



British Columbia Securities Commission

Another Way Forward for Securities Reform

Presentation to

The Task Force to Modernize Securities Legislation in Canada

British Columbia Securities Commission

Brent W. Aitken, Vice Chair

October 14, 2005

I Introduction

Good morning.

First let me say thank you for the opportunity to speak to the Task Force. The BC Securities Commission thinks regulatory reform – and by this we mean the substance of regulation, as opposed to the structure through which it is administered – is very important. So we welcome the opportunity to tell you about our thoughts and actions on the subject. We hope you will find it useful in your deliberations.

Let me also mention that our Chair, Doug Hyndman, would very much liked to have been here today, and would have been, but had date conflicts with both days that were available to us. Yesterday he had a meeting with our new Minister, and today he is meeting with our commissioners and staff in a strategic planning session.

When Tom asked us to come and tell you about our new legislation, he suggested you would be interested not just in “what” we did, but the “why”. What studies did we do, and what analysis, to conclude that our regime would work? He suggested we help you walk in our shoes through the work we did.

And that is what we plan to do this morning. Our written submission that we sent you earlier this week focuses on the actual legislative changes we propose and some of the reasoning behind those, which I will expand on later.

However, the new legislation is just one aspect of a philosophy and approach to regulation that we have developed over the past few years. So if you really want to understand what the new legislation is all about, we have to start with that – the intellectual underpinning of how we look at regulation as a whole.

We think it’s all about healthy, vibrant, and competitive capital markets. That’s what Canadians deserve, and our economy needs, to grow and prosper.

Just how healthy, vibrant and competitive our markets are can be much affected by how we regulate them. And we think your mandate captures perfectly what is at stake – integrity and competitiveness. At the British Columbia Securities Commission, we have been thinking about exactly that over the past few years – how to design and administer a system of regulation that enhances the integrity of our markets and allows them to be competitive. We are now putting our ideas into action. And we can do that, even though our new legislation has not yet been proclaimed, because in many ways the approach and philosophy of

regulation has as much impact as, if not more impact than, the substantive provisions of the legislation itself.

II How The BCSC Thinks About Regulation

Starting Point

There are some background points to where our thinking starts. One, we live in a free market economy. Two, competitiveness requires integrity, but integrity does not require competitiveness. Third, our system depends heavily on voluntary compliance.

Regulation in a free market economy

We live in a free market economy. The market forces at work in a competitive free market will usually be effective in promoting behaviours and conditions that will benefit the market, and in penalizing behaviours that harm the market. However, markets do not always do this perfectly, and when they do not, the perception of the market's integrity is put at risk.

As regulators, our job is to intervene in situations where market forces fail to establish conditions favourable to a fair and efficient market. When we are successful, the integrity of our capital markets is not in question.

However, market forces work best when unencumbered, so regulatory intervention in a free market economy should be limited to the least degree necessary to solve the market problem. Therefore, in British Columbia, we follow a risk-based, problem-solving regulatory approach that focuses on outcomes rather than prescription and processes.

Integrity and competitiveness

The second point is the nature of the relationship between integrity and competitiveness. You cannot have competitiveness without integrity – if market participants do not trust your markets, they won't trade in them. However, you can have integrity without competitiveness. Indeed, this is the usual result of over-regulation.

This has implications for the role of the regulator. For example, the BC Securities Commission mission statement says our mission is to foster fair markets and “a dynamic and competitive securities industry”. In fact, there is little that we can do in a proactive sense to foster competitiveness in the securities industry but, if we are not careful, there is much we could do to hinder it. So to our way of thinking, the primary means through which regulators successfully enhance competitiveness is, putting it bluntly, to stay out of the way.

This is part of our answer to your questions about what can be done to encourage investors to execute trades in Canada's markets, and to encourage issuers to list in Canada. To this we would say, first and foremost, ensure that

regulators intrude into the operation of the market only where demonstrably necessary, and keep down the costs of regulation, both direct and indirect, so Canada will be a low-cost operating environment.

Another aspect to competition, which you raise in your questions about governance, is whether there can be a Canadian context for regulation.

We believe not only that Canadians *can* think and act independently of the US about regulation – but also that we *must* do so. And we must think and act independently about all aspects of regulation, including governance.

The response to the governance issues that came to light over the past few years is actually a good example of this. We think things may have gotten off to an unfortunate start because some focused on the prominent Canadian companies interlisted in the US and concluded that we have a single North American market needing a single set of rules. This was a mistake, for two reasons. First, relatively few Canadian companies are interlisted. For example, only 13% of TSX issuers are interlisted in the US.

Second, and more important, there was no point to creating new governance laws in Canada to match those in the US for the sake of the interlisted companies – these companies, by definition, were already required to meet US requirements.

But the main reason that we must think and act independently of the US (and other large markets, for that matter) is that the total Canadian market represents a very small proportion of global markets – about 3% or so. And the market capitalization of most of our public companies is much smaller than, say, US public companies.

It is because our markets are smaller, and because much of our economy depends on healthy, dynamic and entrepreneurial smaller companies to thrive, that we must always be thinking about new and innovative ways to regulate. Slavishly adopting US-style regulation will, over time, ensure that we are less competitive. We need to ensure that our system of regulation lets our market participants be more nimble in order to compete internationally.

The US has chosen to regulate securities with a very heavy hand. As a result, compliance costs are high. Market participants nevertheless come from all over the world to list and trade in US markets because of the advantages associated with their enormous size and liquidity. The US therefore gets away with a high-cost environment because its markets offer advantages that are perceived to outweigh the high costs.

Canadian markets do not offer those kinds of advantages. We therefore cannot afford to import the high costs of US-style regulation. We need to think about our

approach to regulation as an opportunity to provide a low-cost, high-credibility market that will not only help make our own market participants more competitive, but will attract foreign market participants to our markets.

Dependence on voluntary compliance

The third point is that all of us in the regulatory business depend on the fact that the vast majority of market participants are compliance-minded. That means that our regulatory system depends heavily on market participants choosing to follow the rules. This has implications for how the system should be designed. We have to make it understandable for market participants so they know how to comply, and we have to build it in a way that motivates market participants to make the right compliance decisions. If the system encourages a tick-the-box mentality about compliance, it puts market integrity at risk. As market participants make thousands upon thousands of compliance decisions each day, there is no assurance that ticking all those boxes is actually protecting the interests of investors.

If, however, the system uses outcomes-based requirements, market participants must consider the interests of both investors and markets in making their compliance decisions, and are more likely to do business in ways that do not threaten market integrity.

We think this is what a good system of regulation should do – encourage market participants to think about what is best for investors and markets in deciding how to comply, rather than looking to the regulator for instructions on what to do. And those managing the regulatory system should focus on holding market participants accountable for their decisions, not telling them how to run their businesses. Too often, we see accountability and effective regulation undermined by “nanny” regulators too eager to involve themselves in the business decisions of the regulated community.

The BC Approach to Regulation

Our system is risk-based and applies outcomes-based tools to bring about the desired results. And that is really at the heart of all this – results. The effectiveness of a regulatory system, or of the regulator that administers it, is not measured by output – how many prospectuses we review, how many registrants we oversee, or how many exemption applications we process – but by outcomes. We should be asking, does our system of regulation:

- deliver value for money?
- focus on the right things?
- identify and minimize threats to investors and markets?

We think those who rely on us to regulate the markets, and those who pay our fees, have the right to answers to those questions. And we think it is how our effectiveness should be measured.

The five elements

Our approach to regulation in British Columbia has five elements:

- pick important problems and fix them
- make the rules few, simple, and clear
- promote a culture of compliance
- act decisively against misconduct
- educate investors and industry

Pick important problems and fix them

This is a phrase coined by Harvard professor Malcolm Sparrow, who has very much influenced our thinking about regulation. In his book, *The Regulatory Craft – Controlling Risks, Solving Problems and Managing Compliance*, Sparrow encourages regulators to focus on rigorous problem definition and a thorough evaluation of the available tools of compliance. We recommend that the Task Force familiarize itself with this book (and we understand you plan to do so) because we think it will provide a useful perspective for you in your deliberations.

At the BCSC, we have been following Sparrow’s methodology since 2001.

A full description of how the Sparrow process works could easily consume the whole morning, if not more, so I’ll just summarize the fundamentals of how it works.

The methodology has six steps:

1. Nominate the problem for solution.
2. Define the problem precisely.
3. Determine how to measure the impact of solutions.
4. Develop solutions or interventions.
5. Implement, monitor, review, adjust.
6. Close project.

This morning, I’m going to focus on steps two, three and four.

Problem definition

The problem definition stage is critical. It ensures that our resources are spent only on real problems, properly framed, that relate to our regulatory objectives. We demand two factors to be satisfied before we consider intervention. First, we have to be satisfied, not just that a problem exists, but that it is a problem *that warrants regulatory intervention*. This rules out intervention to solve demonstrable problems that can be addressed by competitive forces in the market, or by voluntary self-regulation by market participant groups. These problems, by definition, do not require regulatory intervention.

The second factor is that the problem be defined precisely.

Demanding that these two factors be present ensures that we limit our intervention only to those issues that require it, and limit the scope of our intervention to the problem as defined.

It is worth pausing for a moment to consider the potential role of market-based solutions. Markets usually reward good behaviour (that is, behaviour that is good for the market) and discourage bad behaviour, at least in the longer term. When market problems do arise, therefore, does it not make some sense to think about giving the market some time to respond to the problem to see if regulatory intervention is required at all? This, it seems to us, is an important aspect of risk assessment. Regulatory intervention is not a risk-free process. Like any other choice, it carries risks. So unless the problem is such a clear threat to investors or markets that immediate intervention is required, it makes sense to assess the relative risk of non-intervention for a period of time to see how the market responds, compared to the risk of premature regulatory intervention.

The Sparrow approach does not require that a problem actually surface before action is taken. A significant risk to investors or markets that has not yet materialized but is foreseeable can itself be a problem.

We won't intervene without objective evidence of a problem. Ideally this is qualitative and quantitative, rather than merely anecdotal. However, we will act on anecdotal evidence if it is sufficiently compelling. The anecdotal evidence may be compelling because:

- there is enough of it to lead a reasonable person to conclude that the apparent problem is widespread (generally or in a particular market segment), or
- it identifies a significant market risk, such as a clear and present danger to investors.

However, when we do proceed on the basis of anecdotal evidence, we are especially careful about the solutions we consider. Because in that case we know we don't know all the facts.. The risk of unwarranted regulatory intervention increases when we have less cogent evidence of the problem.

If you remember only one thing about the Sparrow approach, remember this: you must define the problem and identify the measurements you will use to determine whether it has been solved *before you consider solutions*. This order is important. If we have a solution in mind before the problem is properly identified and defined, the solution can distort the problem definition analysis. An example of this is to begin the problem analysis from the point of view that we need to have a new rule. With that mindset, the analysis is no longer about what the real problem is, and what tools might be best used to solve it, but about what the rule

should say to deal with the problem. This often distorts understanding of the nature of the problem and prematurely closes off consideration of non-rule solutions.

Defining problems with precision is an art as much as a science but is necessary to a successful outcome. For example, suppose you believe there is a problem around fees charged by dealers. Defining the problem as “fees” is not useful. How about, “fees are not being fully disclosed”? Even then, you need to consider aggregation. Is it the disclosure of all fees, or just fees paid to dealers under particular circumstances? Or just to a particular segment of dealer? Or just fees related to certain products? If you allow yourself to think briefly about solutions to these different statements of the problem you will see how important is this aspect of problem definition. Each formulation of the problem could yield quite different solutions.

Another current example: defining the problem as “hedge funds” is not useful. How about, “Registrants are not complying with “know-your client” and suitability rules when selling hedge funds”? If so, is the problem with all product varieties of “hedge funds”? And is it “hedge funds” or all “alternative investment products”? And is the practice found among all registrants, or just in some categories of registrant?

When you do the problem definition work properly, the resulting statement of the problem will

- frame the problem so it can be fixed
- suggest clear and measurable outcomes that are independent of any proposed solution
- identify measures for those outcomes

Measurement

In following the Sparrow approach, we insist that measurements be identified before the solutions are considered, for three reasons. First, if it turns out that the solution is a rule, it prevents the temptation to create measures that verify only compliance with the new rule, rather than whether the rule is solving the problem. Second, it identifies the measurement challenges early. If, for example, we have no good way of measuring the resolution of a problem, we have no way to quantify the potential benefit of addressing the problem, which will affect our ability to do a cost-benefit analysis. Third, identifying the measurement criteria first will identify the data that needs to be collected.

The way you choose to measure the expected outcome should be as objective as possible and should produce enough data so that the measurement will be a reliable indicator of how successful the rule has been in fixing the problem. We examine the measurable outcomes of the project and assure ourselves that the measures are specific – will they give us meaningful information – and practical – can we actually collect and analyze the data the measure needs.

Solutions

Choosing the right solution and implementing it speaks to both the efficiency and effectiveness of our regulatory actions. Once we have properly defined the problem, and know how we will measure our success in dealing with it, the next step is to consider what regulatory tools could effectively address the problem, and to choose the tool (or tools) that will solve the problem with the least additional regulatory burden.

We consider all regulatory tools in searching for solutions.

We prefer non-rule solutions, because rules are generally the most intrusive and expensive form of regulatory intervention, and this expense filters down to investors.

Rules can also have adverse effects, such as limiting competition, slowing innovation, increasing costs, encouraging a loophole mentality, or creating other unanticipated or undesired responses. Rules can interfere unduly with normal market forces. This introduces inefficiencies into the market, which in turn weakens competition, and imposes costs on market participants not justified by the benefits. We damage the ultimate efficiency of our market if we choose to use rules when other alternatives can adequately address the issue. So we consider other options first.

We are not alone in this belief. The Australian authorities have concluded that “Unless a comprehensive assessment of alternatives [to rule making] is undertaken there can be no confidence that the regulatory proposal adopted represents the best solution to the problem.”

This does not mean that we should shy away from a rule when it is clearly the best way to deal with a problem, just that we must recognize that rule-based solutions involve serious risks.

So what are the alternatives to rule-based solutions? The main ones are:

- compliance monitoring
- enforcement
- guidance
- education

To choose among the various tools to solve each problem, we consider, for each alternative:

- its cost (both for us to implement and for industry to comply)
- its effectiveness (how much of the problem it will address; likelihood of success)
- how easy it will be to implement
- the need and ability to monitor it

- its enforceability

Often, we use more than one alternative to deal effectively with a problem.

Sparrow's methodology carries on with the implementation and wrap-up phases, which I will leave for your consideration when you read his book.

Make the rules few, simple, and clear

This is the second element of our approach to regulation.

Sometimes the best solution to a problem does include rulemaking. However, we aim to limit the scope and content of new rules to what is clearly needed to achieve specific outcomes efficiently.

I have already spoken in general terms about the risks associated with rule-based solutions. When a rule is required, we must take care to craft it properly. Perhaps the most perverse outcome from poor rulemaking is that instead of protecting investors, it can actually compromise investor protection. For example, overly detailed disclosure requirements result in thick, legalistic documents that obscure information that really matters to investors. And if the rule is too detailed and prescriptive, market participants focus on satisfying the details of the requirements, instead of doing what is right for investors and clients.

Rules also add complexity, which in turn increases costs for industry, costs that ultimately come from the pockets of investors. Every requirement imposed by regulators triggers compliance costs for market participants. Higher costs for investment firms mean higher fees for their clients. Higher costs for public companies mean lower returns for their shareholders.

This is what we demand from a rule-based solution:

- It must influence behaviour. The rule must require market participants to exercise judgment in their business practices with the interest of investors and the markets in mind (except, as occasionally happens, when an outright prohibition or prescriptive response is the only solution).
- It must have a strong link to the desired outcome. A rule can impose a regulatory burden without yielding corresponding benefits to industry or investors if it merely prescribes how something must be done, rather than stating the outcome expected.
- It must be flexible. The rule must allow industry to design efficient processes to achieve the target outcomes.

- It must have longevity. It must be able to deal with new market developments.

Promote a culture of compliance

Effective regulation depends on market participants to put effective systems and controls in place to comply with both the spirit and the letter of securities laws. Investors rely on investment firms to monitor their compliance responsibilities, and on issuers to provide accurate, complete, and timely public disclosure. We are working to establish an effective culture of compliance in British Columbia that aligns the private interests of market participants with the public interest in a fair, efficient, and reputable securities market.

Act decisively against misconduct

Decisive action involves investigating complaints, and our own leads, to identify market conduct requiring a compliance or enforcement response. It means responding to illegal activities forcibly through enforcement actions. We use enforcement to deter misconduct and to remove from the market those who pose a threat to investors or to market integrity.

Educate industry and investors

Education is a fundamental strategy in our approach to securities regulation. Through our investor and industry education programs, we seek to:

- equip investors with the knowledge and skills necessary to help them protect their financial interests.
- inform market participants about the rules to help them comply with their regulatory obligations.

The central role of outcomes-based solutions

No matter which regulatory tool we choose, the methodology almost always leads to outcomes-based solutions. We believe that outcomes-based solutions are much superior to prescriptive solutions, because they do a better job of investor protection and yet reduce regulatory burden at the same time.

This is the opposite of what many would expect. In fact, when we began our project to reform our legislation, we came at it from a point of view similar to yours – how to reduce regulatory burden. We started out thinking of the exercise this way: how can we reduce regulatory burden without compromising investor protection.

We learned along the way that this is a false dichotomy. We did not, and you do not, need to choose between low-cost regulation and investor protection as if it were a zero-sum game. It turned out that the more we removed prescription and replaced it with outcomes-based approaches, the better the regime became at protecting investors, and the less regulatory burden we imposed.

This gives you an idea of what is possible: we had to count total regulatory requirements, before and after, as part of the government's province-wide deregulation initiative. The count showed that our new legislation will contain less than half the number of regulatory requirements in the current legislation. (To be exact, under the new legislation, regulatory requirements will drop 55% compared to the current legislation).

And yet, the new legislation improves investor protection. For example, it requires both issuers and registrants to make clearer and more understandable disclosure. It protects investors better in conflict of interest situations, and it substantially improves fee disclosure.

These are what we see as the advantages to outcomes-based rules compared to prescriptive regulation:

- Outcomes-based rules require market participants to exercise judgment in their business practices with the interest of investors and the markets in mind. If the rule is too prescriptive, market participants will simply comply with the letter of the rule and give no thought to the intended outcome.
- Outcomes-based rules hold the individuals in senior management accountable for making appropriate compliance decisions.
- Outcomes-based rules are more efficient at producing the desired outcomes. Prescriptive rules are less so because they prescribe specific conduct as a proxy for the ultimate behaviour we want. The result is that the rule ends up imposing a regulatory burden without necessarily yielding corresponding benefits to industry or investors. Outcomes-based rules simply impose directly the requirement for that behaviour, and are more likely to produce the benefits that were identified to justify the rule in the first place.
- Outcomes-based rules allow industry to design efficient processes to achieve the target outcomes. This is the major reason they are powerful tools to reduce regulatory burden – they are the most cost-effective means of aligning regulatory interests with industry's self interests. Prescriptive regulation imposes "one-size-fits-all" requirements that can inflict significant and unnecessary costs on market participants, which filter down to the investor. Prescriptive rules also force firms to maintain structures purely for regulatory reasons even when the process has little regulatory or business value.
- Outcomes-based rules are hardy. They demand certain behaviours and, regardless of the specific context, there is usually little variation in what constitutes optimal behaviour. They are therefore much more likely to deal with new market developments than prescriptive rules, which are designed to regulate specific scenarios.

This is not to say that detailed rules are never appropriate. And although industry supports outcomes-based regulation in broad terms, it will need time to adjust compliance practices to an outcomes-based regulatory environment.

Applying the Approach – Examples

Hedge funds

We recently used our approach to consider how to respond to the growth in hedge funds investment and the collapse of two Canadian hedge funds. When analyzing the problem, we found that most hedge fund products available in the Canadian market are associated with firms that are registered as portfolio managers, including the two funds that collapsed.

Our analysis shows that the rules we already have appear to govern the issues surrounding hedge funds. Two existing rules that are particularly relevant are the “know your client” and “suitability” rules. These rules require brokers to understand their clients’ investment needs and to recommend only investments that are suitable to those needs. To comply with this requirement, the broker obviously must understand the nature of the investment being recommended. If there is a problem with hedge funds, we suspect it lurks in this area.

We have not identified any other risks in the hedge fund market that are not covered by current rules governing registrants.

Therefore, the BC response to the growth in hedge fund investment is not to impose new rules. Instead:

- We are conducting compliance reviews of BC hedge fund managers.
- We have reminded registrants that they must understand any products they sell, and that without conducting appropriate due diligence they are not discharging their obligations to clients under the KYC and suitability rules.
- We will take appropriate compliance and enforcement action where warranted, and have reminded industry of that, too.
- We are looking for opportunities to inform investors that hedge fund products are complex and risky and that they should not purchase them if they do not understand them.

We believe that this response addresses investor protection issues associated with hedge funds by addressing the actual risks, without imposing unnecessary costs through new rules.

Market timing in the mutual fund industry

When the market-timing issue related to the mutual fund industry first came to light, the response led by the Ontario Securities Commission reflected an approach similar to the one we advocate. First, it was risk-based. The OSC began by assessing the risk. It did surveys and compliance reviews to determine the nature and scope of the problem, and the areas in industry where it should focus its future regulatory attention.

Second, it was outcomes-based. To alter industry behaviour, the OSC took targeted enforcement action, using existing rules. This resulted in a number of well-publicized settlements.

It seems clear that, through all this, the high risk areas were identified, industry got the message, and behaviour has changed.

So far, so good. Under the BC approach, we would stop there. Despite the clear effectiveness of the non-rule solution the OSC implemented, however, it is now developing some new rules to regulate this activity. This appears to be in response to claims by some firms that they did not know there was anything wrong with market-timing. The OSC's report shows quite clearly that most firms knew well that it was wrong and avoided getting involved in it.

III British Columbia's New Legislation

Our new legislation (*Securities Act*, SBC 2004, c. 43) is a key component of our new approach to regulation. While it has received Royal Assent, it is not yet in force. The original intended date for proclamation was last November, but the government decided to delay implementation to give industry more time to prepare. We are now discussing with our new minister a revised plan for implementation.

In our written submission, and in my remarks today, when we refer to the new BC legislation, we are not referring to any part of the current legislative regime in force in British Columbia. What we are referring to is the package consisting of:

- the new Act
- the new *Securities Rules* to be adopted under the new Act
- the few National Instruments that would have remained in force in British Columbia had the new legislation been implemented last year as planned

Our Methodology

A disciplined, zero-based review

We followed a rigorous, zero-based process in developing the new legislation. For each existing provision we asked ourselves

- What problem was this designed to address?
- Is it still a problem?

- Is this rule needed to address the problem, or can an existing rule or another tool be used?
- If this rule is needed, can we simplify it and redraft it in plain language?

We applied this analysis line-by-line to every provision of the Act, our rules, the National and Multilateral instruments in force in British Columbia, and all of the forms.

Five studies

We conducted cost benefit or regulatory impact analyses of the following areas of our new legislation:

- *Better Disclosure: Lower Costs – A Cost-Benefit Analysis of the Continuous Market Access System* (October 2002)
- *Strong and Efficient Investor Protection – Dealers and Advisers under the BC Model – a Regulatory Impact Analysis* (November 2003)
- *Enforcement of Outcomes-Based Securities Legislation* (May 2004)
- *Cost Savings under a Firm-Only Registration System* (May 2004)
- *Investor Remedies in Securities Legislation – a Regulatory Impact Analysis* (May 2004)

All of these are on our website; the first four are also attached to our submission.

Consultations

We carried out extensive consultation with market participants on the concepts and proposals that led to the new legislation. We met with more than 2,000 people in BC and across Canada who would be affected by the law. Public company directors, dealers and advisers, lawyers, accountants, and academics joined focus groups, attended seminars, completed surveys and responded to regulatory impact studies. We also received 160 comment letters between March 2002 and September 2004.

Experience of other outcomes-based regulators

We considered the experience of a number of other regulators that operate using an outcomes-based approach to regulation. Regulators such as the U.K. Financial Services Authority, the Australian Securities and Investment Commission, the U.S. Commodity Futures Trading Commission and the Office of the Superintendent of Financial Institutions in Ottawa all approach regulation from an outcomes-based perspective. Specifically, we analyzed the Australian firm-only registration system. We published this analysis with our New Proposals for Securities Regulation (June 2002).

Comments on Specific Aspects of the New Legislation

Most of what I am going to comment on you will find in our submission, but I would like to highlight a few aspects of that, as examples of our approach to regulation in action as we developed our new regime. Like our submission, my remarks are organized around the headings of your issues to review.

Protecting individual investors

The submission identifies four ways the new legislation improves investor protection:

- The use of outcomes-based requirements
- Its streamlined and simplified design
- Strengthened enforcement powers
- New investor remedies

Outcomes-based requirements

First on the list for investor protection in our submission is the use of outcomes – based requirements, which I have already addressed.

The submission has a few examples of how it works; I'd like to review one of them in more detail.

The example is drawn from the new Code of Conduct for registrants. Under the current regime, fee disclosure requirements are scattered through a variety of provisions and consist largely of prescriptive requirements that mandate specific disclosures. The result is that there is no holistic approach to fee disclosure, and compliance has evolved into legalistic, boilerplate disclosure.

When drafting the Code, we felt the real issue was broader than just fee disclosure. It was whether clients have all the information they need to assess the objectivity of their advisers. That being the outcome we concluded we wanted, that is how we wrote the requirement in the Code:

“Disclose promptly to the client any information that a reasonable client would consider important for assessing your ability to provide objective service or advice.”

Then, in the guidance to that rule, we said this about fee disclosure:

“One of the most important areas for full disclosure is anything to do with compensation you receive that relates to the work you do for the client or to your relationship with the client.”

The guidance goes on to say that registrants should disclose various types of compensation, such as referral fees, contingency fees, trailer fees, switching fees and so on. It also says that “blanket” disclosure about routine compensation

arrangements in general is all right, but that more specific disclosures need to be made before the client has to make his or her investment decision.

In combination with the requirement that registrants communicate with their clients in plain language, we believe this will result in clients getting more complete, and more understandable, disclosure.

Streamlined and simplified design

We believe, based on what we heard in our consultations, that a significant barrier to compliance, even among those who are compliance-minded, is simply being aware of, and understanding, the requirements. This difficulty arises from both the volume of regulation, and its complexity (not to mention the steady stream of additional requirements).

It sounds like merely a statement of the obvious, but the fact is that compliance improves when market participants can understand what is expected of them. So we streamlined and simplified the design of the legislation (again, the use of outcomes-based requirements helped with this) and wrote it in plain language.

We also provide formal guidance documents like these I'm showing you now.

All this makes the requirements clearer, and allows us to hold market participants to high standards of conduct. All that adds up to better investor protection.

Strengthened enforcement powers and new investor remedies

The new legislation includes some beefed-up enforcement powers and new investor remedies that we'll come to later.

Balancing cost and effectiveness of modern governance

As is clear from our submission, we have a view quite different than some of our regulatory colleagues as to how best to deal with the governance issues that came to light in recent years.

In a nutshell, we believe that much that has been done is unnecessary and is unlikely, in the long run, to have much impact on the quality of governance. Not to say that governance will not improve, but we are skeptical that it will ever be shown that the new rules contributed in any significant way to any improvement that does occur. In our view, other factors will have greater influence.

So in some areas we have come to different conclusions. Partly we did so because the new CSA governance rules were not created through a risk-based, problem-solving methodology. And not surprisingly, we chose not to adopt some requirements because they favour prescription over an outcomes-based approach. The submission identifies the major areas where we have taken a different approach:

- we do not require all audit committee members be independent nor any of them to be financially literate
- we do not use bright line tests to determine independence
- we would probably not even have an audit committee rule (except perhaps to require that an issuer have one, or that its board fulfills that function) but in order to ensure our legislation conformed to IOSCO standards, we created an audit committee rule (although it follows IOSCO standards and is more outcomes-based)
- we do not require senior officer certification of financial statements and internal controls
- we have no requirements specific to internal controls on financial reporting, or a requirement that those controls be audited

If there is anything that bears out our skepticism about the regulatory response to the governance issues, it is the high costs of SOX 404. The most severe cost impacts are associated with the audit requirement, but other costs are also problematic.

Difficulties with the implementation of SOX 404 emphasize the importance of adding new rules only where demonstrably appropriate and ensuring that the costs of a new rule do not outweigh the benefits.

US surveys also indicate that the costs of compliance with SOX 404 rules are disproportionately higher for smaller issuers than for larger issuers. This brings us to your question about whether regulation should be differentiated for small issuers.

We do not agree with that approach, because we believe a properly designed outcomes-based regime will provide sensible outcomes for all market participants without having to devise separate regimes.

We also believe that differentiated regulation has significant disadvantages. First, it is almost impossible to get right the thresholds between classes of issuers. Even if it works most of the time, the regime spins off a welter of exemption applications as issuers who should be in one category find themselves in a different one. (Even if this is seen as an acceptable side-effect, it deals only with those who seek less burdensome requirements. What about those who belong in a category with more burdensome requirements? They are unlikely to apply.)

Second, there is a risk that issuers regulated in the less rigorous categories will be seen as less desirable investments. We do not think it is wise to create a perception that any part of the market is less adequately regulated. It plays into exactly the misconception I referred to earlier – that less regulation means less investor protection. As we have shown, less regulation, if replaced by outcomes-

based requirements, properly implemented and supervised by the regulator, actually increases investor protection.

Access to capital

The submission reviews our Continuous Market Access system in the new legislation, which we think clearly improves access to capital. We also think that that system, plus the absence in our regime of hold periods, resale restrictions, and escrow requirements, are examples of regulatory initiatives that would encourage issuers to list in Canada, or maintain their listings here. We also think that prescriptive regulation, particularly if onerous like SOX 404, is likely over the long term to have the opposite effect.

Replacing prescriptive, process-driven trading rules with outcomes-based requirements, and ensuring that regulatory intervention is limited to those circumstances where it is demonstrably necessary, could do much to encourage market participants to view Canada as a favourable place to trade securities. Again, prescriptive regulation is likely to have the opposite effect.

You asked if we considered the British experience with NOMADS on the London Stock Exchange Alternative Investment Market. We were aware of it and it helped us in developing our approach to due diligence providers.

Issuers in the junior market advised us that the cost of underwriters is often prohibitive considering the benefits they provide. To address this issue, the new legislation allows persons other than registered dealers to apply to the Commission for approval to perform the due diligence functions currently done by underwriters. (A due diligence provider is liable, as an underwriter would be, for misrepresentations in the offering.)

In developing this proposal, we noted that, although in practice most NOMADs appear to be dealers, some are accounting firms and specialized corporate finance advisory firms.

Regulatory burden

I have already discussed how much of what we have done reduces regulatory burden:

- we use a risk-based approach to ensure that we do not intervene in the first place unless there is a demonstrated problem that warrants regulatory intervention
- we tailor solutions to solve the problem using pre-defined measurement criteria and we avoid the most expensive and intrusive regulatory tool – rule making – unless demonstrably necessary
- we favour outcomes-based solutions that allow industry to design their compliance models in ways that best suit their businesses

- the new legislation’s streamlined and simplified design makes it easier for market participants to determine what they need to do to comply, reducing their costs of external advisers

The submission talks about why we think outcomes-based approaches work, and how they are enforced. It also has two examples of how we analyzed a problem (conditional registration and firm-only registration) and concluded that regulatory requirements could be eased without affecting investor protection.

Enforcement effectiveness

The submission outlines our views on criminal, civil, and regulatory enforcement.

Our main points here, however, are two. One, regulatory enforcement, considered in context, is much more effective than is generally recognized, and two, the main thing Canada needs to significantly improve the perception of enforcement effectiveness is to establish a credible criminal deterrent, something that is beyond the powers of securities regulators.

IV Conclusion

Again, thank you for this opportunity to make a presentation to the Task Force. I hope we have been successful in giving you an understanding of how we think about securities regulation, how we have put that thought into practice, and how we built our new legislation.

As you undertake your deliberations, we encourage you to give serious consideration to the power of a risk-based, problem-solving approach to regulation, and the opportunity that outcomes-based regulation provides to make regulation that both better protects investors and reduces regulatory burden.