Another Way Forward for Securities Reform

Submission to

The Task Force to Modernize Securities Legislation in Canada

British Columbia Securities Commission

Vancouver, British Columbia

October 11, 2005

Securities Regulation at the BC Securities Commission

The British Columbia government passed a new *Securities Act* in May 2004. While the new Act is not yet in force, our Commission continues to reform regulation in ways that are consistent with the philosophy of the new legislation. We have sharpened our focus on attacking the more significant threats to investors and market integrity, so BCSC resources are used in the most cost-effective way to achieve our regulatory objectives. To minimize burden on industry and to place responsibility for compliance where it belongs, with senior management, we now aim to address regulatory issues by directing the outcome to be achieved rather than imposing detailed and inflexible requirements.

To	The Task Force to Modernize Securities Legislation in Canada
From	British Columbia Securities Commission
Date	October 11, 2005
Subject	Another Way Forward for Securities Reform

We are pleased to respond to your request for submissions on ways to modernize securities legislation in Canada.

This submission focuses on the provisions of the new BC securities legislation, which consists of the *Securities Act*, SBC 2004, c. 43, and the related rules proposed by the BCSC. The new legislation is part of a new, outcomes-based approach to regulation that the BCSC adopted several years ago and continues to implement, despite the delay in bringing the new legislation into force.

In examining how to modernize securities legislation in Canada, you should consider the following: it is very important to get the rules right; it is even more important to administer the rules the right way. As we will explain in our meeting, we are doing both.

We have structured our written submission to explain how the new BC legislation deals with the 5 key issues you raised:

- Investor Protection
- Finding a balance between cost and effectiveness of modern governance
- Access to Capital
- Regulatory Burden
- Enforcement Effectiveness.

In each area, we describe how the issues have been dealt with in the new BC legislation and explain the rationale for the decisions. We ask that you read this submission along with the remarks we will make in our oral presentation, a copy of which we will provide to you at the conclusion of our presentation.

We attach the following appendices referred to in our submission:

- Appendix A – Proposal to Redefine the Materiality Standard (June 2002)
- Appendix B – Better Disclosure: Lower Costs – A Cost-Benefit Analysis of the Continuous Market Access System (October 2002)
- Appendix C – Strong and Efficient Investor Protection – Dealers and Advisers under the BC Model – a Regulatory Impact Analysis (November 2003)
- Appendix D – Enforcement of Outcomes-Based Securities Legislation (May 2004)
- Appendix E – Analysis of Firm-Only Registration (April 2003)
- Appendix F – Cost Savings under a Firm-Only Registration System (May 2004)

We look forward to discussing our outcomes-based approach to regulation and answering any questions you may have during our presentation on Friday October 14, 2005.

TASK FORCE NOTE: The appendices attached to this submission by the British Columbia Securities Commission are not enclosed as part of this Volume, Comments by Industry Participants. However, they are available on the BCSC website.

Collectively, under Submission to the IDA Task Force at
http://www.bcsc.bc.ca/instruments.asp?id=1894#October2005

Part 1– Investor Protection

The new legislation improves investor protection in four key ways:
1. The use of outcomes-based requirements
2. Its streamlined and simplified design
3. Strengthened enforcement powers
4. New investor remedies

1. Outcomes-based requirements

The new legislation is built around outcomes-based requirements. These will replace many of our detailed, prescriptive rules. We believe outcomes-based regulation better protects investors because prescriptive regulation can encourage a loophole mentality, where market participants follow the letter (but not the spirit) of the rules. Prescriptive regulation does not demand that management exercise judgment or focus on broader obligations to the market and specific requirements can quickly become outdated in the continually evolving securities industry. A regime that relies excessively on detailed and prescriptive requirements is also a symptom of a regulator that is too involved in the operations of regulated firms.

Outcomes-based requirements, on the other hand, focus market participants on what is right for investors, clients and markets. Investors are protected best when market participants fully understand, and are held accountable for, their broader obligations to clients and the market. Outcomes-based requirements are responsive and flexible, adapting to market changes as they occur. This means they lower the cost of regulation, a cost ultimately borne by investors. They provide a sound basis for regulators to hold industry to high standards of conduct. In addition, they permit market participants to comply in ways that fit the size and nature of their businesses rather than having to adapt to detailed, "one size fits all" rules. Market participants operating in an outcomes-based environment can adapt their compliance practices in response to changing market conditions. This means better investor protection at a lower cost to investors and the market.

These are examples of the differences between prescriptive regulation and outcomes-based regulation, and how the latter better protects investors:

- **Clearer disclosure –** Current disclosure requirements are generally detailed and prescriptive. The disclosure that results is legalistic and largely impenetrable. The new legislation contains fewer detailed disclosure requirements and has an overriding outcomes-based requirement that disclosure must be understandable to ordinary clients and investors. This will lead to disclosure that is meaningful, understandable, and achieves its intended purpose.

- **More useful documents –** Since all material information about the issuer is available to investors all the time, the new legislation requires no disclosure document for offerings after the IPO (see Part 3). However, issuers are free to prepare one if they like. If they do so, there are no mandated disclosure requirements; they must only ensure that the document does not contain a misrepresentation. This allows the issuer to craft a document it thinks will be most useful to prospective investors, yet holds it and its senior management accountable if it makes a misrepresentation. Regulatory burden is reduced, yet investor protection is improved by ensuring that any disclosure is complete and truthful.

- **More informed decision-making –** The current legislation requires registered dealers and advisers to provide prescribed disclosures to clients, who can also obtain some additional information on request. However this does not ensure clients get all the information they need to make informed investment decisions. The new legislation replaces these requirements with a requirement that registrants provide clients with the information necessary to make informed investment decisions. It also requires registrants to tell clients all important facts about fees and conflicts of interest, and indeed any information that a reasonable client would consider important in assessing the registrant's ability to provide objective services or advice. These outcomes-based requirements will mean that investors will get more relevant and meaningful information.

- **Improved protection against conflicts –** The current legislation handles conflicts of interest by prohibiting some specific transactions, restricting others, and requiring disclosure of others. This approach restricts some transactions that pose no threat to investors, while ignoring some conflict of interest situations entirely because they are not specifically mentioned in the legislation. The new legislation replaces these provisions with a requirement that registrants resolve conflicts of interest in favour of the client, and tell the client anything that would lead a reasonable client to question the objectivity of the advice being given. This forces the registrant to consider what conduct will be appropriate, and covers all conflict situations, whether known today or arising in the future.

2. Streamlined and simplified design

Current securities legislation is complex and excessively detailed. It is often hard for market participants to understand. Complex requirements can cause them to lose sight of the underlying principles. The new legislation streamlines and simplifies the rules and writes them in plain language. We will also provide accessible guidance and comprehensive industry education programs for market participants, enabling market participants to understand more easily what is expected of them. This means we can hold them to high standards of disclosure and conduct, while providing better protection for investors and market integrity.

3. **Strengthened enforcement powers**

Strengthened enforcement powers and penalties will provide the Commission, and the courts, with more tools to deal with those who break the rules and to deter misconduct that threatens investors. Under the new disgorgement power, investors will be able to make claims against money recovered from wrongdoers. The increased enforcement powers are discussed in Part 5.

4. **New investor remedies**

Like in Ontario, there is a new remedy that permits investors in the secondary market to sue companies for misrepresentations in public disclosure documents or oral statements. Unlike in Ontario, the new remedy in BC is streamlined, as is the rest of the new legislation. This means that the liability standard for different defendants does not vary with the type of disclosure. Instead, we included a new defence that lets directors rely on management as long as the issuer has a reasonable system to ensure compliance.

Another difference is that the new remedy integrates primary market liability and secondary market liability. This puts all investors on the same footing, whether they buy from the issuer or in the secondary market. It recognizes that all investors depend in the same way on the information that a public issuer discloses.

The new legislation also includes an improved right to sue for insider trading. The current section provides a remedy to any person who trades with the person who contravenes the insider trading prohibition. The new section provides the remedy to any person who trades between the time of the contravention and the time that the material information or significant change is disclosed. Eliminating the requirement to prove who is on the other side of a trade in the secondary market makes the remedy more effective and will allow it to operate as originally intended.

Currently, the only way an investor can bring wrongful conduct to the Commission's attention is by making a complaint. This may or may not result in an investigation and enforcement proceeding by the Commission. The new legislation permits anyone who believes another person has contravened the legislation to seek leave from a Commissioner for the Commission to hold a hearing in the matter. Further details of this provision are in Part 5.

Part 2 – Balancing Cost and Effectiveness of Governance

The new legislation imposes governance requirements that are less costly and more effective. It requires:

- an auditor's report on the financial statements of a public issuer, to be prepared and signed by a person subject to the requirements of the Canadian Public Accountability Board (CPAB)
- a reporting issuer to have an audit committee with a majority of independent members
- a reporting issuer to disclose its governance structure

It does not require:

- that all audit committee members be independent and financially literate
- that independence be determined using bright-line tests
- senior officer certification of financial statements and internal controls
- anything specific to internal controls on financial reporting, or that those controls be audited

Auditor oversight
The new legislation requires that an auditor's report on the financial statements of a public issuer, be prepared and signed by a person subject to the requirements of the CPAB. Unlike the regime under National Instrument 52-108 *Auditor Oversight*, the new legislation does not include the requirement that the auditor must be in compliance with any restrictions or sanctions imposed by the CPAB. It is up to the CPAB to enforce its requirements, and to issuers to ensure their auditors are qualified to do the audit under CPAB rules.

Audit committee
The new legislation requires a reporting issuer to have an audit committee that performs specified functions and has a majority of independent members. There is an exemption from the audit committee and independence requirements for issuers who have fewer than five members on the board if the board performs the responsibilities of the audit committee. This recognizes that directors of small companies are often also officers or significant shareholders of the company.

Unlike the regime elsewhere in Canada, the new legislation does not require all audit committee members to be independent, or that they be financially literate. There was no analysis to demonstrate that independence of all members was necessary to achieve the desired outcome, and we do not believe that the financial literacy requirement is enforceable as a practical matter.

We also did not use the same test for independence. Our test is objective and considers what a reasonable person with knowledge of all the relevant circumstances would conclude. The definition of independence in the rest of Canada includes a general test that is supplemented by bright-line exclusions, which in our view defeat the purpose of the general principle. Issuers will focus more on whether they fit a specified circumstance than whether they meet the general test.

Disclosure of governance structure
The new legislation requires reporting issuers to disclose corporate governance information.

The requirement is intended to ensure that meaningful corporate governance information is available for investors about the structures, processes and practices issuers use so investors can make informed decisions. It also leaves issuers free to choose an effective governance structure that suits their particular circumstances.

No certification requirements
Our new rules do not include certification requirements. The rest of CSA requires the CEO and CFO of a reporting issuer to certify that:

- the issuer's annual or interim filings do not contain any misrepresentations and fairly present, in all material respects, the issuer's financial position
- they are responsible for the issuer's disclosure controls and procedures and internal control over financial reporting and that those controls are effective

The new legislation does not have any similar requirements because directors and officers have a general duty under securities legislation to ensure that an issuer's disclosure is not false or misleading. Directors and officers are also directly accountable under the legislation for any violations by the issuer and are exposed to both quasi-criminal prosecution and administrative sanctions. Requiring directors and officers to confirm responsibility for disclosure, and requiring the issuer to follow specific internal governance practices, therefore adds nothing meaningful to the legal duties of directors and officers.

We were also concerned that although these requirements might have short-term benefits by focusing issuers on improving disclosure, the longer-term effect would be to undermine the effectiveness of general regulatory obligations by promoting a mentality of rote compliance.

Enforcing outcomes-based requirements, rather than specifically defining how issuers should manage their affairs to achieve the intended outcomes, provides better regulation by setting the expectation of behaviour, and then holding directors and officers accountable. It also ensures that the persons best placed to exercise judgment (the officers and directors) do so. In addition, this approach gives regulators the tools to deal immediately with emerging issues, through enforcement, compliance reviews, education or guidance, instead of constantly creating new rules after the fact to deal with each new problem that arises.

Many of the recent large corporate failures demonstrate that these requirements would not necessarily have prevented the wrongdoing. The perpetrators were already breaking existing laws and presumably would have had little compunction about signing false certificates. It is likely that the benefits ascribed to the Sarbanes-Oxley requirements in the US and the similar "investor confidence" rules in Canada really resulted from heightened market attention to governance, disclosure, and financial reporting and auditing issues following the scandals and subsequent regulatory and criminal action, not from the actual regulatory requirements.

No internal controls rule

Although other Canadian jurisdictions have proposed a Canadian equivalent to SOX 404, the new legislation includes no requirements along these lines. We do not think that the case has been made for the rules, and we are not alone. The United Kingdom and Australia have not implemented a SOX 404-type internal control rule for the same reason. Instead, both jurisdictions require disclosure about internal controls and the United Kingdom also requires a limited auditor review.

Reliable and timely financial reporting by Canadian issuers is essential, and no doubt many issuers need to improve their internal controls over financial reporting. But is a new rule the best way to focus issuers' attention and resources on the objective of improving financial reporting? Existing financial reporting requirements already require issuers to develop and maintain appropriate internal control over financial reporting. Even without an internal controls rule, any issuer making erroneous disclosure could defend itself only by showing that it exercised due diligence in its financial reporting processes.

This type of rule also promotes a "box-ticking" approach to controls, rather than an outcomes-based approach that focuses on both business needs and regulatory compliance.

Experience in the US has shown that SOX 404 compliance is extremely expensive. Since investors ultimately pay the costs imposed on issuers by regulatory requirements, this underlines the need for caution. We will not impose requirements unless we believe that the value to investors would exceed the costs. So far we have seen no credible evidence that any benefits arising from the proposed rule would outweigh the potentially significant costs and adverse outcomes.

Part 3 – Access to Capital

Several features of the new legislation would improve access to capital in Canada's markets. The new legislation:

- Streamlines initial public offerings and eliminates regulatory approval for offerings after the IPO using a system we call Continuous Market Access
- Eliminates the "closed system" regime of hold periods and resale restrictions for securities of public issuers
- Eliminates mandatory escrow and looks to the market to develop other methods to achieve the intended purposes of escrow

Continuous market access

The prospectus disclosure system dates from the 1930s. Although partly modernized by the short form offering system, it is still complex and costly to use. More importantly, the disclosure it requires of companies that are already public adds little value in the modern market environment. Continuous disclosure is now the cornerstone of disclosure and modern technology enables investors to access that information quickly and easily. Interestingly, the rules surrounding the prospectus regime account for nearly 25% of the volume of securities regulation and yet less than 5% of all trading in Canadian markets occurs in the primary market.

Under Continuous Market Access, a public issuer files a prospectus only once – when it first goes public. After that, the issuer discloses material information[1] as it occurs and files the financial statements and other periodic disclosures (including an annual information form) required under the continuous disclosure rules. Because its public disclosure record therefore always contains all material information about the issuer, when the issuer wishes to raise funds it simply does so – no prospectus or other disclosure document is required (although in most cases the issuer will have to issue a news release).

We found in our cost-benefit analysis of CMA (attached as Appendix B) that CMA's primary benefits – faster and cheaper access to capital – could be captured by issuers without eroding investor protection.

- Issuers could complete an IPO up to 19% faster and up to 51% cheaper. Offerings after the IPO would be up to 56% faster and up to 82% cheaper depending on the size of the issuer. The study showed that if CMA were available nationally, issuers would save $170 million in net present value over five years in reduced prospectus preparation and filing costs.

- CSA plans to make the short form offering system available to almost all issuers. This would simplify the current system, but a move to CMA would still yield more significant benefits. Our cost benefit analysis showed that TSX issuers, most of

[1] The new legislation replaces the current "material fact" and "material change" disclosure triggers with a "material information" standard. The analysis of this change is in Appendix A.

which at the time of our study were already using the short form system, would be able to complete offerings 30% faster and 24% cheaper under CMA.

It is also worth remembering that most investors rely on the advice of their advisers in making investment decisions. If investors want to review documents, they can request the documents from the issuer who must send recent documents to them without charge.

No hold periods
The new legislation has no hold periods or resale restrictions for the securities of public issuers. Because material information about the issuer is required to be available at all times, there is no need for hold periods. All of a public issuer's securities – whether issued before, on, or after its IPO, and whether issued in a public offering or private placement, are free trading.

The current system of hold periods and resale restrictions for privately placed securities of public issuers is a complex and burdensome system. The new legislation reduces the regulatory burden on public issuers by eliminating this regime.

No mandatory escrow
The new legislation does not mandate escrow in IPOs. We concluded that the escrow system imposed significant disadvantages on issuers, yet provided no significant benefits to investors.

Requiring escrow has been justified as a means of tying management to the company and helping to prevent a post-offering drop in market price as a result of overselling. Some also see it as a way to help prevent market abuse. However, escrow requirements tend to restrict the sale of shares held by shareholders who are not key to carrying out the issuer's business plan. It is a "one-size-fits-all" approach that does not account for the duration of the investment or the price paid for the security, and therefore often offends investors' sense of fairness.

We do not believe it is necessary to make escrow mandatory, because the problems it is intended to solve can be solved in other ways.

- For example, an underwriter wishing to ensure management's commitment to the issuer can require things like performance-based incentives, management contracts, and non-competition agreements. Alternatively, the underwriter could impose escrow or lock-up agreements by contract, as happens in the U.S. This would also provide aftermarket price protection.

- Nor do we think an escrow rule is the right way to deal with market abuse. It imposes a burden on everyone for the abusive behaviour of a few. There are many other provisions in the new legislation that will allow us to take enforcement action against those who choose to engage in market abuse in connection with IPOs, or otherwise.

Part 4 – Regulatory burden

The new legislation provides more efficient and flexible regulation that minimizes regulatory burden for market participants in three significant ways:
1. Outcomes-based requirements
2. A risk-based approach
3. A streamlined and simplified design

1. Outcomes-based requirements

The current detailed, prescriptive rules force firms to spend time and resources on mandated processes that do not provide optimum investor protection. As discussed in Part 1, the new legislation replaces most of these with outcomes-based requirements that provide better investor protection. These outcomes based requirements also reduce regulatory burden.

Examples of Outcomes-based Requirements

Continuous market access – Under CMA no disclosure document is mandated for offerings after the IPO (although in most cases the issuer will have to issue a news release). Issuers are free to prepare a more formal disclosure document. If they do so, however, they must ensure that it does not contain a misrepresentation (which the legislation prohibits), so they must consider not only what they put in it, but also what they leave out. Any disclosure document also becomes part of their continuous disclosure record, so if there is a misrepresentation, investors will be able to sue them under the new statutory right of action.

This illustrates the difference between traditional regulation and outcomes-based regulation. Instead of mandating the content of the disclosure document, the legislation allows issuers to craft a document in a form that they think will be most useful to prospective investors. However, the legislation requires that the document contain no misrepresentations, and holds the issuer and its senior management accountable if it does. This reduces regulatory burden and yet improves investor protection by ensuring that the disclosure is complete and truthful.

Code of conduct – Another example is how the new legislation regulates dealers and advisers. The current legislation has many detailed and prescriptive requirements that have doubtful value in protecting investors or markets. Investors don't care if firms comply with detailed processes. They want to know that the firm treats them fairly, protects their interests and provides them with the information they need.

So the new legislation replaces the current detailed requirements with an outcomes-based Code of Conduct. This will allow market participants to tailor their compliance systems to suit their individual business models. For example:

- **Firms will focus on compliance problems –** Our regulatory impact analysis on the Code of Conduct (see Appendix C) showed that under the Code, firms would establish compliance systems focused on detecting compliance problems rather than on auditing mandated processes. One of the dealers surveyed detected only 10% of compliance problems through the daily reviews that the rules require. The firm found the rest of its compliance problems using a proprietary, outcomes-based system that tracked patterns of behaviour.

- **Firms will spend less time on new rules** – The reduction in regulatory burden under the outcomes-based approach in the Code is significant, because firms spend significant resources dealing with new and complex rules. For example, one firm spent 18 person-months of senior professional time preparing a policy to respond to new NASD and IDA rules relating to analyst conflicts (see Finding 10 in Part III.B.2 in Appendix C). Under the Code, which deals with conflicts by requiring firms and their representatives to put the clients' interests first, there is no need for a special rule to deal with analysts' conflicts.[2] Although firms might have to develop new compliance processes to deal with the broader conflict of interest provisions of the Code, they would have the flexibility to do it in a more cost effective way.

Outcomes-based requirements work – The study in Appendix C shows that firms gravitate to outcomes-based approaches once they understand the benefits. We saw that, left to their own devices, firms already design compliance systems to deliver the outcomes they want. This is true even when they have to incur the cost of developing parallel systems when the mandated ones are not effective in detecting non-compliant behaviour. We have also concluded, based in part on discussions we had with experienced litigators, that litigation risk would not increase if firms could demonstrate that they have an adequate system that they follow and keep up to date.

We think that providing an outcomes-based regulatory environment inherently encourages principles-based behaviour. This has happened in the United Kingdom under the largely outcomes-based system administered by the Financial Services Authority. The BCSC's approach to regulation (keep the rules few, simple and clear, create culture of compliance and train industry) will further encourage market participants to adjust to the new outcomes-based regime.

Outcomes-based requirements are enforceable – We prepared a regulatory impact assessment (attached as Appendix D), which focuses precisely on enforceability. It analyzed Commission decisions and settlements over a two-year period against the provisions of the new legislation that would replace those enforced under the current legislation.

We concluded that most significant enforcement actions taken under the current legislation would continue to be supported by corresponding provisions in the new legislation. This is because most of what the Commission enforces today is existing outcomes-based requirements. Indeed, 92% of alleged breaches in the two-year period covered in Appendix D are in areas where the requirements under the new legislation are

[2] The study in Appendix C refers to paragraph 5 under Principle 6 of the Draft Code of Conduct dealing with analyst conflicts. Paragraph 5 was later dropped from the Code because the basic conflict requirements cover the situation.

identical or substantially similar to the current legislation or have a similar test. For some types of conduct (for example involving conflicts of interest), the new legislation would provide a more specific basis for enforcement than the current legislation.

Most of the other new requirements in the new legislation would be readily enforceable because they require measurable outcomes, use objective tests that are familiar to adjudicators, or deal with areas where there is an existing understanding of what constitutes acceptable behaviour.

2. Risk-based approach

A regulator cannot prevent all risks to investors and markets (nor should it). The regulator therefore needs some framework to decide when and how to apply its resources. At the BCSC we use a risk-based approach. It is a dynamic system that seeks to identify the most serious threats to investors and markets and to then allocate resources appropriately. The cornerstone of the approach is the problem-solving methodology we will describe more fully in the presentation.

Examples of Risk-based Approach

Conditional registration – For example, in most jurisdictions brokers who transfer between firms cannot work while their transfers are being processed. We analyzed the number of serious problems we identified when processing transfer applications and found that the number was insignificant, and those would likely have been discovered through other means. We therefore concluded that there would be minimal risk to investors in allowing brokers to continue dealing with clients for the few days or weeks while their transfers were processed. As a result, we moved administratively to a conditional registration system. Under this system, we conditionally register a representative (even if the Commission has not received a termination notice from the prior firm) while the transfer is processed. (Other jurisdictions are now considering whether to implement a similar system.)

Firm-only registration – Following a risk-based approach presents opportunities for placing regulation on a sounder footing and introducing regulatory innovation. The registration requirement, for example, actually creates risks. Some firms attempt to shift responsibility for employee compliance to Commissions or SROs. Some investors also place undue reliance on the Commission's registration. It creates a false sense of security for these investors because they regard registration as a "seal of approval".

Applying a risk-based approach to registration requirements, we concluded that there would be no significant risk to investor protection if we did not require individual brokers and advisers to be registered. This led to our proposal for firm-only registration. Under this system, the Commission would register only the dealer and adviser firms — not the individual representatives.

This is how we analyzed the risk.

The registration requirement for individuals has these objectives:

- Prevent unsuitable individuals from becoming representatives
- Monitor representatives when they change firms and impose conditions if necessary
- Discipline or remove representatives who contravene the legislation or act contrary to the public interest
- Make information about representatives available to the public

We determined that most of these objectives could be met without the need to register individuals (see Appendix E for the full analysis).

- Using outcomes-based requirements, the Code of Conduct requires firms to hire suitable individuals and ensure they are properly supervised. It also makes firms responsible for those they hire and requires firms to share information about individuals at the time of hiring. Individual representatives must comply with virtually all requirements in the Code, including plain language disclosure and putting the client's interests first.
- As noted in the previous example, the risks associated with transfers were minimal.
- Under the new legislation the Commission can prohibit a person from being registered, or restrict a person's trading or advising activities.
- As firms are responsible for those they hire, investors should look to the firm, not the Commission, for information about their representatives.

Firm-only at work in other jurisdictions

- The SEC does not register representatives of advisers.
- The FSA does not authorize an appointed representative of a firm although they do require notification.
- Australia has a firm-only system that applies to those offering financial services. ASIC does not register representatives but requires notification of those representatives that are not directors or employees of the registered firm.

Firm-only lowers costs – Although the National Registration Database has reduced some of the regulatory burden associated with registration, we found savings in a move to firm-only registration. The study (see Appendix F) found that if firm-only registration were adopted nationally, firms would save $12.6 million. This represented 49% of their current internal costs related to individual registrations.

Although we chose not to proceed with firm-only registration for the time being, it is a good example of applying a risk-based approach to policy-making. (We did not proceed because it would have complicated the national passport discussions. In addition, our study suggested the greatest benefits of a firm-only registration system would come about only if the system were adopted nationally.)

3. Streamlined and simplified design

Securities legislation (including much of what is currently in force in British Columbia) is not easy for industry participants to understand. They need to retain professional advisers to help with even routine compliance matters, or spend time seeking guidance from the regulator. Firms might not comply simply because they cannot understand the rules.

The new legislation is designed to address these problems.

- **Fewer detailed requirements –** It has a simpler structure and far fewer detailed requirements. In fact there are fewer than half the number of regulatory requirements under the new legislation than there are now in British Columbia. For example, the current underwriting conflict rule and related policy and flow charts take up 20 pages in the rulebook. It is very difficult to understand. The Code of Conduct in the new legislation covers the same subject matter in a rule that is 5 lines long, supported by 9 paragraphs of plain language guidance.

- **Plain language –** The legislation is written in plain language and we provide extensive written guidance, also in plain language.

- **Reduction in paper load –** The new legislation reduces paper load. This is a natural by-product of moving to an outcomes-based regime. The legislation is also designed with electronic data storage and transmission in mind. For example, dealers will no longer have to keep paper copies of documents if they have an electronic documentation system (see the study in Appendix C for other examples). Many forms have been eliminated; those that remain have been simplified, and almost all forms can be completed and filed electronically.

Overall, the new legislation reduces the regulatory burden on market participants while enhancing investor protection as discussed in Part 1.

Part 5 – Enforcement Effectiveness

An effective system of deterrence would see a balance among criminal prosecution, civil liability and regulatory enforcement.

Criminal enforcement
You ask whether expectations are unrealistic. We think that unrealistic expectations are at least part of the reason that there is a perception that enforcement is not effective. People see those who break US securities laws going to jail and wonder why it is not happening here. Part of the problem is that many people do not understand that securities commissions do not have the power to impose criminal penalties like prison sentences.

But the problem goes deeper. The fact is that there is no credible criminal deterrent in Canada for securities law violations. Generally speaking, financial crime is not a priority for police or prosecutors. When a prosecution does happen, it usually takes years to come to trial. And even when there are convictions, the courts often do not impose meaningful sentences.

The Criminal Code empowers the courts to impose meaningful sentences. There are limits to the penalties that can be imposed under provincial legislation, but the new legislation increases the maximum fine from $1 million to $3 million. Even higher maximum penalties continue to apply in insider trading and fraud and have been added for front running cases.

The new legislation also empowers the criminal court to make restitution and disgorgement orders (orders requiring wrongdoers to return funds equal to their profits earned or losses avoided).

However, these legislative provisions will mean little until the criminal justice system — police, prosecutors and courts — adopt a different attitude to securities fraud. As noted in the Eron Mortgage Study by Professor Neil Boyd in 2005,

> . . it is appropriate to ask whether the current penalties adequately reflect the harms created by such activity. . . . Their crimes (i.e. typical murders) are appropriately punished, but the deliberateness of their conduct and its impact on the wider community is often much less significant than the actions of those who engage in investment fraud. The principals in Eron appear to have demonstrated little remorse, though the consequences of their actions were literally devastating to hundreds of investors. And yet the civil and criminal penalties imposed are, in relative terms, quite minimal.

Civil enforcement
As discussed in Part 1, the new legislation provides a new statutory right of action for misrepresentations in continuous disclosure, and provides a better civil remedy for insider trading.

The new legislation also includes an improved disgorgement power to help to ensure that those who breach the Act cannot benefit from contravening the legislation. As mentioned in Part 1, investors will be able to make a claim against the disgorged funds. This new disgorgement power makes it more likely that investors can get their money back.

We considered whether the Commission should have the power to order restitution as well as disgorgement. We decided not to propose a restitution power. Making restitution orders would take the Commission into the area of determining rights between parties, traditionally a matter for the courts. This could jeopardize the Commission's effectiveness in dealing with public interest matters. Weighed against that risk, the potential benefit seemed small, especially with the improved disgorgement power for the Commission and the power of the criminal courts to order restitution.

The new legislation maintains the provision under which the commission can apply to the Supreme Court for restitution (and other) orders. We are in fact using this provision in a current action.

Regulatory enforcement

The current BC legislation has strong enforcement powers and the BCSC has been active in using them. A study done for the Wise Persons' Committee in 2003 showed that BC led the country in the number of securities enforcement actions from January 2000 to mid-2003.

Under its existing enforcement powers, the Commission can:

- bar those involved in misconduct from the securities markets in various ways
- prohibit wrongdoers from holding office in any issuers
- assess administrative penalties and hearing costs
- order that certain securities not be traded
- apply to court for a compliance order
- apply to court for disgorgement, restitution or damages

The new legislation broadens existing enforcement powers. It:

- increases the maximum administrative penalty the Commission can order to $1 million per contravention of the legislation (the current maximum is $250,000 per hearing for an individual and $500,000 per hearing for a non-individual). The new legislation increases the maximum administrative penalty so that BC does not fall behind the maximum administrative penalties in Ontario and Québec.

- allows investors the right to claim funds disgorged (under the current legislation, disgorged funds are paid into the province's general revenue fund)

- allows anyone who believes another person has contravened the legislation to seek leave from a Commissioner for the Commission to hold a hearing in the matter.

Currently complaints are assessed in the Commission's enforcement department and then (when appropriate, using a risk-based process), proceed through the formal investigative and enforcement process. The new legislation includes this power so that market participants have an explicit process to have serious complaints heard directly, if they are able to gather the evidence and present the cases themselves. The new legislation includes the leave procedure before a single Commissioner so that the Commission can retain control over its process and resources. The leave process also protects against frivolous and pre-mature cases.

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 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.

<u>Streamlined and simplified design</u>

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.

<u>Strengthened enforcement powers and new investor remedies</u>

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.

Principles-based regulation
Financial Services Authority (UK)

Presentation to

The Task Force to Modernize Securities Legislation in Canada

British Columbia Securities Commission

Robin Ford, Commissioner

November 17, 2005

Up-dated December 19, 2005

Outline

I am a regulatory lawyer who until recently was not a securities specialist. From 1988 until 2004 I worked in the UK. During that time I worked primarily in the areas of administrative law generally, competition law (EU and domestic), privatization, and telecommunications (helping to move that regulator to a more principles-based regime).

In 1998 I joined the insurance legal advisory team in HM Treasury to help the Government manage the transfer of the insurance regulatory function to FSA, and to move the legal team to FSA. I joined the FSA in January of 1999.

I advised on insurance regulatory law for 5 years including advising on a very ambitious program of insurance regulatory reform. As a head of department I was also involved with other senior managers at FSA in managing the integration of the 9 regulators and the transition to a more principles-based and outcomes-focused regime.

All of which is a round-about way of saying that I am knowledgeable about the EC and EU generally, and about the FSA, but I can't say much about the specifics of securities regulation in the UK or the EU. However, my contacts at FSA remain good and I would be happy to assist your staff in tracking down any specific information.

The following remarks, which only brush the surface, may make a complex and in some ways difficult transition at the FSA seem simple. It was not. In addition, it was made far more difficult by the need to integrate 9 regulators which had very different cultures and regulatory requirements, and by the over-arching EU Framework.

My remarks may also seem to suggest that a move to a more outcomes-focused regime means no detailed requirements. Of course, that is not so. It is more a matter of where one sits on a continuum and one's focus.

At the FSA the starting point was the regulatory objectives and the requirements under the new Act and regulations, the over-arching Principles for Businesses in the FSA Handbook and the EU Directives.

The regulatory objectives under section 2 of FSMA are:

(a) market confidence;

(b) public awareness;

(c) the protection of consumers; and

(d) the reduction of financial crime.

The FSA has set out its aims for 2005/06 under three broad headings:

- promoting efficient orderly and fair markets;
- helping retail consumers achieve a fair deal; and
- improving the FSA's business capability and effectiveness.

In discharging its general functions the FSA must have regard to

(a) the need to use its resources in the most efficient and economic way;

(b) the responsibilities of those who manage the affairs of authorised persons;

(c) the principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction;

(d) the desirability of facilitating innovation in connection with regulated activities;

(e) the international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom;

(f) the need to minimise the adverse effects on competition that may arise from anything done in the discharge of those functions; and

(g) the desirability of facilitating competition between those who are subject to any form of regulation by the FSA.

However, the FSA also had to deal with the substantial amount of regulation of the regulators who were merged with it. In drafting its rules to come into effect with the new Financial Services and Markets Act 2000 in December 2001, the FSA had to be extremely pragmatic. There was not enough time to conduct a full review of the existing requirements. For insurance, we bundled the requirements into one part of the Handbook (a substantial improvement in itself) and rewrote them to conform with the new Act and the Handbook drafting protocols. Thus the Handbook of rules was what the British describe as a curate's egg - good in parts and bad in parts. Going forward, the FSA has imposed increasing discipline on its rules and I expect we will see even more pulling away from detailed regulation to the extent possible under the EU Framework.

All of which is to say that the FSA rules in force now are not necessarily the best example overall of a principles-based regime.

This is what the FSA says today on its website about "better regulation".

"Our Handbook presents the standards we expect of regulated firms and is a key vehicle for communicating those standards to the outside world. So it should reflect our vision and values. These include an approach to rule-making based as far as possible on high-level principles, rather than detailed prescription; a focus on senior management responsibility; and acting in a proportionate and risk-based way.

"The Handbook is long and sometimes detailed, bringing together a legacy of rules from previous regulators. The Handbook also includes new material to accommodate government decisions to increase the scope of our responsibilities, for example, to include mortgage and general insurance business. It is also the means through which numerous European directives are implemented.

"We also believe the policy content of the Handbook should be kept under review, in a targeted way. Both [in] financial markets and the overall regulatory environment that firms operate in have changed since our Handbook was introduced in December 2001. Our Business Plan 2005/06, set out the following criteria for identifying areas where we should look to make changes:

- Where requirements are more restrictive than needed to achieve our objectives;
- Where they do not deliver benefits to justify their costs; or
- Where they are not consistent with our focus on senior management responsibility.

"'We are determined to be more rigorous about the costs and burdens that regulation imposes on firms. We are also simplifying our Handbook requirements and the way we express them, which will help all firms but particularly smaller ones who do not have access to expert advice. It sits alongside other major initiatives we have in hand to make us an easier organisation to do business with such as Firms Online, Integrated Regulatory Reporting and the shorter application packs which will reduce the time and effort firms need to spend in dealing with us.'

Sir Callum McCarthy, Chairman"

To express the FSA philosophy in my own words, a more outcomes-focused regime frees firms to do what they do better than the regulator, run their businesses. It gives firms more flexibility and allows them to adapt to changing conditions more quickly. But this cannot be a blank cheque. To ensure that firms nevertheless avoid excessive risk taking, regulators need to have in place appropriate entry barriers, clear standards, effective risk-based monitoring and supervision and effective enforcement. But they must not reduce the benefits of a principles-based regime with detailed guidance or overzealous supervision. This requires changes in behaviour of regulatory staff and firms.

The Task Force has provided me with some questions and I have build this presentation around them.

Culture change at FSA

1. (a) What were the biggest obstacles to implementing a principles-based and outcomes-focused regulatory regime at the FSA?

    - Managing change and breaking old habits. An outcomes based regulatory approach requires culture and process changes in the regulator and regulated. Old habits are hard to break, for both staff and industry.

    - Need:

        - Strong leadership and a bold vision
        - A change management team
        - Clear messages for industry and staff repeated over and over again (including follow-through by staff in their working relationships with firms)
        - Mechanisms to obtain buy-in from staff and industry
        - Advance preparation and ongoing support for industry and staff (eg, storyboarding)
        - New employee profiles for recruitment of new staff and development of existing staff
        - Support for middle management.

(b) Was there a “re-education process” undertaken among the FSA’s staff?

- Very much so. Many staff were initially involved in focus groups to steer decision making in a variety of areas and obtain buy-in (eg, where are the important risks to investors, what skills and attributes do staff need in the new world?). Training was then offered to help staff acquire the skills needed for revamped job profiles and personal objectives (eg, project management, change management, industry training, risk training). Staff were also moved from areas that were overstaffed (eg, banking) to areas that were understaffed (eg, insurance) and new skills and experience were mixed into teams that way.

- Managers were made responsible to ensure that staff knew what to do and were weaned off old practices (eg, spending a lot of time with small firms to help them comply, spending time with large firms to help them draft applications to the regulator). To the extent staff did not meet the new profiles and expectations, they were given every opportunity to acquire the necessary skills or experience. In theory, the few non-performing staff should then have been weeded out, but this part of the equation was not always handled terribly well which caused problems of efficiency and morale.

- Fostering a culture of compliance in firms means encouraging market participants to exercise judgment about what is right and wrong, and about how to meet high level standards. Senior management must ensure that systems and controls are in place that are, first, right for their business and, second, adequate to secure compliance with regulatory requirements.

- For staff, this means giving firms assistance by directing them to the relevant requirements and identifying indicators of best practice where they exist, but stopping well short of providing consulting services or legal advice. Where judgment may be exercised, firms must not be told in specific terms what to do in order to comply with the rules. It means rejecting applications that are not adequately supported (and not stepping in to prepare the applicant's case for it).

Generally staff must also exercise greater judgment or discretion in their work, within specified limits. That follows from less prescription. Their manager needs to work more closely with them, at least initially, to ensure they are working well within these limits, but generally staff need to assume more responsibility and accountability for their work and managers need to let them do this.

2. How did the shift to a principles-based and outcomes-focused regulatory regime at the FSA affect enforcement initiatives? Did it cause a change in the types of matters that are subject to enforcement?

- The shift to a more principles-based regime did not significantly affect enforcement. First, firms were already subject to some principles under the FSA's predecessor organizations. Second, the FSA publicized in advance its new emphasis on, for example, adequate systems and controls. The main change arose from the FSA's risk-based approach, which meant that breaches that did not have a significant impact on the FSA's regulatory objectives were no longer pursued through enforcement. Instead, the FSA may send a warning letter.

- Having said that, a principles-based regime does imply greater responsibility on firms and their senior management to get it right. That also means, in appropriate cases, making senior management accountable for the systems and controls that they have put in place by directing compliance or enforcement action at them personally (as well as at the individuals who have breached the requirements and the firm itself). It also means rewarding firms that have in place adequate systems and controls (including compliance programs) by, for example, subjecting them to fewer compliance reviews.

- FSA does bring enforcement actions for breach of a principle, but it says in the Enforcement Manual that it will not generally do so unless the breach is clear. Most often an alleged breach of a principle will be combined with allegations of breach of more specific rules. However, the FSA has brought several cases based only on breach of principles, which led to significant penalties against the firms.

- This is what Hector Sants at the FSA recently said about enforcement against market abuse. "It is incumbent on the senior management of City firms to guard against the risk that their staff will commit or facilitate market abuse and I would hope that our common desire to promote the UK as an efficient, orderly and fair market will ensure they do so. The FSA would much prefer to deter than to enforce: it is more cost-effective and better for market confidence. We are therefore being open about our new institutional focus. Firms must be warned that we know market abuse happens and, if we find it, we will take it very seriously. Such discoveries may lead to enforcement of the rules. The number of enforcement cases brought and the sums levied in financial penalties are not good measures of success, but public action against those who commit market abuse sends a clear message to the markets about what is and is not acceptable behaviour. We will not hesitate to use these powers when appropriate. I have no doubt that any such action would be hard fought and would result in references to the Financial Services and Markets Tribunal. Such cases are complex and personal reputations would be at stake - but the FSA must not be deterred by that or by the risk that it may not always have its decisions upheld at tribunal. This is a long-term piece of work and I do not expect to see a shift in behaviour overnight."

Regulatory burden

3. Did the FSA's shift to a principles-based and outcomes-focused regulatory regime reduce the amount of regulation (and the regulatory burden) imposed on market actors?

- Yes. On the insurance side, some of the detailed requirements were initially turned into guidance, but not repealed, to assist the transition. More recently, some of that guidance has been repealed. In addition, to the extent permitted by the EU Directives, some requirements that did not meet a cost-benefit analysis or were no longer needed were not picked up in the new FSA Handbook. The rules were also redrafted into plainer language.

- However, amount of regulation and regulatory burden are not the same thing. Clearly a principles-based regime pushes responsibility onto firms to decide how to comply. At first, some firms will have trouble responding to this. Over time, they adapt and learn to build compliance into more sophisticated risk management systems. At the FSA, the change to a more principles-based regime came at a time when it was increasingly apparent that risk management systems in firms were inadequate. The FSA has been pushing firms to improve risk management and systems and controls at the same time as it has stepped back from detailed regulation. It is not always easy to pull these two strands apart.

- In its Eighth Report in 2004, the Treasury Committee of the UK House of Commons said:

  81. The evidence we have heard in the course of this inquiry tends to confirm that [the Financial Services and Markets Act 2000] is currently working well. Apart from in the limited area of money-laundering regulations, we received no specific complaints of excessively burdensome regulation from the major companies in the industry,

while consumer groups generally acknowledged a significant improvement in the protection afforded to the consumer. ...

- Having said that, the FSA is working with the Practitioner Panel to review the cost of regulation. The review is looking at two elements of cost: the direct cost of being regulated by the FSA; and the net cost. (Without regulation, firms would still hold capital, have a compliance function, and so on.)

- One of the great advantages of principles-based regulation is that it makes a passport system easier. This is very clear in the EU. The EU Directives in the financial services area are designed mainly to ensure that firms established in one member state are free to establish a branch or provide services in another. The Directives also harmonize by requiring states to meet or impose certain minimum standards on their regulated firms, but the detail of the minimum standards is, in theory at least, kept to a minimum. Generally, member states are free to impose higher standards on firms established there if they wish, but they cannot ban or restrict firms established in other states which meet only the minimum standards. Underlying this system is the recognition that adequate regulation can be achieved in different ways in the different member states.

4. Can you please provide an example of how the FSA's shift to a principles-based and outcomes-focused regulatory regime affected a particular body of regulation?

- I cannot give a securities example from my own experience although I am aware that the FSA has resisted the urge to add more requirements on hedge funds and has been very restrained on soft dollars. In insurance, one area affected was reporting requirements. The FSA began to ask itself hard questions about the information it was requiring and began to pare it back or make requirements more outcomes-focused. For example, rather than requiring to see information, it might require that firms be able to produce it if asked. Alternatively, guidance might say that on the happening of certain events, if a firm cannot produce certain information, then it might find it hard to demonstrate compliance. In addition, the FSA became more flexible about whether it would accept other information which achieved the desired outcome. And staff increasingly got the message that they should not ask for information just because it was 'nice to have'.

- The FSA's work with industry over the past 2 or 3 years to provide sufficient clarity around the duty to treat customers fairly (TCF) is a very good example of a principles-based regime in action. The starting point is - http://www.fsa.gov.uk/pages/doing/regulated/tcf/. A review of the speeches and reports on the FSA's supervisory work with firms shows that the FSA has worked and consulted with firms extensively to help them "consider the implications of TCF for their business and to take steps to tackle any shortfalls". There is the absolute minimum of guidance, and certainly no prescription.

5. What other jurisdictions' regulators use a principles-based and outcomes-focused to regulation?

- Australian Securities and Investments Commission
- U.S. Commodity Futures Trading Commission
- Office of the Superintendent of Financial Institutions, Canada
- UK Financial Reporting Council
    - A recent review of the "Turnbull" guidance on internal control indicates it has gone a long way to meeting its objectives without the need for detailed prescription. The Review Committee strongly endorsed retention of the principles-based approach and proposed only a small number of changes to the guidance. Anthony Carey, in an article in the Financial Times (http://www.rsmi.co.uk/rrweb/news.nsf), noted that maintaining the business focus (rather than a compliance focus) of the guidance has been critical to its success as it has encouraged boards to take ownership of it.
    - The FRC webpage on this review is - http://www.asb.org.uk/corporate/internalcontrol.cfm.
- The FSA approach has been accepted as adequate by regulators not using outcomes based approach themselves:
    - The SEC generally accepts the UK as an equivalent regulatory regime and it has accepted the Turnbull guidance as a suitable alternative to the "COSO" framework for internal control under section 404 of SOX. (Many UK

foreign filers have, however, been dragged down the COSO path by their consultants and auditors.)

  - SEC has set up a risk office to help it decide where to allocate its resources and has credited the FSA for its help.

  - The UK regulatory regime is widely respected by regulators in other countries.

- The media and powerful consumer bodies in the UK recognize the value of the FSA approach

- UK industry also supports the approach:

  - Chair of the FSA noted at 2005 annual meeting that industry now fully supports the approach and recognizes the additional flexibility it provides and reduction of regulatory burden

  - Firms are now likely to react quickly if they perceive the FSA is slipping back into the old ways, although that does not mean that calls for prescription or detailed guidance will stop. The listing review is an example of this - see CP 04/16 FSA: Feedback on proposed new listing principles - http://www.fsa.gov.uk/pubs/cp/cp04_16.pdf.

Impetus for change

6. What was the impetus to move to a principles-based and outcomes-focused model at the FSA?

- There was strong support from HM Treasury and the Prime Minister in the UK for a reduction of regulatory burden and greater senior management responsibility and accountability as a means of maintaining the UK's competitive position generally. There is a strong view held across party lines that lighter regulation, firm but fair, with education, will be most effective both to protect UK consumers and to maintain London's position as world leading financial centre.

- The old regime was a nightmare with its detailed rules and multiple regulators (both in the securities area and across the pillars). There was industry support for a change.

7. What would we introduce into or delete from the regulatory mosaic that would help us distinguish Canada's capital markets, in a positive way, from the crowd and attract issuers or international investors to our marketplace?

- We should recognize that regulation is not the main factor in being competitive. The US is very competitive and yet has an extraordinarily labyrinthine regulatory system. In the securities area there is the SEC, NASD and other SROs, state regulators in 50 states and 3 territories, and others. Similarly on the insurance side, there are the state insurance regulators with some input from the Fed and others but no equivalent to the SEC. Banking regulation is equally messy. Yet the financial services sector remains astonishingly competitive. The sheer size and competitive culture in the US allows this to happen.

- Nevertheless, regulation is a factor, especially in a small market like Canada. The main issue for the regulator is to ensure regulation does not unduly inhibit competition and innovation. Regulation could be used to enhance competition, but that is a dangerous purpose for a regulator. For example, a requirement that a firm have in place adequate internal control should mean that financial reporting will be accurate. It may also mean that firms will be stronger competitors, but that would be an indirect outcome.

- Introducing a principles based regime with other good regulation principles would certainly distinguish us from the crowd (ie, the US) in a positive way.

- Some major provincial regulators have a highly interventionist culture and rely excessively on issuing new rules and guidance to deal with every issue in the market, however minor. This leads to excessive and complex regulation and can undermine the higher level principles in the legislation. Regulators could deal with many market problems more quickly and effectively by applying existing law and using other regulatory tools. We could make Canadian regulation more effective and less burdensome if regulators would think differently about how to regulate.

- I would also like Canadian regulators to be more overtly consumer focused, but with the clear message that we will interfere with the markets only to the extent this is justified and that consumers also bear some responsibility for their investment decisions.

- Although I think enforcement is a key component of consumer protection, I do not think the regulator should be primarily an enforcer (like the SEC).

I agree with the FSA that deterrence is more cost effective. Having said that, in a principles-based regime that is working, less time may be spent by the regulator on supervision and more on enforcement. And clearly the credibility of the regime will be substantially undermined if the rules are not properly enforced.