the efficiency and effectiveness of SROs and market infrastructure entities. Such self-assessments would also provide us with more meaningful information that would allow us to improve the nature of oversight reviews and ensure that they focus on the entities' high priority and high risk areas.

Recommendations

(a) The CSA, SROs and market infrastructure entities should establish a working group to review the high level standards described at the beginning of Part II of this paper and to develop qualitative and quantitative criteria or performance benchmarks to evaluate the SROs and market infrastructure entities against those standards, as well as to evaluate CSA oversight. A facilitator or consultant should be retained to help ensure that these benchmarks are both meaningful and objective and, to the extent that SROs and market infrastructure entities already have performance benchmarks in place, they should be considered in the process.

(b) These benchmarks will be used to evaluate SROs and market infrastructure entities in oversight reviews, and to help focus CSA resources on the high-risk areas of the entities they oversee. The criteria would be clearly communicated to them in advance.

(c) The continuing appropriateness of the high-level standards referred to above should be evaluated periodically, taking into consideration results of oversight reviews.

(d) The SROs and market infrastructure entities should more meaningfully self-assess and document their efficiency and effectiveness in meeting their strategic plan, their regulatory mandate, and any relevant high level standards and benchmarks.

(e) The information included in the enhanced self-assessment should be used by the CSA in conjunction with oversight reviews to evaluate the overall performance of the entities they oversee and to assess whether the degree of reliance and the extent and nature of oversight of the SROs and market infrastructure entities remain appropriate.

2. Process for Conducting Oversight Reviews

Even though oversight reviews are currently coordinated as discussed above, a number of entities believe that the recognizing regulators can improve their processes. The most significant concern raised was regarding the different approaches taken by regulators when conducting these reviews. The SROs and market infrastructure entities told us that the regulators should have consistent approaches, for example, on the scope of their reviews and, as discussed later in this report, on publication of reports. For related entities (such as TSX and TSXV), the nature and scope of the oversight reviews should be consistent when their policies, processes and structures are the same. Other entities noted that securities commissions have recommended different solutions to address the same deficiencies. One SRO thought that regulators could issue a single oversight review report, in order to avoid contradictory recommendations in different jurisdictions.

One way to accomplish more consistency is for staff from different recognizing regulators to work as a team in conducting oversight reviews. This “mixed team” approach would entail the following:

- Teams composed of staff from different recognizing regulators would conduct oversight reviews at each SRO or market infrastructure entity district office.
- Each team would evaluate each district office using the same review program, and using the same examination approach.

- Each of the mixed teams would agree on the recommendations for deficiencies noted.

The advantage of this mixed team approach is that individuals from different CSA jurisdictions working as a team would have the opportunity to better understand each other's concerns and objectives (which should be consistent with those of their respective commissions) and would coordinate to reach a consistent approach that addresses everyone's concerns. Further, the inconsistencies may be decreased.

The disadvantages include the following:

- The likelihood of inconsistencies would not be completely eliminated, since, in an environment with multiple regulators, there will be different views and priorities, which may sometimes be conflicting. As a result, there would still be delays in the process caused by dealing with issues raised by different regulators and there would be a need for a conflict resolution process.
- This approach would require staff from different jurisdictions to travel to other jurisdictions, increasing the cost and time of a review. Furthermore, some staff may not be able to travel for extended periods of time.
- Different recognizing regulators follow different approaches with respect to the publication of oversight review reports, which means that regulators that follow different approaches would not be in a position to issue a single oversight report. The mixed team approach, therefore, could complicate the process of issuing oversight review reports for different branches.

We are of the view that the CSA jurisdictions should continue their efforts to improve their coordination of oversight reviews to address issues raised by the entities they oversee. Although the above mixed-team approach has shortcomings, we believe it serves as a starting point for considering other alternatives for improving coordination.

C. Review of Rule Proposals

1. Timeliness and the level of review of rule proposals

As set out above, the review and approval of SROs' rule proposals is coordinated among the recognizing regulators for the IDA,[64] the MFDA[65] and RS.[66] The lead regulator for the exchanges reviews and approves their regulatory proposals.[67] Recently, the OSC also implemented a rule review protocol for CDS.[68]

---

[64] The joint rule protocol for the IDA (IDA Joint Rule Protocol) is set out in the *Coordination of Oversight of the IDA by the CSA Plan* adopted in June 2001.

[65] The process for review and approval of the MFDA rules is set out in a draft protocol, implemented on a pilot basis. The draft protocol will be finalized upon completion of the SRO Oversight Project.

[66] The joint rule protocol for RS is part of the *Memorandum of Understanding regarding Oversight of Market Regulation Services Inc.* between RS' recognizing regulators implemented in May 2002.

[67] The process for OSC review of TSX rule proposals is set out in the *Protocol for Commission Oversight of Toronto Stock Exchange Rule Proposals* (TSX Rule Review Protocol) adopted in October 1997. For the Bourse, the rule review process is set out in provisions of the AMF Act.

[68] In July 2005, the OSC amended the recognition and designation order of CDS and included a rule protocol for review of CDS rules.

Despite the efforts to coordinate, one of the concerns expressed by most of the entities that participated in the CSA SRO Oversight Project related to the delays and the high degree of scrutiny in the CSA's review and approval of their rule proposals. This was a matter of particular concern for the exchanges and for RS. They said that a lengthy rule review and approval process (for both exchange rules and the UMIR) has a negative impact on the integrity of their markets and thus put the public and the reputation of their markets at risk. Some meeting participants also indicated that processes should not interfere with the business decisions of the exchanges in a way that would restrict their international competitiveness. While other entities shared the concerns about delays, they acknowledged that complex rule proposals would require more detailed and lengthy reviews.

Furthermore, for certain market infrastructure entities for which rule amendments are needed to implement system changes, the rule review process needs to take into account the strict delivery dates associated with such changes. The rules of these entities may also be very technical, and specialized expertise and experience of commission staff involved in their review is needed. For these reasons, commission staff should be involved as early as possible in the process to develop required expertise and eliminate the need for a long review and approval process subsequent to the submission of the rule proposal. One entity underscored the importance of ongoing communication to ensure that commission staff's expertise remains current.

During the meetings, the desirability of a process to fast-track certain types of rules was discussed. One entity suggested that the CSA do not need to review and approve all regulatory proposals.

While some of the delays are due to the additional time needed to coordinate the rule review among recognizing regulators under a principal regulator model, the meeting participants have also attributed some of the delays to the high degree of scrutiny to which commission staff subjected their rule proposals. They believe that securities commissions should rely on the SROs' and market infrastructure entities' expertise and their policy development process. One entity recommended a process that would involve the CSA only on an exceptional basis, and only when the entity did not follow due process.

2. U.S. Approach

In the U.S., the rule review process by regulators is more streamlined. For example, the SEC process provides for different levels of review of SRO rule proposals, depending on their nature. With the exception explained in the next paragraph, all regulatory proposals submitted by SROs are published[69] and approved by the end of the comment period

[69] SEC rule 19(b)(1) of the Exchange Act requires the SROs to file all new rules and proposed rule changes with the SEC. Upon filing, the SEC must publish for comment notices of the new rule or proposed rule change describing its substance and a description of the issues involved. The comment period is 35 days from the date of publication of the notice of filing (and may be extended to a maximum of 90 days if appropriate).

unless proceedings have been instituted by the SEC to determine whether they should be disapproved. The deadlines for these proceedings are strict.[70]

Certain regulatory proposals designated by SROs as being housekeeping in nature[71] need not be published, are approved by the SEC upon filing and may be implemented by the SROs immediately. The SEC may abrogate rules implemented in this fashion within a limited time period. Furthermore, proposed rule changes may be put into effect summarily if the SEC believes that such action is necessary for the protection of investors, the maintenance of fair and orderly markets, or the safeguarding of securities or funds.

In 1998, the SEC's Office of Inspector General conducted an audit of the SEC's process for review of SRO rules to assess their adequacy.[72] The findings show that, overall, the SEC's process was efficient and effective. The deficiencies identified related to: time delays in the rule review and approval by SEC staff;[73] inadequate documentation of review and approval of rules; lack of written justification for delays in rule review; and inadequate recordkeeping for rule filings. The report recommended that communication with SROs be enhanced in order to ensure that they are clear on the rule review procedures.

The CFTC process for review and approval of rules by designated contract markets and registered derivatives clearing organizations is even more streamlined.[74] The process, which applies to any of these entities' rules (including operational rules or terms and conditions of products listed for trading on the exchanges), with one exception,[75] allows them to adopt new rules or amend existing ones without prior CFTC approval,[76] as long as they certify that the rule complies with the *Commodity Exchange Act*. The SROs must file their self-certified submissions no later than the close of business on the business day preceding the implementation date of the rule proposal. The CFTC may stay the effectiveness of a rule implemented in this fashion if it decides that the SROs filed a false

[70] Rule 19(b)(2) of the Exchange Act requires the SEC to either: approve a proposal by the end of the comment period, or institute and conclude a proceeding to determine whether the proposed rule change should be disapproved, within 180 days following publication.

[71] Such rule changes: (i) constitute a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule of an SRO; (ii) establish or change a due, fee, or other charge imposed by the SRO; or (iii) concern solely the administration of the SRO or other matters that the SEC, by rule, must specify.

[72] *Commission Review of Self-Regulatory Organization Rules* Audit Report No. 272, July 14, 1998.

[73] The report indicates, however, that the oldest filings related to complex and/or controversial proposals, which led to a longer review period.

[74] The CFTC process is set out in CFTC regulations 38.4 and 40.6. The SROs' rule submissions must include: the text of the rule; the date of expected implementation; and a brief explanation of any substantive opposing views expressed to the SRO by its board or committees or members, if changes due to these comments were not incorporated in the rule.

[75] The only rules and rule amendments of Designated Contract Markets that are not eligible for self-certification are those that materially change a term or condition of a contract for future delivery of an agricultural commodity enumerated in section 1a(4) of the Commodity Exchange Act, or an option on such a contract or commodity in a delivery month having open interest.

[76] CFTC Rule 40.5 allows the SROs to voluntarily submit rules for CFTC's review and approval. The CFTC must deem the rules approved 45 days after their receipt, or later if an extension is needed.

certification. The SROs may implement certain rules or rule amendments without filing them with the CFTC, as long as they notify the CFTC on a weekly basis, and may implement others without either self-certification or notice to the CFTC.

One concern regarding this approach relates to its lack of transparency. For example, one respondent to the CFTC request for comments on self-regulation and SROs noted that members do not have a chance to comment on SROs' rules, as they are implemented without a public comment period. This comment was reiterated at a recent hearing on self-regulation held by the CFTC on February 15th, 2006. However, one of the SROs present at the hearing indicated that, due to the need to keep up with the fast moving markets and to be able to implement rules quickly, adding a comment period after filing with the CFTC would be impractical. It added that members may comment through committees, in the rule development process.

3. Self-certification by Canadian SROs and market infrastructure entities

Despite the differences in the protocols for rule reviews currently in place for Canadian entities, the Project Committee members noted that most SROs and market infrastructure entities are required to state in their submissions whether the proposals are material in terms of their impact on investors or market participants. For example, the IDA Joint Rule Protocol requires the IDA to assess whether the regulatory proposals it submits for CSA approval are either "public interest" (if the IDA's board believes that they affect the application of the securities legislation or could affect investors, issuers, members, registrants or the capital markets in any province or territory of Canada) or "housekeeping" (if they fall outside the definition of public interest rules). Similarly, the TSX Rule Review Protocol requires the TSX to classify its rule proposals as public interest or non-public interest. Public interest rules are those which, in the opinion of TSX, impinge upon the application of Ontario securities law or have a material impact, positive or negative, on public investors, listed or unlisted companies or non-member registrants.

In practice, in our view, the analysis provided by the SROs and market infrastructure entities to support their assessment of whether the proposals were of a public interest or housekeeping nature has often been insufficient. This may be due to a lack of understanding of the criteria for classification of rule proposals as "public interest". The entities that want the CSA to reduce their detailed review of rule proposals will need to focus more on this area in future.

In addition, in our view the CSA's rule review and approval process should be streamlined, but should remain transparent and allow for public review and comment. If the CSA adopts a mutual reliance system for oversight, the principles behind this model would be applied in the rule review process.

Recommendations

1. The CSA, SROs and market infrastructure entities should work together to agree on criteria for what is "material", as follows:
   (a) The CSA should set out their expectations on how the SROs and market

infrastructure entities would assess and certify whether proposed changes to an existing rule or proposed new rules are material;

(b) The criteria for assessing materiality should take into account whether the proposal impinges on the application of securities law or could have a significant impact (positive or negative) on investors, an SRO's members, or other market participants.

2. Once the criteria for materiality are agreed upon, the CSA should revise the rule review processes for the SROs and market infrastructure entities to ensure better coordination of substantive comments from the CSA jurisdictions and transparency of the rule review processes, as follows:

(a) The entities would be required to assess and certify whether proposed changes to an existing rule or proposed new rules are "material" or not, based on the agreed-upon criteria;

(b) They would be required to publish *for comment* all rule proposals, whether material or not (except for rules of a purely housekeeping nature, which would follow the process set out in (c) below), for at least 30 days, and to address any public comments received;

(c) The entities would publish for information only, without prior public consultation, rules of a purely housekeeping nature, such as changes to correct spelling, punctuation, typographical or grammatical mistakes or inaccurate cross-referencing or stylistic formatting (the frequency of publication would be determined by the SROs or market infrastructure entities and the notice to the public would state that the amendments are purely housekeeping and that no approval by the CSA is needed);

(d) Generally, the CSA would rely on the SROs' or market infrastructure entities' classification of rule proposals; however, the CSA could object to the classification of non-material rule proposals before the end of the comment period on the ground that it is material;

(e) Material rule proposals would follow the normal course of review and CSA staff would only raise substantive comments, as long as the submissions made by the SROs or market infrastructure entities to support approval are comprehensive and substantiated with adequate analysis, including analysis of the public interest impact;

(f) Non-material, non-housekeeping rule proposals would be deemed approved at the end of the comment period;

(g) Rules of a purely housekeeping nature would not need to be approved by the CSA; [77]

(h) The process and criteria for the SROs' and market infrastructure entities' rule development and their classification would be evaluated through the ongoing oversight process periodically; and

(i) The SROs and market infrastructure entities would include appropriate analysis in submissions on rule proposals.

D. Inconsistent Approaches to Regulation and Policy Interpretation

[77] The AMF notes that legislative amendments would be necessary in order to implement this new process in Québec.

In the meetings, we discussed situations where the different securities commissions had inconsistent approaches to regulation due to different requirements. For example, with respect to distribution of exempt securities, the OSC and the Securities Commission of Newfoundland and Labrador require a Limited Market Dealer registration, the BCSC imposes a due diligence requirement, and the ASC issues orders depending on the products involved. Sometimes there are different interpretations of the same securities requirements. For example, some jurisdictions consider interests in land to be securities, while others do not, even though the definitions of "securities" under their respective legislation are similar. These differences lead to difficulties in compliance with regulatory requirements for dealers operating in multiple provinces. Increased dialogue and coordination among securities regulators is therefore necessary in order to manage such inconsistencies.

Recommendations

(a) There should be increased dialogue and coordination among the securities regulators in order to ensure that inconsistencies in interpretation and legislation are managed to the extent possible. This may include ongoing discussion of emerging issues or new products and the securities regulators' approaches to regulating them.
(b) The recognizing regulators should invite the SROs and market infrastructure entities to meet with their commissioners (or, in the case of the AMF, their equivalent) on an annual basis in order to discuss and exchange views on regulatory issues.

E. Lack of Clear Criteria for Division of Responsibilities

During the meetings, we asked the participants whether, in their view, there are any duplications in the regulatory activities carried out by them and the CSA. We received comments with respect to the enforcement functions. Some SROs expressed concerns that, in areas of concurrent jurisdiction, particularly in enforcement, there is confusion or differences of view regarding respective roles. There are no clear criteria for determining who has primary responsibility for enforcement matters where there is overlapping jurisdiction between an SRO and its recognizing regulators. We agree that further clarification of roles is needed for enforcement.

Recommendation

The CSA and the SROs should establish criteria for deciding which enforcement cases the commissions take on, and which cases the SROs will carry with assistance from the commissions as necessary. Such criteria would be used to allocate cases to be investigated by the respective entities and outline the process for referral between them.

F. Transparency of Oversight Activities

In recent years, some of the recognizing jurisdictions started increasing the level of transparency regarding certain of their oversight activities by publishing the oversight reports of SROs and the SROs' responses in their entirety. This approach was a practical

response to requests for SRO oversight reports made under the applicable *Freedom of Information and Protection of Privacy Act*.

The approach to publication remains, however, inconsistent across jurisdictions. For example, the BCSC and ASC publish oversight review reports on all the SROs they review in their entirety. The OSC, which historically kept oversight reviews in confidence, is re-considering publication. The AMF and NSSC do not publish oversight review reports at all, because they believe that oversight reviews should be conducted in confidence to avoid a potential chilling effect in the review process caused by publication.

One concern raised was that, if an entity is reviewed by jurisdictions that subsequently publish their oversight review reports, the public might mistakenly conclude that it had more deficiencies and needed to be subject to more rigorous regulation as compared to other entities, for which review reports were not published.

We reviewed the current approaches for publication and noted that there are advantages and disadvantages to each. For example, publishing oversight reports in their entirety gives the public a complete picture of the results of oversight reviews. However, in addition to those noted above, disadvantages include:

- issues disclosed in a published report may be taken out of context and misinterpreted by the public;
- confidential information contained in the reports may negatively affect their competitive position; and
- new entities would likely have more deficiencies in their early years of operations and it would not be fair to publish the first oversight review report.

Further, reviews constitute only one component of oversight and their publication may overshadow other components, such as reviews of rule proposals and other initiatives, and self-assessment reports.

Finally, publishing oversight review reports in their entirety may cause recognizing regulators to limit the scope of the reviews to areas that can be tested more objectively, such as operational and process-related matters. While this may reduce the possibility that review results are misinterpreted by the public, it may also make it difficult to include findings of a more qualitative or sensitive nature in a published report.

Publishing a report of all oversight activities would help inform the public of the full scope and nature of oversight, but might also lack findings of a more qualitative or sensitive nature. In addition, such a report may not include the level of detail regarding oversight activities that the public may want, for example, because it would only include important findings related to oversight reviews.

Keeping reports confidential may contribute to more openness of staff of entities subject to oversight in dealing with the CSA, especially through the oversight review process, as confidentiality prevents the publication chilling effect.

Since the CSA rely on the IDA, the MFDA and RS as the front-line regulators for dealers, we believe that the CSA must be accountable to the public for their oversight. Some members of the Project Committee feel that the best approach is to publish oversight review reports of these entities together with the entities' responses in their entirety. To address the concerns that published reports might be taken out of context and misinterpreted, the CSA should continue to prepare balanced reports that outline both positive and negative findings from reviews.

We also discussed whether oversight review reports of the market infrastructure entities should be published. Some Project Committee members believe that, for the entities' regulatory functions, the CSA have the same obligation to the public to account for their oversight. Other members noted that, although they have regulatory functions, they do not perform the same level of regulation as the SROs. In addition, those Project Committee members are sympathetic to the fact that some market infrastructure entities operate in a competitive environment and some of them, such as the TSX, are public companies.

Recommendation
The prevailing view is that the CSA should publish the oversight review reports of the IDA, MFDA and RS, together with the entities' responses, in their entirety.

V. IMPLEMENTATION

The Project Committee's recommendations should be implemented in two stages, informally, through letters of understanding or protocols, and formally by amending the recognition orders and joint rule protocols as necessary. The CSA should undertake a complete review of the various recognition orders and protocols to harmonize and reflect changes.

Recommendations

(a) Recognizing regulators should use informal mechanisms, such as letters of understanding or protocols, to document the following:
- The criteria and processes used by each SRO and each market infrastructure entity to demonstrate how its decisions meet (or do not prejudice) the public interest;
- If the CSA adopts an enhanced mutual reliance system for oversight, this mutual reliance system, including the revised processes for reviewing and approving SROs' rule proposals and any rotation of the principal regulator role; and
- The approach in conducting oversight reviews including whether mixed teams will be used and which recognizing regulator would take the lead in a particular review.

(b) Recognizing regulators should amend the joint rule protocols in due course to formally document the above and should amend the recognition orders to reflect any changes to the high level standards (or expected outcomes).

(c)	While implementing (b), securities commissions should harmonize their recognition orders for each SRO, and harmonize the rule review process for all SROs and market infrastructure entities.

VI. CONCLUSION

In the last few decades, as markets have grown and become more complex and fast-moving, SROs and market infrastructure entities have expanded their regulatory programs and staff resources. At the same time, the securities commissions' oversight programs have increased. The increase in oversight activities and the higher level of scrutiny raise questions regarding duplication, the extent of the analysis of proposals submitted by SROs and market infrastructure entities, their processes for developing rules, policies and programs, and the level of oversight generally.

There will always be a need for oversight, but the CSA should adjust the extent of their reliance and the scope of their oversight to the extent that the SROs and market infrastructure entities demonstrate that they are meeting their responsibilities efficiently and effectively. To achieve this, we need to be clearer about our expectations of the entities we oversee. These entities must also improve their reporting to the CSA on how they are meeting or exceeding those expectations. The Project Committee made some recommendations to address this, and other recommendations aimed at making our oversight more efficient and effective.

APPENDIX A
CFTC's and SEC's Studies on Self-Regulation

(A) CFTC's SRO Study

The CFTC published two requests for comment regarding self-regulation, on June 9, 2004[78] and on November 21, 2005.[79] The areas of interest to CFTC include composition of SRO boards, impact on self-regulation of changing ownership structures and business models, structure of SRO disciplinary committees, and public transparency. Many of the questions that the CFTC raised in its requests for comment were also addressed in the SEC's concept release and proposed regulation.

(B) SEC's SRO Study

In November 2004, the SEC published for comment a concept release regarding self-regulation[80] and proposed regulation to deal with self-regulation and oversight.[81] The concept release discussed the fairness and efficiency of the current SRO structure and oversight approach, and identified the issues that needed to be addressed as including: the inherent conflicts of interest between an SRO's regulatory obligations and the interest of its members, its market operations, listed issuers or, for demutualized SROs, their shareholders; the adequacy of SROs' funding; and the inefficiencies arising in a system with multiple SROs. The SEC recommended enhancements to the current system of reliance on SROs, and raised for discussion alternate regulatory models.

The alternate regulatory models were: (1) an independent regulatory and market corporate subsidiary model, where all SROs would create independent subsidiaries for regulatory and market operations; (2) a hybrid model where the SEC would designate a market neutral single SRO to regulate all SRO members with respect to membership rules, while allowing each SRO that operates a market to remain responsible for its own market operations and market regulation; (3) a competing hybrid model that would permit the existence of multiple competing member SROs; (4) a universal industry self-regulator model where one industry SRO would be responsible for all market and member rules for all members and all markets; (5) an universal non-industry regulator model, where one non-industry entity would be responsible for the market and member regulation for all members and all markets; and (6) a model where the SEC would be solely responsible for the market and member regulation for all members and all markets.

The proposed regulation was intended to make improvements to the current system of reliance on SROs. The SEC key proposals that address the independence of an SRO are as follows:[82]

- A majority of the members of an SRO's board of directors should be independent, and an independent director[83] is a director who has no material relationship with

[78] Release No. 4936-04.
[79] Release No. 5138-05.
[80] Release no. 34-50700.
[81] Release no. 34-50699.
[82] Proposed SEC Rules regarding governance, administration, transparency and ownership of SROs that are national securities exchanges or registered securities association (release no. 34-50699), SEC, November 9, 2004.

the entity or its affiliate that could reasonably affect the independent judgment or decision-making of the director;[84]

- Each SRO should have the following board committees that are made up solely of independent directors: the nominating committee, the governance committee, the compensation committee, the audit committee and the regulatory oversight committee;[85]
- An SRO should separate its regulatory and commercial operations either structurally or functionally;
- Monies collected from regulatory fees, fines or penalties (regulatory funds) should be used exclusively to fund the regulatory operations of an SRO; and
- An SRO member who is a broker/dealer should be prohibited from owning and voting more than 20% of the ownership interest in the SRO or a facility of the SRO.

Other proposals included: additional disclosure by SROs of their governance, regulatory programs and ownership; and additional reporting from the SROs to the SEC in order to enable the latter to enhance its oversight of the SROs.

The public response to the SEC's concept release and proposed regulation has been overwhelming. Although there were differences in the responses, overall, the commenters appeared to support changes and improvements to the U.S. system of reliance on SROs and oversight, but thought that a less prescriptive approach should be taken.

[83] Proposed SEC Rules 6(a)-5(b)(12) and 15Aa-3(b)(13) also contain specific circumstances in which a director would not be considered independent, for example, when the director or an immediate family members is being employed by the entity, its members or an issuer listed on the entity during the past three years.

[84] In order to preserve the "self" in self-regulation, the SEC proposed to allow members of an SRO to select at least 20% of the directors.

[85] Proposed SEC Rules 6a-5(f)(2), 6a-5(g)(2), 6a-5(h)(2), 6a-5(i)(2), 6a-5(j)(2), 15Aa-3(f)(2), 15Aa-3(g)(2), 15Aa-3(h)(2), 15Aa-3(i)(2) and 15Aa-3(j)(2) also require that the mandate of these committees should contain, at a minimum, certain specified responsibilities.

APPENDIX B
Reports of the Five Year Review Committee and the Standing Committee on Finance and Economic Affairs of Ontario

(A) Five Year Review Committee

A review committee chaired by Purdy Crawford (Five Year Review Committee) released its Final Report[86] on March 21, 2003 (the Crawford report) recommending amendments to the *Securities Act* (Ontario) (Ontario Act) in several areas related to SROs.[87] The Crawford report considered whether any of the SROs regulated by the Commissions should be required to be recognized by the Commission,[88] as well as other issues relating to self-regulation.

Recognizing that flexibility in legislation is important and that a legislative requirement that SROs be recognized may be appropriate in some, but not all, situations, the Five Year Review Committee did not recommend that every SRO in Ontario be recognized. However, it recommended that the Ontario Act be amended to authorize the OSC to require a self-regulatory organization to apply for recognition where it is taking on activities which are properly discharged by, or subject to the oversight of, the Commission if it has not otherwise applied to be recognized. In addition, the Five Year Review Committee recommended that clearing agencies be required to obtain recognition and that the Commission re-examine the definition of "clearing agency" in the Ontario Act to ensure that it properly captures the activities which should trigger the requirement to be recognized.

The Crawford Report also discussed whether recognized self-regulatory organizations should have legislated enforcement powers with respect to their own rules. The Five Year Review Committee recommended that the Commission study whether the Ontario Act should be amended to give self-regulatory organizations the following statutory powers, and recommended that the OSC consider the checks and balances that would be necessary to ensure procedural fairness and protections available to those that are subject to these new statutory powers:

- Jurisdiction over current and former members or "regulated persons" and their current and former directors, officers, partners and employees;
- The ability to compel witnesses to attend and to produce documents at disciplinary hearings;
- The ability to file decisions of disciplinary panels as decisions of the court;
- Statutory immunity for SROs and their civil liability arising from acts done in good faith in the conduct of their regulatory responsibilities; and

[86] Ontario, Five-Year Review Committee (Purdy Crawford, Q.C., Chair), *Five Year Review Committee Final Report: Reviewing the Securities Act* (Toronto: Queen's Printer, 2003).

[87] Amendments to the Ontario Act in 1994 (effective in 1995) require the Ontario Minister of Finance to appoint a committee to review the legislation every five years.

[88] Under the Ontario Act, it is possible for an organization whose purpose is to regulate the operations and standards of practice of its members to establish itself as an SRO without being recognized. For example, the IDA acted for decades as an SRO until it was formally recognized by the OSC in 1995.

- The power to seek a court-order "monitor" for firms that are in chronic and systemic non-compliance, close to insolvency or for other appropriate public interest criteria.

The Five Year Review Committee also considered whether recognized SROs should have the explicit authority and obligation to enforce Ontario securities law and concluded, in response to comments from the IDA and TSXV, that SROs should not be required to enforce Ontario securities law.[89] However, the Crawford Paper recommended that stock exchanges and recognized self-regulatory organizations be required to report to the Commission any breaches and possible breaches of securities law that they believe have occurred and may have occurred. Further, the Crawford Report included extensive discussion regarding the potential conflict of interest due to an SRO's dual role as a trade association and as a regulator.[90]

After consideration of comments including those made by the IDA and the Nova Scotia Securities Commission, the Five Year Review Committee reconsidered their recommendation and expressed the view that a division of the IDA's trade association and regulatory function would occasion major structural change to the IDA, with little evidence of either the necessity or the benefits of such a change. However, the Five Year Review Committee encouraged the IDA to remain constantly mindful of the conflict inherent in self-regulation and that it organize and conduct itself in a way that is designed to give confidence to outsiders that, while the industry is policing itself, it does this in an adequate manner. The committee focused on the IDA's process in addressing investors' complaints, and noted the importance of investors receiving fair and unbiased treatment from the IDA. The Crawford Report recommended that the IDA consider whether improvements can be made to certain of its structures, such as the composition of its disciplinary panels and the membership of its board of directors, in order to lessen perceptions of conflict of interest in self-regulation.[91]

Finally, the Five Year Review Committee also considered whether changes to the Ontario Act were required to address the SRO oversight function and to provide the OSC with the tools necessary to perform its oversight function effectively. It saw no need for additional oversight powers at the time.

(B) Standing Committee on Finance and Economic Affairs (SCFEA)

On June 29, 2004, an Order of the House directed the SCFEA to fulfill the review, consultation and reporting obligations as set out in Section 143.12(5) of the Ontario Act

[89] In their submissions, the IDA opposed requiring SROs to enforce securities law. It contended that this would result in confusion as to these roles and could further result in "double jeopardy" for registrants. TSX Venture Exchange echoed this view, stating: "it is not appropriate to delegate responsibility for enforcement of securities legislation to SROs… . SROs, not being government bodies, have different burdens of proof, different evidentiary standards and different procedures than do securities Commissions." TSX Venture Exchange stated that the roles of securities commissions and SROs should be kept distinct.

[90] The only Canadian SRO that has been both a regulator and a trade association is the IDA. On December 14, 2005, following an unanimous vote by the IDA's board to formally divide the Association's regulatory and trade association functions, 88% of the IDA members voted to split the mandate.

[91] Some amendments were made to the IDA's by-law 20 and the IDA announced a move to a board structure with 50% public directors.

and the priority recommendations of the Crawford Report, including the securities regulation in Canada. In October 2004, SCFEA issued a report that focused on priority recommendations of the Crawford Report that required further action.[92] With regards to SROs, the SCFEA report included a recommendation that the government establish a task force to review the role of SROs, including whether the trade association and regulatory functions of SROs should be separate.

[92] Twenty of the 95 recommendations of the Crawford Report had either been implemented or required no further action.