asset management group

December 8, 2014

SUBMITTED VIA EMAIL
commentonlegislation@ccmr-ocrmc.ca

Re: Consultation Draft of the Capital Markets Stability Act

Dear Sirs and Madams:

The Asset Management Group ("AMG")[1] of the Securities Industry and Financial Markets Association ("SIFMA") appreciates the opportunity to comment to the governments of Canada, British Columbia, New Brunswick, Ontario, Prince Edward Island, and Saskatchewan (the "Participating Governments") on the Cooperative Capital Markets Regulatory System Governance and Legislative Framework (the "Framework").[2] The AMG's members are primarily U.S. asset management firms, and our letter will focus solely on provisions in the Capital Markets Stability Act ("CMSA").

The AMG supports the Participating Governments' efforts to protect and strengthen Canada's capital markets. We also understand the conceptual appeal of a high-level legislative framework that creates a powerful regulator, the Capital Markets Regulatory Authority (the "Authority"), and imposes few limits on its ability to regulate Canada's capital markets in the name of managing systemic risk. However, we have significant concerns with this approach and many of the specific provisions in the CMSA, including the legislation's: (1) vague definition of systemic risk, (2) unbalanced mandate that focuses only on potential risks in capital markets without considering the capital markets' benefits or the costs of regulatory intervention, and; (3) insufficient due process protections. Our concerns arise from the experiences that other jurisdictions have had with similar approaches. We believe the CMSA could have significant damaging impacts on individual market participants, their customers and counterparties, the markets themselves and the Canadian economy if the Participating Governments do not revise it to correct these flaws.

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[1] The AMG's members represent U.S. asset management firms whose combined assets under management exceed $30 trillion.

[2] The Cooperative Capital Markets Regulatory System Governance and Legislative Framework, available at http://www.newsroom.gov.bc.ca/downloads/Commentary.PDF.

Our comments are intended to assist the Participating Governments in drafting and ratifying the best possible legislation that provides clear guidance to regulators and the markets and is much more likely to achieve its objectives. However, it is difficult, if not impossible, to provide complete comments to the Framework without reviewing the regulations that are required to implement it, particularly given that many details are absent from the legislation. Therefore, the AMG reserves the right to comment, as necessary, on all aspects of the Framework, including any regulations drafted to implement the CMSA. We respectfully request that the Participating Governments refrain from finalizing the CMSA until draft regulations are published for comment and the Participating Governments have the opportunity to review those comments.

I. Definition of Systemic Risk

Section 2 of the Preamble of the CMSA defines systemic risk as:

> A threat to the stability or integrity of Canada's financial system that originates in, is transmitted through, or impairs capital markets and that has the potential to have an adverse effect on the Canadian economy.

According to the Participating Governments' overview of the Framework (the "Overview"), this definition is based on definitions of systemic risk used by foreign regulators and international financial sector standard setting bodies.

The AMG understands the conceptual appeal of providing the Authority with significant discretion to address any circumstance that may require action in the future. However, the proposed definition of systemic risk is overly broad and nonspecific. It provides no meaningful guidance to the Authority or the capital markets regarding what constitutes systemic risk, how it should be measured, or what magnitude of "potential" effect and probability of its occurrence should elicit a response. In practice, this uncertainty is more likely to hinder the Authority's ability to meet its mandate under the CMSA than to help it.

The words "systemic risk" are used throughout the CMSA and serve as a primary basis for the Authority's national powers under the new Framework. However, the definition does not provide the Authority with any clear quantifiable guidance regarding what should be considered systemic risk. Words like "threat" and phrases like "the potential to have an adverse effect" are vague, and effectively unlimited in their potential interpretations. Similarly, the "stability" or "integrity" of Canada's financial system cannot be defined by the Authority, let alone measured, unless the Participating Governments describe clearly what it means for Canada's system to be considered stable. Without that clarity, the Authority will be powerful but undirected. As a result, the Authority itself, the Participating Governments and the Canadian public will be unable to determine objectively whether the Authority is fulfilling its mandate or falling short.

Further, Section 2 of the CMSA provides the Authority with broad discretion to designate a market entity, product, or practice as systemically important if "in the Authority's opinion," the entity, product, or practice "could pose a systemic risk related to capital markets." These provisions are troubling, particularly given the vague definition of "systemic risk." In essence,

they indicate that the Participating Governments are deferring to the Authority to determine for itself how to develop its mandate, and then how to execute on that mandate. This, we believe, will set up the newly created regulator for failure. By not clearly defining for the regulator what should be considered systemic risk, it will be extremely difficult for the Authority to develop standards that will be embraced by the Participating Governments and the marketplace. It will also be difficult for the Authority to prove that it is successful without the aid of quantifiable goals or metrics for their measurement. In practice, the Authority will likely always have to take a defensive posture when policymakers or the market evaluate its actions, which will impede constructive dialogue.

Additionally, sufficient clarity in the CMSA would allow market participants to address systemic risks, without the need for designation. For many market participants, including asset managers and investment funds, risk assessment is integral to their business. They continuously evaluate and manage risks associated with their own activities and those of others in the capital markets. They could reasonably be expected to consider actions to reduce risk if it were clearly defined. Therefore, the Participating Governments could both reduce risk in the system and help the Authority effectively regulate by agreeing on a measurable definition of systemic risk before creating and empowering a regulator to address such risk.

II. The Authority's Mandate

In the Overview, the Participating Governments explain that the Framework is intended to foster more efficient and globally competitive capital markets in Canada. Yet, there is little in the CMSA's text indicating that the Authority's mandate includes identifying or enhancing the many benefits of the capital markets. We believe an effective capital markets regulator should have a balanced mandate, which seeks to both detect and manage risks to the markets, and help the markets grow and flourish so that their benefits to the Canadian economy are protected and enhanced. This has been embraced by other regulators and policymakers around the world, such as the International Monetary Fund ("IMF"), who stated in a recent report that when policymakers are regulating capital markets, they should seek to "maximize the benefits … while minimizing the systemic risks."[3] Similarly, the President-elect of the European Commission recently asked the new European Commissioner for Financial Stability, Financial Services, and Capital Markets Union to focus, among other things, on creating, "a well-regulated and integrated Capital Markets Union … with a view to maximising the benefits of capital markets and non-bank financial institutions for the real economy."[4]

[3] International Monetary Fund – Global Financial Stability Report (8 October 2014) at 65, available at https://www.imf.org/external/pubs/ft/gfsr/.
[4] See Letter from Jean-Claude Juncker to Jonathan Hill, dated 1 November 2014, at 5, available at http://ec.europa.eu/about/juncker-commission/docs/hill_en.pdf.

To ensure that the Authority has a balanced mandate, the AMG suggests that the Participating Governments consider amending Section 4 of the CMSA to read as follows:

> 4. The purposes of this Act are, as part of the Canadian capital markets framework,
>
> (a) to ~~promote~~ protect and enhance the benefits of Canada's capital markets;
> (b) to protect the stability and integrity of Canada's financial system through the management of systemic risk related to capital markets; and
> ~~(b)~~(c) to protect capital markets against the commission of financial crimes.

III. Systemic Risk Framework

The Participating Governments explain in the Overview that the Authority's approach to managing systemic risk in the capital markets will include three interrelated components: (1) national data collection powers; (2) the ability to address threats to financial stability; and (3) cooperation and coordination with federal, provincial, and foreign financial sector regulatory authorities. The AMG has specific concerns related to each area that are discussed below.

A. Data Collection

Section 9 of the CMSA provides the Authority with the ability to collect records and information for the purpose of: "(a) monitoring activity in capital markets or detecting, identifying or mitigating systemic risks related to capital markets; or (b) conducting policy analysis related to the Authority's mandate and the purposes of the [CMSA]."

The AMG supports the Participating Governments' efforts to ensure that the Authority has the ability to collect necessary information and records for the purposes of monitoring capital markets activity and detecting, identifying or mitigating systemic risk. However, to the extent the Authority collects data about a specific entity, the CMSA's provisions should include language addressing the entity's rights related to the Authority's data collection efforts.
For example, the provisions should note the process the Authority must undertake to request records from the entity, and procedures for notifying an entity about data collection efforts. The CMSA should also include provisions allowing an entity to review the materials collected about it, as well as supplement or correct any data collected by the Authority that may be incomplete or inaccurate.

The AMG suggests that the Participating Governments consider adding the following Section 18 to Part 1 of the CMSA:

> **18.** (1) To the extent that the information collected relates to a trading facility, a clearing house, a credit rating organization, a capital markets intermediary, a trade repository, or a self-regulatory organization, the Chief Regulator shall notify the entity in a timely manner that data information or reports are being collected pursuant to this Act.
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> (2) Any notice sent by the Chief Regulator pursuant to paragraph 18(1) shall

(a) be sent by the Chief Regulator and not delegated
(b) be made in writing and shall include unredacted copies of the data, information or reports that have been collected pursuant to this Act; and
(c) provide the trading facility, clearing house, credit rating organization, capital markets intermediary, trade repository, or self-regulatory organization with a reasonable amount of time to review and respond to the data, information, or reports that have been collected and voluntarily submit any additional relevant data, information, or reports.

We also support efforts to ensure confidential information is treated appropriately, as well as efforts to coordinate data collection with other domestic and foreign financial sector regulatory authorities to avoid undue regulatory burdens.

B. Systemic Risk Designations

1. Entity Designations

a. Entity Designations are Inappropriate for Certain Capital Markets Intermediaries

Part 2 of the CMSA provides the Authority with broad discretion to designate market entities, including Capital Markets Intermediaries, as systemically important. Capital Markets Intermediaries are defined in the CMSA as: "a person that, as a significant part of its business, trades in securities or derivatives or provides services related to trading or holding securities or derivatives, and includes: (a) dealers; (2) an issuer whose primary purpose is to invest money provided by its security holders, including an investment fund; (c) a pension fund; (d) a person that directs or manages the business, operations or affairs of an issuer referenced in paragraph (b) or of a pension fund; (e) a person that manages the investments of clients that have granted the person discretionary authority to do so; and (f) a person that is within a class of persons that are prescribed to be capital markets intermediaries."

We recognize that the Participating Governments are not explicitly directing the Authority to designate Capital Markets Intermediaries as systemically significant, but rather giving the Authority broad discretion to designate as needed, if the Authority determines that a Capital Markets Intermediary's "activities or material financial distress" … "could pose a systemic risk related to capital markets." However, some entities, including investment funds and their managers, are included in the definition of Capital Markets Intermediaries, yet cannot present the type and scale of systemic risk that the Authority is created to address through designation of individual entities. For these types of entities, systemic risk designations would reflect fundamental misconceptions of the market and would be ultimately ineffective in addressing potential systemic risks.

Investment funds and asset managers operate differently than other types of financial entities, and these differences reduce the ability of these entities to exhibit the characteristics necessary to

be designated as systemically risky. Any risk that may be associated with investment funds or their managers is not concentrated in individual entities. Rather, it is broadly distributed and shifts in response to investor preferences and exogenous factors that affect not only investment funds, but other investors and capital markets participants as well. Therefore, any risk that presented itself would likely be found in many entities and extend beyond the asset management industry to other market participants, requiring that the Authority assess and regulate activities rather than singling out entities for different regulation than their competitors.

Indeed, investment funds regularly close with little market impact, and they fail very rarely. An investment fund, like any other financial entity, "fails" when it becomes insolvent or is unable to meet its obligations to its creditors and other counterparties. Unless credit and counterparty relationships cause an investment fund to become insolvent and expose its creditors and counterparties to the risk of loss, even severe declines in the value of an investment fund's assets that may cause the fund to close will be borne by the fund's investors and will not cause the fund to fail.

Investors – not the fund or the asset manager – ultimately own the assets, and bear the investment risk. This limits the potential threat to Canada's economy, and also ensures that entity designations would be ineffective at addressing the risk. Under this system, even if risk did concentrate at one or more funds at a particular point of time, investors could (and likely would) move their assets away from designated investment funds or designated asset managers to other un-designated investment funds or asset managers pursuing the same or similar strategy. In other words, asset managers and funds are almost always substitutable. Designation of a few investment funds or asset managers is not likely to reduce the overall level of risk associated with the activities of investment funds and other capital markets participants because entities that are not designated will continue to engage in the same activities.

The Financial Stability Board ("FSB") and International Organization of Securities Commissions ("IOSCO") recognized many of these differences in the consultative document on *Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemic Financial Institutions.*[5] In particular, the consultative document noted that investment funds are highly substitutable, that asset managers are agents of their clients, that investors provide investment funds a "shock absorbing" function that differentiates investment funds from banks, and that an investment fund's assets are not available to claim by creditors of the investment fund's manager.[6] Additionally, neither investment funds nor their managers guarantee investment results or backstop losses, and investors control their assets and select investment funds with strategies that meet their investment needs.

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[5] FSB/IOSCO, ASSESSMENT METHODOLOGIES FOR IDENTIFYING NON-BANK NON-INSURER GLOBAL SYSTEMIC FINANCIAL INSTITUTIONS (8 January 2014) at 5, available at http://www.financialstabilityboard.org/wp-content/uploads/r_140108.pdf?page_moved=1.
[6] See *Id.* at p. 29-30.

For these reasons, many foreign regulators, including the FSB and IOSCO, as well as the Financial Stability Oversight Council ("FSOC") in the U.S., have indicated that it may be more appropriate to evaluate and, if necessary, regulate products and activities rather than funds and asset managers. For example, the FSB has stated that even viewed in the aggregate, fund liquidations historically have not created a "systemic market impact."[7] The FSB indicated in the same report that it is considering focusing on particular activities or groups of activities rather than asset management entities.[8] Similarly, although the FSOC began its review of the U.S. asset management industry by focusing on asset managers, in July 2014 FSOC Chair, Treasury Secretary Jack Lew, directed the staff to "undertake a more focused analysis of industry-wide products and activities to assess risks associated with the asset management industry."[9] We believe it could be beneficial to both the Participating Governments and market participants, for Canada to consider the significant research that has already been undertaken by other jurisdictions and the growing consensus that evaluation and regulation, if necessary, of products and activities are more appropriate than entity designations in the asset management industry. In doing so, we believe Canada will ultimately decide to take a similar approach to analyzing and, if necessary, regulating these types of market participants.

Further, while we understand the Participating Governments' goal of granting broad discretion to the Authority, in practice we believe providing an unnecessarily broad spectrum of powers will merely muddy the waters for the regulator. If the CMSA suggests, by naming specific types of entities like funds and their managers, that the Authority should consider designating them individually, regardless of whether they can create the systemic risk required to justify entity-level designation, the Authority will likely waste time and resources to review these entities. Time and resources will therefore be diverted from focusing on parts of the market that could actually create systemic risk and developing more effective and efficient tools to mitigate it. It would be far more effective for the Participating Governments to create a tailored mandate that appropriately focuses on products and activities when it makes sense to do so, such as in the context of investment funds and their managers.

b. Weighing Designation Factors

According to Section 27(2) of the CMSA, before the Authority may designate a Capital Markets Intermediary as systemically important, the Authority must consider a variety of factors and provide the entity in question with an "opportunity to make representations." These factors include:

> (a) the capital markets intermediary's vulnerability to material financial distress or insolvency resulting from, among other things, its leverage, liquidity, off-balance-sheet exposure or reliance on short-term funding;

[7] *Id.*
[8] *Id.* at 32.
[9] *See* Minutes of the Financial Stability Oversight Council (31 July 2014) at 4, available at http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/July%2031,%202014.pdf.

(b) the capital markets intermediary's size and the volume and value of trading by it;
(c) the importance of the capital markets intermediary with respect to particular market activities;
(d) the availability of substitutes for the capital markets intermediary's products and services;
(e) the nature and extent of the capital markets intermediary's interdependencies, relationships and other interactions;
(f) the nature, interconnectedness and mix of the capital markets intermediary's activities;
(g) the complexity of the capital markets intermediary's business, structure or operations; and
(h) any other risk-related factors that the Authority considers appropriate.

To the extent that the Authority considers Capital Markets Intermediary designations, we also believe the Participating Governments should provide guidance regarding how the Authority should weigh the various factors that it must consider. In our view, leverage and interconnectedness should be given the greatest weight, as in practice these factors provide the most information regarding whether individual entities present a systemic risk. Leverage, in particular, must be present in order for an entity to be able to fail. Therefore, leverage should be the primary focus when evaluating a Capital Markets Intermediary for potential designation. The inclusion of leverage among the factors also demonstrates another reason that designation of investment funds would be unjustified - an unleveraged investment fund consists of 100% equity capital.[10]

Other factors, such as size, should not be weighted as highly, because size could capture too many large but not systemically important entities, and miss highly leveraged but relatively small entities that could be sources of systemic risk.

c. Providing Due Process Rights

Additionally, given the serious consequences that would be attached to being designated as systemically important, the CMSA should provide entities, including Capital Markets Intermediaries, with certain due process rights to help ensure the designation is both justified and implemented appropriately.

While we appreciate paragraph 27(3) of the CMSA, which permits a Capital Markets Intermediary "to make representations," it is unclear what this phrase would mean in practice. The Participating Governments should clearly state that an entity under review has the right to: (1) early and continued access to the entirety of the materials collected by the Authority on the entity; (2) a detailed description of the Authority's theory as to why designation is appropriate;

[10] Many investment funds, including U.S. mutual funds and other registered funds, use relatively little or no leverage. Therefore, the inclusion of Section 27(2)(a) indicates that it is more appropriate to consider products and activities related to asset managers and investment funds, rather than entity designations.

(3) regular meetings with the Authority; and (4) an opportunity to submit written materials that correct or supplement the Authority's information and contest the Authority's conclusions.

Further, if the Authority proceeds with a designation, the CMSA should clarify that the Authority must provide the designated entity with a complete report outlining the basis for the designation and the manner in which being designated would address such risks. This report should include a detailed economic analysis supporting the Authority's position. The entity should also have the ability to challenge the designation through a nonpublic evidentiary hearing venue.

To implement such due process safeguards, the AMG suggests that the Participating Governments consider adding the following language to Paragraph 27:

> (3) Before making the order, the Authority must:
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> (a) notify the Council of Ministers of its intention to make the order;
> (b) provide the capital markets intermediary with written notice that the Authority is considering whether to make a proposed determination, which notice shall set forth the factual basis for the Authority's consideration; ~~and~~
> (c) give the capital markets intermediary an opportunity to ~~make representations~~ submit written materials to the Authority to correct or supplement the facts on which the Authority is relying and contest the rationale for a proposed determination; and
> (d) provide the capital markets intermediary with the opportunity to meet in person with the Authority, if so requested by the capital markets intermediary.
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> (4) Upon completing the order, the Authority must provide the Capital Markets Intermediary with:
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> (a) a detailed assessment of the capital markets intermediary's systemic risks necessitating designation, which must include a detailed economic analysis supporting the Authority's position;
> (b) detailed assessments of the manner in which the Authority's designation would mitigate the threat that may be posed by the capital markets intermediary, the costs and benefits of designation to the intermediary, Canadian capital markets and the Canadian economy, and the probability that designation will mitigate the threat more effectively and efficiently than alternative approaches; and
> (c) a notice stating that the capital markets intermediary has the right to request, in writing, a nonpublic evidentiary hearing before the Authority to contest the proposed order under paragraph 27(1);

2. Product or Practice Designations

Sections 30 through 33 of the CMSA provide that the Authority may prescribe a class of securities or derivatives to be systemically important, or a practice to be systemically risky if, "in

the Authority's opinion," the product or practice "could pose a systemic risk related to capital markets." Section 32(2) of the CMSA then directs the Authority to consider a list of factors before determining that a practice poses a systemic risk related to capital markets. These factors include:

> (a) the financial effect or consequences of engaging in the practice;
> (b) the manner in which the practice makes use of maturity transformation, liquidity transformation, credit risk transfer or leverage;
> (c) the extent to which the practice is engaged in;
> (d) the extent to which the practice could transmit risks through the capital markets or financial system;
> (e) the type of persons that are engaged in the practice and the extent to which they are regulated as systemically important capital markets intermediaries or otherwise regulated under capital markets or financial legislation in Canada or elsewhere;
> (f) the extent to which the practice can be otherwise regulated under this Act; and
> (g) any other risk-related factors that the Authority considers appropriate.

The AMG supports the CMSA's focus on products and practices, and believes that in most circumstances, effective regulation of any systemic risk that may arise from capital markets will be best achieved through a broad activities-based approach rather than singling out individual entities for disparate treatment. Certain activities, such as engaging in uncollateralized credit transactions or employing highly leveraged investment strategies could lead to systemic risk. We believe the Authority should focus on restricting risky activities or products, to the extent necessary, across the entirety of the market. By doing so, the Authority would fully address any targeted risk, rather than only partially address the risk within certain market players.

Further, regulators worldwide have employed and endorsed an activities- or products- based approach to regulating many activities since the financial crisis. For example, U.S. and other foreign regulators have adopted new rules to regulate derivatives trades, including central clearing and minimum margin requirements, which seek to address market risk broadly. Similarly, reforms of the money markets and funds that invest in them have been targeted at specific risks and applied broadly to all activities and entities that may present them. Regulators seem to have recognized that they would not have been able to address risks associated with these products and activities effectively by regulating only the largest players in the relevant markets.

3. Regulation of Designated Entities

To the extent that the Authority designates an entity or product as systemically important, or an activity as systemically risky, the AMG supports the Participating Governments' decision to empower the Authority to regulate that entity, product, or activity. This framework differs from the United States' FSOC framework, where systemically important entities are subject to prudential regulations. The AMG strongly believes that a dedicated capital markets regulator, in this case the Authority, should oversee capital markets and their participants. Oversight by a

capital markets regulator with a balanced mandate should deliver greater benefits, more efficiently, as a result of the regulator's expertise and market focus.

C. Coordination with International Regulators

Section 6(2) of the CMSA instructs the Authority to "coordinate, to the extent practicable, its regulatory activities with those of other federal, provincial and foreign financial authorities so as to promote efficient capital markets, to achieve effective regulation and to avoid imposing an undue regulatory burden."

The AMG is strongly supportive of the Participating Governments' efforts to ensure there is coordination with provincial and foreign financial authorities. We believe that a threshold question for the Authority before designating any entity as systemically important should be whether existing regulation at the provincial or national level effectively addresses systemic risk related to the entity, product, or activity or could be modified to do so most effectively and efficiently. For example, the Authority should consider whether U.S. registered investment companies or their advisers, which are already subject to comprehensive regulation, should be subject to duplicative systemic risk regulation in Canada. Additionally, we believe that the CMSA should clearly define the Authority's jurisdictional limits, clarifying thresholds related to Canadian activity that must be met before the Authority would have the ability to designate an entity, product or activity as systemically significant.

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We appreciate the opportunity to comment afforded to us by the Participating Governments and stand ready to provide any additional information or assistance the Participating Governments might find useful. Should you have any questions, please do not hesitate to contact me at 202-962-7447 or tcameron@sifma.org.

Sincerely,

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