

**SHAPING THE FRAMEWORK OF CAPITAL MARKETS REGULATION:
POLITICAL INSTITUTIONS AND SECURITIES REGULATION
IN AUSTRALIA AND CANADA**

by

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PROJECT SUBMITTED IN PARTIAL FULFILLMENT OF
THE REQUIREMENTS FOR THE DEGREE OF
MASTER OF BUSINESS ADMINISTRATION

in the Faculty
of
Business Administration

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SIMON FRASER UNIVERSITY

March 2004

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ABSTRACT

This project examines the relationship between capital markets and political institutions. I use Australia and Canada as case studies. The main hypothesis I advance is that the framework of securities regulation must “fit” into a society’s broader institutional context. A regulatory system that is not well adapted to its institutional surroundings risks becoming implausible. I also argue that one of the key conditions for capital markets to be regulated in a centralized way is the presence of institutions that allow national policy makers to overcome resistance from regional authorities. This condition is present in Australia, but not in Canada. Other developments in Australia, such as large-scale corporate scandals, facilitated the centralization of capital markets regulation.

Political institutions descended from the British Westminster Parliamentary system govern both Australia and Canada. However, the framework through which each country regulates capital markets presents a sharp contrast: while Australia has a single national regulatory agency, in Canada each province retains jurisdiction over securities regulation. Analysis of this contrast provides evidence to support this project’s hypotheses.

Regulating capital markets can have important effects on a society’s financial and economic development. Political authorities, whether national or regional, are generally keen to exercise this power in order to prevent market failures that can impede economic development and frustrate the implementation of a government’s economic agenda.

ACKNOWLEDGEMENTS

I would first like to express my thanks to Dr. Aidan Vining, Senior Supervisor for this project. The work I have completed owes a great deal to his help and guidance. His feedback and encouragement have been extremely valuable.

The faculty, staff, and students of the Global Asset & Wealth Management MBA Program at Simon Fraser University have provided me with much support. I thank the program's Academic Director, Dr. Peter Klein, for his help. Dr. Klein has also acted as the Second Supervisor of this project, for which I am grateful. I would also like to express my appreciation to Mr. Don Fraser, Executive Director of the Global Asset & Wealth Management MBA Program. Mr. Fraser's understanding approach and optimism have been very encouraging to me.

I dedicate this work to my grandmother, Maria Luisa Viaplana Gordon. She is a source of strength to her family and her community.

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CHAPTER 1: INTRODUCTION

This project analyzes the relationship between securities regulation and political institutions. The case studies of Australia and Canada provide evidence to support this project's conclusions. The regulatory framework is the dependent variable in this exercise. Institutional context is the primary independent variable. This project has seven chapters. The introductory chapter does four things. First, it touches on the importance on market efficiency. Second, it emphasizes the need for trust and stability in an economic system. Third, it argues that a regulatory framework must be compatible with a society's institutions. Fourth, it looks at the case studies employed in this project. Finally, Chapter 1 provides a project outline.

1.1 THE REGULATORY FRAMEWORK AND ECONOMIC EFFICIENCY

The framework used to regulate a capital market has a direct impact on that market's efficiency. An effective regulatory framework can promote increased investment, can generate increased capital inflows, and strengthen investor confidence. An ineffective regulatory framework can encourage capital flight, weaken investor confidence, and result in declining investment levels.

1.2 THE NEED FOR TRUST IN CAPITAL MARKETS

In order to function efficiently, an economic system requires a degree of trust among its participants. Trust among the participants in economic transactions is greatly

enhanced by laws that uphold the sanctity of contracts. These laws, while varying from state to state, are often a reflection of a society's norms.

Capital markets are an integral part of any capitalist system. Private sector economic activity depends on sound capital markets. Capital markets also require a stable institutional and judicial framework to function effectively. The political institutions that govern a society largely shape this framework. The regulatory policies implemented by public authorities steer the system.

1.3. REGULATION AND INSTITUTIONS

This project argues that any framework employed to regulate capital markets must be compatible with the political institutions that govern a society. Changes to the framework of capital markets regulation can only work if the proposed changes allow the regulatory system to remain “in sync” with broader institutional arrangements. This project does not attempt to propose which security regulatory system is best. Rather, this project will develop its conclusions by explaining *why* the regulatory systems of Australia and Canada differ.

1.4. AUSTRALIA AND CANADA AS CASE STUDIES

This study uses a comparison of securities regulation in Australia and Canada to lend support to its arguments. While both countries have similar political institutions, the regulation of capital markets in each country is quite different: in Australia, securities

regulation is in the hands of a single national regulatory agency. In Canada, securities regulation is in under provincial jurisdiction.¹

This divergence can be understood through both normative and positive perspectives. From a normative standpoint, proponents of national regulatory agencies for capital markets argue that this system brings consistency, lower costs, and high standards to securities regulation.² On the other hand, proponents of allowing regional authorities to retain control over securities regulation argue that this framework allows for healthy competition³ and protection of regional political and economic rights.⁴

From a positive perspective, a centralized regulatory system can be implemented only if national political authorities wield powers that local authorities are unable or unwilling to resist.⁵ In turn, powerful regional authorities, conscious of their prerogatives, are able to preserve their control over capital markets regulation and resist interference from national authorities.

Regulatory differences between the two countries are perhaps rendered more intriguing by that fact that the Australian and Canadian constitutions share some fundamental similarities:⁶

¹ David Mitchell, 2003, "Evaluation of Canadian Securities Regulation: Should Canada Adopt the Australian 'One-Stop' Regulatory Approach?," *Journal of Financial Crime*, p. 382.

² *Ibid.*, p. 382.

³ Fazil Mihar, 2003, "What our securities markets don't need: a national regulator," *Financial Post*, July 4, FP11.

⁴ David Mitchell, 2003, "Evaluation of Canadian Securities Regulation: Should Canada Adopt the Australian 'One-Stop' Regulatory Approach?," *Journal of Financial Crime*, p. 386.

⁵ *Ibid.*, p. 385.

⁶ George Goulet, 1991, *A Comparative Analysis of Constitutional Aspects of Securities Regulation in Canada and Australia*, p. 51.

- 1) A federal system of government. The national government shares political power with regional governments. Regional authorities have exclusive jurisdiction over important areas of policy-making.
- 2) A bi-cameral central parliament. The parliament of both countries is composed of a lower chamber (the House of Commons) and an upper chamber (the Senate).
- 3) A system of responsible government. The executive branch of government is answerable to parliament in both countries.
- 4) An independent supreme court is the final arbiter of the constitution and the constitutional validity of laws. George Goulet notes that in Australia the Constitution itself established the High Court. In Canada, the Constitution empowered Parliament to establish the Supreme Court. “The High Court is constitutionally entrenched. The Supreme Court is a creature of a federal statute, but may now be constitutionally entrenched.”⁷
- 5) The supremacy of the constitution. The constitution provides the legal basis for the division of jurisdictional policy-making prerogatives between the various levels of government.

1.5. PROJECT OUTLINE

The institutions and norms mentioned above have a direct impact on capital markets and securities regulation. Goulet defines securities regulation as “that body of laws, regulations, policies and procedures which governs the securities market and

⁷ George Goulet, 1991, *A Comparative Analysis of Constitutional Aspects of Securities Regulation in Canada and Australia*, Footnote 34.

participants in that market, including securities issuers, traders and investors, investment dealers and underwriters, securities salesmen and stock exchanges.”⁸

This project proceeds as follows. Chapter 2 reviews current literature relevant to economic regulation. Chapter 3 analyzes the regulation of capital markets in the context of public policy. Chapter 4 looks at the effect of federalism on capital markets regulation. Chapter 5 reviews Australia’s experience and analyzes the implications we can draw from this case study. Chapter 6 carries out a similar exercise using Canada as a case study. The evidence provided by the experience of Australia and Canada in the field of securities regulation supports this project’s key finding. Finally, Chapter 7 analyzes the lessons drawn from the two case studies and offers concluding remarks.

An effective regulatory system can help increase the efficiency of financial markets. This project reaches the conclusion that a regulatory system must fit into broader institutional conditions in order to be effective.

⁸ George Goulet, 1991, *A Comparative Analysis of Constitutional Aspects of Securities Regulation in Canada and Australia*, p. 7.

CHAPTER 2: LITERATURE REVIEW

Chapter 2 attempts to provide a comprehensive summary of current theories dealing with the concept of regulation, the dependent variable of this project. This summary establishes a theoretical context to the general conclusions of this project. Chapter 2 surveys the main regulatory themes studied by academics; analyzes the literature's predictions on future developments in the field of financial regulation; and takes a look at current regulatory debates in Canada.

2.1. DEVELOPMENTS IN REGULATORY THEORY

Current socio-economic trends have had a considerable impact on theories of governmental regulation. Such trends include: globalization, re-assessment of the effectiveness of policy-making models, recent scandals in the field of corporate governance, and the growing role played by multi-lateral organizations (e.g., the European Union) in the field of public policy-making. These trends are changing the environment in which regulatory agencies operate. Policy makers have sought to improve regulatory regimes by changing the dynamics of governments' interaction with interest groups. Regulation theorists have become cognizant of the fact that policy-making must remain one step ahead of contextual change. Some theorists (e.g., Graham Wilson) study the ability of policy makers to "import" regulatory practices from other countries and jurisdictions. Other theorists (e.g., Tony Porter, David Vogel, etc.) analyze the impact of institutions and culture on the policy-making process.

2.2. THEMES IN THE LITERATURE ON “REGULATION”

The three main themes that appear (at some level) as common denominators in most of the works I have researched are: (1) the effect of institutional structures, (2) the effect of social structures, and (3) the impact of regulatory innovation. While these three concepts often provide a common thread to the literature, I shall review other relevant themes, such as “culture” or “legitimacy.”

2.2.1. Regulatory Policy and Institutions

Institutions are the vehicle through which regulatory policy is implemented. A number of academics have studied the relationship between institutional design and public policy-making. Beryl Radin and Joan Price Boase have written extensively on the relationship between federalist political structures and public policy-making in both the United States and Canada. They state that public policy should be analyzed in the context of relationships prevalent within the political structure, political culture, and public administration.⁹ They write that, in Canada, the fragmentation of political power has generated “the need for high-level political involvement in the pursuit of nationwide re-distributive policy-making.”¹⁰

These two authors make the case that federalism is generally a conservative force in Canada – the extensive division of powers dampens policy change. This is largely the result of two factors: (a) the executive power of provincial governments and (b) Quebec’s

⁹ Beryl Radin and Joan Price Boase, 2000, “Federalism, Political Structure, and Public Policy in the United States and Canada,” *Journal of Comparative Policy Analysis*, p. 67.

¹⁰ *Ibid.*, p. 67.

insistence on fully exercising its jurisdictional prerogatives.¹¹ However, Donald Smiley argues that while the federalist system sometimes stands in the way of rational policy-making, the Canadian polity has generally been able to design effective public policy.¹²

Tony Porter has studied international financial regulation from a constructivist perspective. Constructivist approaches “focus on the norms and other shared understandings between actors...”¹³ These norms contribute to the strength of institutions. According to constructivist theory, institutions and beliefs can shape actors’ perceptions of their own interests.¹⁴ Porter defines a constructivist viewpoint:

A constructivist perspective suggests that institutions will be heavily shaped by a developmental trajectory that can be traced back through the institution’s history, rather than by a constantly changeable configuration of national interests.¹⁵

Politics is present in the international financial regulatory regime. At the same time, the institutional character of the regime largely shapes its politics.¹⁶ The political power present in the international regime for financial regulation “works through the structure of the international institutions which have been developed.”¹⁷ In turn, these institutions and the regime they are part of impact political dynamics by “bequeathing an idiosyncratic institutional structure with policy-relevant effects...”¹⁸ Tony Porter contrasts the constructivist approach to the “rationalist” school of thought. Rationalist

¹¹ Beryl Radin and Joan Price Boase, 2000, “Federalism, Political Structure, and Public Policy in the United States and Canada,” *Journal of Comparative Policy Analysis*, p. 67.

¹² *Ibid.*, pp. 66-67. Cites Donald Smiley, 1987, *The Federal Condition in Canada*, p. 22.

¹³ Tony Porter, 2002, “Politics, Institutions, Constructivism, and the Emerging International Regime for Financial Regulation,” *The Review of Policy Research*, p. 55.

¹⁴ *Ibid.*, p. 57.

¹⁵ *Ibid.*, p. 58.

¹⁶ *Ibid.*, p. 70.

¹⁷ *Ibid.*, p. 72.

¹⁸ *Ibid.*, pp. 75-76.

approaches assume that actors maximize their interests through implicit cost-benefit calculations.¹⁹

2.2.2. Regulation and Culture

Culture helps shape social structures. These social structures include institutions, norms, and traditions. Regulatory action must operate within the bounds set by these structures. Innovative regulatory policies have a much greater chance of success if existing social structures are able to absorb policy changes. Efforts “to adopt new styles of regulation remain highly constrained by the familiar variables of institutions, interest group systems, and culture.”²⁰

Steven Kelman and David Vogel stress the importance of “culture” when explaining differences in regulatory styles between countries.²¹ Graham Wilson writes the following about authors such as David Vogel:

... [T]hey do not treat culture as some sort of exogenously generated influence but explain it in terms of the history of the relationship between social classes and the state over an extended historical period.²²

2.2.3. Regulatory “Styles” and Approaches

The nature of regulatory techniques can determine the level of regulatory effectiveness. In his paper “Changing Regulatory Systems,” Graham Wilson discusses the development of different regulatory approaches in developed countries. He writes:

¹⁹ Tony Porter, 2002, “Politics, Institutions, Constructivism, and the Emerging International Regime for Financial Regulation,” *The Review of Policy Research*, pp. 75-76.

²⁰ Graham Wilson, 2003, “Changing Regulatory Systems,” p. 28.

²¹ *Ibid.*, p. 6.

²² Graham Wilson, 2003, “Policy Transfer Versus Varieties of Capitalism in Environmental Policy,” p. 8.

Studies of regulatory systems have ... tended to emphasize the importance of long enduring factors that promote considerable stability in regulatory styles that can differ considerably from one country to another.²³

Graham Wilson's paper focuses on a comparison of the United Kingdom's traditionally "consensual" regulatory style and the United States' traditionally "confrontational" regulatory system. This traditional contrast can be explained by the different historical developments of North American and European societies. In the USA, large-scale business pre-dated the appearance of large-scale government. In Europe (and Japan), the opposite happened.²⁴ Certain authors posit that the traditional contrast in regulatory styles between Europe and the USA is due to different legal cultures.²⁵ The idiosyncratic character of institutions can also help account for differences in regulatory styles.²⁶ "Indeed... the purpose of institutional design is often to lock policies into place by making change difficult, even impossible."²⁷

Graham Wilson identifies some implications from existing analysis of regulatory structures around the world: (1) institutions matter, (2) interest group structures count, and (3) culture counts. This means longstanding variables such as institutions, interest group systems, and culture constrain attempts to adopt new styles of regulation.²⁸

Techniques employed in banking regulation provide useful insight into public policy-making in the field of financial services. There are two general theories of banking regulation: (1) the "public interest" approach "suggests that regulatory measures

²³ Graham Wilson, 2003, "Changing Regulatory Systems," p. 4.

²⁴ Ibid., pp. 6-7.

²⁵ Ibid., p. 7.

²⁶ Ibid., pp. 7-8.

²⁷ Ibid., p. 9.

²⁸ Ibid., pp. 26-28.

are designed to protect against market failures, such as natural monopoly, imperfect information, and externalities”;²⁹ (2) the “capture” or “self-interest” theory of regulation “suggests that interest groups seek regulation primarily for the benefits it produces for them.”³⁰ Robert Litan outlines two paradigms in the field of banking regulation. The first paradigm is the “prevention-safety net” paradigm, designed to prevent bank failures. This paradigm is also designed to protect depositors and creditors. Litan’s second paradigm is the “competition-containment” paradigm, which calls for allowing banks to compete with non-banks. This paradigm calls for isolating problems that may arise.³¹

Some recent academic studies emphasize the value of obtaining voluntary compliance from regulated entities. Magali Delmas and Ann Terlaak have discussed the effectiveness of Negotiated Agreements (NA) in the context of attempts to obtain “voluntary compliance.” They argue that NAs can be implemented “when regulators are able to commit credibly to the objectives of NAs.”³² The credibility of regulatory agencies can suffer if they operate in an institutional environment in which power is fragmented. In such an environment, many competing actors might attempt to play conflicting roles.³³

²⁹ Jill Hendrickson and Mark Nichols, 2001, “How Does Regulation Affect the Risk Taking of Banks? A U.S. and Canadian Perspective,” *Journal of Comparative Policy Analysis*, p. 60. Cites Robert Litan and William Nordhaus, 1983, *Reforming Federal Regulation*.

³⁰ *Ibid.*, p. 60. Cites Sam Peltzman, 1976, “Toward a More General Theory of Regulation,” *Journal of Law and Economics*, and George Stigler, 1971, “The Theory of Economic Regulation,” *The Bell Journal of Economics and Management Science*.

³¹ *Ibid.*, p. 64. Cites Robert Litan, 1997, “Institutions and Policies for Maintaining Financial Stability,” *Maintaining Financial Stability in a Global Economy*.

³² Magali Delmas and Ann Terlaak, 2000, “Regulatory Commitment to Negotiated Agreements: Evidence from the United States, Germany, The Netherlands, and France,” *Journal of Comparative Policy Analysis*, p. 5.

³³ *Ibid.*, p. 5.

Institutional theory shows that a country's institutional structures condition regulatory options. These structures shape the authorities' ability to commit credibly to regulatory policies.³⁴ The potential benefits derived from establishing NAs can be outweighed by costs if the NAs "are implemented in an institutional setting that limits the agreements' stability."³⁵ The presence of a culture of "consensual policy-making" can enhance institutional stability.³⁶

Pinaki Bose has written about "anticipatory compliance" in the context of what we might call "non-confrontational" enforcement. A firm's ability to anticipate potential compliance problems before they arise can greatly reduce regulatory problems. Anticipatory compliance requires increased communication and cooperation between regulators and those regulated. This regulatory technique can result in higher levels of compliance at "lower monitoring frequencies."³⁷ Presumably, anticipatory compliance could minimize regulatory costs.

Regulatory "forbearance" is another type of "non-confrontational" regulatory technique. We can define "forbearance," in a regulatory context, as the willingness of regulators to eschew confrontation in favour of collaboration. This approach might include reducing enforcement actions, relying on positive rather than negative reinforcement. Gary Woller and Neil Brady believe that "regulatory forbearance" can be an effective tool when used judiciously. However, if it becomes routine it can result in

³⁴ Magali Delmas and AnnTerlaak, 2000, "Regulatory Commitment to Negotiated Agreements: Evidence from the United States, Germany, The Netherlands, and France," *Journal of Comparative Policy Analysis*, p. 6.

³⁵ *Ibid.*, p. 24.

³⁶ *Ibid.*, p. 24.

³⁷ Pinaki Bose, 1995, "Anticipatory Compliance and Effective Regulatory Activity," *International Review of Law and Economics*, p. 1.

ineffective regulation.³⁸ Addressing a regulatory technique of growing popularity in governmental circles, Nutavoot Pongsiri has analyzed the relationship between regulation and public-private partnerships.³⁹

2.2.4. Regulatory Policy “Transfers”

A “policy transfer” refers to the ability of a regulatory entity to adopt the policy-making techniques being used by agencies in separate jurisdictions. In his paper “Policy Transfer Versus Varieties of Capitalism in Environmental Policy,” Graham Wilson outlines three main causes of recent “policy transfers” across jurisdictions: (1) the demand for new ideas; (2) globalization; and (3) the growth in the importance of international networks and organizations.⁴⁰ Wilson looks at two case studies. First, Wilson analyzes the State of Wisconsin’s new initiatives in the field of environmental regulation in the 1990s. Second, Wilson examines the Labour government’s environmental policy reform in the late 1990s in the United Kingdom.

In both cases, efforts to fundamentally change environmental policy failed. Efforts to import alternatives to traditional regulation into Britain and the United States failed because they attempted to replicate a specific set of policies, but could not adopt the entire institutional setting that supports those policies.⁴¹ Nevertheless, in cases where policy transfers do not succeed, the attempt to import new methods can still have a

³⁸ Gary Woller and Neil Brady, 1995, “An Ethical Defence of Regulatory Forbearance,” *International Journal of Public Administration*, p. 851.

³⁹ Nutavoot Pongsiri, 2002, “Regulation and Public-Private Partnerships,” *The International Journal of Public Sector Management*, p. 487.

⁴⁰ Graham Wilson, 2003, “Policy Transfer Versus Varieties of Capitalism in Environmental Policy,” pp. 1-4.

⁴¹ *Ibid.*, p. 32.

significant impact on policy-making.⁴² Wilson offers these concluding remarks in regards to policy transfers:

“The fundamental problem that has afflicted the attempts to import alternatives to traditional regulation into Britain and the United States might be said to be that they attempt to borrow a specific set of policies but cannot import the entire set of practices, assumptions, attitudes and institutions that underpin them.”⁴³

2.2.5. Regulation and Information

The quality and quantity of information available to regulators and those regulated can affect the results of regulatory policies. Søren Winter and Peter May affirm that the availability of information can enhance compliance by enhancing awareness of rules. Greater awareness can help develop a “sense of duty” among those regulated. Information, however, does not directly influence compliance. The authors also believe that interest groups play an important role in the “legitimization” of regulatory policies.⁴⁴ Interest groups are important vehicles for socialization. They help shape their members’ view of regulatory entities.

2.2.6. Regulation and Compliance

Compliance with regulatory policies will decline if policy makers rely only on enforcement methods. Jon Sutinen and K. Kuperan have developed a theory of regulatory compliance that takes into account “moral obligation” and “social influence,”

⁴² Graham Wilson, 2003, “Policy Transfer Versus Varieties of Capitalism in Environmental Policy,” p. 34.

⁴³ Ibid., p. 32.

⁴⁴ Søren Winter and Peter May, 2003, “Information, Interests, and Environmental Regulation,” *Journal of Comparative Policy Analysis*, p. 115.

in addition to the costs normally associated with law breaking.⁴⁵ The authors conclude that the socialization of regulated entities plays a large role in ensuring compliance with regulations. Those regulated will probably not perceive arbitrary policies as legitimate. Such policies will therefore not elicit high levels of compliance.⁴⁶ This theory implies that institutional design can play an important role in regulation. As a corollary, regulatory bodies should be “designed” in a way that will enhance their legitimacy in the eyes of others.⁴⁷ Legitimacy can encourage greater voluntary compliance. Voluntary compliance, in turn, can reduce costs to all parties involved.

2.3. LITERATURE’S DISCUSSION OF FUTURE DEVELOPMENTS

Some regulatory theorists have attempted to outline the future direction of regulatory policy. In his paper “Changing Regulatory Systems,” Graham Wilson has identified three broad possible changes in regulatory techniques around the world: (1) convergence, with governments attempting to learn from each other and harmonize their rules; (2) a new model for all; and (3) the persistence of national differences. Giandomenico Majone analyzes the possible effect of dismantling of national barriers on regulatory policy.

2.3.1. Market Integration

Giandomenico Majone discusses the issue of “market integration” in the context of new regulatory trends. Integration can be negative or positive. “Negative integration

⁴⁵ Jon Sutinen and K. Kuperan, 1999, “A Socio-Economic Theory of Regulatory Compliance,” *International Journal of Social Economics*, p. 8.

⁴⁶ *Ibid.*, p. 8.

⁴⁷ *Ibid.*, p. 8.

denotes the removal of discrimination in national rules and policies that may impede the free movement of people, goods, service, and capital.”⁴⁸ On the other hand, positive integration “entails the delegation to supranational institutions, or the joint exercise by the national authorities, of at least some regulatory powers.”⁴⁹ In the European Union today we see the development of new regulatory concepts, such as “harmonization,” “mutual recognition,” and “regulatory federalism.”⁵⁰

Interestingly enough, Hugh Sherman *et al.* have concluded that a stringent regulatory environment can bring about increased internationalization of a firm’s operations.⁵¹ This might carry interesting implications for the relationship between regulatory public policy and “globalization.” Could one actually re-enforce the other?

2.4. DEBATES OVER SECURITIES REGULATION IN CANADA

A number of commentators have increasingly called into question the effectiveness of Canada’s securities regulation structure. The regulation of capital markets in Canada falls under provincial jurisdiction. This is the result of prevailing interpretations of Canada’s constitution. A 1932 decision of the Canadian Privy Council (Lymburn v. Mayland) “held that the provinces may constitutionally regulate securities markets by virtue of their authority to make law in relation to ‘property and civil rights in the province.’”⁵²

⁴⁸ Giandomenico Majone, 1999, “Regulation in Comparative Perspective,” *Journal of Comparative Policy Analysis*, pp. 310-311.

⁴⁹ *Ibid.*, p. 311.

⁵⁰ *Ibid.*, pp. 312-320.

⁵¹ Hugh Sherman *et al.*, 1998, “Inside Board Members, Regulatory Change and Internationalization: the Case of the U.S. Telecommunications Industry,” *International Journal of Organizational Analysis*, p. 1.

⁵² Jeffrey MacIntosh, 1996, *A National Securities Commission for Canada?*, pp. 191-192.

Each province and territory in Canada has its own agency for securities regulation. Such agencies are accountable only to provincial/territorial governments. There is no national regulatory agency, although provincial securities commissions coordinate their actions through the Canadian Securities Administrators (CSA). This arrangement is unique among developed nations. Partly as a result of this unique degree of decentralization, Canada's current regulatory system is the subject of growing debate in business, government, and academic circles.

2.4.1. Arguments in Favour of Centralizing Securities Regulation

A number of lobby groups (e.g., the Investment Dealers Association of Canada)⁵³ have criticized the current regulatory system as being cumbersome, too complex, and inefficient.⁵⁴ They favour the creation of a single national regulator that would harmonize securities laws across Canada. Such a harmonization would make it easier for Canadian firms to raise capital, as investors would not have to simultaneously conform to different provincial laws. According to this school of thought, the existence of one national securities regulator would also reduce firms' administrative costs.

Some analysts affirm that foreign investors have a negative perception of Canada's "disparate" regulatory regime.⁵⁵ They argue the present system puts Canada at a competitive disadvantage by discouraging investment and imposing high compliance

⁵³ Fazil Mihlar, 2003, "What Our Securities Markets Don't Need: A National Regulator," *Financial Post*, July 4, FP11.

⁵⁴ Tamara Gignac, 2003, "Securities Under the Microscope," *Calgary Herald*, August 1, D1.

⁵⁵ Investment Counsel Association of Canada, 2002, *The Path to Achieving a National Securities Regulatory System for Canada*, p. 1.

costs.⁵⁶ The current system may work well for an issuer present only in one jurisdiction, but not for an issuer present in various.⁵⁷

Some limitations of the current system are:⁵⁸

- 1) Different applications of uniform rules. Efforts to design uniform legislation can be frustrated by different application methods in different jurisdictions.
- 2) Differing regulations, rules, and policies. The regional focus of each regulatory agency can lead it to enact regulations with local needs in mind.
- 3) Differing philosophical approaches. The absence of a single national regulator allows each regulatory agency to adopt a peculiar philosophical approach to issues.
- 4) Audits are not coordinated. The independent character of each securities commission renders coordination difficult.
- 5) Extensive regulatory overlap. Lack of coordination can translate into regulatory overlap.

2.4.2. Possible Ways of Centralizing Securities Regulation

The present allocation of responsibility for securities regulation is a result of current interpretation of the Canadian Constitution. Some constitutionally viable

⁵⁶ Investment Counsel Association of Canada, 2002, *The Path to Achieving a National Securities Regulatory System for Canada*, p. 1.

⁵⁷ *Ibid.*, p. 2.

⁵⁸ *Ibid.*, p. 2.

procedures for the formation of a national securities commission might have the following characteristics:⁵⁹

- 1) Provincial adoption by reference of federal legislation. In this case, each province would delegate its authority to a federal body.
- 2) Joint delegation of power to a common regulatory body by both provincial and federal governments. This option could hold the advantage of increasing regulatory coordination, while retaining responsiveness to local needs.
- 3) Delegation of provincial authority to a national (but not federal) commission. Such a commission would be independent from the federal government.
- 4) A national securities commission might strengthen Canada's position in international negotiations. On the other hand, it might lack transparency, responsiveness, and political accountability.⁶⁰ In the past, provincial governments funded and collected income from the activities of provincial securities commissions. The recent adoption of self-funding by the larger securities commissions (through registration fees, etc.) may eliminate some of the provinces' concerns over loss of revenue.⁶¹

2.4.3. Opposition to the Centralization of Securities Regulation

Most provincial governments are opposed to proposals to create a single national securities regulator in Canada. They argue that the present system fosters high regulatory

⁵⁹ Jeffrey MacIntosh, 1996, *A National Securities Commission for Canada?*, pp. 198-200.

⁶⁰ *Ibid.*, p. 231.

⁶¹ Investment Counsel Association of Canada, 2002, *The Path to Achieving a National Securities Regulatory System for Canada*, p. 6.

standards, as different securities commissions must compete with each other to attract financial industry players.⁶² Opponents of the centralization of securities regulation essentially believe that competition is as useful here as it is in other markets. Those in favour of retaining the present regulatory system also posit that the creation of a single national monopoly regulator would bring higher costs. A national regulator could also signify the establishment of a new layer of bureaucracy.⁶³ In other words, they argue that monopoly regulation has the same disadvantages as monopoly elsewhere in the economy. Furthermore, a national regulator would likely mean the imposition of a “Central Canadian” perspective on the rest of the country. The province of Quebec, in particular, is concerned about any type of reform that would infringe on its jurisdiction in the area of securities regulation.

There is also debate in Canada over the roles played by specific individual securities commissions. Commentators such as Philip Anisman are concerned that Canadian securities commissions have simultaneously exercised policy-making, investigative, prosecutorial, and adjudicative functions.⁶⁴ At the very least, this poses questions as to commissions’ impartiality in the adjudicative process, for they are currently able to act as both “prosecutor” and “judge” in any investigation.

2.5. OBSERVATIONS ON REGULATORY THEORY

Giandomenico Majone believes that “international diffusion of regulation as a distinct type of policy-making” accounts for the growing interest in regulatory studies.

⁶² Fazil Mihlar, 2003, “What Our Securities Markets Don’t Need: A National Regulator,” *Financial Post*, July 4, FP11.

⁶³ Ibid.

⁶⁴ Philip Anisman, 2003, “The OSC Taint: ‘T Ain’t There: Adjudication Follows Tradition of Regulatory Agencies Playing Multiple Roles,” *Financial Post*, July 8, FP11.

Recent “theoretical advances in the comparative study of institutions” also help promote growing interest in regulation.⁶⁵ New research “pays careful attention to institutional factors that affect both industry performance and the choice of policy tools.”⁶⁶ This project will analyze such institutional factors as an independent variable. I focus on the role played by political institutions in the field of capital market regulation. Therefore, literature that studies the links between regulation and institutions is of great relevance to this project.

Institutional constraints, however, are not the only exogenous factor affecting regulatory systems. Current literature also looks at the relationship between regulatory procedures, on one hand, and international dynamics, culture, and psychological forces, on the other.

I will attempt to incorporate the concepts reviewed in this chapter into its analysis of securities regulation in Australia and Canada. Chapter 2 has presented the theoretical bases of proposals to reform financial and economic regulation. Chapter 3 will analyze regulation in the context of public policy-making.

⁶⁵ Giandomenico Majone, 1999, “Regulation in Comparative Perspective,” *Journal of Comparative Policy Analysis*, p. 309.

⁶⁶ *Ibid.*, pp. 309-310. Cites Aidan Vining and David Weimer, 1999, “Informing Institutional Design: Strategies for Comparative Regulation,” *Journal of Comparative Policy Analysis*.

CHAPTER 3: REGULATION AS PUBLIC POLICY

This chapter links financial regulation with the broader concept of public policy. Securities regulation is a form of public policy. A basic understanding of public policy can provide useful insights into securities regulation. Awareness of public policy goals can provide insight into efforts to enhance the efficiency of financial markets. Chapter 3 first offers a definition of the concept of public policy. Second, it proceeds to discuss the market failure. Finally, this chapter outlines the main objectives of securities regulation.

3.1. DEFINITION OF PUBLIC POLICY

David Weimer and Aidan Vining define public policies as the alternatives and strategies designed to promote public goals. They define public goals as the values a society seeks to promote.⁶⁷ Alternatives and strategies crafted in pursuit of public goals “should be consistent with available resources, including jurisdictional authority and controllable variables.”⁶⁸ Public policy must use accurate information. Public policy should be grounded in reality. “More generally, the list of constraints [taken into consideration when carrying out policy analysis] should include any resources that are essential for either maintaining the status quo or implementing alternative policies.”⁶⁹

⁶⁷ David Weimer and Aidan Vining, 1998, *Policy Analysis*, p. 269.

⁶⁸ *Ibid.*, p. 282.

⁶⁹ *Ibid.*, p. 267.

The five basic approaches to policy analysis are: (1) Formal Cost-Benefit Analysis, (2) Qualitative Cost-Benefit Analysis, (3) Modified Cost-Benefit Analysis, (4) Cost-Effectiveness Analysis, and (5) Multi-Goal Policy Analysis.

From a public policy perspective, government must regulate capital markets in order to counter market inefficiencies. “If theory and evidence suggest market failure in an operational market, there is a prima facie case for government intervention.”⁷⁰ According to Weimer and Vining, the effectiveness of regulatory intervention can be measured against market efficiency:

“Markets offer the potential for efficiently allocating goods. Markets, therefore, provide the yardsticks against which to measure the efficiency of government interventions.”⁷¹

On the other hand, government regulation of a market that operates efficiently on its own can bring “significant efficiency losses.”⁷² Public policies are capable of doing more harm than good. Yukio Adachi writes the following on inefficient public policies:

“‘Government failures,’ or inefficient public policies, can be classified broadly into two groups: those whose faults fall on the supply side and those that are imperfect on the demand side. The former are further divided into X-inefficiencies and those deriving from the failure to adequately perceive the actual policy benefits or costs. The latter result when policy demands are either inflated or lower than the socially optimal level.”⁷³

Aggregate policy demand that is either too great or too small to correctly reflect societal benefits accruing from a policy will also result in inefficiencies.⁷⁴ The principal types of demand-side inefficiencies are distortions due to externalities or information

⁷⁰ David Weimer and Aidan Vining, 1998, *Policy Analysis*, p. 269.

⁷¹ *Ibid.*, p. 197.

⁷² *Ibid.*, pp. 262-263.

⁷³ Yukio Adachi, 1999, “Inefficiencies in Public Policies,” *Journal of Comparative Policy Analysis*, p. 225.

⁷⁴ *Ibid.*, p. 225.

asymmetries and incorrect reflection of marginal social benefits.⁷⁵ Weimer and Vining state the following in regards to the possibility of reducing regulatory action:

“Freeing regulated markets should be considered in those situations in which an effective market can be expected to re-emerge with relatively minor efficiency distortions – in other words, where there is no inherent market failure.”⁷⁶

3.2. MARKET FAILURE

Public authorities regulate capital markets in the belief that the absence of such regulation increases the chances of market failure (with its inevitable negative social effects). Market failure is a “circumstance in which the pursuit of private interest does not lead to an efficient use of society’s resources or a fair distribution of society’s goods.”⁷⁷ Market failures bring inefficiency to production and consumption patterns of a society.⁷⁸ Interventions to correct market failure must not inflict greater costs than benefits.⁷⁹ Four traditional market failures are:

- 1) Public Goods. According to David Weimer and Aidan Vining, public goods are “non-rivalrous in consumption, non-excludable in use, or both.”⁸⁰
- 2) Externalities. “An externality is any valued impact (positive or negative) resulting from any action (whether related to production or consumption) that affects someone who did not fully consent to it through participation in voluntary exchange.”⁸¹

⁷⁵ Yukio Adachi, 1999, “Inefficiencies in Public Policies,” *Journal of Comparative Policy Analysis*, pp. 230-235.

⁷⁶ David Weimer and Aidan Vining, 1998, *Policy Analysis*, p. 197.

⁷⁷ *Ibid.*, p. 41.

⁷⁸ *Ibid.*, p. 58.

⁷⁹ *Ibid.*, p. 41.

⁸⁰ *Ibid.*, p. 75.

⁸¹ *Ibid.*, p. 94.

3) Natural Monopoly. The absence of competition in an industry can have negative effects on society as a whole.

4) Information Asymmetry. Information asymmetry can cause market failure “when the producer does not supply the amount of information that maximizes the difference between the reduction in deadweight loss and the cost of providing the information.”⁸²

These four market failures “represent violations of the ideal competitive model.”⁸³

Market failure, or the possibility of market failure, thus prompts public authorities to intervene in the market through the implementation of public policies. There are two “broad classes of rationales for public policies: the correction of market failures to improve efficiency in the production and allocation of resources and goods, and the reallocation opportunity and goods to achieve distributional and other values.”⁸⁴ The two market failures generally used to justify government intervention in capital markets are information asymmetry and natural monopolies.

3.2.1. Information Asymmetry

Information asymmetry is present in capital markets because corporate insiders and managers have greater access to knowledge than clients who purchase securities. In spite of recent efforts (by investors’ associations, regulatory agencies, etc.) to reduce information asymmetry in financial markets, this market failure remains pervasive. Furthermore, it is not greatly affected by technological advances: professionals who deal

⁸² David Weimer and Aidan Vining, 1998, *Policy Analysis*, p. 109.

⁸³ *Ibid.*, p. 116.

⁸⁴ *Ibid.*, p. 158.

in securities will generally know more about their products than clients. The ability of potential information asymmetry to cause market inefficiency “depends largely on whether public goods problems hinder the operation of secondary market mechanisms that provide corrective information.”⁸⁵ A combination of information asymmetry in primary markets with public good problems in secondary markets has a high likelihood of causing market inefficiencies.⁸⁶

3.2.2. Natural Monopoly

Natural monopolies arise when a single firm can produce a good at a lower cost than any other competitor.⁸⁷ This circumstance leads the monopolist to maximize its profits at a level of output that is not consistent with economic efficiency. Economic efficiency requires an output level of a good in which the price of this good equals its marginal cost.⁸⁸ By contrast, the monopolist maximizes profits by producing goods at an output level in which marginal revenue equals marginal cost.⁸⁹ Profit maximization by the monopolist results in overall economic “underproduction” – the economy functions at less than full capacity.⁹⁰ Underproduction results in artificially high prices (assuming demand is fixed), another economic limitation (for consumers, in this case). Moreover, “natural monopolies do not face as strong incentives as competitive firms to operate at

⁸⁵ David Weimer and Aidan Vining, 1998, *Policy Analysis*, p. 115.

⁸⁶ *Ibid.*, p. 115.

⁸⁷ *Ibid.*, p. 100.

⁸⁸ *Ibid.*, p. 101.

⁸⁹ *Ibid.*, p. 101.

⁹⁰ *Ibid.*, p. 101.

minimum cost.”⁹¹ The entire process described above results from the monopolist’s ability to set prices (a direct consequence of the absence of competition).

Natural monopoly can be more easily affected than information asymmetry by technological change.⁹² Financial de-regulation and improved communications are moving us into a global securities market. This development can break down regional monopolies. Nevertheless, some natural monopolies remain. One example is stock exchanges. Their monopoly over securities trading in a particular geographical area is what causes governments to regulate them.

3.2.3. Addressing Market Failure

There is no consensus, from a regulatory perspective, on how to address market failure. John Coffee argues that a “mandatory disclosure” system is the answer. “Empirical data suggest that a mandatory disclosure system reduces price dispersion and enhances the allocation efficiency of capital markets.”⁹³ On the other hand, Neil Campbell believes additional regulation is not the answer to market failure. “The practical problem is how to determine the appropriate degree of regulatory intervention to cure market failure when costs and benefits are not readily measurable.”⁹⁴ Larry Ribstein also believes that “market-based” approaches are more likely than regulatory action to enhance market efficiency.⁹⁵ Investors, according to Ribstein, will naturally avoid

⁹¹ David Weimer and Aidan Vining, 1998, *Policy Analysis*, p. 106.

⁹² *Ibid.*, p. 101.

⁹³ John Coffee, 1984, “Market Failure and the Economic Case for a Mandatory Disclosure System,” *Virginia Law Review*, p. 717.

⁹⁴ Neil Campbell, 1993, “Compulsory Disclosure of ‘Soft’ Information,” *The Canadian Business Law Journal*, p. 321.

⁹⁵ Larry Ribstein, 2002, “Market vs. Regulatory Responses to Corporate Fraud,” *Journal of Corporation Law*, pp. 3.

investing in firms that are inefficient. Markets naturally develop devices (e.g., hostile takeovers or incentive compensation schemes for managers) to overcome regulatory problems.⁹⁶

3.3. OBJECTIVES OF SECURITIES REGULATION

The securities market has two principal goals: (1) to allow the raising of capital and (2) to allow the continuing valuation of securities.⁹⁷ The overall goal of securities regulation is to balance investor protection with market efficiency.⁹⁸ George Goulet lists the efficient allocation of capital, the protection of fairness and liquidity, investor protection, and the promotion of trust in the market among the main objectives of securities regulation.⁹⁹ Public policy determines how capital markets are regulated.

3.4. CONCLUSION

Regulatory agencies must advance the interests of society as a whole. Thus, securities regulation is an activity that pursues public policy goals. Regulators must tackle, through public policy initiatives, market failure in the financial services industry. Greater efficiency and fairness in financial markets can result in increased prosperity for a society's entire economy.

There is a clear link between public policy and regulatory policy. This chapter has analyzed regulatory policy using the concept of public policy as a theoretical context.

⁹⁶ Larry Ribstein, 2002, "Market vs. Regulatory Responses to Corporate Fraud," *Journal of Corporation Law*, p. 7.

⁹⁷ George Goulet, 1991, *A Comparative Analysis of Constitutional Aspects of Securities Regulation in Canada and Australia*, p. 9.

⁹⁸ *Ibid.*, p. 7.

⁹⁹ *Ibid.*, p. 7

Chapter 4 will study the effect an institutional context (federalism) can have on regulation and public policy.

CHAPTER 4: THE IMPACT OF FEDERALISM

This chapter analyzes effect of federalism on regulatory policy. First, it offers a definition of federalism. Second, it studies the impact of regionalism on policy-making. Third, it analyzes the decentralization of policy-making in federal states. Fourth, this chapter contrasts the structural characteristics of Australia and Canada. Finally, Chapter 4 touches on the possible effects of globalization on federal states.

4.1. DEFINITION OF FEDERALISM

Federalism is a system of government in which national authorities and regional authorities share political power. This often implies that central authorities, on one hand, and local authorities, on the other, have exclusive jurisdiction over distinct areas of policy-making. The degree to which power is divided between central and local authorities varies from country to country. In many cases, there is considerable overlap between the jurisdiction of national and regional authorities. George Goulet defines a federal state as “an association of formal communities of the peoples of several distinct geographical regions forming a polity consisting of a national union of the regions coupled with the preservation of agreed regional rights...”¹⁰⁰

The distinctive features of a classic federation are:¹⁰¹

- 1) Division of powers. The exercise of legislative, executive, and judicial power is clearly separated. However, in parliamentary democracies such as

¹⁰⁰ George Goulet, 1991, *A Comparative Analysis of Constitutional Aspects of Securities Regulation in Canada and Australia*, p. 41.

¹⁰¹ *Ibid.*, p. 44.

Australia and Canada, the cabinet often plays a leading role in exercising both executive and legislative power.

2) Supremacy of the constitution. A constitution provides guidelines through which jurisdictional authority and political power are allocated.

3) Presence of an independent supreme court as final arbiter of the constitution and of the constitutional validity of laws. An independent supreme court should be able to render decisions, on constitutional matters, free from political interference.

4.2. REGIONALISM AND PUBLIC POLICY-MAKING

One key difference between federal and unitary states is the role played by regionalism. In federal states, “balkanization [of the public policy process] will occur to a greater extent along regional lines, because regionally concentrated interest groups will be stronger in federal systems.”¹⁰² Federalism thus magnifies the regional dimension of entry [into the policy-making process] barriers.¹⁰³ In any event, policy makers in both centralized and federal states must take into account new social and economic trends. International factors are exerting increasing influence on the domestic policy-making process of sovereign states. The influence of international market reactions, the role of international institutions, and so forth, are placing growing constraints on the policy

¹⁰² Walter Hettich, 1987, “Federalism, Special Interests and the Exchange of Policies for Political Resources,” *European Journal of Political Economy*, p. 50.

¹⁰³ *Ibid.*, p. 51.

autonomy – economic and social – of national and state [or regional] level governments.”¹⁰⁴

4.3. DECENTRALIZATION OF POLICY-MAKING

The nature of federalism renders policy-making in a federalist system very different from policy-making in a unitary state. Federalism brings a high degree of decentralization to political systems. The formulation of public policies in federalist systems must take this into account. “The objective of a federation is to balance the diverse and distinctive regional interests and identities with the greater political and economic advantages derived from the union of the various regions.”¹⁰⁵

The decentralization of policy-making can bring a number of important benefits: the presence of checks and balances on policy makers; greater ease in matching the production of goods to local preferences; the ability of citizens to express their opinions on public goods and public policies; the ability of citizens to move to jurisdictions in which more efficient policies are in place.¹⁰⁶

The decentralization of public policy-making can also have negative side effects: greater complexity; greater difficulties in implementing policies; the effectiveness of policies can be limited; and fiscal externalities can occur in association with the supply of local public goods.¹⁰⁷ Fiscal externalities come about when, for instance, two

¹⁰⁴ Cliff Walsh, 1996, “The Challenges of Globalization: Lessons from Australian Experience.” Paul Boothe, Ed., *Reforming Fiscal Federalism for Global Competition*, p. 23.

¹⁰⁵ George Goulet, 1991, *A Comparative Analysis of Constitutional Aspects of Securities Regulation in Canada and Australia*, p. 41.

¹⁰⁶ David Weimer and Aidan Vining, 1998, *Policy Analysis*, p. 191.

¹⁰⁷ *Ibid.*, p. 191.

jurisdictions keep lowering their regulatory standards in order to compete to attract new industries.¹⁰⁸

4.4. AUSTRALIA AND CANADA: SIMILARITIES AND DIFFERENCES

Australia and Canada are both federalist states under the same constitutional monarchy. In each country, regional political bodies (the states in Australia, the provinces in Canada) wield considerable power with respect to the central government. In fact, in each country regional authorities have exclusive jurisdiction over various key areas of policy-making. Both countries also share in common the supremacy of written constitutions and the role played by a Supreme Court. On the other hand, the approaches to constitutional interpretation and in the distribution of powers are different in each nation.¹⁰⁹

Australia and Canada can, at first sight, lend themselves to a seemingly easy comparison due to their considerable similarities. Both countries are former British colonies and members of the Commonwealth of Nations (whose head is the British monarch). Both countries are federal constitutional monarchies with a large land mass and low population density. Both countries have small economies and abundant natural resources. Both countries are home to a relatively large aboriginal population.¹¹⁰ In spite of these apparent similarities, there are a number of key differences between the two countries:

¹⁰⁸ David Weimer and Aidan Vining, 1998, *Policy Analysis*, p. 195.

¹⁰⁹ George Goulet, 1991, *A Comparative Analysis of Constitutional Aspects of Securities Regulation in Canada and Australia*, p. 237.

¹¹⁰ Thomas Courchene, 1996, "The Comparative Nature of Australia and Canadian Economic Space." Paul Boothe, Ed., *Reforming Fiscal Federalism for Global Competition*, p. 7.

- 1) Canada must live with a superpower by its side (we might say that Australia plays the role of superpower vis-à-vis New Zealand).
- 2) Canada must deal with a strong separatist movement, based largely on cultural and linguistic identity, in Quebec.
- 3) Australia's Senate, representing the states' interests, is much more powerful than Canada's.
- 4) Regional disparities are roughly four times as large in Canada as in Australia.
- 5) Canada's federal transfer payments system targets poor areas to a greater extent than Australia's. Wages and equalization payments are more consistent across regions in Australia. The federal government delivers social expenditure more uniformly across regions in Australia than in Canada.
- 6) Economic activity "is distributed more equally across Australian economic space" than across Canada's. "... Canadian provinces have much more own-source-revenue fiscal room than Australian states..." The internal economic union of Canada is more fragmented than Australia's.¹¹¹
- 7) The size of cities is more equally distributed across Australia than Canada: five out of six Australian states have an urban conglomerate of at least one million people.
- 8) Canadian provinces have much greater ability to legislate freely in a number of areas than do Australian states. "One result of this is that there is much more leeway for the provinces to fragment the internal common market."

¹¹¹ Thomas Courchene, 1996, "Preserving and Promoting the Internal Economic Union." Paul Boothe, Ed., *Reforming Fiscal Federalism for Global Competition*, pp. 217-218.

9) Regional or provincial considerations influence federal public policy debates much more in Canada than in Australia. This is a result of the fact that the federal Senate and equity in federal transfer payments “automatically” provide representation to regional concerns in Australia. No such intrinsic equity or representation exists in the Canadian federal policy-making process.

10) Trends in the development of Australian federalism are distinct from Canada’s. “In lieu of Canadian-style decentralization, the Commonwealth government is instead bringing the states more into decision-making at the centre.”¹¹²

To summarize these differences, Australia is not undergoing Canadian-style decentralization.¹¹³ The greater equality among its regions and the greater strength of its central government provide checks to decentralizing tendencies.

4.5. FEDERALISM AND GLOBALIZATION

The differences enumerated above ensure that Canada and Australia respond in different ways to the phenomenon of “globalization.” Canada seems to be accommodating increased globalization through decentralization, giving provinces considerable leeway to pursue their international interests. The challenge for Canadian policy-makers will be to maintain Canada’s internal “social union.”¹¹⁴ On the other hand, increasing globalization may place Australia’s social union in jeopardy. A trend toward

¹¹² Thomas Courchene, 1996, “The Comparative Nature of Australia and Canadian Economic Space.” Paul Boothe, Ed., *Reforming Fiscal Federalism for Global Competition*, pp. 7-14.

¹¹³ *Ibid.*, p. 14.

¹¹⁴ *Ibid.*, p. 14.

growing centralization may be an “obstacle” for states trying to integrate with each other. This trend may also make it difficult for states to compete internationally.¹¹⁵

4.6. CONCLUSION

This chapter has defined the concept of federalism. This chapter has also studied the effects a federal institutional structure can have on policy-making. I have noted that similar federalist systems can have a different impact on two countries with different social, economic, and demographic characteristics. Chapter 5 and Chapter 6 will proceed to examine in detail the case studies I use to provide evidence to this project’s conclusions.

¹¹⁵ Thomas Courchene, 1996, “The Comparative Nature of Australia and Canadian Economic Space.” Paul Boothe, Ed., *Reforming Fiscal Federalism for Global Competition*, p. 14.

CHAPTER 5: AUSTRALIA

Australia's experience in the field of securities regulation provides evidence to support this project's hypothesis that a regulatory framework must adapt to other existing institutions. Australia's institutional context facilitated the centralization of securities regulation in 1989-1991 (when a national securities regulator was created). This chapter will first review the background to Australia's recent initiatives in the area of securities regulation. Second, it will look at jurisdictional issues in capital markets regulation. Third, this chapter will analyze the effects of federalism on Australia's policy-making process. Finally, Chapter 5 discusses the broader implications of Australia's experience.

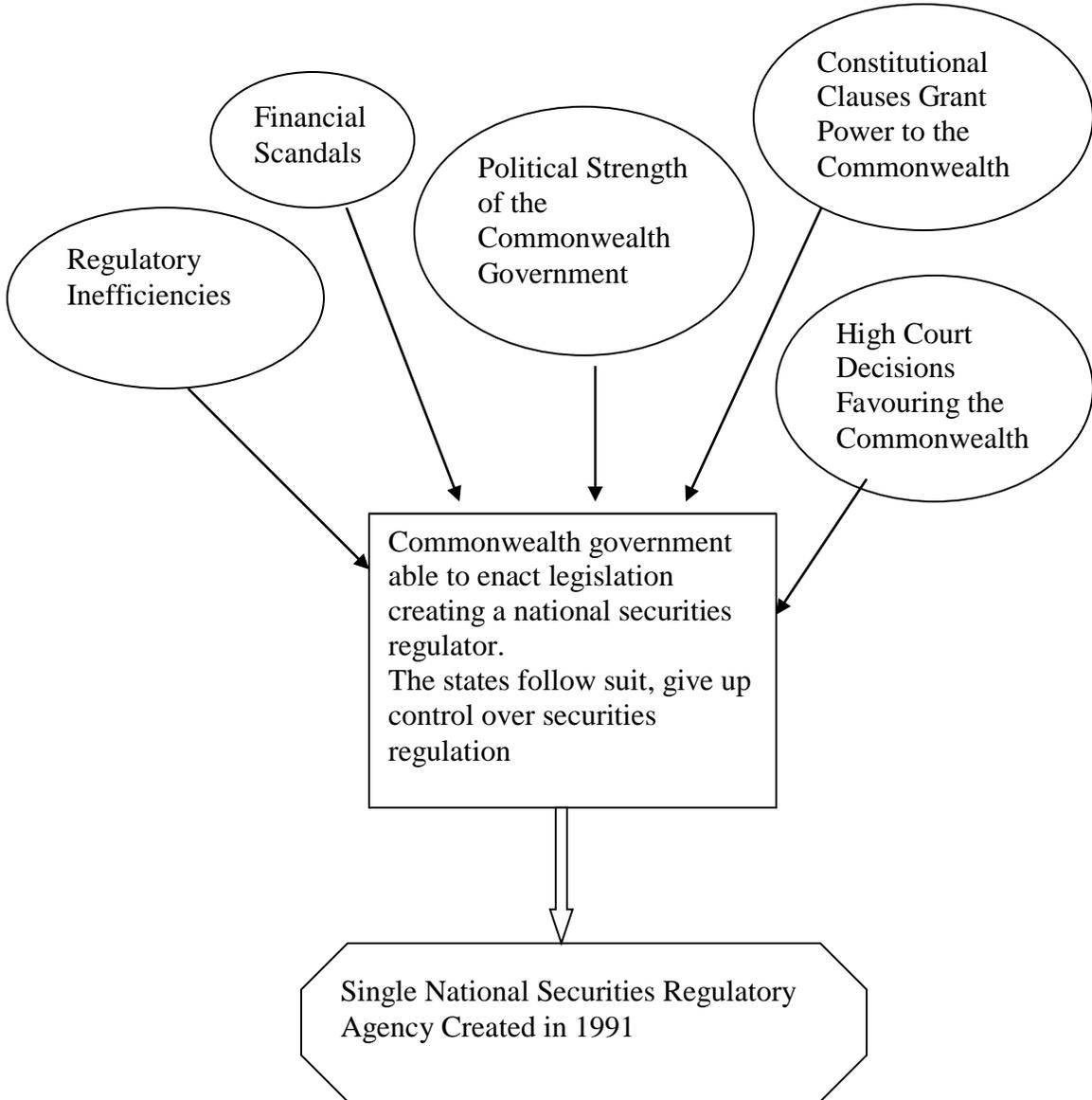
5.1. BACKGROUND

Australia's constitution is federal. Still, the Commonwealth¹¹⁶ (i.e., national or central) government in Canberra retains considerable capacity to challenge state (i.e., "provincial") governments on a variety of issues. The Commonwealth is able to implement policies in the face of state-level opposition. This fact played an instrumental role in the establishment of a single national securities regulatory agency in Australia. The Commonwealth government has retained considerable power vis-à-vis state governments due to the following factors: the design of the Australian Constitution; the role played by the Australian High Court; the relative equality and homogeneity of the

¹¹⁶ Throughout this project I will use the expression "Commonwealth" to designate the national Australian government (in accordance with Australian custom)

different state governments; and the assumptions and traditions embedded in the Australian body politic.

Figure 1: Change in Australia's Securities Regulation Framework



5.1.1. Financial Scandals in the 1980s

The creation of a national securities regulator in 1989-1991 must be seen in the context of the 1980s boom and subsequent bust. This bust saw the collapse of large media, brewing and industrial firms, and major banks.¹¹⁷ Investors excoriated “corporate cowboys.” These “cowboys” had artificially driven up the prices of businesses, properties, and equities.¹¹⁸ The state-level corporate affairs commissions were starved of resources and could not cope with the simultaneous scandals.¹¹⁹ The scandals and prosecutions of the late 1980s prompted the Commonwealth government to intervene, through legislation, in the regulation of capital markets. This attempt failed “because the High Court¹²⁰ ruled that the power to legislate for trading and financial corporations did not extend to the power to incorporate them.”¹²¹

5.1.2. Efforts to Centralize Securities Regulation

The High Court’s action led to a “deal” between the six states, the Northern Territory and the national government. Under this agreement, the Commonwealth “effectively bought corporate regulation from the states and that territory...”¹²² The Commonwealth enacted a company law for the Australian Capital Territory through its plenary power to legislate for territories. This law would serve as a legislative base that

¹¹⁷ Alan Cameron, “Keynote Lunchtime Presentation,” *A Symposium on Canadian Securities Regulation: Harmonization or Nationalization?*, p. 3.

¹¹⁸ *Ibid.*, p. 4.

¹¹⁹ *Ibid.*, p. 4.

¹²⁰ Australia’s Supreme Court

¹²¹ Alan Cameron, “Keynote Lunchtime Presentation,” *A Symposium on Canadian Securities Regulation: Harmonization or Nationalization?*, p. 4.

¹²² *Ibid.*, p. 5.

could be adopted by the other seven regional authorities.¹²³ Agreements reached between the Commonwealth government and the states throughout 1990 required identical legislation to be passed in each of the seven state parliaments (the state government of Western Australia was the most reluctant to relinquish its regulatory powers).¹²⁴ Through these agreements, the states were “effectively bought out of the business of regulating companies and markets.”¹²⁵ The federal authorities would take over the job of regulation, but the states would continue to receive the income they had gathered through regulatory activities (through fees, fines, etc.).¹²⁶

The reform efforts Australia has gone through include the following:¹²⁷

- 1) Uniform legislation in the 1960s and 1970s.
- 2) Draft federal legislation in 1974 that was never passed.
- 3) Multilateral agreements among states and territories in place of federal legislation. This represented an attempt to achieve direct coordination between the states, “by-passing” the Commonwealth government.
- 4) State and territory incorporation by reference of federal legislation in 1978. This initiative failed inefficiency, instability, and a lack of ministerial accountability. The threats of regional authorities to withdraw produced a “lowest common denominator”-type regulation.

¹²³ Alan Cameron, 2002, “Keynote Lunchtime Presentation,” *A Symposium on Canadian Securities Regulation: Harmonization or Nationalization?*, p. 5.

¹²⁴ *Ibid.*, p. 6.

¹²⁵ *Ibid.*, pp. 5-6.

¹²⁶ *Ibid.*, pp. 5-6.

¹²⁷ Douglas Harris, 2002, “White Paper,” *A Symposium on Canadian Securities Regulation: Harmonization or Nationalization?*, p. 86.

- 5) In the late 1980s, the Commonwealth government took a leading role in the drive to reform securities regulation. The national government exercised the political will necessary to corral state authorities into acquiescing to reforms.
- 6) In 1988, local stock exchanges in Australia merged. This represented an important step toward financial rationalization.

The Australian Securities and Investments Commission was initially established through federal legislation, without state involvement. This proved to be unconstitutional in certain respects. The regulatory system established in 1989-1991 is based on federal legislation that the states apply as their own legislation.¹²⁸ Australia thus successfully completed the transition of moving from a state-based regulatory system to a centralized system.

5.2. REGULATION OF CAPITAL MARKETS

Capital formation has played an increasingly important role in Australia's economic life. "Within a decade from its wartime nadir of a mere 5 per cent of GDP, capital formation had risen above 25 per cent of that measure..."¹²⁹ Capital formation remained at around that figure until 1990.¹³⁰

¹²⁸ Canadian Bankers Association, 2003, *Proposals for an Efficient and Effective Regulatory System in Canada*, p. 11.

¹²⁹ David Merrett, 1998, *Capital Markets and Capital Formation in Australia*, p. 6.

¹³⁰ *Ibid.*, p. 6.

5.2.1. State Jurisdiction

States have traditionally held jurisdiction over corporate law and securities regulation.¹³¹ The reform of Australia's securities regulation system has taken place in a "staged fashion." Business dissatisfaction with the costs associated with fragmented regulation led the states to seek improvement to the existing system. "In the 1960s, [the states] passed uniform legislation that eventually diverged again as individual jurisdictions reacted individually to events."¹³² Prompted by various financial scandals, a Senate Committee recommended the creation of a national securities commission in 1970.¹³³ "In 1978, a three-tiered scheme was enacted that had the states enact federal legislation by reference..."¹³⁴ This scheme created a federal body, the National Companies and Securities Commission, in addition to existing state Corporate Affairs Commissions. "This approach provided uniform legislation but fragmented administration and enforcement."¹³⁵ The three-tiered system proved to be inadequate.¹³⁶

5.2.2. Commonwealth Jurisdiction

Section 51 of the Australian Constitution appears to provide enough scope for the Commonwealth to forge a uniform approach to company law. Section 51 states the Parliament has the power to make laws "for the peace, order and good government of the

¹³¹ Canadian Bankers Association, 2003, *Proposals for an Efficient and Effective Regulatory System in Canada*, p. 10.

¹³² *Ibid.*, p. 10.

¹³³ *Ibid.*, p. 10.

¹³⁴ *Ibid.*, p. 10.

¹³⁵ *Ibid.*, pp 10-11.

¹³⁶ *Ibid.*, p. 11.

Commonwealth.”¹³⁷ The Commonwealth Parliament holds this power “with respect to ... foreign corporations, and trading or financial corporations formed within the limits of the Commonwealth.”¹³⁸ However, through the *Corporations Case* (1990), the High Court established that legislation relating to the formation of corporations is to be regarded as a state matter. The Court held that section 51 only empowers the Commonwealth to legislate in terms of already “formed” companies.¹³⁹ Each state has the power to incorporate corporations.¹⁴⁰

Both the Commonwealth and the states are able to play a role in the regulation of corporations. The States have the authority to regulate the affairs of state corporations. The Commonwealth can regulate the affairs of state corporations that are characterized as trading or financial corporations. The Commonwealth may also regulate corporations that are formed under specific Commonwealth powers. Finally, the Commonwealth can regulate the activities of foreign corporations in Australia. However, the Commonwealth’s authority to regulate does not extend to internal affairs of state corporations (e.g., their powers, capacities and internal regulations).¹⁴¹

5.2.3. The Alice Springs Agreement

The so-called *Alice Springs Agreement* in 1990, aided in large part by financial scandals in a number of states, effectively “federalized” company law. Under this

¹³⁷ Thomas Courchene, 1996, “Preserving and Promoting the Internal Economic Union.” Paul Boothe, Ed., *Reforming Fiscal Federalism for Global Competition*, p. 203.

¹³⁸ *Ibid.*, p. 203.

¹³⁹ Thomas Courchene, 1996, “Preserving and Promoting the Internal Economic Union.” Paul Boothe, Ed., *Reforming Fiscal Federalism for Global Competition*, p. 203.

¹⁴⁰ George Goulet, 1991, *A Comparative Analysis of Constitutional Aspects of Securities Regulation in Canada and Australia*, p. 105.

¹⁴¹ *Ibid.*, pp. 105-106.

agreement, federal law would no longer apply to the states – the text of the Commonwealth law would be adopted by each of the states and the Northern Territory and enacted as their own legislation or law.¹⁴²

5.2.4. The Australian Securities and Investments Commission (ASIC)

The Australian Securities and Investments Commission (ASIC) is the national agency tasked with regulating the Australian securities industry. The ASIC is an independent Commonwealth body. The Governor-General appoints the ASIC's Commissioners on the nomination of the Treasurer. The ASIC is accountable to the Commonwealth Parliament, to the Treasurer, and to the Parliamentary Secretary to the Treasurer.¹⁴³ The *Australian Securities and Investments Commission Act 1989* established the ASIC. It began to function on January 1, 1991. The ASIC took over the functions previously performed by the National Companies and Securities Commissions (NCSC) and the Corporate Affairs offices of the [individual] States and Territories.”¹⁴⁴

The main functions of the ASIC are: registration of companies; registration of company auditors and liquidators; processing and distributing information to the public about securities schemes; exercising statutory discretion to relieve companies from compliance with provisions of the Corporations Law; regulating the securities industry; regulating the futures industry; investigating suspected contraventions of the Corporations Law; enforcing compliance with the Corporations Law; and enforcing and

¹⁴² Thomas Courchene, 1996, “Preserving and Promoting the Internal Economic Union.” Paul Boothe, Ed. *Reforming Fiscal Federalism for Global Competition*, pp. 203-204.

¹⁴³ Australian Securities and Investments Commission, 2003, *ASIC at a Glance*, <http://www.asic.gov.au/asic/asic.nsf/byheadline/ASIC+at+a+glance?opendocument>.

¹⁴⁴ *Ibid.*

investigating suspected contraventions of consumer protection provisions.¹⁴⁵ “The powers of the [ASIC] are complemented in many ways by the powers of the Exchange (ASX) with respect to listed companies and other securities interests.”¹⁴⁶

Some critics posit that the ASIC’s powers “involve an unwarranted interventionist stance in relation to the regulation of the corporate market sphere.” Opponents of this view believe that the ASIC needs broad powers to protect the public.¹⁴⁷ Some commentators believe that regulation promotes investor confidence and encourages market investment. Other commentators believe that too much market regulation reduces the market’s dynamism.¹⁴⁸

In 1998 Australian authorities broadened the jurisdictional scope of the ASIC in order to cover the regulation of market conduct for banking, insurance, and pension sectors.¹⁴⁹ “In June 2001, the Australian parliament passed into law the *Corporations Act, 2001*, designed to place Australia’s system of corporate regulation on a secure constitutional foundation.”¹⁵⁰

5.3. FEDERALISM AND PUBLIC POLICY

Bicameralism in the central government and divided jurisdiction (between the Commonwealth and state governments) are two principal characteristics of the

¹⁴⁵ University of the South Pacific, School of Law, 2000, LA426, Advanced Pacific Commercial Transactions – Module 10, *The Australian Securities Commission*, http://www.vanuatu.usp.ac.fj/courses_masters/LA426_Advanced_Pacific_Commercial_Transactions/LA426_module10.html.

¹⁴⁶ Ibid.

¹⁴⁷ Ibid.

¹⁴⁸ Ibid.

¹⁴⁹ Program Agenda, 2002, *A Symposium on Canadian Securities Regulation: Harmonization or Nationalization?*, p. 2.

¹⁵⁰ Ibid., p. 2.

institutions that determine public policy in Australia.¹⁵¹ According to the Australian Constitution, Commonwealth powers are largely concurrent with the states'. The states generally hold any residual powers.¹⁵² "However, in those areas where the Commonwealth does have concurrent powers, its legislation ultimately is paramount..."¹⁵³ The Commonwealth also has a grant power, under section 96 of the Constitution, "which enables it to enter into the fields that are exclusively those of the states..."¹⁵⁴ The Commonwealth can do this by setting conditions on its provision of financial support for State activities in said fields.¹⁵⁵

5.3.1. Increase in the Commonwealth's Power

Recent years have seen an increase in the power of the Commonwealth vis-à-vis the states in the field of public policy-making. This is a result of various factors. First, political authorities have used clauses in the Australian Constitution to advance the federalist cause. Second, the High Court has reached decisions in favour of expanding Commonwealth powers. Third, the Commonwealth exerts control over finances and economic resources. Fourth, the political make-up of recent federal governments has aided the expansion of Commonwealth powers.

¹⁵¹ Alan Fenna, 1998, *Introduction to Australian Public Policy*, p. 90.

¹⁵² Cliff Walsh, 1996, "The Challenges of Globalization: Lessons from the Australian Experience." Paul Boothe, Ed., *Reforming Fiscal Federalism for Global Competition*, p. 25.

¹⁵³ *Ibid.*, p. 25.

¹⁵⁴ *Ibid.*, p. 25.

¹⁵⁵ *Ibid.*, pp. 25-26.

5.3.2. The Role of the Right and the Left

Conservative or “right-wing” social groups in Australia have generally favoured federalism as an instrument that can protect regional interests against national majorities. Federalism “helps insulate markets from interventionism and society from social engineering.”¹⁵⁶ In contrast, left-wing groups in Australia have traditionally been centralists. They seek to minimize or eliminate the obstacles federalism places in the way of nation-wide reformist policy-making.¹⁵⁷ The ascendancy of the Labour Party in the 1980s and early 1990s provided political and ideological support to the movement to centralize the regulation of the securities industry.

5.3.3. Economic Rationalism

The general trend we can observe in the approach of Australian policy-makers to the financial sector represents a shift from “draconian” regulation to de-regulation.¹⁵⁸ Australia’s stock exchanges, founded in the late 19th century, were initially self-regulated. “This process of self-regulation was overwhelmed during the speculative boom in mining stocks in the late 1960s.”¹⁵⁹ Wide speculation led to number of scandals. These scandals caused the government to launch an investigation into the securities industry. The recommendations of a government report submitted in 1974 led to the establishment of an Australian Companies and Securities Commission. This Commission

¹⁵⁶ Alan Fenna, 1998, *Introduction to Australian Public Policy*, p. 99.

¹⁵⁷ *Ibid.*, p. 99.

¹⁵⁸ David Merrett, 1998, *Capital Markets and Capital Formation in Australia*, p. 2.

¹⁵⁹ *Ibid.*, p. 4.

would henceforth regulate the stock exchanges, thus ending the exchanges' self-regulation.¹⁶⁰

The drive toward economic “rationalism” has played a prominent role in recent public policy debates in Australia.¹⁶¹ The centralization of securities regulation (among other policy initiatives) must be seen in this context. Economic rationalism has raised the profile of public policy in Australia. Economic rationalism has also re-invigorated debates about the role of government.”¹⁶²

5.3.4. The Constitution and Commonwealth Supremacy

While Australia is a federation in which the states enjoy large degrees of autonomy, the Australian Constitution provides some support to notions of Commonwealth supremacy over the states. Section 109 declares that in the event of a clash between State and Commonwealth legislation, “the latter shall prevail.”¹⁶³ Under section 51, the Commonwealth has extensive powers over taxation and the supply and borrowing of money. However, the Commonwealth’s authority over other areas is ambiguous. There is contention over the Commonwealth’s jurisdiction over business regulation and control.¹⁶⁴

5.3.5. Interventions of the High Court in Jurisdictional Conflicts

The High Court of Australia is an important player in public policy debates due to its role as an arbiter in Commonwealth-State jurisdictional conflicts. Since, the early

¹⁶⁰ David Merrett, 1998, *Capital Markets and Capital Formation in Australia*, p. 4.

¹⁶¹ *Ibid.*, p. 24.

¹⁶² *Ibid.*, p. 37.

¹⁶³ Alan Fenna, 1998, *Introduction to Australian Public Policy*, p. 93.

¹⁶⁴ *Ibid.*, p. 94.

1970, High Court decisions have helped the cause of policy-making centralization. The Court's decisions have allowed an expansion of the Commonwealth's policy-making abilities.¹⁶⁵ High Court decisions have extended federal powers over the regulation of anti-competitive business practices, human rights legislation, and environmental heritage preservation.¹⁶⁶ Judicial action has thus contributed to a shift away from what has been called "co-operative federalism" and toward Commonwealth dominance.¹⁶⁷

5.3.6. The Commonwealth's Financial Clout

The Commonwealth's power over the purse strings is another reason for which it has been able to increase its dominance over public policy-making in Australia. The federal government raises around 80 percent of all government revenue. Federal authorities are only responsible for 50 percent of government spending.¹⁶⁸ A series of Commonwealth-State agreements (e.g., on company law) have enhanced the internal economic union of Australia. Inter-state agreements (e.g., on mutual recognition) have complemented Commonwealth-State agreements.¹⁶⁹

5.3.7. Hawke's New Federalism

Federal and state political parties are linked (e.g., the state Labour parties are joined to the federal Labour party). Some resistance to new federal policies can come from the regional branches of federal parties. Such resistance is due to the possible local

¹⁶⁵ Alan Fenna, 1998, *Introduction to Australian Public Policy*, p. 95

¹⁶⁶ *Ibid.*, p. 95.

¹⁶⁷ *Ibid.*, p. 96.

¹⁶⁸ *Ibid.*, p. 96.

¹⁶⁹ Thomas Courchene, 1996, "Preserving and Promoting the Internal Economic Union." Paul Boothe, Ed., *Reforming Fiscal Federalism for Global Competition*, p. 217.

impact of national policies.¹⁷⁰ Prime Minister Bob Hawke (1983-1991) attempted to re-invigorate Australian federalism. He established a framework through which the federal and state governments could jointly formulate new policy initiatives. Through Hawke's *New Federalism*, regional and federal authorities tackled a number of regulatory regimes where differences existed between the states. Policy makers made substantial progress in achieving a greater degree of consistency, though not necessarily uniformity, between the states.¹⁷¹

The Hawke *New Federalism* allowed the states to “rediscover” their role within the federation. State policy makers realized how powerful they could be if they coordinated their actions. Hawke's successor as Prime Minister, Paul Keating (1991-1996), attempted to re-establish Commonwealth dominance over the policy-making process. He was, however, unable to shut out the states from the federal policy-making process. The consultative framework established by Hawke could not be dismantled.¹⁷²

5.4. IMPLICATIONS OF AUSTRALIA'S EXPERIENCE

In my view, Australia's experience in the field of securities regulation shows that any reform of the framework of securities regulation must “fit” broader institutional trends. The centralization of securities regulation in 1989-1991 would not have been possible without a number of broader institutional developments in Australian society. These developments included: the growing power of the Commonwealth with respect to the states (admittedly based on strong constitutional and judicial foundations); the

¹⁷⁰ Cliff Walsh, 1996, “The Challenges of Globalization: Lessons from the Australian Experience.” Paul Boothe, Ed., *Reforming Fiscal Federalism for Global Competition*, p. 26.

¹⁷¹ *Ibid.*, p. 29.

¹⁷² *Ibid.*, pp. 32-37.

electoral successes of the Labour Party, a party favourable to the strengthening of the Commonwealth's policy-making prerogatives; and the relative equality, in terms of political and economic weight, of the different states. The creation of the ASIC might not have been possible without the simultaneous confluence of these institutional trends. The common denominator of these trends is their tendency to strengthen the role of the Commonwealth in any policy dispute with the states.

The Australian authorities working to centralize securities regulation had the political will to see their regulatory reforms through, in spite of constitutional challenges to these reforms.¹⁷³ “The Australian experience also provides a working example of how a delegation model can be used to create a single national securities commission without entering the realm of constitutional reform.”¹⁷⁴

¹⁷³ Douglas Harris, 2002, “White Paper,” *A Symposium on Canadian Securities Regulation: Harmonization or Nationalization?*, p. 87.

¹⁷⁴ Canadian Bankers Association, 2003, *Proposals for an Efficient and Effective Regulatory System in Canada*, p. 11.

CHAPTER 6: CANADA

Canada's experience in the field of securities regulation provides evidence to support this project's conclusions. Canada's institutional context and regional imbalances cause Canadian securities regulation to remain decentralized. This chapter will first review the background to Canada's recent initiatives in the area of securities regulation. Second, it looks at jurisdictional issues in capital markets regulation. Third, this chapter analyzes the effects of federalism on Canada's policy-making process. Finally, Chapter 6 discusses the implications of Canada's experience.

6.1. BACKGROUND

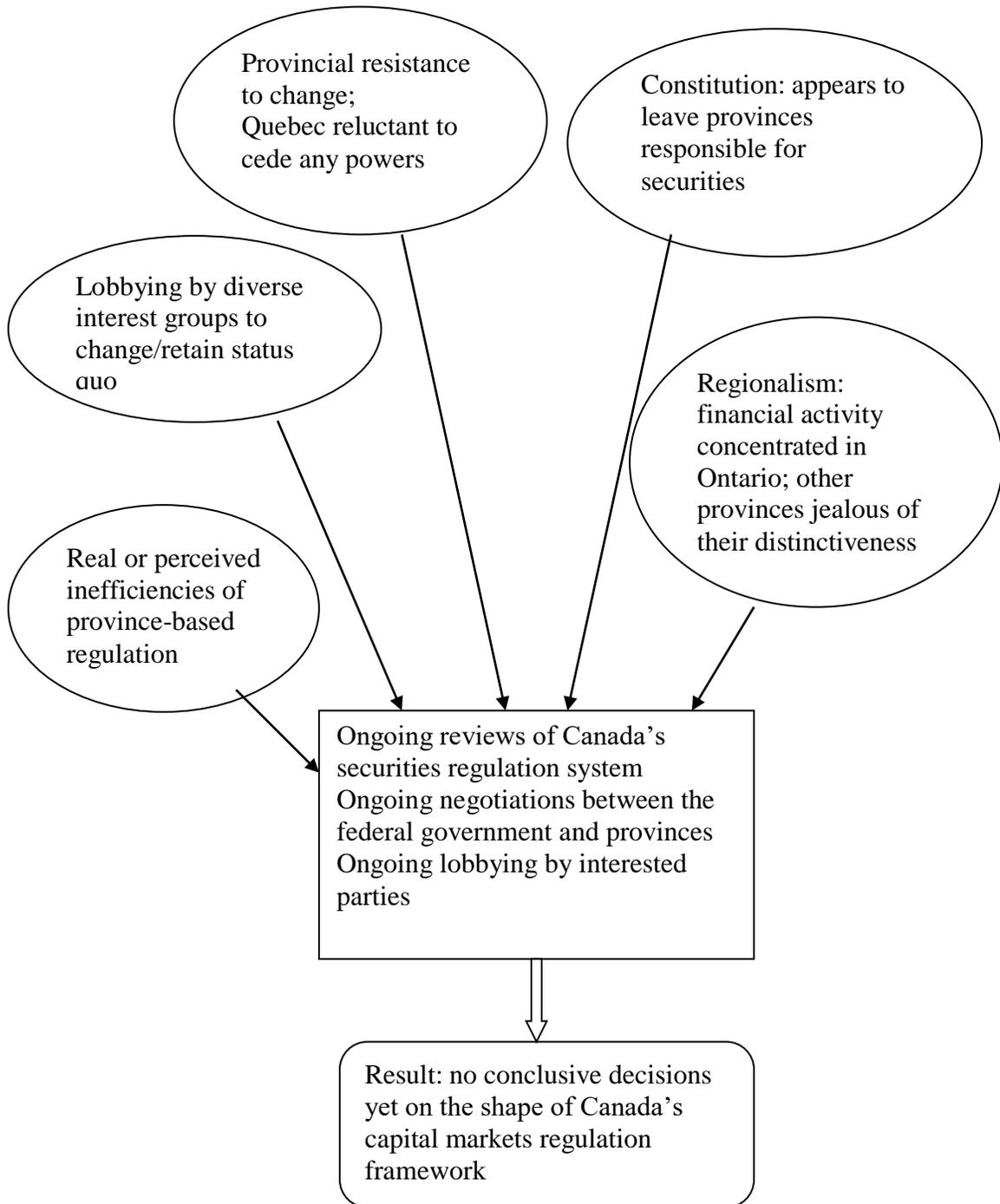
Canadian political institutions place great emphasis on the power and autonomy of provincial governments. The Canadian federal government is much weaker, with respect to its respective regional authorities, than the Australian Commonwealth government. Canada's Constitution, political history, and domestic balance of power make it extremely difficult for the federal government to appropriate powers presently belonging to provincial governments. This is one of the reasons for which it has been impossible to establish a single national securities regulatory agency in Canada. The authority to regulate capital markets remains in the hands of provincial governments.

6.1.1. Attempts to Reform Securities Regulation

There have been several attempts to create a national securities authority. In 1977, a federal proposal to create such an agency was dropped due to insufficient

support. In the mid-1990s, provincial concerns over the loss of revenues (from filing and registration fees) provoked the breakdown of negotiations to create a national securities

Figure 2: Change in Canada's Securities Regulation Framework



authority.¹⁷⁵ Other reform initiatives include: the Porter Report (1964), the CANSEC Proposal (1967), the Proposals for a Securities Market Law for Canada study (1979), and the 1994 Memorandum of Understanding and its revival in 1996.¹⁷⁶

6.1.2. The Canadian Securities Administrators (CSA)

In order to coordinate their actions, policy proposals, and legislation, Canada's provincial securities regulators have formed the Canadian Securities Administrators (CSA). The CSA is an association formed by provincial securities regulators through which regulatory agencies meet "to discuss matters of mutual concern and policy and which has an objective of compatibility or harmony of provincial securities regulation."¹⁷⁷

6.1.3. Recent Federal and Provincial Initiatives

In 2002-2003, the federal government created a "Wise Persons" Committee in order to study the future direction of securities regulation in Canada. Provincial ministers established the Steering Committee of Ministers for the same purpose.¹⁷⁸ A number of important players in the Canadian securities industry have continued to lobby for the creation of a single national securities regulatory agency in Canada. Most provincial authorities, with the key exception of Ontario, are sceptical of the creation of a national regulatory agency. An alternative to such a creation is the establishment of a "passport"

¹⁷⁵ Investment Counsel Association of Canada, 2002, *The Path to Achieving a National Securities Regulatory System for Canada*, p. 3.

¹⁷⁶ Douglas Harris, 2002, "White Paper," *A Symposium on Canadian Securities Regulation: Harmonization or Nationalization?*, p. i.

¹⁷⁷ George Goulet, 1991, *A Comparative Analysis of Constitutional Aspects of Securities Regulation in Canada and Australia*, p. 28.

¹⁷⁸ Canadian Bankers Association, 2003, *Proposals for an Efficient and Effective Regulatory System in Canada*, p. i.

system that will allow investment firms licensed in one province to automatically receive authorization to conduct operations in all other provinces. This “passport” system has received considerable support. The following are some critical elements in the debate over the form Canada’s securities regulation structure should take:¹⁷⁹

- 1) The role of regional interests. The decentralized nature of the Canadian federation requires that any reform take into account regional interests. It would be exceedingly difficult to implement initiatives that are not accepted by provincial authorities.
- 2) Costs associated with the current structure. These costs must be measured against the costs that might be incurred by the creation of an alternative regulatory system, such a single national securities regulator.
- 3) Benefits/Risks associated with regulatory competition. The present framework of securities regulation provides for regulatory competition among the various agencies. On one hand, this can encourage regulatory creativity. On the other hand, it might lead to a “race to the bottom” between the different agencies.
- 4) Analysis of the experience of other countries or jurisdictions. Canada can learn from the experiences of foreign jurisdictions with federal or quasi-federal systems of government (e.g., Australia or the European Union).

6.1.4. Federal Legislation and Capital Markets

While securities regulation remains in provincial hands, some current federal legislation plays a role in the oversight of capital markets. Legislation such as the

¹⁷⁹ Douglas Harris, 2002, “White Paper,” *A Symposium on Canadian Securities Regulation: Harmonization or Nationalization?*, p. iv.

Canadian Business Corporations Act, the Bank Act, the Investment Canada Act, and the Criminal Code of Canada must be taken into account in the field of securities trading.¹⁸⁰

“Securities legislation in Canada is an amalgam of two philosophies, mandatory disclosure and merit regulation.”¹⁸¹

6.1.5. Stock Exchange Amalgamation

Canada’s stock exchanges recently went through an amalgamation process. Ten years ago, there were a number of equity exchanges in existence: Toronto, Montreal, Vancouver, Calgary, Winnipeg, etc. The only equity exchange today is the TSX, with the TSX Venture Exchange as its subsidiary. The Montreal Exchange is responsible for derivatives trading.¹⁸²

6.2. REGULATION OF CAPITAL MARKETS

Canada “is surely unique among federations in that the securities industry is almost entirely provincially regulated.”¹⁸³ Provincial securities commissions control the regulatory apparatus, including the accreditation of brokers.¹⁸⁴ Stock exchanges, on the other hand, have undergone much consolidation in recent years. In spite of its balkanized regulatory system, Canada has a “very effective” capital market for a country of its size. This is, in part, the result of a considerable degree of harmonization among the different

¹⁸⁰ George Goulet, 1991, *A Comparative Analysis of Constitutional Aspects of Securities Regulation in Canada and Australia*, p. 17.

¹⁸¹ *Ibid.*, p. 15.

¹⁸² Canadian Bankers Association, 2003, *Proposals for an Efficient and Effective Regulatory System in Canada*, p. 1.

¹⁸³ Thomas Courchene, 1996, “Preserving and Promoting the Internal Economic Union.” Paul Boothe, Ed., *Reforming Fiscal Federalism for Global Competition*, p. 204.

¹⁸⁴ *Ibid.*, p. 204.

securities commissions.¹⁸⁵ One possible explanation is that the absence of a federal role forced the provinces to build a national capital market.

6.2.1. The Constitution and Provincial Jurisdiction

The Canadian Constitution establishes clearly that the provinces have authority to legislate securities law. This authority was re-affirmed by the Privy Council in 1932.¹⁸⁶ A Privy Council decision in that year stated that provinces have the constitutional authority to regulate securities markets through their ability to make laws in relation to “property and civil rights in [a] province.”¹⁸⁷ “Additional authority to regulate securities markets derives from the provinces’ ability to incorporate companies with ‘provincial objects,’ but only insofar as the regulation is ancillary to company law objectives.”¹⁸⁸

Section 92 (13) of the *Constitution Act, 1867* gives Canadian provinces jurisdiction over “property and civil rights in the province.” This authority “is limited by the territorial boundaries of the province.”¹⁸⁹ The federal government’s constitutional ability to regulate securities markets is less clear.¹⁹⁰ Some possible constitutional/legislative bases for the exercise of federal power in this arena are: ¹⁹¹ (1) the Peace Order and Good Government of Canada; (2) the Regulation of Trade and Commerce; (3) Banking, Incorporation of Banks, and the Issue of Paper Money; (4) Savings Banks; (5) the Criminal Law; and (6) Federal works and undertakings.

¹⁸⁵ Thomas Courchene, 1996, “Preserving and Promoting the Internal Economic Union.” Paul Boothe, Ed., *Reforming Fiscal Federalism for Global Competition*, p. 204.

¹⁸⁶ Jeffrey MacIntosh, 1996, *A National Securities Commission for Canada?*, pp. 191-192.

¹⁸⁷ British North America Act

¹⁸⁸ Jeffrey MacIntosh, 1996, *A National Securities Commission for Canada?*, pp. 191-192.

¹⁸⁹ George Goulet, 1991, *A Comparative Analysis of Constitutional Aspects of Securities Regulation in Canada and Australia*, p. 113.

¹⁹⁰ Jeffrey MacIntosh, 1996, *A National Securities Commission for Canada?*, p. 192.

¹⁹¹ *Ibid.*, p. 192.

6.2.2. The Constitution and Federal Jurisdiction

The Constitution appears to grant the federal government at least a limited role in the regulation of capital markets. We can find the basis of federal competence in the field of securities regulation in the federal Parliament's powers under the *Constitution Act, 1867*. These powers include primarily the power to make laws in relation to trade and commerce (section 91 (2)), the power to make laws in relation to inter-provincial works and undertakings (sections 92 (10) (a) with 91 (29)) and the power to make laws for the peace, order and good government of Canada (found in the lead-in words to section 91).¹⁹²

The federal government can also “indirectly” play a role in securities regulation through its jurisdiction over national and international trade. “The Parliament's powers with respect to inter-provincial and international trade and commerce give it competence over inter-provincial and international securities regulation.”¹⁹³

The “Wise Persons” Committee (WPC) established by the federal minister of finance to review the structure of securities regulation in Canada proposed the establishment of a single national securities regulatory agency in its final report (December 2003). The model proposed by the WPC would take into account the Uniform Securities Legislation Project undertaken by the Canadian Securities Administrators.¹⁹⁴ A number of studies included in the WPC's report argue that the

¹⁹² George Goulet, 1991, *A Comparative Analysis of Constitutional Aspects of Securities Regulation in Canada and Australia*, pp. 123-124.

¹⁹³ *Ibid.*, p. 167.

¹⁹⁴ Wise Persons Committee (WPC) – Committee to Review the Structure of Securities Regulation in Canada, 2003, *It's Time – WPC Final Report*, December 2003, p. ix.

federal government has the constitutional ability to centralize securities regulation in Canada. In a Constitutional Opinion presented to the WPC, Ogilvy Renault writes:

“In our view, Parliament has the constitutional power to enact the Act [establishing a single national securities regulator]. The general branch of the federal trade and commerce power under section 91 (2) of The Constitution Act, 1867 ... provides Parliament with the strongest basis for enacting the Act.”¹⁹⁵

Allan McEachern (of Fasken Martineau DuMoulin LLP), in an Opinion offered to the same committee, essentially agrees, explaining:

“In summary, it is my opinion that Parliament has the legislative authority to enact legislation implementing the CSC model [of a national securities regulator]. Further, the provinces and territories have legislative authority to enact legislation that incorporates federal securities legislation by reference, delegates administrative powers to the CSC and dissolves the existing provincial and territorial securities regulatory bodies.”¹⁹⁶

6.2.3. Arguments for Centralizing Securities Regulation

One of the arguments advanced in favour of the creation of a national securities regulator is the belief that this initiative would reduce current regulatory costs. There are presently three primary reasons for the high costs of securities regulation in Canada: (i) differences among the various jurisdictions, (ii) the presence of multiple decision-makers, and (iii) the complexity of regulation.

6.2.4. Initiatives to Increase the Efficiency of Securities Regulation

The existing regulatory bodies in Canada have taken steps to make the securities regulation framework more efficient:¹⁹⁷

¹⁹⁵ Ogilvy Renault, 2003, “Constitutional Opinion.” Douglas Harris, Ed., *Wise Persons Committee – Committee to Review the Structure of Securities Regulation in Canada: Research Studies*, p. 2.

¹⁹⁶ Allan McEachern, 2003, “Constitutional Opinion.” Douglas Harris, Ed., *Wise Persons Committee – Committee to Review the Structure of Securities Regulation in Canada: Research Studies*, p. 25.

¹⁹⁷ Canadian Bankers Association, 2003, *Proposals for an Efficient and Effective Regulatory System in Canada*, p. i.

- 1) The design of *National Instruments*. These represent an attempt to reduce the differences between regulatory jurisdictions.
- 2) Efforts have been made to create a *Uniform Securities Law*. This initiative might eliminate legislative differences between jurisdictions.
- 3) The creation of a mutual reliance system. This allows provinces and territories to “rely on a lead jurisdiction to process prospectuses and related material.”
- 4) Regional regulatory agencies can use standard electronic filing systems (e.g., SEDAR, SEDI). This initiative can help harmonize the procedures of the various provincial regulatory agencies.

Issuers, registrants, and intermediaries must deal with Self-Regulating Organizations (SROs), in addition to regulatory agencies. Examples of such SROs are the Investment Dealers Association (IDA), the Mutual Fund Dealers Association (MFDA), the Canadian Investor Protection Fund, and the Market Regulatory Services.¹⁹⁸

6.2.5. Ongoing Debate in Canada over Securities Regulation

No final decision has yet been taken on the framework of securities regulation in Canada. It seems that debates over this framework arise every few years. The debate may continue well into the future. Past and present trends indicate, in my view, Canada is still struggling to find a regulatory framework that can “fit” into the broader Canadian institutional context. This is made all the more difficult by the fact that Canada’s institutional context is itself subject to frequent debate and change.

¹⁹⁸ Canadian Bankers Association, 2003, *Proposals for an Efficient and Effective Regulatory System in Canada*, p. i.

6.3. FEDERALISM AND PUBLIC POLICY

Canada appears to be more decentralized than Australia at a political and economic level. It is much more difficult for Canadian policy-makers to pursue an internal economic union.¹⁹⁹ On the other hand, Canada's greater decentralization leaves greater scope for what has been dubbed "competitive federalism": different jurisdiction can "experiment" with different public policy systems in order to find out which are most efficient²⁰⁰ (presumably the results of policy experimentation and competition could be shared).

6.3.1. The Federalist Character of Canada

In contrast to Australia, Canadian courts have not consistently promoted the notion of federal primacy. The relative absence of national cohesion has played a role in leaving Canada with a more fragmented "internal economic space" than Australia.²⁰¹ The 1867 *British North America Act* firmly established the federal character of policy-making in Canada. The "patriation" of the Constitution in 1982 and the enactment of the *Charter of Rights and Freedoms* in the same year re-affirmed this federal character. Attempts to reform the Canadian Constitution in 1987-1990, through the "Meech Lake Accord," and in 1992, through the "Charlottetown Accord," failed. Nevertheless, the proposals put forward during these two negotiation processes revealed the depth of Canada's federalist character: Canadian provinces are jealous of their prerogatives.

¹⁹⁹ Thomas Courchene, 1996, "Preserving and Promoting the Internal Economic Union." Paul Boothe, Ed., *Reforming Fiscal Federalism for Global Competition*, p. 206.

²⁰⁰ Ibid., p. 212.

²⁰¹ Ibid., p. 217.

6.3.2. The Quebec Factor

The importance of the role played by the “Quebec factor” in structuring the Canadian securities regulation framework, and indeed in Canada’s entire economic framework, cannot be underestimated. Quebec’s social, judicial, and economic systems are based on traditions that are distinct from the British models implanted in much of the rest of Canada. Since the *révolution tranquille* in the 1960s and the growth of separatist tendencies occurred around the same time, Quebec’s claim to a unique status within the Canadian Confederation has grown more shrill and urgent. It seems unlikely that Quebec would ever relinquish the independence of its *Commission des valeurs mobilières du Québec* (Quebec’s own provincial securities commission).

6.3.3. Ontario’s Preponderance

The political, demographic, and economic preponderance of Ontario in Canada also plays an important role in shaping the debate over securities regulation. However, rather than using its dominance to play a coordinating role, Ontario’s financial “hegemony” has actually increased other provinces’ reluctance to join in the creation of a national regulatory agency. Smaller provinces fear that Ontario and its interests would dominate such an agency.

6.3.4. Asymmetric Character of Canadian Federalism

The protagonism played (for different reasons) by Quebec and Ontario in the Canadian federation makes it more difficult for the federal government to introduce constitutional innovations. The “asymmetry” (in terms of power and wealth) between the different Canadian provinces easily results in distrust among the various provinces. At

the same time this distrust prevents the federal government from implementing a conciliatory or a “divide-and-rule” strategy. This renders constitutional innovation in Canada very difficult. The reform of the framework for securities regulation would require some kind of constitutional change.

6.4. IMPLICATIONS OF CANADA’S EXPERIENCE

Canada’s experience in the field of securities regulation shows that any reform of the framework of securities regulation must adapt to the broader institutional context. Federalist tendencies within Canada’s institutional framework are very strong. For this reason, the current province-based securities regulation system is, to some degree, well adapted to the existing institutional framework. Any reform of securities regulation today would require not only that the new regulatory system “fit” the institutional context, but also that the process through which reform is achieved “fit” institutional requirements (i.e., that all relevant actors be satisfied with the consultative and policy-making process). “The Canadian system of securities regulation is the product of [Canada’s] history.”²⁰² We might add that the future shape of Canada’s regulatory framework will be a product of Canada’s future institutional development.

6.4.1. What is Required to Reform the Canadian System?

The absence of an “exogenous event” (e.g., European unification or domestic financial scandals) that can help jump-start structural reform of the securities regulation system distinguishes reform efforts in Canada from the experience in Australia and the

²⁰² Canadian Bankers Association, 2003, *Proposals for an Efficient and Effective Regulatory System in Canada*, p. 24.

European Union.²⁰³ A thorough reform of the Canadian regulatory system would require sustained “political and regulatory will” to see changes through – at this time it is not clear whether that “will” exists.²⁰⁴

6.4.2. The Implausibility of Exclusive Federal Jurisdiction

To date, proposals for reform of the regulatory system have not suggested exclusive federal jurisdiction over securities regulation. Most policy makers do not consider exclusive federal jurisdiction over securities a realistic option. Policy makers recognize that “the political realities of regulatory reform, as well as the constitutional division of powers in Canada” make exclusive federal jurisdiction difficult.²⁰⁵ Moreover, we must take into account that Quebec would never participate in the creation of a national regulator.²⁰⁶ Commentators in Canada, after studying the Australian experience in securities regulation, “have recognized the need for a regulator’s activities to be grounded in constitutional authority.”²⁰⁷

6.4.3. Political Obstacles to the Centralization of Securities Regulation

The following are some of the lingering “political” issues that make the formation of a national securities commission difficult: ²⁰⁸

²⁰³ Douglas Harris, 2002, “White Paper,” *A Symposium on Canadian Securities Regulation: Harmonization or Nationalization?*, pp. i-ii.

²⁰⁴ *Ibid.*, pp. i-ii.

²⁰⁵ *Ibid.*, pp. i-ii.

²⁰⁶ *Ibid.*, pp. i-ii.

²⁰⁷ Canadian Bankers Association, 2003, *Proposals for an Efficient and Effective Regulatory System in Canada*, p. 11.

²⁰⁸ Jeffrey MacIntosh, 1996, *A National Securities Commission for Canada?*, pp. 186-191.

- 1) The loss of power (of smaller provinces) to the “Eastern Establishment.” Any reform of securities regulation in Canada must provide re-assurances to smaller provinces that their interests will be respected.
- 2) The loss of power to Ontario. Other provinces would be reluctant to join any new regulatory scheme that simply increased Ontario’s financial dominance.
- 3) The difficulty of altering the existing distribution of power in a federal system. A reform of securities regulation would involve some form of constitutional change.
- 4) Quebec’s claims. Strong nationalist sentiment in Quebec makes the surrender of any provincial power highly problematic.
- 5) Bureaucratic turf wars and the possibility of job cuts. Turf wars between provincial and federal agencies could ensue from a re-distribution of responsibility for securities regulation. The creation of a single national securities regulator would likely lead to job cuts at the local level.
- 6) Turf battles within the provinces.
- 7) A possible “veto” from Ontario. Ontario hegemony in financial matters gives this province an effective “veto” over any initiatives in the area of securities regulation.
- 8) Federal-Provincial horse-trading. The need for “consensus” between federal and provincial authorities over regulatory change can impose considerable challenges to the swift reform of securities regulation.

6.4.4. Developments Undermining the Status Quo

Canada's relatively lesser degree of economic union [than Australia's] is a result of provincial and federal actions and omissions.²⁰⁹ Current developments may undermine the status quo. For instance, banks, which are federally regulated, have largely taken over Canadian securities firms – this development could undercut provincial control over regulation.²¹⁰ “External forces (north-south trade and agreements like the FTA and NAFTA) have played a much greater role in freeing up domestic markets in Canada than in Australia.”²¹¹ In any event, this chapter has shown that Canada will likely cope with these changes in a different way than Australia. Canada's securities regulation framework may change, but it will probably not change in the “Australian” fashion.

²⁰⁹ Thomas Courchene, 1996, “Preserving and Promoting the Internal Economic Union.” Paul Boothe, Ed., *Reforming Fiscal Federalism for Global Competition*, p. 218.

²¹⁰ *Ibid.*, p. 205.

²¹¹ *Ibid.*, p. 217.

CHAPTER 7: ANALYTIC SYNTHESIS

Chapter 7 summarizes the conclusions of this project. First, it reviews the importance of the role played by the institutional framework of capital markets. Second, this chapter touches on the effect of regionalist forces on financial regulation. Third, it reviews the main lessons drawn from the case studies of Australia and Canada. Finally, Chapter 7 emphasizes the main conclusion of this project: namely, the need for a regulatory system to “fit” into its institutional surroundings in order to be successful.

7.1. THE POLITICAL FRAMEWORK OF CAPITAL MARKETS

This project has attempted to examine the relationship between capital markets and political institutions. Political institutions establish a framework for the exercise of the power of the state in a society. One of the ways in which the state exercises its power is by regulating capital markets. Capital markets cannot flourish in a society in which the power of the state is exercised arbitrarily. Capital markets in Australia and Canada are generally not faced with the arbitrary exercise of state power. In Australia, capital markets are regulated in a highly centralized way. In Canada, capital markets are regulated in a highly decentralized way.

Regulatory authorities in both countries operate under a number of constraints. At the same time, capital markets are compelled to operate within certain regulatory requirements. These requirements play an important role in determining the level of

efficiency, the attractiveness, and the cost levels of capital markets. Regulatory intervention by public authorities is designed to prevent or diminish market failure.

It is difficult to determine the impact the centralization of capital markets regulation has had on market failure issues in Australia. The creation of the ASIC has, in theory, rationalized public policies in the field of securities regulation. ASIC centralizes information on securities trading and investment firms. ASIC should be capable of providing information to investors nationwide within a short period of time. On the other hand, ASIC's expertise on regional financial markets may be less than the expertise of the defunct state securities commissions.

The centralization of securities regulation in Australia represents, in part, an attempt to counter the information asymmetry-like effects resulting from the difficulties in transferring information from one regional regulatory agency to another. Future results will establish whether regulatory centralization also counters the information asymmetry-like effects that result from the difficulty in transferring information from regional financial centres to a central regulatory agency.

It is likewise difficult to hypothesize on how the centralization of securities regulation in Canada might affect existing market failures in the securities industry. One of the main weaknesses of the present regulatory system, the lack of coordination among provincial agencies, can foster information asymmetry-like effects. Lack of regulatory coordination means that valuable information is often not transferred rapidly from one province to another. However, centralizing securities regulation may simply alter information transfer problems, rather than eliminating them. For instance, a national

regulatory agency may solve the issue of province-to-province information sharing, but it might have trouble collecting information from provincial financial centres.

7.2. THE REGIONAL DIMENSION OF CAPITAL MARKETS

Both Canada and Australia are “characterized by regional segmentation in capital markets activity.”²¹² Douglas Hyndman, Chair of the British Columbia Securities Commission, believes that the “regional dimension” of capital markets activity is more challenging for Canada than for Australia.²¹³ This is a result of the sharp regional contrasts in Canada. These contrasts are found at a variety of levels: political, economic, demographic, etc. Regional imbalances in Canada represent a serious obstacle to the centralization of securities regulation. Relatively greater regional balance in Australia was a key factor that enabled the Australian Commonwealth government to centralize the capital markets regulation in 1989-1991.

7.4. LESSONS DRAWN FROM THE CASE STUDIES

We can draw a number of abstract conclusions from the experiences of Australia and Canada:

- (1) The experiences of both Australia and Canada indicate that the way in which capital markets are regulated is in many aspects a reflection of a country’s “institutional character” and “way of doing things.”
- (2) Any change to the framework of capital markets regulation requires a solid constitutional and legal foundation.

²¹² Douglas Harris, 2002, “White Paper,” *A Symposium on Canadian Securities Regulation: Harmonization or Nationalization?*, p. 86.

²¹³ *Ibid.*, p. 87.

(3) National (federal) policy makers must have the political will to overcome the status quo in order to centralize capital markets regulation.

(4) The centralization of capital markets requires that regional authorities be willing to cede power to the central government.

(5) Extraordinary events, such as corporate scandals or financial crises, can aid attempts to change the status quo. Such events lend impetus, through public opinion, to reformist proposals. In Australia, financial and corporate scandals in the late 1980s gave an added impulse to proposals to reform securities regulation. Eventually, reform proposals resulted in the creation of a single national regulatory authority. Hypothetically, the reverse might happen: scandals in a country's financial centre or central government might provide arguments to those in favour of keeping capital markets regulation in the hands of regional authorities.

(6) It is difficult to centralize the regulation of capital markets if regional authorities oppose such an initiative.

7.5. THE NEED FOR A REGULATORY FRAMEWORK TO “FIT” EXISTING INSTITUTIONS

The common denominator running through these six generic conclusions is the need a capitalist society has for a securities regulation system that is “in sync” with broader institutional conditions. I believe this lesson can be extended to encompass the entire financial system of a society, not just securities regulation. A financial system can thrive only if it is responsive to society's needs. A financial system must also be held to account with respect to a society's values.

This project has attempted to shed some light on the institutional factors that affect how capital markets are regulated. The case studies of Australia and Canada illustrate how a regulatory system must adapt to a broader institutional context. Otherwise, a regulatory system will risk becoming ineffective or implausible. While institutional factors are extremely important in the area of capital markets regulation, we must not lose sight of the fact that other factors, such as globalization, play important roles in shaping the framework of capital markets.

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