AUTORITÉ DES MARCHÉS FINANCIERS

Notes pour un discours
prononcé par

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Seul le texte prononcé fait foi.

Bonjour à toutes et à tous,

Il me fait extrêmement plaisir d'être avec vous ce matin et j'aimerais remercier le CSTA de m'avoir invité à participer à votre conférence annuelle… ou plutôt en fait je devrais remercier notre PDG Jean St-Gelais d'être actuellement en vacances car c'est évidemment lui qui aurait dû être ici avec vous ce matin. On m'a fortement suggéré de faire ma présentation en anglais alors j'espère sincèrement ne choquer personne en m'exprimant ici à Québec dans la langue de Shakespeare ! I always feel it is important to meet with various market participants and I haven't often had the privilege of addressing traders since I joined the AMF three years ago. My role at the AMF used to focus primarily on issuers but it has recently been expanded to encompass the oversight of SROs and the derivatives industry in Québec, so we will undoubtedly have further opportunities to exchange ideas.

I was initially asked to present to you a CSA project update. However, knowing that tomorrow, my colleague from the OSC, Susan Greenglass, will discuss some of our projects, I've decided to focus on other topics of interest to you. In a context of market turbulence, I thought it was appropriate to discuss the issue of short selling and how regulators have dealt with it. In addition, as Québec is the lead regulator in Canada with regard to derivatives, I couldn't avoid highlighting recent developments in that area. But before I go any further, I think it would be suitable to say a few words on the federal government's proposal to create a single securities regulator.

As you are aware, this highly political debate has recently taken another turn. On June 22, the federal government announced the creation of the Canadian Securities Regulation Regime Transition Office, the latest step toward setting up a single regulator. Doug Hyndman, arguably the strongest proponent of the Canadian passport system, who spent the past 22 years defending provincial jurisdiction, has now changed sides following B.C.'s decision to move in step with the federal government. In its June 22 announcement, the federal government stated that the Transition Office's principal responsibility would be to develop the federal *Securities Act*, and negotiate with participating provinces and territories and prepare a transition plan with respect to organizational and administrative matters.

We can now say that the creation of the Transition Office opens a new chapter of this old debate. In Canada, the federal and Ontario governments have initiated efforts over the past 40 years to create a single securities regulator. The report released last January by the Expert

Panel led by Tom Hockin is the third report in the past decade in support of the need for a single regulator. The federal government has decided to move forward now with the conclusions of the Hockin Report even if the creation of a single regulator raises a number of issues and many, many uncertainties. I believe it is crucial that all stakeholders be aware of the risks — and indeed there are many —related to the implementation of a centralized regime that would replace the current system administered by provincial authorities.

First, it is critical to examine how a single regulator would improve the securities regime in Canada. Despite what the detractors say, the current passport system is an effective approach. It is a framework that is suitably adapted to the realities of the Canadian markets and, had Ontario opted in, would have been tantamount to a single regulatory system.

Very soon, the passport system will apply not only to issuers but also to registrants. On September 28, 2009, when National Instrument 31-103 is implemented, an additional phase of the passport system will be launched and as a result, both issuers and registrants will reap the benefits of the system.

It would have been worthwhile to evaluate the effectiveness and benefits of the passport system before seeking an alternative solution. A single regulator is unlikely to settle all market-related problems. In many respects, the Hockin Report merely makes sweeping statements on the virtues of a centralized system that are not supported by empirical data, actual situations or market realities.

The single regulator structure proposed by the Expert Panel also seems to be overly complex. It would consist of :

- regional and local offices,
- a governance board,
- a federal-provincial nominating committee,
- a council of ministers,
- an investor panel,
- a small reporting issuer panel,
- an independent adjudicative tribunal, and
- a capital markets oversight office.

There are no assurances that a single regulator with regional or local offices in each province and such a complex structure would generate significant economies of scale compared with the current system. In fact, experience with mergers of large organizations often shows exactly the opposite. Just look at the forecasted figures in the most recent federal budget, which has put the cost at more than $150 million dollars for the initial transition year. If the Transition Office is expected to cost $150 million in the first year alone, one has to wonder about the annual price tag of the proposed megastructure.

Another major flaw of the single regulator model proposed in the Hockin Report is the fact that this centralized entity would be responsible to develop in isolation new regulation applicable across the country. In practice, this would mean that the individuals in charge of policy development at the head office could turn a blind eye to the concerns of Québec-based market participants and the specific realities of this province, and any other province for that matter. Although the Hockin Report proposes the establishment of regional offices, there is no indication that these offices would take part in regulatory policy decisions or would have the opportunity to influence such decisions.

In my opinion, competition in matters of regulatory development is essential for fostering a robust and innovative market. The structure currently in place at the CSA allows stakeholders from different markets to strive together to seek optimal regulatory solutions across the country. The current system is conducive to sharing information in a healthy competitive environment that promotes innovation, debate on different ideas and the adoption of best practices across Canada. This considerable strength of the CSA would be lost under the single regulator model.

With respect to harmonization of regulations and rules applicable around the country, we have as you know made great strides over the past few years. Unfortunately, proponents of a single securities regulator don’t see it that way. They continue to argue that issuers are required to deal with 13 jurisdictions under the current regulatory system. Anyone promoting the creation of a single regulator based on this statement is simply misleading the public.

As regards regulatory development, proponents of a single regulator complain that the need to obtain consensus from 13 jurisdictions makes the process protracted and burdensome. Allow me to respond to that by saying that the lion's share of the regulatory development work in

Canada is undertaken by the securities regulators in 4 jurisdictions: B.C., Alberta, Ontario and Québec. The remaining jurisdictions are generally fully reliant on their development work.

It's true however that having numerous independent stakeholders at the table discussing issues and seeking appropriate solutions can sometimes create additional delays. Nonetheless, I am convinced that the benefits of this approach outweigh the disadvantages. A delayed regulatory response that is a good fit for the entire Canadian market seems to me to be a more desirable and, in the long run, less cumbersome alternative.

Finally, as we have all seen in the recent past, a single regulator would not be better equipped to prevent frauds and financial scandals. I need only mention Madoff, Worldcom, Enron and Tyco in the U.S., Parmalat in Italy or ADDECO in Switzerland. As you know, all of these countries operate a national securities regulator.

So where do we stand now? The debate is obviously highly political and in all likelihood only a political decision will draw it to a close. The Québec government refuses to support the federal government's option, along with Alberta and Manitoba. The Québec government is ready today to challenge in court the constitutionality of the establishment of a federal securities regulator. In the end, our role at the AMF, and it's the same for the other regulatory authorities across the country, is to administer and operate the regulatory system chosen by politicians. Only the future will tell us what is best for Canada. However, I do believe that this major shake-up that Federal Minister James Flaherty so eagerly wants must thoroughly be examined and considered. I therefore ask Doug Hyndman and his crew at the Transition Office the following questions that I believe need to be answered positively in order for the new single regulator to be an improvement to the current system:

- How under a single regulatory structure will we ensure that the various jurisdictions retain latitude and their ability to innovate for the benefit of their stakeholders and their economies?

- Will the framework governing the issuers, registrants and other stakeholders in each jurisdiction be improved when compared with the current framework available through provincial regulatory authorities?

- Will the concerns of companies and registrants in jurisdictions other than the jurisdiction hosting the head office of the single regulator be considered when centralized regulation is developed?

- What will be the costs of creating, implementing and transitioning toward a single regulator, and who will assume these costs?

And finally,

- Why is it advisable to disrupt the Canadian securities system now, at a time when the country is still in the throes of an unprecedented economic crisis?

With no unequivocal positive responses to all of these questions, we can only wonder about where the federal government's project will lead us. For the time being, we at the AMF continue to extend our co-operation to the other regulatory authorities across the country. We believe that the CSA needs to continue its good work, and we intend to devote all our energy to further improving the current system while unfortunately, others are looking into a different direction.

Short selling

Now, on a completely different and less political note, I would like to talk to you about the most recent developments with respect to short selling. As you may recall, market regulators around the world took the view in September 2008 that some extraordinary measures were needed to restore confidence and stability in the financial markets. Concerns were raised at that time that short selling, and in particular naked short selling, contributed to disorderly markets. To address these concerns, many regulators decided to impose temporary bans on short selling or naked short selling. Furthermore, at that time, many regulators introduced new disclosure obligations with respect to short selling positions in order to increase overall transparency. Imposing short selling bans was certainly drastic but, as some of you might know, these types of ban had been used in the past, even as far back as in 1610 by the Dutch Government!

Why did regulators take those unusual steps? There are two main reasons. First, they concluded that there was still the potential of sudden and excessive fluctuations of securities prices and disruption in the functioning of the securities markets. Second, there were also concerns about the potential for market abuse resulting from short selling, particularly on stock of financial institutions, and the consequent threat on financial stability.

Within that context, despite our fragmented regulatory framework, provincial regulators in Canada reacted very quickly, in a concerted effort, to implement measures following the bans issued on September 18, 2008 by both the FSA in the UK and the SEC in the United States. On the following day, many provincial regulators, including all of the largest jurisdictions, issued temporary orders banning short sales. As you know, the orders issued in Canada targeted only a very small number of interlisted financial stocks that were not subject to the tick rule. As a result, the ban was limited to less then 20 stocks here versus close to 1000 in the U.S. At the time, we wanted to make it clear that we would take the appropriate steps to protect our markets and to prevent regulatory arbitrage.

That being said, regulators recognize the important benefits of short selling. Some of these include the fact that short selling enhances or facilitates the price discovery process. Short selling can also prevent or mitigate market bubbles. Another benefit is the overall positive impact on liquidity, which translates into a reduction of the bid/ask spread and total trading cost to investors. As well, short selling can lead to more efficient financial markets by facilitating hedging and risk management activities.

In general, economic theory and the majority of empirical research support the use of short selling. As you know, short sales make up a significant portion of daily market activity in Canada. According to a recent IIROC study, short sales on the TSX accounted for a little more than 26% of trades between May 2007 and September 2008 and more then 30% for interlisted securities. I would like to point out, however, that short selling also raises potential issues for us regulators. We are concerned about potential market abuse by short sellers. In addition, the overall question of transparency of short sales or short positions cannot be ignored. A further issue to consider is the impact on financial stability or the possibility of aggravating disorderly markets in times of crisis. Finally, a concern that cannot be overlooked is the possible disruption in settlements resulting from failed trades.

Within that context, the International Organization of Securities Commissions, IOSCO, known as decided to examine ways to address some of the regulatory gaps in short selling regulation. IOSCO established in November 2008 a Task Force whose mandate was to evaluate the adoption of principles covering crucial aspects such as reporting, delivery of securities and manipulation. Regulators from thirteen jurisdictions, including the AMF and the OSC, participated in the Task Force. The work of the Task Force led to the publication on June 19, 2009 by IOSCO's Technical Committee of a Final Report on the Regulation of Short Selling (the "Final Report").

The Final Report proposes four high-level principles for the effective regulation of short selling. The stated goal is to provide guidance to market authorities to assist them in assessing and developing their short selling regulatory framework. Furthermore, the Report highlights that regulators must take into account the specifics of their own local environment when adopting regulations.

IOSCO's Technical Committee recommends that effective regulation of short selling comprise the following four principles :

1. Short selling should be subject to appropriate controls to reduce or minimize the potential risks that could affect the orderly and efficient functioning and stability of financial markets.

2. Short selling should be subject to a reporting regime that provides timely information to the market or to market authorities.

3. Short selling should be subject to an effective compliance and enforcement system.

4. Short selling regulation should allow appropriate exceptions for certain types of transactions for efficient market functioning and development.

Most of you are probably very familiar with the current regulatory approach in Canada. We are one of the few jurisdictions around the world that has put in place a system for flagging short sales which provides very valuable information to market regulators. A price restriction is also still in place for securities not interlisted in Canada and in the United States. In addition, twice a month, dealers are required to prepare information on short positions of each individual account for all listed securities and the aggregate information is made available to the public. As you know, we do not have mandatory buy-in, close-out of position or locate requirements. However, exchanges and clearing houses have buy-in rules that can be used at the discretion of the buyer, but IIROC reports are showing that they are very seldom used. IIROC rules, namely UMIR, prohibit the entry of an order without the reasonable expectation of settling any trade that would result from the execution of the order.

On the settlement side, the CSA adopted in 2007 National Instrument 24-101 ("24-101") which provides a general framework for ensuring more efficient and timely settlement processing of trades. Registered dealers and advisers are required to establish, maintain and enforce policies and procedures designed to achieve trade matching as soon as practical after the trade has been executed, and in any event no later than 12:00 p.m. on the day after the day on which the trade was executed. The current rule will also require, starting July 1, 2010, that trade matching be done before midnight on trade date (T). In addition, NI 24-101 requires dealers to establish, maintain and enforce policies and procedures designed to facilitate the settlement of trades by the standard settlement date prescribed by an SRO or a marketplace. We believe that NI 24-101 contributed to the decline in value of accumulated fails as a percentage of traded value, which has been declining steadily in the past two years from 2.7 % to less than 1 %.

Finally, UMIR amendments were approved in October 2008 to give IIROC the power to designate securities as ineligible for short selling. With this new power, IIROC is in a position to act quickly with the concurrence of regulatory authorities. The October amendments also introduced the obligation to report to IIROC extended failed trades; the trades that are still unresolved 10 days after the standard settlement date. Such reports will allow IIROC to determine if the trade has failed to settle for an improper reason as well as to monitor trends in failed trades and the steps taken by the participant to finally settle the trades.

Given the recent international developments, we now need to evaluate the Canadian regulatory context and assess it from the perspective of the four IOSCO principles. I will now briefly elaborate on the first and second principles and discuss them within the Canadian context.

As mentioned earlier, the first principle refers to appropriate controls to reduce or minimize potential risks. The Final Report refers to controls such as eligibility criteria, pre-borrow or locate requirements, price restrictions, flagging and margin requirements. As I pointed out a few minutes ago, some of these controls are already in place in Canada. In its Final Report, IOSCO's Technical Committee placed special emphasis on trade settlement. It recommends that regulation should impose a strict settlement of failed trades, such as compulsory buy-in, to discourage and deter abusive short selling.

The Final Report also highlights a few other questions that should be on the radar screen of regulators, for example :

- how many days after the settlement would the buy-in or close-out be triggered?,
- who is to initiate the process? and
- whether a penalty should be imposed in cases of trades unsettled by the standard settlement date?

Over the coming months, the CSA will be looking at all these issues. To that end, the CSA/SRO Working Group on short selling was recently reactivated. We will determine which new control measures, if any, are advisable in Canada. We will also need to consider recent regulatory changes adopted by the SEC, such as the close-out rule and the April 2009 proposed amendments to Reg SHO. As you know, the SEC's April release proposed a number of alternatives on short sale price tests and the circuit breaker rule, which would trigger a temporary ban or short sale price tests.

The second IOSCO principle addresses the market and regulator reporting requirements and recognizes the two types of models currently used by most regulators: flagging of short sales and reporting of short positions. The Technical Committee proposed that regulators take into account a number of elements as part of the policy objectives of their reporting regime. First, the reporting should provide ready access to information on short selling to improve insight into market dynamics. Second, the regime should mitigate the potential disorderly market effects of aggressive short selling. Third, it should deter market abuse. Fourth, it should provide early warning signs of a build-up of large short positions and alerts to prompt investigation into suspicious activities. Fifth, it should help constitute evidentiary proof required in the context of post-event investigation and disciplinary action.

Both models of reporting have their own merits and can be used to broadly serve the regulatory objectives; but they also have limits. For example, on the one hand, flagging does not provide information with respect to the overall short position of a market participant. On the other hand, position reporting is usually done above a set threshold and hence, participants can take a position just below that threshold, in which case no information would be provided to regulators.

Position reporting can also take different forms and be more or less broad in scope. For instance, should the positions reported include derivatives and should the reporting be done on a net or gross basis?

It will be very important for us going forward to evaluate the benefits and costs or challenges related to implementing a position reporting regime within the Canadian context, using the recent experience from other jurisdictions. Given international developments and the call for greater convergence, we will need to decide if any new requirements are necessary here. We will have to assess, for example, whether new requirements could have negative impacts on legitimate short selling and therefore reduce the overall liquidity in the market. Given the size of our market, we will be very sensitive to this potential drawback.

As you may note from my remarks, short selling has been a hotly debated topic at the international level over the last months. Regulators around the world, including us, have further work to undertake in order to evaluate their regulatory regime and take action as necessary. We will continue to participate actively in the discussions taking place at the IOSCO level and we should be in a position to advise the market of the state of our reflection in the course of next year.

As I said a moment ago, one issue looked at by regulators is the inclusion of derivatives in position reporting. Given the explosion of financial innovation in recent years, market participants now have a wide range of financial derivative products to a establish short exposure. Hence, regulation on short selling must take this into account. This brings me to the last topic of my presentation : derivatives.

Derivatives

Québec is the lead regulator in Canada with respect to derivatives. To ensure that our oversight keeps pace with the fast-evolving derivatives markets, the AMF has developed a new, dedicated regulatory framework. The Québec *Derivatives Act*, which came into force on February 1st, 2009, gives legal certainty to derivatives, both exchange-traded and over-the-counter.

It establishes the AMF jurisdiction over all derivatives, be the offered to retail clients or bilaterally negotiated between multinational institutions. It provides a principles-based approach giving regulated entities - such as the Bourse de Montréal - control over their rule-adoption process, while focusing our regulatory scrutiny in a truly risk-based and intelligent manner.

As you know, derivatives do not have the same risk model as securities. They are not used for the same purposes, and they do not provide the same type of returns. Derivatives, developed initially in the 19th century for agricultural risk management, have now become an integral part of the economy as a whole. Financial derivatives are crucial to the risk management of major financial institutions and corporations. They provide tools that help multinational commerce operate effectively by mitigating much foreign currency and interest rate risk.

Of course, such functions require proper oversight, ensuring that markets operate fairly, efficiently, and are not manipulated. What we consider a hallmark of securities regulation – the important work we perform to ensure investor protection – is no less important in the derivatives world.

Further, derivatives markets use the collective knowledge of all its participants for price discovery, based on the fundamentals of supply and demand. The prices determined on the market are disseminated and used widely as the benchmark for underlying prices and off-exchange contracts. Manipulation of the price discovery process can have dramatic effects on individual market participants and the economy as a whole. In drafting our legislation, we have attempted to ensure that we provide adequate protection for investors, that we ensure a fair and effective price discovery process, and that the risk transfer role of the markets can function properly.

There has been considerable attention given to the over-the-counter markets and their role in the current financial crisis. The Québec *Derivatives Act* has given the AMF something that many other regulators would very much like to have – jurisdiction over all derivatives, including OTC contracts. What this means is that the AMF can intervene in OTC markets in cases of fraud or manipulation. However, to provide the OTC markets with legal certainty over their contracts, most of the remedies that are available under our legislation for regulated markets do not apply if the participants are what we have called accredited counterparties. These counterparties include large institutions and corporations that have over $10 million in net assets, individuals with over $5 million in net assets, financial institutions and the like -- entities which have the wherewithal to manage their derivatives positions without regulatory support. Still, if potential fraud or manipulation takes place in these exempt markets, we have the power to act, which is essentially what the public would expect any regulator to be able to do.

The Québec *Derivatives Act* also proposes a qualification process for the counterparty who wishes to offer OTC derivatives to retail customers. We are of the view that the traditional prospectus disclosure does not give an accurate picture of the risks involved in derivatives contracts. The most striking risk is counterparty creditworthiness, which we feel is better communicated through a risk disclosure process.

The new derivatives legislation in Québec has put us in the forefront of futures market regulation in Canada. Like the securities markets before them, it is high time to begin developing a harmonized oversight regime for Canada's derivatives markets. In the fall of last year, the CSA mandated a new committee, led by the AMF, to work on the harmonization of derivatives regulation.

The committee's mandate is quite large: to propose a comprehensive derivatives oversight framework that can be adopted across the country. Much as has been done with the passport system, it is hoped that derivatives will benefit from a level playing field, with no unnecessary duplication or conflicting rules.

The CSA derivatives committee has a lot to do over the next months. It's work is critical, coming at a time when regulators around the world are rethinking their traditional oversight. We are working closely with our colleagues through forums such as IOSCO because we believe that it is vital that our proposals reflect the most appropriate approaches being developed globally.

Conclusion

In conclusion, as the CSA initiatives have shown, there is a high degree of coordination among CSA members, whether it be in rapid response to a developing market situation, such as the halting of short sales, or in long-term projects such as passport and derivatives regulation. This coordination permits us to keep the regulatory burden on our market structures as manageable as possible, while ensuring that regional differences are taken into consideration. Such cooperation and responsiveness has made and can continue to make Canada's financial markets efficient, fair and worthy of the confidence of the investing public.

Thank you very much for your attention.