

Principles-Based Securities Regulation

A Research Study Prepared for the
Expert Panel on Securities Regulation

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Biography

Cristie Ford

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Executive Summary

What is Principles-Based Regulation (PBR)?

Principles-based regulation of capital markets is a hot topic in many jurisdictions, including Canada, the United States, and the United Kingdom. The theory behind principles-based and rules-based law is quite well known. Principles-based regulation is generally believed to be more flexible and more sensitive to context, but potentially less certain. Rules are more certain but may be rigid. Advocates and practitioners of principles-based securities regulation argue that proper regulatory design avoids the theoretical problems associated with principles, and can produce “simply better” regulation – meaning more effective regulation, at a lower cost.

Every system will be (and should be) an amalgam of rules and principles, but a principles-based system looks to principles first and uses them, instead of detailed rules, wherever feasible. In the context of statutory drafting, principles-based regulation means legislation that contains more directives that are cast at a high level of generality.

PBR is also more than a statutory drafting choice. Promulgating principles-based legislation alone, without also paying attention to implementation and regulatory approach, will not foster better regulation. PBR needs to be accompanied by (1) greater reliance on outcome-based and management-based regulation, rather than process-based regulation; (2) transparent, accessible, ongoing guidance from the regulator; (3) methods for incorporating industry experience into regulatory expectations; (4) analytical methods to evaluate regulatory success and allocate regulatory resources; and (5) meaningful oversight of public companies and regulated entities, based on an “enforcement pyramid” that includes compliance examinations, and civil and criminal enforcement.

Best practices and critical success factors

The report identifies six elements that are especially important to a well-functioning principles-based regulatory structure:

- **Regulatory culture:** A principles-based regulator focuses on defining broad themes, articulating them in a flexible and outcome-oriented way, accepting input from industry, and managing incoming information effectively. This requires expertise, a more trusting and communicative relationship with industry, restraint in providing administrative guidance, and the continued use of notice-and-comment rulemaking where appropriate.
- **Accounting for the impact on market participants:** In order to be able to take advantage of the benefits of principles-based regulation, industry needs reasonable lead times to adjust to the new model, education and support, and the ability to rely on legacy rules during the transition period.
- **Learning systems and information management:** A principles-based and outcome-oriented regulator needs information to be credible as it develops its guidance, evaluates results, and interacts with industry.

- **Outcome-oriented regulation:** A focus on results, rather than processes, is crucial in a principles-based regulatory environment to keep the system flexible and capable of learning.
- **Regulatory credibility:** In order to have its judgments respected under a principles-based system, a regulator's conduct must be reasonable, predictable, and responsive.
- **Maintaining control:** A principles-based regulator needs the statutory power to promulgate rules and guidance, and it (not the courts) needs to be the primary interpreter of its principles.

Risks and opportunities of PBR

This report considers background features in the Canadian capital markets, and tries to analyze the costs and benefits of a move to PBR for various stakeholders. A well-implemented PBR system, characterized by the best practices and critical success factors above, promises advantages to most if not all interested parties. A poorly-implemented PBR system imposes costs across the board. This report looks more closely at four key issues affecting risks and opportunities:

- **Certainty and PBR:** Uncertainty imposes costs, and can compromise the rule of law in the enforcement context. However, certainty has less to do with how a statute is drafted and more to do with whether everyone understands what it means. An “interpretive community,” which has a shared understanding of regulatory expectations, needs to exist or be developed. For enforcement purposes, regulatory expectations need to be communicated, explained, and justified in a regular, transparent, and understandable way.
- **Enforcement and PBR:** Credible regulation, including meaningful enforcement, is crucial to PBR. This report considers the particular challenges of enforcement under PBR, especially on the question of bringing enforcement actions for violation of a principle alone. It is imperative that fairness concerns associated with principles-based enforcement be addressed, and that a strong relationship between enforcement and policy functions be maintained.
- **PBR, a national securities regulator, and the passport system:** PBR can be a pragmatic response to the challenges of trying to impose a regime on top of, or superceding, several pre-existing and different regimes. However, promulgating a federal principles-based model act does not automatically reduce the chance of divergence in application from one jurisdiction to another. Consistency in application requires an operational communicative/oversight infrastructure. Within a passport system, a principles-based model act would give provincial and territorial regulators a lodestar by which to orient their own practices, increasing harmonization and facilitating interprovincial mutual recognition. On certain issues, however, it could also *reduce* the pressure to harmonize. Some differences in approach between jurisdictions may become acceptable, provided each regulator is abiding by common principles.

- **Power, proportionate regulation, and participation:** Under PBR, the content of principles will continually be filled in through actual practice over time. Therefore, unless the regulatory structure builds in opportunities for ongoing participation by a broader range of interests, more sophisticated parties will have more control over the process of developing content for those principles. Consumers and small and medium-sized enterprises (SMEs) involved in the capital markets need to be explicitly considered. A strategy for engaging consumers should be multi-faceted. Proportionate regulation and PBR can also work together to be more sensitive to the needs of SMEs.

How legislation is structured to incorporate more principles: striking the balance between rules and principles in statutory drafting

Establishing a balance between rules and principles involves decisions about priorities and concerns. This report proposes a set of considerations for choosing between principles and rules, and compares approaches adopted by different jurisdictions. PBR looks different, and operates differently from more rules-based regulation in four main ways:

- Legislation is drafted in plain language and often substantially reorganized.
- In a principles-based system, less detail is provided in the statute, and more is left to be filled in through the authority’s rulemaking powers.
- Even when it uses more rule-based methods, legislation is structured to be more outcome-oriented, and less process-oriented.
- The principles-based approaches discussed here all set out high level principles to guide the conduct of regulated entities.

Recommendations

This report concludes with the following recommendations. Canada should:

- Move toward a more principles-based approach to securities regulation.
- For statutory drafting purposes, develop a set of criteria reflecting legislative priorities and appropriate choices in regulatory design, for deciding when to use rules and when to use principles.
- Foster mechanisms that help market participants understand regulatory expectations, and that build an “interpretive community.”
- Work toward developing a regulatory culture that matches the needs of the new environment in terms of expertise and approach.
- Design an effective and appropriate enforcement structure, closer to the U.K. approach than the more enforcement-heavy American one.
- Pay particular attention to small firms. Implement a proportionate and risk-based regulatory scheme, provide education and support, and develop appropriate consultation and participation mechanisms.
- Build in ways to facilitate consumer engagement on an ongoing basis.

Principles-Based Securities Regulation

A principles-based system relies on dedicated, well-funded regulators who are interested in regulating. ... Simplifying the current thicket of rules makes sense. But it will only create more trouble if we're not willing to appoint the people—and commit the resources—needed to make the changes work. A principles-based system offers the potential for smarter regulation—the kind that helps markets work more efficiently. But the best principles in the world won't help much if those in charge aren't willing to enforce them.

James Surowiecki, “Parsing Paulson,” THE NEW YORKER (April 29, 2008)

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PART 1. ANALYSIS

What is a “more principles-based approach”?¹

Principles-based capital markets regulation is a hot topic, in theory and in practice, in many jurisdictions including Canada, the United States, and the United Kingdom.²

The classic example of the difference between rules and principles involves speed limits. A rule will say, “do not drive faster than 90 km/h”, whereas a principle will say, “do not drive faster than is reasonable and prudent in all the circumstances.” In this way, rules generally determine, in advance and quite precisely, what conduct is permissible. The frontline decision-maker (here, a police officer) only has to answer a factual question (“was this particular car driving faster than 90 km/h?”) On the other hand, under a principles-based system the frontline decision-maker also has to make a judgment about what is permissible.³ In the speeding situation, the police officer first has to decide what “reasonable” and “prudent” driving in “all the circumstances” actually is, and then whether the specific car in question was driving in such a manner.

Scholars have identified some main theoretical advantages and disadvantages of rules and principles. Rules are generally considered to be more precise and certain, but may be rigid, reactive, and insensitive to the needs of particular situations. They can also be

¹ I am grateful to Sam Cole, UBC Law 2010, for exceptional research assistance.

² See e.g. Crawford Panel on a Single Canadian Securities Regulator, *Final Paper: Blueprint for a Canadian Securities Commission* (Ontario: Ministry of Government Services, 2006) at 7 [Crawford] (“to provide Canadian capital markets with a competitive advantage globally it is desirable to have as much principles-based regulation as is feasible”); Task Force to Modernize Securities Legislation in Canada, *Final Report: Canada Steps Up* (Toronto: Investment Dealers Association of Canada, 2006) at 50 [Task Force] (recommending that securities regulation be based “at every available opportunity” on “clearly enunciated regulatory principles which do not need a detailed set of interventionist rules for sound implementation); U.S., *Blueprint for a Modernized Financial Regulatory Structure* (Washington: Department of the Treasury, 2008) at 106-116 [*Blueprint*] (recommending a merged CFTC-SEC entity that adopts the CFTC’s principles-based approach); U.S., Committee on Capital Markets Regulation, *Interim Report of the Committee on Capital Markets Regulation* (Cambridge, MA: 2006) (arguing that the SEC and self-regulatory organizations should move to a more risk-based and principles-based process); Howell Jackson, “An American Perspective on the U.K. Financial Services Authority: Politics, Goals & Regulatory Intensity,” in Lee-Jay Cho & Joonkyung Kim, eds., *Regulatory Reforms in the Age of Financial Consolidation: The Emerging Market Economy and Advanced Countries* (2006).

³ See Louis Kaplow, “Rules versus Standards: An Economic Analysis” (1992) 42 *Duke L.J.* 557 at 559-60 [Kaplow]; Kathleen M. Sullivan, “The Supreme Court 1991 Term: Foreword: The Justices of Rules and Standards” (1992) 106 *Harv. L. Rev.* 22 at 58-59 [Sullivan].

“gamed” and promote “loophole” behaviour. Principles are more flexible, more sensitive to context, and potentially more fair, but they can be uncertain, unpredictable, and difficult to interpret for those subject to them. They can promote arbitrary and over-reaching discretion by regulators.⁴ Scholars working specifically in securities regulation, accounting and tax have looked at how rules or principles affect industry behaviour, and how to choose between rules and principles in particular situations.⁵ Of course, in real life rules and principles are points on a continuum, not discrete concepts, and there is a good deal of overlap and convergence between them,⁶ though it is still possible to talk about a “more principles-based” or “more rules-based” regulatory approach.

In addition, how principles are implemented *in practice* makes an enormous difference. Application influences theory in direct and indirect ways. For example, through application to real-life situations, principles acquire specific content on a constant, ongoing basis. Decision-makers may also interpret a rule “up” or “down” (making it look more like a principle or more like a detailed rule) to make it fit a specific situation. Principles, also, when interpreted by multiple human beings in multiple situations, may lose their high level character, slide closer to rules, get fuzzy around the edges, and otherwise drift and change. Therefore, whether a regulatory system fosters *clarity* and *predictability*, for example, is not entirely related to whether it is rules-based or principles-based. The real question is whether regulator and regulatees have a shared understanding of what the regulations entail. It is therefore very important to think carefully about the structure through which principles will be implemented. If properly designed, principles-based regulation in practice avoids the biggest problems associated with principles in theory, and can produce “simply better” regulation – meaning more effective regulation, at a lower cost. On the other hand, poor implementation can produce a system that is less transparent, less predictable, and less fair.

This report starts by establishing a working definition for a successful “principles-based” approach to securities legislation. The report then describes some important related concepts in greater detail.

⁴ Key articles include Carol M. Rose, “Crystals and Mud in Property Law” (1988) 40 *Stan. L. Rev.* 577 [Rose]; Sullivan, *supra* note 3; Pierre Schlag, “Rules and Standards” (1985) 33 *UCLA L. Rev.* 379 [Schlag]; Frederick Schauer, “The Tyranny of Choice and the Rulification of Standards” (2005) 14 *J. Contemp. Legal Issues* 803 [Schauer, “Tyranny of Choice”]; Antonin Scalia, “The Rule of Law as a Law of Rules” (1989) 56 *U. Chicago L. Rev.* 1175 [Scalia]; Kaplow, *supra* note 3; Duncan Kennedy, “Form and Substance in Private Law Adjudication” (1976) 89 *Harv. L. Rev.* 1685 [Kennedy]; Cass R. Sunstein, “Problems with Rules” (1995) 83 *Cal. L. Rev.* 953. See also Cristie Ford, “New Governance, Compliance, and Principles-Based Securities Regulation” (2008) 46 *Am. Bus. L. Rev.* 1 [Ford, “New Governance”].

⁵ See e.g. William W. Bratton, “Enron, Sarbanes-Oxley and Accounting: Rules versus Principles versus Rents” (2003) 48 *Vill. L. Rev.* 1023; James J. Park, “The Competing Paradigms of Securities Regulation” (2007) 57 *Duke L. J.* 625 [Park]; Mark W. Nelson, “Behavioural Evidence on the Effects of Principles- and Rules-Based Standards” (2003) 17 *Acct. Horizons* 91.

⁶ See e.g. Russell B. Korobkin, “Behavioral Analysis and Legal Form: Rules vs. Principles Revisited” (2000) 79 *Or. L. Rev.* 23; Neil MacCormick, “Reconstruction after Deconstruction: A Response to CLS” (1990) 10 *Oxford J. Legal Stud.* 539 at 545 [MacCormick]; Frederick Schauer, “The Convergence of Rules and Standards” (2003) *N.Z.L. Rev.* 303 at 305; Ian Ayres, “Preliminary Thoughts on Optimal Tailoring of Contractual Rules” (1993) 3 *S. Cal. Interdisciplinary L.J.* 1 at 18 [Ayres, “Preliminary Thoughts”].

Working definition of “more principles-based” regulation

Every system will be an amalgam of rules and principles. For purposes of this report, a “principles-based” approach to securities legislation is an approach that looks to principles first, and uses principles rather than detailed rules wherever feasible.⁷ In terms of statutory drafting, this means legislation that contains more directives that are cast at a high level of generality. It also means a legislative/regulatory approach that does not respond to every new situation by adding more detail to the written law.

“Principles-based regulation” also requires more than principles-based statutory drafting. It must be accompanied by careful implementation. In fact, the British Columbia Securities Commission example, discussed below, shows that legislative drafting is not even a necessary component. Principles-based regulation can be achieved through regulatory practice alone. Compared to a rules-based or process-based approach, principles-based regulation relies more heavily on outcome-based and/or management-based regulation. It needs to be accompanied by (1) transparent, accessible, ongoing guidance and communication from the regulator, (2) efforts to incorporate industry experience, including good practices; (3) analytical methods such as outcome analysis and risk-based analysis, to evaluate regulatory success and allocate regulatory resources; and (4) meaningful regulation using a variety of tools, based on an “enforcement pyramid.”

The link between legislative design and implementation should not be severed. Principles-based legislation, without corresponding attention to questions of implementation and regulatory approach, will not foster better regulation on its own.

Related concepts

Outcome-oriented / results-oriented regulation

A great deal has been written on outcome-oriented regulation, and both Canadian and international regulators have extensive experience working with it. What is relevant for this report is that:

- In the same way that a government could develop and use performance benchmarks to evaluate the success of its regulatory system, a regulator could develop and use performance benchmarks to evaluate the performance of issuers and registrants.
- Outcome-oriented regulation should be contrasted with process-oriented regulation. Outcome-oriented regulation measures performance against regulatory goals, whereas process-based regulation measures compliance with detailed procedural requirements. Outcome-oriented regulation is attractive because it establishes a more direct relationship between regulatory goals and regulatory requirements. It therefore makes more efficient use of regulatory and industry resources. By contrast, process-oriented requirements are

⁷ It would be more accurate to use the term “*more* principles-based” system, as the FSA does, since no system is or should be entirely principles- or rules-based. This report uses the shorter term “principles-based” in the interest of readability.

developed by regulators in advance, based on less contextual information, and may not be perfectly tailored to regulatory goals. Process-oriented regulation can also permit “cosmetic” compliance by market participants.

- For present purposes, outcome-oriented regulation can function alongside management-oriented regulation, described below. There are differences between the two concepts, but both place responsibility for detailed decision-making with industry actors (who possess the best information about their own businesses), and give those actors the flexibility to design mechanisms that work for them.
- Good outcome analysis can be challenging. Defining a clear set of objectives, developing criteria to evaluate outcomes and outputs, and measuring performance is demanding work.⁸ Progress should be measured by reference to high-level impacts and outcomes, not just outputs.
- Principles-based and outcome-oriented regulation are different concepts and should not be conflated. For example, one could have a system that is simultaneously rule-based and outcome-oriented. However, “principles-based process-oriented regulation” is nonsensical. By definition, outcome-oriented regulation accepts that there may be more than one way (i.e., more than one process) to achieve a regulatory goal. Principles-based regulation, also, focuses on high-level expectations and tries to avoid detailed, prescriptive, process-based requirements.
- Outcome-oriented regulation is not automatically proportionate regulation. Like process-oriented regulation, outcome-oriented regulation can be “one size fits all,” which may put a greater burden on smaller firms without the same resources. Thought needs to be given to how to make outcome-oriented processes work with proportionate regulation, perhaps using such techniques as risk-based regulation, as the United Kingdom’s Financial Services Authority (“FSA”) does.⁹

Management based regulation

Under a management-based regulatory approach,¹⁰ the regulator focuses on providing incentives to regulated parties to achieve socially desired goals. This shifts the centre of decision-making from the regulator to regulatees, by requiring regulatees to do their own planning and decision making about how to achieve goals. The difference between outcome-oriented and management-based regulation is that outcome-oriented regulation focuses on the final stage, i.e., whether the firm achieved regulatory goals. Management-based regulation focuses on the planning stage; i.e., the regulatee’s internal compliance processes including monitoring, risk assessment, training, etc. (Both can be contrasted

⁸ See Malcolm Sparrow, *The Regulatory Craft: Controlling Risks, Solving Problems, and Managing Compliance* (Washington: Brookings Institution Press, 2000) at 109-122, 281-292 [Sparrow].

⁹ The particular issues facing small issuers and registrants are addressed separately under “Power, proportionate regulation and participation,” below.

¹⁰ Cary Coglianese & David Lazer, “Management-Based Regulation: Prescribing Private Management to Achieve Public Goals” (2003) 37 *Law & Soc’y Rev.* 691.

with process-based regulation.) One advantage of management-based regulation is that it involves higher management in decision-making and accountability around such processes.

As with other approaches, management-based regulation can impose high costs on small firms. Requiring smaller market actors to implement sophisticated compliance mechanisms could impose a considerable burden, and outweigh the risks that any individual small issuer or firm poses to the market or investors.¹¹ As discussed below, particularly within the Canadian context, it is important that any legislative changes take into account the dramatic effect they may have on smaller issuers.

“Good” or “best” practices

For purposes of this report,

- “Best” practices refer to the most state-of-the-art and highest, and perhaps the most comprehensive and elaborate, practices being used by industry leaders. “Good” practices are industry practices that have been shown to work in achieving regulatory goals.
- The key difference between best/good practices on one hand, and “industry standards” on the other, is that the terms best and good practices refer to a process that is inherently dynamic, flexible, and evolving. Good and best practices are also effective in meeting regulatory goals. Industry standards simply reflect what industry is doing.
- Principles-based regulation relies on best and good practices coming from industry to help define the content of principles-based regulatory requirements. Using best and good practices, as opposed to industry standards, allows regulatory standards to evolve and remain flexible. It also builds in a learning process for both regulators (who are learning from industry about what works in different contexts) and regulatees (who are learning from each other.)
- Best and good practices are meant to be instructive, not mandatory. One size will not fit all. One of the risks of having a regulator share examples of good practices is that regulatees will interpret the good practices as de facto mandatory, process-based expectations to be applied across the board.¹² This also potentially shifts accountability away from management for developing its own appropriate procedures. Partly for this reason, some regulators believe that industry associations, trade councils, or consultants are in a better position to disseminate *best* (as opposed to *good*) practices.
- A related risk is that using good practices (or certainly best practices) can produce regulatory expectations that keep ratcheting up endlessly. This amounts to regulatory “creep,” and de facto “raises the bar” without the

¹¹ See “Power, proportionate regulation and participation,” below.

¹² See Steven Schwarcz, “The Principles Paradox” (2008) Legal Studies Paper, No. 205 [archived at Duke Law School] [Schwarcz].

safeguards of notice-and-comment rulemaking or advance guidance to firms. This can be especially onerous for small firms.

Administrative guidance

“Administrative guidance” refers to pronouncements from regulators that help regulatees understand how law or regulations are likely to be interpreted and applied. In its narrowest sense, guidance refers to the official written comments that often accompany statements of principles from regulators such as the FSA. In Canada, Companion Policies to CSA National Instruments are guidance. More broadly, guidance includes all information disseminated by the regulator about its approach, including speeches, “no action” or “Dear CEO” letters, and published enforcement decisions. Guidance is especially important for a principles-based approach, because it adds “flesh” to the “bones” of principle without resorting to detailed or complex rule-making. It should be transparently communicated, and is non-binding.

Guidance can be a flexible and useful mechanism for clarifying regulatory expectations. However, a regulator must be careful to keep its guidance clear and to manage it well. Otherwise, guidance (in the broader sense of the word) may reside in too many places and in too many forms, making it difficult to make sense of. This would produce less transparency and certainty for industry, not more.¹³ If the regulator does not signal well with its guidance, it could be criticized for taking industry by surprise with a particular interpretation, leading to procedural problems with enforcement actions. On the other hand, regulators could also over-juridify their guidance in response to industry hunger for certainty. Doing so would compromise the flexibility of principles-based regulation.

Strategies to promote regulatory efficiency

- *Risk-based regulation:* The general idea of risk-based regulation is widely understood. Its nuances are beyond the scope of this report. For present purposes, the term refers to a regulatory approach that uses risk analysis to proactively identify those market actors that need the most hands-on oversight, because of the risk they pose to regulatory goals. It is a method for trying to allocate regulatory resources efficiently. The Ontario Securities Commission, among others, is a risk-based regulator and has published its risk assessment criteria.¹⁴

The relationship between risk-based regulation and principles-based regulation is not direct. In fact, risk-based and principles-based regulatory

¹³ Black, Julia, *et al.* “Making a Success of Principles Based Regulation” (2007) 1(3) L. & Financial Markets Rev. 191 [Black, “Making a Success”].

¹⁴ Ontario Securities Commission, News Release/Communiqué, “OSC Publishes Risk-based Criteria to Promote Transparency and Educate Market Participants” (19 December 2002), online: OSC <http://www.osc.gov.on.ca/Media/NewsReleases/2002/nr_20021219_osc-risk-based.jsp>; Ontario Securities Commission, Staff Notice, 11-719, “A Risk-based Approach for More Effective Regulation” (2002), online: OSC <http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part1/sn_20021218_11-719_effective-reg.pdf>.

approaches may not yet be speaking to each other very clearly.¹⁵ However, risk analysis can be a tool that allows a principles-based regulator to try to ensure that the overall arrangement of regulatory interventions and guidance reflects real problems in the markets and a proportionate, rational regulatory response. As noted below,¹⁶ the FSA's risk-based approach also has implications for the regulation of small firms.

- *The Enforcement Pyramid*: Like risk-based regulation, the basic concept of the enforcement pyramid is quite widely understood although its actual operation can be complex.¹⁷ The basic idea of the enforcement pyramid is that regulators should use the least possible regulatory intervention to achieve their goals. Most regulatees (the thick bottom layer of the pyramid), who are generally well-intentioned and fairly capable, are coaxed or persuaded into compliance through regular compliance examinations and followup, warning and publicity, or other methods. A progressively smaller number of progressively more difficult or intransigent firms are dealt with through increasingly severe sanctions. This preserves enforcement resources and ensures the regulator reserves its greatest "fire" for the cases that call for it.

In order to be credible, a regulator using the enforcement pyramid must be able to accurately identify problematic conduct and noncompliance, and to tell the difference between that and innocent mistake or market failure. Recent research seems to indicate that a "tit-for-tat" strategy, in which the regulator begins with a cooperative stance and then mirrors every response by the regulatee in moving up the pyramid, is most effective.¹⁸ An enforcement pyramid helps ensure that enforcement action is proportionate and reasonable, and that the content of principles develops appropriately.

Country/jurisdiction survey

Below are "thumbnail" descriptions of the more principles-based approaches to securities regulation adopted by the British Columbia Securities Commission ("BCSC"), the U.K. Financial Services Authority ("FSA"), and in North American derivatives regulation.

¹⁵ Mary Condon, "Risk-Based and Principles-Based Regulation" (Paper presented to the Joint Annual Meeting of the Canadian Law and Society Association and the (U.S.) Law & Society Association, Montreal, 30 May 2008) [unpublished].

¹⁶ See "The U.K. Financial Services Authority," below.

¹⁷ John Braithwaite, *To Punish or Persuade: Enforcement of Coal Mine Safety* (Buffalo, NY: State University of New York Press, 1985); Ian Ayres & John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford: Oxford University Press, 1992).

¹⁸ Christine Parker & Vibeke Lehmann Nielsen, "Testing Responsive Regulation in Regulatory Enforcement" (Paper presented to the Joint Annual Meeting of the Canadian Law and Society Association and the (U.S.) Law and Society Association, Montreal, 29 May 2008) [unpublished].

British Columbia Securities Commission

In 2004, after conducting regulatory impact analyses and engaging in public consultations,¹⁹ the British Columbia legislature introduced a bill to create an innovative new principles-based *Securities Act* for the province.²⁰ Bill 38 and its associated proposed rules and regulations (together, the “B.C. Model”) would have established the most comprehensively principles-based regime in securities regulation in North America. The characteristics of the B.C. Model – plain language drafting, stripped down statutory architecture, outcome-oriented provisions and practice, a Code of Conduct for Dealers and Advisors – are discussed in more detail below.²¹

In support of its approach, the BCSC argued that prescriptive requirements emphasize the wrong things. That is, they encourage firms to focus on detailed compliance rather than to exercise sound judgment with a view to the best interests of their clients and the markets. Detailed and “top-down” requirements also calcify the regulatory system to reflect one-size-fits-all industry practice in a particular point in time. By contrast, the BCSC argued, principles-based regulation supported by industry-driven learning stimulates innovation, reduces the regulatory burden, and ensures flexibility.²² The BCSC also argued that compliance will increase if rules are fewer, easily understood, and adequately communicated.²³

Bill 38, British Columbia’s proposed new legislation, received Royal Assent on May 13, 2004, and was set to come into force by regulation,²⁴ but it has not done so.²⁵ The BCSC has chosen instead to focus its efforts on the passport system.²⁶ In any event, the BCSC now takes the position that “the most important aspect of regulatory reform is a change in how [regulators] *administer* securities legislation.”²⁷ It has stated that “although the 2004

¹⁹ The regulatory impact studies, results of public consultations, and other documents associated with Bill 38 are available on the B.C. Securities Commission website at <<http://www.bsc.bc.ca/instruments.aspx?id=1894>>.

²⁰ Bill 38, *Securities Act*, 5th Sess., 37th Parl., British Columbia, 2004 (assented to 13 May 2004), s. 203 [Bill 38]. Bill 38 and the research studies and other documents associated with it are available on the British Columbia Securities Commission website at <http://www.leg.bc.ca/37th5th/3rd_read/gov38-3.htm>.

²¹ See “Meaningful Differences: How Rules- and Principles-Based Approaches to Drafting Differ,” above.

²² British Columbia Securities Commission, *New Proposals for Securities Regulation* (British Columbia: A New Way to Regulate, 2002), online:

<http://www.llbc.leg.bc.ca/public/PubDocs/bcdocs/353958/bcsc_proposals2002_report.pdf> [*New Proposals*].

²³ British Columbia Securities Commission, *New Concepts for Securities Regulation* (British Columbia: A New Way to Regulate, 2002), online:

<http://www.llbc.leg.bc.ca/public/PubDocs/bcdocs/351209/New_Concepts.pdf> [*New Concepts*].

²⁴ Bill 38, 5th Sess., 37th Parl., Nos. 72, 73 (assented to 13 May 2004), online: <<http://www.leg.bc.ca/37th5th/votes/v040513.htm>>.

²⁵ British Columbia passed more circumscribed *Securities Amendment Acts* in May 2006 and November 2007, which respectively dealt, *inter alia*, with interjurisdictional cooperation and secondary market civil liability.

²⁶ British Columbia Securities Commission, News Release, “Securities laws to be harmonized across Canada” (10 February 2006), online: BCSC <<http://www.bsc.bc.ca/release.asp?id=2944>>.

²⁷ British Columbia Securities Commission, *Moving ahead with regulatory reform in British Columbia* (March 2005), online: BCSC <http://www.bsc.bc.ca/uploadedFiles/Moving_Ahead.pdf> [emphasis added].

act is not in force, the BCSC has moved ahead with changing [its] regulatory processes and approach in much the same way [it] would have done under the 2004 act.”²⁸ Like the FSA, the BCSC emphasizes outcome-based analysis at the level of practice.

The U.K. Financial Services Authority

The United Kingdom’s Financial Services Authority (the “FSA”) has been a thought leader on principles-based financial services regulation. The FSA’s design was influenced by concurrent U.K. regulatory reform efforts, as exemplified in the “Principles of Good Regulation”: proportionality, accountability, consistency, transparency, and targeting.²⁹ Its enabling statute, the *Financial Services and Markets Act 2000* (“FSMA”), emphasizes these priorities.³⁰ Apart from the FSMA, the key document for market participants working with the FSA is the Handbook.³¹ The main components of the FSA regulatory approach are:

- a *hybrid rules and principles* structure, with an emphasis on the use of principles wherever possible. In 1998, the FSA decided that in the interest of continuity, it would maintain existing material and rules where possible.³² In the intervening years, it has gone about replacing broad swaths of these detailed legacy rules with short high level requirements, often accompanied by regulatory guidance.³³ The FSA says that its work is unfinished and that its Handbook “will rely increasingly on principles and outcome-focused rules rather than detailed rules prescribing how outcomes must be achieved.”³⁴ In referring to its industry-leading approach as simply “*more* principles-based regulation,” the FSA is also acknowledging that no statutory scheme is a pure type, and that good regulation requires a combination of rules and principles.³⁵
- *Consultation*. The FSMA requires the FSA to consult practitioners (i.e., registrants) and consumers, to establish a Practitioner Panel and a Consumer Panel, and to consider their representations.³⁶ It has engaged in consultations on several topics, including how to simplify its rules relating to its relationship to retail customers, and how to streamline and improve existing money

²⁸ British Columbia Securities Commission, *History of the 2004 BC Securities Legislation* (2004), online: BCSC <<http://www.bcsc.bc.ca/instruments.asp?id=1894>>.

²⁹ U.K., Better Regulation Task Force, “Principles of Good Regulation” (London: 2003), online: BRC <<http://archive.cabinetoffice.gov.uk/brc/upload/assets/www.brc.gov.uk/principles.pdf>>.

³⁰ *Financial Services and Markets Act 2000* (U.K.), 2000, c. 8, ss. 2(2), 2(3) [FSMA].

³¹ *FSA Handbook* (U.K.). The Handbook contains the Principles for Business, which are set out in the Appendix to this report.

³² U.K., Financial Services Authority, Consultation Paper, No. 8, *Designing the FSA handbook of rules and guidance* (London: 1998) at 4-6, 11, online: FSA <<http://www.fsa.gov.uk/pubs/cp/CP08.pdf>> [Designing].

³³ Between 2002 and 2005, for example, the FSA simplified and restructured its rules relating to listed companies, reducing the length of the rules by 40% and adding six listing principles plus guidance. U.K., Financial Services Authority, *Better Regulation Action Plan: What we have done and what we are doing* (London: 2005) at 7, online: FSA <http://www.fsa.gov.uk/pubs/other/better_regulation.pdf> [Better Regulation].

³⁴ U.K., Financial Services Authority, *Principles-based regulation: Focusing on the outcomes that matter* (London: 2007) at 2, online: FSA <<http://www.fsa.gov.uk/pubs/other/principles.pdf>> [Focusing].

³⁵ Further discussion of the breakdown between rules and principles is contained below.

³⁶ FSMA, *supra* note 30, ss. 8-11.

laundering provisions.³⁷ The FSA has also formulated its guidance through collaboration with financial market actors, for example on the topic of trading ahead of investment research.³⁸ The FSA also consults on many aspects of its own operations.³⁹

- *Management-based regulation.* The FSA has also shifted some of the innovative burden from itself to industry – for example, in challenging industry to propose a credible solution to conflict of interest issues arising from soft commission and bundled brokerage arrangements.⁴⁰ According to the FSA’s interpretation of the Principles of Good Regulation, a well-designed regulatory approach “recognizes the proper responsibilities of consumers themselves and of firms’ own management.” This helps it to become more forward-looking and preventive, shifting its own resources “from reactive post-event action towards front-end intervention.”⁴¹
- *Risk based regulation.* The FSA uses its ARROW (or ARROW II) methodology to “prioritize the risks [to its statutory objectives], inform decisions on the regulatory response and, together with an assessment of the costs and benefits of using alternative regulatory tools, help determine resource allocation.” The FSA takes a “differentiated approach” to supervision under which fewer regulatory resources are devoted to firms designated “low impact.”⁴² This also means that the FSA is not a “zero failure” regime.⁴³
 - The FSA approach to risk-based regulation is also *proportionate*. The FSA does not subject small firms to the same scrutiny as larger ones, or require the same kinds of structured and detailed responses from them,

³⁷ U.K., Financial Services Authority, *Better Regulation Action Plan: Progress Report* (London: 2006) at 8, online: FSA <http://www.fsa.gov.uk/pubs/other/2660_Action_plan.pdf>.

³⁸ *Better Regulation*, *supra* note 33 at 8.

³⁹ For example, and has consulted on streamlining its own Enforcement and Decision Making manuals. U.K., Financial Services Authority, Consultation Paper, No. 07/2, *Review of the Enforcement and Decision making manuals* (London: 2007), online: FSA <http://www.fsa.gov.uk/pubs/cp/cp07_02.pdf>. The FSA has also established a Small Business Practitioner Panel, to “advise on the overall impact of regulation and FSA policy initiatives on small businesses, given the potentially disproportionate nature to them of that impact.” U.K., Financial Services Authority, *First Annual Report of the FSA Small Business Practitioner Panel (SBPP)* (London: 2000), online: FSA <<http://www.fsa.gov.uk/pubs/annual/SBPP01.pdf>>.

⁴⁰ *Better Regulation*, *supra* note 33 at 7.

⁴¹ U.K., Financial Services Authority, *A new regulator for the new millennium* (London: 2000) at 3-4, online: FSA <<http://www.fsa.gov.uk/pubs/policy/P29.pdf>> [*New Regulator*].

⁴² See generally U.K., Financial Services Authority, *The FSA’s risk-assessment framework* (London: 2006), online: FSA <http://www.fsa.gov.uk/pubs/policy/bnr_firm-framework.pdf>; see also U.K., Financial Services Authority, “Operating framework,” online: FSA <<http://www.fsa.gov.uk/Pages/About/What/Approach/Framework/index.shtml>>; also *New Regulator*, *supra* note 41 at 15.

⁴³ Hector Sants, “Recent Market Events and the FSA’s Response” (Remarks at the IMA AGM Dinner, 20 May 2008), online: FSA <http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2008/0520_hs.shtml>.

because of their sheer number and because on an individual level each one poses a relatively small risk to consumers.⁴⁴

- *Outcome-oriented regulation.* It has linked its statutory objectives and the Principles of Good Regulation into three (formerly four) strategic aims: helping retail consumers achieve a fair deal, promoting efficient, orderly and fair markets, and improving [its] business capability and effectiveness. It measures its regulatory effectiveness against nine high level outcomes under the three aims, as well as two “lower” tiers of activity measures, and process measures. A substantial body of supporting frameworks and systems, including surveys and metrics (some of them pre-existing and some created to support outcome-oriented regulation), exists to support the process.⁴⁵ The FSA also interacts with industry in an outcomes-oriented manner, as the Treating Customers Fairly initiative demonstrates.⁴⁶
- A consistent *enforcement approach.* The FSA enforcement regime is quite different from the U.S. approach.⁴⁷ The FSA does not take formal enforcement action nearly as often as the U.S. SEC, and its penalties are not as severe.⁴⁸ Rather than focusing on ex-post enforcement actions, the FSA tries to maintain an open and cooperative relationship with firms based on dialogue, proactive supervision, and a focus on compliance.⁴⁹ Significantly, the FSA is also prepared to pursue enforcement actions based on breach of principles alone (without necessarily a breach in specific rules), and expects to see more such cases in the future.⁵⁰ Margaret Cole, the FSA’s Director of Enforcement, suggested the value of these types of actions in the drive to achieve “credible deterrence.”⁵¹

⁴⁴ See e.g. Lesley Titcomb, “Supervision of small firms” (Remarks to the Association of Professional Compliance Consultants 5 March 2008), online: FSA <http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2008/0305_It.shtml>.

⁴⁵ U.K., Financial Services Authority, *How we evaluate our performance – the Outcomes Performance Report and developments in our approach since 2002* (London: 2007), online: FSA <http://www.fsa.gov.uk/pubs/other/evaluate_OPR.pdf>.

⁴⁶ U.K., Financial Services Authority, *Treating customers fairly – towards fair outcomes for consumers* (London: 2006) at 11-13, online: FSA <http://www.fsa.gov.uk/pubs/other/tcf_towards.pdf>.

⁴⁷ See generally U.K., Financial Services Authority, *Enforcement Annual Performance Account 2006/07* (London: 2007), online: FSA <http://www.fsa.gov.uk/pubs/annual/ar06_07/enforcement_progress.pdf> [*Enforcement Annual*].

⁴⁸ Even adjusting for differences in market capitalization, financial penalties imposed by the SEC in 2005/06 exceeded those imposed by the FSA by a ten to one ratio. In absolute numbers the ratio is thirty to one. John C. Coffee, “Law and the Market: The Impact of Enforcement” (2007) 156 U. Pa. L. Rev. 229 [Coffee].

⁴⁹ See generally U.K., Financial Services Authority, Consultation Paper, No. 17, *Financial Services Regulation: Enforcing the New Regime* (London: 1998), online: FSA <<http://www.fsa.gov.uk/pubs/cp/cp17.pdf>>.

⁵⁰ U.K., Financial Services Authority, *Business Plan 2008/09* (London: 2008) at 9, online: FSA <http://www.fsa.gov.uk/pubs/plan/pb2008_09.pdf>.

⁵¹ In her words, the regulator must be “ready, willing and able to do enough cases of the right sort to get the right outcomes, to get the message out to firms and individuals that they will suffer meaningful consequences if they fail to raise their game and improve standards of behaviour.” Margaret Cole, “How

The FSA describes its approach as something very different from deregulation, outsourcing, or reduced regulation. John Tiner, the FSA's former Chief Executive, described his organization's principles-based approach to include, "[t]he heightened significance of communication in a principle-based system. Our efforts to rationalise and focus the FSA Handbook. Our enhanced Risk-Based approach. And, managing down regulatory costs."⁵² He argued that principles-based regulation produced simply "better" regulation, meaning simultaneously "(1) a stronger probability that statutory outcomes are secured; (2) lower cost; and (3) more stimulus to competition and innovation."⁵³ In the wake of the nationalization of Northern Rock and the overall liquidity crisis this year, Mr. Sants reiterated his support for the FSA's principles-based and outcome-oriented approach.⁵⁴

Regulation of Derivatives Trading in North America

The U.S. Commodity Futures Trading Commission operates in a principles-based manner and its primary statute, the *Commodity Futures Modernization Act*,⁵⁵ has several principles-based components. In particular, that *Act* incorporates a set of "core principles," reproduced in this report's Appendix, that share features with the FSA's Principles for Business and the BCSC's proposed Code of Conduct for Dealers and Advisors.⁵⁶ Quebec's new *Derivatives Act*⁵⁷ is also substantially principles-based, and it is a first attempt internationally to regulate a full range of derivatives. It has not yet come into force, and regulations and rules have not been published. The statute is cast in plain language, and its drafting is streamlined and remarkably outcome-oriented. (It is also a more circumscribed statute because it relies on a pre-existing regulator and a companion Quebec *Securities Act*.) One of its more interesting features is that, so as not to inhibit fast-moving practice in the derivatives industry, the *QDA* has adopted a self-certification mechanism (similar to the American one), under which regulated entities must demonstrate that proposed new products are consistent with core principles. Some of the *Act*'s key principles-based provisions are set out in this report's Appendix, along with the

Enforcement makes a difference" (Remarks at the Enforcement Law Conference 18 June 2008), online: FSA <http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2008/0618_mc.shtml>.

⁵² John Tiner, "Better regulation: objective or oxymoron" (Remarks at the SII Annual Conference 9 May 2006), online: FSA <http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0509_jt.shtml>.

⁵³ *Ibid.*

⁵⁴ Hector Sants, "Principles-Based Regulation – Lessons from the Sub-Prime Crisis" (Remarks at the Securities and Investments Institute Annual Conference, 15 May 2008), online: FSA <http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2008/0515_hs.shtml>.

⁵⁵ *Commodity Futures Modernization Act*, 7 U.S.C. § 1 (2000).

⁵⁶ In January 2007, Ontario's Commodity Futures Act Advisory Committee issued a final report recommending that Ontario's *Commodity Futures Act*, R.S.O. 1990, Chapter C.20, be redrafted and that the new legislation "should adopt a core principles approach." Ontario Commodity Futures Act Advisory Committee, *Final Report* (Ontario: Ministry of Government Services, 2007) at 17, online: <<http://www.gov.on.ca/mgs/graphics/121810.pdf>>.

⁵⁷ *Derivatives Act*, S.Q. 2008, c. 24. The Quebec National Assembly passed the former Bill 77 into law on June 19, 2008 and it received royal assent on June 20.

“core principles” from the May 2006 proposed framework of the Autorité des marchés financiers for the regulation of derivatives.⁵⁸

Best practices and critical success factors

The best resource for understanding the best practices and critical success factors in principles-based securities regulation are the regulators, like those at the BCSC and FSA, that have worked with such an approach. This report limits itself to identifying some key themes.

Six critical success factors are discussed below.⁵⁹ Note that *good legislative drafting* is not on the list. This is for two reasons: first, drafting considerations are discussed in the context of implementation.⁶⁰ Second, although well-designed, principles-based legislative drafting makes it easier to implement a principles-based approach, the BCSC and FSA examples demonstrate that principles-based statutory drafting is less important than regulatory practice.

Regulatory culture

Working well with principles-based regulation requires considerable changes to traditional regulatory culture. Rather than trying to articulate non-negotiable, specific requirements, a principles-based regulator needs to focus on defining broad themes, articulating them on a flexible and dynamic basis, accepting input from industry, and effectively managing incoming information. This requires a different relationship between regulator and regulatees, different expertise, and a pragmatic and measured regulatory stance. Moving to a new model would also take time, and training. Former BCSC Commissioner Robin Ford’s presentation to the Allen Task Force in 2006 sets out her experience with change management at the FSA, including obstacles the FSA faced in implementing an outcome-oriented, principles-based system and the tools the FSA used to help staff adjust.⁶¹ The four bullet points below identify some key elements that need to be considered.

- *Expertise*: Principles-based regulation, like risk-based regulation, is characterized by a hands-off philosophy. However, this does not necessarily mean that fewer regulatory resources will be required. Depending on choices about implementation, principles-based regulation may actually require intensive interaction with firms, at least around certain issues or situations.⁶²

⁵⁸ Autorité des marchés financiers, *Regulation of Derivatives Markets in Quebec* (Quebec: 2006), online: AMF <<http://www.lautorite.qc.ca/userfiles/File/industrie/encadrement-produits-derives/Regulation-Derivatives-Markets.pdf>>.

⁵⁹ One very helpful academic source is Black, “Making a Success,” *supra* note 13.

⁶⁰ See “How legislation is structured to incorporate more principles,” below.

⁶¹ British Columbia Securities Commission, “Principles-based Regulation: Financial Services Authority,” by Robin Ford (Task Force to Modernize Securities Legislation in Canada, *Final Report: Canada Steps Up*, vol. 7, 2005) at 105-108, online: TFMSL <http://www.tfmsl.ca/docs/Volume7_en.pdf> [Robin Ford].

⁶² See Black, “Making a Success,” *supra* note 13. (Re: U.K. Treat Customers Fairly rules, which require registrants to demonstrate that they are in fact treating customers fairly at every stage.)

Malcolm Sparrow's empirical work in the United States also illustrates the point.⁶³ Sparrow describes how the most effective modern regulatory techniques use sophisticated problem-solving methods and self-reflective analysis to do the challenging and complex work of "pick[ing] important problems and solv[ing] them." According to Sparrow, three common elements characterize the best new regulatory structures, and each one calls for multiple difficult professional judgments:

- a clear focus on results—not in terms of process or quotas, but based on an expanded and more specific set of indicators including "big picture" Mission Statement-level impacts, behavioral outcomes such as compliance rates, agency activities, outputs, and resource efficiency;
- adoption of a disciplined problem solving approach based on systematic identification and prioritization of important risks or patterns of noncompliance, a flexible and functional project-based approach, and periodic outcome evaluation with flexible resource allocation based on outcomes;
- selective investment in collaborative partnerships.⁶⁴

The Northern Rock debacle in the U.K. highlights the kinds of staffing and resource problems that can afflict a principles-based regulator, like any other regulator.⁶⁵ Indeed, principles-based regulation actually requires more skills than the box-ticking aspect of rule-based regulation does. The FSA's responses to Northern Rock, and its challenges in meeting them, are instructive. The FSA plans to enhance its supervisory teams (meaning more staff, better training, a mandatory minimum number of staff per high-impact institution, and closer contact between senior staff and the biggest firms.) It also plans to improve the quality of its staff, hiring risk specialists to support frontline supervision teams by focusing on the complex models used by banks to gauge financial risk. However, as one commentator observed, the FSA may find recruitment a problem, since the regulator will be pursuing "the same PhD rocket scientists the banks are chasing. ... As Northern Rock shows, it's not just about evaluating the problems, but having the people who can follow them up and forcefully make the case to the bank."⁶⁶

⁶³ The literature on best practices in regulation is extensive and far beyond the scope of this report, but Sparrow is especially relevant because he has been a muse for the BCSC for several years. See British Columbia Securities Commission, "Another Way Forward for Securities Reform," by Brent W. Aitken (Task Force to Modernize Securities Legislation in Canada, *Final Report: Canada Steps Up*, vol. 7, 2006) at 86, online: TFMSL <http://www.tfmsl.ca/docs/Volume7_en.pdf>.

⁶⁴ Sparrow, *supra* note 8 at 103-08, 99-122, 155-70.

⁶⁵ The collapse and subsequent nationalization of the bank Northern Rock, which was a byproduct of the American subprime mortgage crisis, was a blow to the FSA's regulatory credibility. The FSA acknowledged extraordinarily high turnover of FSA staff directly supervising the bank, inadequate numbers of staff, and very limited direct contact with bank executives among the reasons for its "unacceptable" regulatory performance. It put forward a series of proposed changes in response. Jennifer Hughes, "FSA admits failings over Northern Rock" *The Financial Times* (26 March 2008), online: Financial Times <http://www.ft.com/cms/s/0/0833a416-fb0d-11dc-8c3e-000077b07658.html?nclick_check=1>.

⁶⁶ *Ibid.*

- *Trust and Communication*: Principles-based and outcome-oriented regulation requires regular and open communication with regulatees. Among the greatest advantages of principles-based regulation are its flexibility and its ability to move with, and learn from, industry experience. This requires the regulator to step back, and to “steer not row” more often.⁶⁷ The FSA, for example, consults with industry and consumers in developing its guidance, and shares information about good practices with industry stakeholders.

When it comes to enforcement, a principles-based regulator should build a “paper trail” for an enforcement action whenever possible. This is especially true where the regulator is concerned about a possible breach of a principle, without a corresponding breach of a detailed rule.⁶⁸ The regulator needs a systematic way to communicate with firms through various steps – compliance, warning letters, etc. – so that enforcement is not a surprise to anyone when it happens. Of course, there will still be those rare cases that call for urgent action, where conduct is egregious and a fundamental principle has been violated, in which it is not possible to develop the same kind of paper trail. Just as they have to do today when pursuing those cases under a public interest power, a regulator will have to justify its exercise of judgment after the fact in those situations.

- *Restraint with regard to guidance*: Guidance is an essential component of a principles-based regulatory scheme. As Julia Black points out, however, if a regulator elaborates principles too often, through too much guidance in too many different forms, the result can be increasing prescriptiveness, potential inconsistency, and potentially a body of complex and inaccessible case law. Black notes that “[u]nless great care is taken in the formulation of guidance it could simply reintroduce detail and prescription in a much less transparent and accessible way.”⁶⁹ Resisting the impulse to provide too much guidance, in terms that are too concrete, can be especially challenging in the face of industry demands for greater certainty. Nevertheless, the regulator should keep the “big picture” in mind and should work to communicate guidance in an effective, accessible, and non-prescriptive manner. The same point applies to the accretion of guidance over time. The regulator should periodically review its guidance, to identify and address the relevance of older guidance.
- *Continued use of notice-and-comment rulemaking*: The other risk with guidance under a principles-based regime is that it could become – or could be interpreted as becoming, even if it is not – de facto rulemaking through the “back door,” without the transparency and accountability safeguards provided by notice-and-comment rulemaking. The *Ainslay* case and the subsequent Osbourne report reflect Canada’s experience here, and stand for the principle

⁶⁷ David Osborne & Ted Gaebler, *Reinventing Government: How the Entrepreneurial Spirit is Transforming the Public* (New York: Penguin Books, 1992) at 25.

⁶⁸ See “Enforcement and principles-based regulation,” below.

⁶⁹ Black, “Making a Success,” *supra* note 13.

that one cannot do an “end run” around notice-and-comment, creating wholly new sets of rules without administrative safeguards.⁷⁰

Impact on market participants

Registrants and issuers operating under a principles-based regime have the flexibility to design effective processes based on their own intimate understandings of their businesses and attendant risks. When implemented and overseen effectively, this can reduce the regulatory burden, permit innovation, and permit more effective regulation. On the other hand, there are costs associated with learning to work with principles, and a principles-based approach puts greater pressure on management to do its own thinking, exercise its own judgment, and develop its own dynamic and self-analytical processes. Process-based regulatory requirements may sometimes be easier to work with, even if they are less well-suited than outcome-based or management-based requirements. Firms and companies need the responsibility to decide how to best align their business objectives and processes with regulatory objectives, in order to take advantage of the benefits of flexibility that principles-based regulation offers.⁷¹ This may require both a shift in orientation, and robust educational resources and other support – especially for smaller market actors.

As mentioned above, principles-based regulation also requires a relationship between regulator and regulatee that is generally trusting and collaborative, not adversarial or cat-and-mouse. Ongoing communication helps provide clarity around principles. Communication must go both ways to be effective, since the regulator relies on industry experience to further its own learning. Therefore, a principles-based approach requires market participants to share information with regulators. Not sharing information must be actionable on its own. The regulator should also develop short and long term incentives to induce market actors to be cooperative and communicative.

The transition to a principles-based approach could be challenging for regulated entities and public companies. As the FSA recognized in an early document, “Changes in the manner of expression of requirements may impose a burden on businesses ... substantive changes ... need to be accompanied by reasonable lead times for adjustments to systems and procedures.”⁷² Along with providing lead time and educational and other support, a regulator transitioning to a principles-based approach may want to maintain existing rules as a “quasi safe harbour” until they can be incrementally reviewed, revised, and supplanted by guidance.⁷³

⁷⁰ Administrative guidance has not been the subject of widespread litigation in Canada, with the notable exception of *Ainsley Financial Corporation v. Ontario Securities Commission*, 14 O.R. (3d) 280, [1993] O.J. No. 1830 [*Ainsley*]. On the distinction between guidance and rules in the United States, see Peter L. Strauss, “Publication Rules in the Rulemaking Spectrum: Assuring Proper Respect for an Essential Element” (2001) 53 Admin. L. Rev. 803.

⁷¹ *Focusing*, *supra* note 34 at 4.

⁷² *Designing*, *supra* note 32 at 6. But see British Columbia Securities Commission, *Strong and Efficient Investor Protection: Dealers and Advisers under the BC Model – A Regulatory Impact Analysis*, by Christina Wolf (British Columbia: Deregulation Project, 2003) at 48-57, online <http://www.llbc.leg.bc.ca/public/PubDocs/bcdocs/365940/regulatory_impact_analysis.pdf> [*Strong*].

⁷³ The notion of the quasi safe harbour is discussed below at “Power, proportionate regulation and participation: SMEs and smaller regulated actors.”

Learning systems and information management

In order to keep a principles-based approach both flexible and functional, structures need to be developed that allow the regulator to gather useful information, analyze it effectively, learn from it, share it, and plough it back into subsequent regulatory decision-making. At the FSA, the Operations Business Unit serves this function.⁷⁴ Without a systematic method for working with a large and varied body of information, both transparency and learning (by industry and regulator) will be compromised.

Especially in fast-moving environments like capital markets regulation, a principles-based regulator needs information to be credible as it develops its guidance and interacts with industry. As mentioned above, collaboration with industry in various forms is a key means by which a principles-based regulator adapts its expectations and approach. For example, when a firm comes to the regulator with a proposed new approach to a compliance problem, it must demonstrate that the proposed method is consistent with regulatory principles and goals. The regulator also gains considerable insight from compliance examinations and enforcement actions. These kinds of interactions are rich sources of information, and that information needs to be captured. In the same way, a regulator needs to be able to measure and understand results achieved, in order to take an effective outcome-oriented approach. The regulator can then leverage all this information to assess risk more reliably and accurately, to publicize “good practices”, to support industry learning, and to provide clarity about principles without unduly compromising the system’s flexibility.

Outcome-oriented regulation

Outcome-oriented regulation is defined above,⁷⁵ and further discussed below in the statutory drafting context.⁷⁶ It is a critical success factor for principles-based regulation, because a focus on outcomes rather than processes is needed to keep the system flexible and capable of learning. The FSA continues to emphasize the link between principles-based regulation and outcome-oriented regulation, and to revise its rulebook to be more outcome-oriented and less process-oriented.⁷⁷ Because of misunderstandings that have arisen about the meaning of principles-based regulation, the BCSC submission to the Expert Panel on Securities Regulation even prefers to describe its approach as “outcomes-based” rather than “principles-based.”⁷⁸

⁷⁴ See U.K., Financial Services Authority, “Operations Business Unit,” online: FSA <<http://www.fsa.gov.uk/Pages/About/Who/Management/Services/index.shtml>>.

⁷⁵ See “Outcome-oriented / results-oriented regulation,” above.

⁷⁶ See “Outcome-oriented versus process-oriented structure,” below.

⁷⁷ See e.g. Hector Sants, U.K., Financial Services Authority, *Annual Report 2007/08* (London: 2008) at 10; *Focusing*, *supra* note 34 at 10 (asserting that the rules it is interested in discontinuing are those that are “detailed” and “process oriented.” The rules it sees as most useful for providing clarity and amplifying principles are those that “will not focus on a specific process that a firm should undertake, but an endpoint that should be achieved”).

⁷⁸ British Columbia Securities Commission, *Submission of the British Columbia Securities Commission* (Expert Panel On Securities Regulation, 2008), at 4, online: BCSC <http://www.bsc.bc.ca/uploadedFiles/BCSC_Submission_to_Expert_Panel_on_Securities_Regulation-July2008.pdf>.

Regulatory credibility

Especially under a principles-based system, a regulator must exhibit trustworthiness and competence if it wants its judgments to be respected. Regulatory conduct should be as transparent as possible. The regulator must resist the temptation to seize easy but less consequential technical violation cases. Regulators should cooperate with responsible market actors where those actors continue to behave responsibly, and should maintain ongoing dialogue. They should be reasonable, and responsive. The ratcheting-up stages of the enforcement pyramid should be predictable and defensible.⁷⁹ Market actors should be able to predict, with some degree of accuracy, whether or not their conduct will be found to breach a principle.⁸⁰ All of this sends the message that regulatory conduct will not be arbitrary, which encourages responsible firms to believe that they will be rewarded for their responsibility. The regulator also needs to be able to work with an outcome-oriented rather than process-oriented method. Professor Black has described the credibility gap and confusion that result when regulatory staff at an ostensibly principles-based regulator interpret internal agency guidelines in ways that produce rigid, non-negotiable expectations for industry.⁸¹

Maintaining control

In order to establish a functioning principles-based regulatory system, the regulator must be able to maintain considerable control over its own processes and the interpretation of its principles. This means, first, that the regulator must have the statutory power to promulgate rules and guidance. Second, allowing courts to interpret regulatory principles and goals could dilute regulatory interpretations and undermine both coherence and flexibility. Securities commissions tend to attract considerable deference by courts on judicial review / statutory appeal, and surely some degree of court oversight is important. But it should be pointed out that with respect to enforcement actions, which can be appealable to the courts, the FSA tends to settle its principles-based actions. (It also makes extensive use of compliance and other methods before even getting to the enforcement stage.) It is difficult to predict whether a court, which by virtue of training and mandate may have a different perspective, would necessarily endorse the regulator's particular interpretation of a principle or its use of it.⁸²

A principles-based regulator should also be concerned about the impact of civil liability on its ability to define its own principles. At least one observer has suggested that an American-style approach to civil liability can make principles-based regulation unworkable.⁸³ In response, one early FSA document suggests that despite the legal

⁷⁹ *New Regulator*, *supra* note 41 at 29-33. (A recent document describing the FSA's approach to and experience with an enforcement pyramid.)

⁸⁰ *Focusing*, *supra* note 34 at 14.

⁸¹ Black, "Making a Success," *supra* note 13 at 198.

⁸² Black has suggested that lawyers in particular struggle with judgment calls made by regulators, rather than courts, and that this is a basis for their otherwise difficult-to-understand resistance to principles-based regulation in the U.K. Julia Black, "Forms and Paradoxes of Principles Based Regulation" (2008) [unpublished manuscript, on file with author].

⁸³ See e.g. Peter J. Wallison, "Fad or Reform: Can Principles-Based Regulation Work in the United States?" (2007) American Enterprise Institute for Public Policy Research, online: AEI <http://www.aei.org/publications/pubID.26325/pub_detail.asp> [Wallison].

importance of the principles for business, it should not be possible “for private persons to found an action for damages on the principles alone.” Violating a principle would only make a market actor liable to disciplinary sanctions. The FSA argued that the principles are a statement of “regulatory expectations” that need to be applied in line with the overall body of FSA rules and guidance. As such, it was not desirable for “civil litigation between private parties [...] to become the engine driving the interpretation of the principles.”⁸⁴

Is this the right approach for Canada? Risks and opportunities

Background features in the Canadian landscape

- *Nature of Canadian capital markets:* Canada is a small market, comprising only about 3.17% of total market capitalization worldwide. Canada’s public companies are bifurcated into a modest number of large companies, and a large group of very small companies, with the latter group disproportionately located in British Columbia and Alberta. Canadian companies are also substantially smaller in absolute dollar terms than their American counterparts, they tend to be closely held relative to American and U.K. ones, and they are often characterized by a dual class share structure.⁸⁵ In his June 2006 research paper for the Allen Task Force, Professor Christopher Nicholls remarked that these factors mean that compared to the United States, “Canadian securities regulation should be relatively more focused upon preventing the abuse of minority shareholders of public companies that may arise in connection with going-private transactions, related-party transactions, and unlawful insider trading.” He also observes that “[t]he number of small, thinly traded Canadian corporations further suggests that share price manipulation ought to be a key securities regulatory focus,”⁸⁶ and that “lighter or more flexible regulation that may be considered appropriate for U.S. micro-cap and, more particularly, small-cap companies could, potentially, still prove

⁸⁴ U.K., Financial Services Authority, Consultation Paper, No. 13, *The FSA Principles for Businesses* (London: 1998) at 11, online: FSA <<http://www.fsa.gov.uk/pubs/cp/cp13.pdf>>. The BCSC also decided against providing for a private right of action based on violations of the Code of Conduct for Dealers and Advisors, though on the basis that doing so would significantly increase dealers’ and advisors’ liability relative to the common law, and that it could not quantify the risk. British Columbia Securities Commission, *Investor Remedies in Securities Legislation* (British Columbia: New Legislation Project, 2004) at 8-10, online: BCSC <[http://www.bcsc.bc.ca/uploadedFiles/RIA_Investor_Remedies\(1\).pdf](http://www.bcsc.bc.ca/uploadedFiles/RIA_Investor_Remedies(1).pdf)>.

⁸⁵ See generally Christopher Nicholls, “The Characteristics of Canada’s Capital Markets and the Illustrative Case of Canada’s Legislative Regulatory Response to Sarbanes-Oxley” (2006) Task Force to Modernize Securities Legislation in Canada, *Final Report: Canada Steps Up*, vol. 4, online: TFMSL <http://www.tfmsl.ca/docs/Volume4_en.pdf> [Nicholls]; on Canadian distinctiveness, see also Ronald J. Daniels & Jeffrey G. MacIntosh, “Toward a Distinctive Canadian Corporate Law Regime” (1991) 29 *Osgoode Hall L.J.* 863 at 873.

⁸⁶ Nicholls, *ibid.* at 201. See also Randall Morck & Bernard Yeung, “Some Obstacles to Good Corporate Governance in Canada and How to Overcome Them” (2006) Task Force to Modernize Securities Legislation in Canada, *Final Report: Canada Steps Up*, vol. 4, at 279-348, online: TFMSL <http://www.tfmsl.ca/docs/Volume4_en.pdf>.

overly burdensome for significantly smaller Canadian small-cap companies.”⁸⁷

- *Federal/provincial distribution of powers:* This information is well known and does not need to be repeated here. It is relevant that securities regulation is a provincial matter in Canada, a passport system exists, and recent research has been done on relevant regional differences in capital markets, capital raising, and enforcement priorities.⁸⁸ The Crawford Panel has recently recommended a model for achieving a securities regulatory framework featuring a common securities regulator, a common body of securities law, and a single fee structure.⁸⁹
- *Enforcement challenges and international perceptions:* It is frequently observed that there is an international market discount for Canadian-listed companies based on perception of failures of enforcement, although some recent empirical studies have challenged this claim.⁹⁰
- *Proximity to United States:* Canada’s proximity to the United States is most relevant for our largest public companies, many of which cross-list on American exchanges.⁹¹ Professor Nicholls has suggested that adequate investor protection already exists in these cases, and there is a need to ease certain formal requirements for the largest public companies.⁹² Principles-based regulation could reduce costs for multinational actors, such as cross-listing Canadian companies, because the jurisdiction with the more detailed standards sets the de facto requirements (assuming the systems’ principles are generally consistent, as they are currently between Canada and the United States.)⁹³ One concern about principles-based regulation is that it could engender scepticism by American investors and regulators about Canadian companies’ domestic reporting requirements, which could affect the unique

⁸⁷ Nicholls, *ibid.* at 162.

⁸⁸ Poonam Puri, “Local and Regional Interests in the Debate on Optimal Securities Regulatory Structure” (2003) Wise Persons’ Committee to Review the Structure of Securities Regulation in Canada, *Final Report: It’s Time*, Research Studies, online: <http://www.wise-averties.ca/reports/WPC_6.pdf>.

⁸⁹ Crawford, *supra* note 2.

⁹⁰ See e.g. Peter C. Cory & Marilyn Pilkington, “Critical Issues in Enforcement” (2006) Task Force to Modernize Securities Legislation in Canada, *Final Report: Canada Steps Up*, vol. 6, at 165-252; Utpal Bhattacharya, “Enforcement and its Impact on Cost of Equity and Liquidity of the Market” (2006) Task Force to Modernize Securities Legislation in Canada, *Final Report: Canada Steps Up*, vol. 6, at 131-164; Crawford, *supra* note 2 at 12. For a review of some recent research challenging the existence of the Canadian discount, see Cecile Carpentier et al., “On the Competitiveness of the Canadian Stock Market” at 14-17, online: <<http://ssrn.com/abstract=1262874>>.

⁹¹ Of the largest 50 Canadian TSX issuers, 33 are also listed on the New York Stock Exchange. 51 of the TSX’s 100 largest Canadian issuers are listed on the NYSE. Other TSX-listed companies are cross-listed on other American exchanges, including the Nasdaq Capital Market and the American Stock Exchange. Nicholls, *supra* note 85 at 158.

⁹² Nicholls, *ibid.* at 141.

⁹³ See e.g. Comments by Penny Tham, Group Compliance, Head of North Asia, ABN Amro Bank, Hong Kong (Remarks at Capital Ideas 2006, 28 September 2006), at 48-49, online: BCSC <<http://www.bcsc.bc.ca/uploadedFiles/news/publications/CompleteTranscript-Capitalideas2006.pdf>> (stating that principles-based regulation provides a “really good framework ... for some of us who deal across borders.”)

Multijurisdictional Disclosure System that Canadian companies enjoy. How United States representatives would respond to principles-based regulation in Canada, in terms of the MJDS, is unclear. Assuming (as seems likely) that the MJDS remains in place, companies that want to use the southbound MJDS option will probably choose to make additional disclosure – as many Canadian companies already do – or make disclosure in a U.S.-friendly format, to facilitate marketing and meet liability concerns when conducting a public offering in the United States.

There may be some possibility that American regulation will move more toward a principles-based approach.⁹⁴ Regardless, what works for a dominant market like the United States' will not necessarily work for the Canadian one. In Professor Nicholls' words, "Canada's regulators do not have the luxury of crafting regulation secure in the knowledge that the lure of Canada's markets will ensure that modest regulatory burdens will not dampen the interest of issuers and investors."⁹⁵ A more streamlined approach may even make Canada a North American listing destination of choice, if a better regulatory system (meaning one that regulates at least as effectively while imposing a lesser regulatory burden) gives it a competitive advantage.

Costs and benefits of rules- and principles-based systems: stakeholder analysis and key questions

This report does not try to precisely value the costs and benefits to various stakeholders in moving towards a more principles-based system. As Lawrence Schwartz observed to the Allen Task Force, this is work for highly trained specialists.⁹⁶ What is possible here is to identify some relevant factors in light of existing knowledge about rules-based and principles-based approaches.

The advantages of rules are generally thought to go to certainty and predictability, while the advantages to principles are that they are more flexible and better tailored to a given factual situation. The costs of each approach are the flip-side of their benefits. However, this accepted wisdom tends to oversimplify the distinction. It does not recognize that rules and principles operate along a spectrum, or that concepts like "certainty" and "flexibility" can be quite complicated.⁹⁷ Also, the rigid dichotomy fails to consider how important *application* is. Depending on context, a legal requirement drafted as a principle may actually operate much more like a rigid rule, and the converse is true as well. "Costs" and "benefits" can also be nuanced concepts, and there is a relationship between the valuation of particular goods, the distribution of costs or benefits to different stakeholders, and larger policy priorities that are beyond the scope of this report.

⁹⁴ See e.g. Blueprint, *supra* note 2; *contra* Wallison, *supra* note 83.

⁹⁵ Nicholls, *supra* note 85 at 192.

⁹⁶ Lawrence P. Schwartz, "Cost-Benefit Analysis in Canadian Securities Regulation" (2006) Task Force to Modernize Securities Legislation in Canada, *Final Report: Canada Steps Up*, vol. 4, at 357, online: TFMSL <http://www.tfmsl.ca/docs/Volume4_en.pdf> [Schwartz].

⁹⁷ For a critique of Louis Kaplow's well-known account of the costs of principles and rules, see Ford, "New Governance," *supra* note 4 at 38-41. Note, as well, that from a strict cost-benefit analytical perspective, Kaplow's account is actually about cost *shifting* rather than cost saving.

That said, the table below tries to identify some key considerations on either side of the ledger, based on existing literature and experience. It looks at costs associated with an up-and-running principles-based system, not costs associated with transition to such a system. Perhaps most usefully, it illustrates how complex these calculations can be, and how much the evaluation of a particular cost or benefit depends on how the principles-based legislation is structured. Following the table, this report separately addresses some of the main outstanding questions about principles-based regulation in Canada, which tend to centre around

- certainty and predictability,
- problems of enforcement,
- the passport system and the prospect of a single regulator, and
- power, proportionate regulation, and participation.

Stakeholder Analysis: Potential Costs and Benefits of Principles-based Regulation, Relative to Status Quo			
Stakeholder	Potential Benefit	Potential Cost	Possible Responses to Costs Presented / Other Comments
Issuers and Registrants	<ul style="list-style-type: none"> • Accessibility: May allow registrants to tailor processes to their business needs rather than following rigid, ill-suited regulatory requirements (account supervision example). • Congruence: Over long term, better suited process may reduce risk of civil liability, reputational damage. • Certainty: Common sense judgment likely to result in compliant behaviour – more intuitive, less technocratic than rules. • Flexibility: More scope for business judgment (permits flexibility, innovation). • Transparency: Reduced risk of being faced with nontransparent regulatory discretion under existing Public Interest powers (Cartaway example). 	<ul style="list-style-type: none"> • Transparency: Interpreting principles in context requires more resources than applying bright line rules. • Cost: Transition costs in moving to PBR; learning costs. • Uncertainty: Clear rules replaced with contextual judgments. • Uncertainty: Desire for clear guidelines (want regulator to tell them what to do). • Transparency: Risk of regulatory “creep”; risk of being faced with “back door” rules – ie. new best practices-based regulatory expectations that haven’t been subjected to notice and comment rulemaking procedure. • Cost: More costly (Kaplow). • Compliance: Rules or principles irrelevant; market participants will use either rules or principles to engage in self-serving behaviour 	<ul style="list-style-type: none"> • Many issuers, registrants are in favour of PBR. • Whether something is a cost or benefit depends on how it is implemented – eg. impact on small issuers and registrants may be positive or negative depending on other factors such as use of risk-based regulation, best or good practices as basis for rulemaking. • Whether US rules treated as compatible depends on drafting agreements. (FSA precedent exists). • Hoped-for effect on corporate culture an empirical unknown.

Stakeholder Analysis: Potential Costs and Benefits of Principles-based Regulation, Relative to Status Quo			
Stakeholder	Potential Benefit	Potential Cost	Possible Responses to Costs Presented / Other Comments
	<ul style="list-style-type: none"> • Cost: Less costly (FSA). • Compliance: Potential to affect long term corporate culture of compliance, reduce liability-creating loophole behaviour. 	anyway (Nelson).	
	<p>US Crosslisted Issuers / Southbound MJDS Issuers (assuming larger, sophisticated)</p> <ul style="list-style-type: none"> • US rules recognized as compatible with PBR, doesn't require separate Canadian processes • Opportunities for innovation under PBR more likely to be leveraged by firms with greater resources. 	<p>US Crosslisted Issuers / Southbound MJDS Issuers</p> <ul style="list-style-type: none"> • US may not recognize Canadian PBR standards as equivalent. 	<ul style="list-style-type: none"> • Whether US rules treated as compatible depends on drafting agreements. (FSA precedent exists).
	<p>Small Issuers</p> <ul style="list-style-type: none"> • More flexible regulation means less disproportionately heavy compliance burden. 	<p>Small Issuers</p> <ul style="list-style-type: none"> • Opportunities for innovation under PBR more likely to be leveraged by firms with greater resources. • Smaller issuers forced to develop new compliance systems without reference to others' experience (depending on how system designed). 	<ul style="list-style-type: none"> • Depends on implementation; some flexibility-related advantages of PBR inure to those with more resources. • Options for reducing burden on small firms: sharing of good/best practices through regulator and/or third parties; hybrid rules/principles approaches; risk-based regulatory approach as at FSA.
Other Professionals Involved in Industry	<ul style="list-style-type: none"> • Compliance consultants may be needed to work through principles, design systems. • Some suggest PBR as opportunity for rent-seeking behaviour by consultants (Partnoy). 	<ul style="list-style-type: none"> • Harder to say no to noncompliant clients without rigid rules to point to (Bratton, Cunningham). • Clients require less reliance on technical knowledge (reduction in business for advisers); more opportunity 	<ul style="list-style-type: none"> • Hard to assess costs versus benefits – which outweighs the other. • Common law lawyers are comfortable with principles emerging from caselaw. Whether they are equally

Stakeholder Analysis: Potential Costs and Benefits of Principles-based Regulation, Relative to Status Quo

Stakeholder	Potential Benefit	Potential Cost	Possible Responses to Costs Presented / Other Comments
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		for rent-seeking under detailed rules (Cunningham).	comfortable with PBR in securities regulation will depend on how comfortable they are with the method of implementation, administrative (as opposed to judicial) interpretation of rules.
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Regulators	<ul style="list-style-type: none"> • Less costly to promulgate ex ante (?). • Suitable for fast-moving capital markets: regulators aren't playing catch-up, know what industry practices are. Regulators have opportunity to learn. • More efficient use of regulatory resources: choice of process substantially devolved to regulatees. • Responsive to scandals, egregious breaches of public trust – which produce political pressure to invoke a general standard (Park). • Enforcement more effective, loophole behaviour curtailed. • Guidance – flexible, useful. 	<ul style="list-style-type: none"> • More costly to implement ex post (?). • Requires more skills – judgment, technical industry knowledge. • Less efficient use of regulatory resources: need to build collaborative, communicative relationship; risk of regulatory “creep.” • Unsited to respond to scandals, egregious breach of public trust – which produce political pressure to draft clear rules (Cunningham). • Enforcement potentially harder and subject to greater concerns on rule of law grounds. • Guidance – inscrutable, voluminous, overreaching. 	<ul style="list-style-type: none"> • New skills required, esp. in communication, information management. Requires trusting relationships, more consistent collaboration and communication with regulatees. • Risk management enforcement pyramid to preserve and allocate enforcement resources.
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Consumers, Investors, Canadian Capital Markets	<ul style="list-style-type: none"> • Better regulation – fewer opportunities for loophole behaviour by market actors (FSA). • More credible enforcement = reduces/eliminates capital markets discount for Canadian listed companies. • Potentially more transparency for investors. 	<ul style="list-style-type: none"> • Lower standards, more lax regulation, higher risks for investors – not better (NYSE). • Less credible enforcement = increases/perpetuates capital markets discount for Canadian listed companies. • Potentially less transparency for investors. 	<ul style="list-style-type: none"> • No empirical evidence on whether regulation under PBR is “better” for investors, the public. • Opportunities for broad participation (a benefit) can be built into a principles-based system but are not necessarily part of it.
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Certainty and principles-based regulation

Worries about certainty and predictability under a principles-based regime are real ones. Principles alone can be problematic if, when implemented, they amount to non-transparent, arbitrary, and/or wide-ranging exercises of discretion by regulators. A lack of certainty also increases costs in other ways. On the one hand, it can provoke fears of regulatory overreaching, which will make industry actors more risk averse, more likely to interpret the principles in narrow ways, and less likely to innovate.⁹⁸ On the other hand, a lack of certainty can provoke fears of laxity, undermining the credibility of Canada's enforcement efforts and negatively affecting its capital markets.

The pressure toward certainty is even more pronounced in the enforcement context, where the possibility of sanctions exists. This makes sense for reasons of procedural fairness and the rule of law. Regulatory expectations under a principles-based system can be flexible, but they cannot be so flexible that market participants cannot make reasonably accurate predictions about what behaviour is permissible. The rule of law does not demand absolute certainty, but it does require a degree of predictability in enforcement – meaning that if regulatory expectations are going to be flexible and evolving, they must nevertheless be communicated, explained, and justified in a regular, transparent, and understandable manner.⁹⁹

As important as certainty is, however, it is also important to distinguish between “real” certainty and “superficial” certainty, which gives the illusion of clarity because it masks an exercise of discretion, or pretends that facts on the ground are more settled than they are. New situations (new industries, new business products, new tasks – eg., subprime mortgage servicing) will produce transitional periods during which system participants work out what is reasonable. When faced with new situations, strict rules that were drafted without that situation in mind may provide only the veneer of certainty. A detailed rule that does not cover a new situation will require the interpreter to exercise discretion to square the ill-fitting rule with the new situation. Because this takes place under the guise of an ostensibly “clear” rule, that exercise of discretion is rarely reviewable, or even necessarily recorded or considered in any systematic way. On the contrary, it conceals the working-out process (something that astute market participants will identify) and further compounds the problem of uncertainty. Moreover, to handle the inevitable gaps between clear rules, the regulatory system relies, sometimes quite heavily, on residual public interest powers whose exercise can be even less predictable or transparent.

Certainty and predictability have costs as well. In particular, absolute certainty in regulation can mean that rules are clear but poorly designed to meet regulatory goals. For market actors, ill-fitting legacy rules can create delays and inhibit innovation. A more flexible but less certain principles-based requirement can more effectively address changing market circumstances and practices.

⁹⁸ Schwarcz, *supra* note 12.

⁹⁹ See Timothy A.O. Endicott, *Vagueness in Law* (New York: Oxford University Press, 2001).

In order to function transparently and predictably, a principles-based system must build in mechanisms to communicate with industry about its expectations. Communication can take place through a number of channels including official guidance, specific enforcement actions, or comments on industry standards. Over time, the goal of such communication is to help develop an “interpretive community” that understands regulatory expectations, and can usefully interpret regulatory pronouncements about “reasonableness” or “effectiveness” in different situations.¹⁰⁰ Communication is also important for credibility, so that market participants in general understand the grounds for decisions made by the regulator, and do not experience them as arbitrary or unreasonable. Where uncertainty persists because facts are still changing, this can be clearly identified. This kind of uncertainty is the product of the factual situation, not principles-based regulation. Transitional phases call for ongoing communication and periodic re-evaluations as events unfold.

Regulators may find it challenging not to fall back to concrete rules, and to remain outcome-oriented rather than process-oriented. They may experience both internal and external pressure to commit to particular positions, for example in their administrative guidance, in the interest of certainty.¹⁰¹ However, this is not in the long term best interest of a strong and flexible regulatory structure. Too much juridified, process-based, rule-oriented guidance from a regulator is the worst of both worlds: it loses the flexibility advantages of principles-based regulation while also bypassing safeguards such as notice-and-comment rulemaking. It also undermines legislative intent. Where a decision has been made to regulate something by way of principles, then that approach should be maintained. Other areas will be regulated by way of rules.

Enforcement and principles-based regulation

In addition to the concerns about certainty above, a few additional comments should be made on enforcement under a principles-based approach, on procedural fairness and principles-based regulation, and on the possibility of a federal enforcement tribunal.

- *On principles-based enforcement:*

At the moment the perception is that Canada has neither the intensity of enforcement effort that we see in the United States,¹⁰² nor the additional factors that make U.K. efforts work in the absence of that intensive enforcement.¹⁰³ Credible regulation, including meaningful enforcement, is even more important within principles-based systems because it ensures the system is not lax. Clearly the “Canadian discount” needs to be addressed, but this does not necessarily call for an American-style ex post enforcement strategy.

¹⁰⁰ Sol Picciotto, “Constructing Compliance: Game Playing, Tax Law, and the Regulatory State” (2007) 29 Law & Pol’y 11.

¹⁰¹ William W. Bratton, “Enron, Sarbanes-Oxley and Accounting: Rules Versus Principles Versus Rents” (2003) Vill. L. Rev. 1023; Schauer, “Tyranny of Choice,” *supra* note 4 at 808-809.

¹⁰² See e.g. Coffee, *supra* note 48; Howell E. Jackson, “Regulatory Intensity in the Regulation of Capital Markets: A Preliminary Comparison of Canadian and U.S. Approaches” (2006) Task Force to Modernize Securities Legislation in Canada, *Final Report: Canada Steps Up*, vol. 6, at 75-130, online: TFMSL <http://www.tfmsl.ca/docs/Volume6_en.pdf>.

¹⁰³ Kathryn Cearn and Eilís Ferran, “Non-Enforcement Led Public Oversight of Financial and Corporate Governance Disclosures and of Auditors” (2008) ECGI – Law Working Paper, No. 101/2008.

While the FSA's more pyramid-shaped, consultative, compliance-oriented approach may not be the only way to operate for a principles-based regulator, serious thought must be given to whether reaching for the "big stick" of an enforcement action as a first resort is necessarily consistent with principles-based regulation.¹⁰⁴

Principles-based enforcement cases will look different in other ways as well. For example, technical rule violation actions – even though they may be the easiest to pursue – cannot be a pillar of enforcement strategy. Also, principles-based cases (at least in the U.K.) tend to settle. A series of settled cases may not send the right message to the market about Canada's regulatory seriousness. Third, as discussed further below, there will be times when the regulator brings an enforcement action on the basis of a breach of principle alone – absent any clear rule violation. This approach has been effective at the FSA, for example with regard to Citigroup Global Markets Limited's "Dr. Evil" trades in 2005.¹⁰⁵

Working with principles-based regulation also requires expertise and confidence on the part of regulators. In effect, the regulator is being required to substitute its judgment about what a particular provision means for the judgment of someone in the industry. This can be anxiety-provoking for staff, when facing a panel and operating under the intense scrutiny of a watchful and clever defense bar. It may also be hard to predict what would happen if an enforcement case concerning a violation of a principle alone (i.e., not accompanied by any clear rule violation) made it to the courts. On the other hand, regulatory staff already exercise substantial discretion under the current system, both "under the radar" in deciding to apply rigid rules in a particular manner, and in applying the existing public interest powers. They can get comfort by looking at prior prosecutions, which suggest that in any event, staff is already proceeding based on principles or consistent with them.¹⁰⁶

- *On Fairness:*

Conduct can be harmful to the markets and violate a regulatory principle, even if it does not violate a specific clear rule. The need to be able to respond to such conduct underlies existing public interest powers in, for example, section 127 of the Ontario Act and section 161 of the British Columbia Act. However, broad powers can create the risk of unpredictable, nontransparent, potentially arbitrary enforcement and abuse of discretion by regulators. (Among other things, this means that we must compare any more principles-based system with the actual system in operation, not a perfect one. In the *Cartaway* example cited in BCSC research, the use of its proposed principles would actually have yielded more certainty and predictability than the public interest power, not less.)¹⁰⁷

¹⁰⁴ Wallison, *supra* note 83, argues that a rules-based approach works better where there is intense enforcement; see also Black, "Making a Success," *supra* note 13.

¹⁰⁵ U.K., Financial Services Authority, Final Notice, "Citigroup Global Markets Limited" (28 June 2005), online: FSA <http://www.fsa.gov.uk/pubs/final/cgml_28jun05.pdf>.

¹⁰⁶ British Columbia Securities Commission, *Enforcement of Outcomes-Based Securities Legislation* (British Columbia: New Legislation Project, 2004), online: BCSC <[http://www.bsc.bc.ca/uploadedFiles/RIA_Enforcement\(1\).pdf](http://www.bsc.bc.ca/uploadedFiles/RIA_Enforcement(1).pdf)> [*Enforcement*].

¹⁰⁷ *Enforcement, ibid.*

One form of regulatory overreaching is the hindsight risk, and principles-based enforcement is vulnerable to it. The hindsight risk is that whenever regulatory goals are not achieved, regulators may be inclined, perhaps unconsciously, to find that a principle has been violated. Risks that no one foresaw at the time may seem foreseeable in hindsight, once the risky thing has happened. It is difficult to cast back in time and to “unknow” things that have become known, but principles cannot be applied retrospectively. One response comes from Professor James Park, who has developed a thoughtful framework for determining whether a principles-based enforcement action is appropriate in any given situation.¹⁰⁸

Other mechanisms would could be developed to address fairness concerns at the systemic level might include:

- A “quasi safe harbour” of prior rules, so long as the regulatee does not seem to be intentionally circumventing principles.¹⁰⁹
 - A paper trail: prior compliance action and ongoing communication before enforcement action is taken should mean that enforcement action when required does not come as a surprise.¹¹⁰
 - The continued use and importance of notice-and-comment mechanisms for actual rulemaking.¹¹¹
 - While it is not a complete answer, it should also be remembered that securities commission decisions can ultimately be appealed to and/or judicially reviewed by the courts.¹¹² Particularly when it comes to procedural fairness, this tempers potential overreaching by regulators, and provides regulated entities with an entrée into the judicial system.
- *On the possibility of a federal-level enforcement tribunal:*

The Expert Panel on Securities Regulation is considering a range of options in regard to a common enforcement agency, or tribunal.

Bifurcating securities regulation into policy makers and enforcement staffers could present significant hurdles to principles-based regulation, if information about

¹⁰⁸ Park, *supra* note 5 at 681-688. Park suggests that regulators should ask themselves four questions: first, is the principle to be applied well-established, or is it novel? If the principle is well-established, it raises fewer concerns about fair notice. Second, is the issue raised by the misconduct addressed by existing rules, or is there an inadvertent gap? If rulemakers envisioned the conduct and decided it should not be prohibited, then regulatees should be able to rely on that. Third, is there particular evidence of wrongdoing, or is there only generalized evidence of wrongdoing? There is a greater case for principles-based enforcement where there is particularized evidence of wrongdoing. Finally, is the public harmed in a significant way by the misconduct? Park goes on to consider these questions in different scenarios, and concludes that the case for a principles-based enforcement action is strongest where conduct violates a principle that is also set forth in a rule, and weakest where the conduct is sanctioned by a rule but still violates a principle.

¹⁰⁹ See discussion at “Power, proportionate regulation and participation: SMEs and smaller regulated actors,” below.

¹¹⁰ See discussion at “Best Practices and Critical Success Factors: Regulatory Culture,” above.

¹¹¹ See discussion at “Best Practices and Critical Success Factors,” above.

¹¹² There is a balance to be struck here with the regulatory need to maintain control over the interpretation of its regulatory principles; see discussion above.

enforcement did not efficiently make its way back to policymakers and regulators. Enforcement actions provide excellent information to regulators about where potential trouble spots might be. They also provide important information to market participants about what other parts of the regulatory structure – the compliance department, for example – is likely to require under a particular principle. This is more than expertise; it is an essential component of a system that is capable of learning from its own experience, as an outcome-oriented and principles-based system is supposed to do.

Certain comments by the U.S. Treasury’s Blueprint paper may be relevant here as well. That paper recommends that over the long term, the American banking, insurance, securities, and futures markets should replace its existing regulatory agencies and move toward an “objectives-based” system, similar to that in Australia and the Netherlands. The Blueprint argues building regulatory structures around three core objectives (market stability regulation, prudential financial regulation, and business conduct regulation) greatly increases regulatory efficiency because it consolidates regulatory responsibilities around natural synergies, and aligns regulatory structures directly with regulatory goals. The Blueprint’s recommendations obviously contemplate more far-reaching restructuring of the American financial markets than Canada is considering now. However, its observations about efficiency and goal-orientation seem to argue against bifurcating enforcement and policy making functions in securities regulation.

An independent tribunal, established to review regulatory and enforcement decisions, may not pose the same problems. The FSA’s experience is relevant here and should be sought out. The FSA seems to be able to combine its regulatory approach with oversight of some of its decisions by an independent tribunal, the Financial Services and Markets Tribunal. As noted above, the FSA approach has been to integrate its enforcement efforts into its overall regulatory structure. It relies more on ex ante supervision, monitoring, and ongoing communication than on ex post deterrence, especially relative to the SEC. It sees enforcement as “an important component, not the sole element, of a credible deterrence philosophy.”¹¹³ It measures its enforcement performance using the same outcome indicators as the rest of its regulatory performance. Moreover, the FSA’s experience has been that publishing its enforcement actions is an effective way of communicating with industry – it is a form of guidance – and that firms have reviewed and improved their own processes as a result of published enforcement cases.¹¹⁴ Canada may be able to gain useful insights into how the relationship between regulator and independent tribunal works, in the context of a principles-based and collaborative regulatory approach, by speaking to those with experience with the U.K. model.

There are advantages to having a separate tribunal in terms of independence – an important value, as we all know and as the *Ainsley* judgment made clear. However, particularly in the context of a principles-based regulatory scheme, one would have to ensure that the “learning loop” remains vital.

¹¹³ Hector Sants, U.K., Financial Services Authority, *Business Plan 2008/09* (London: 2008) at 9.

¹¹⁴ *Enforcement Annual*, *supra* note 47 at 3-4.

Passport system versus national securities regulator

This report does not try to answer the question of whether to proceed with a passport system or some form of single securities regulator. However, this question does affect implementation of a principles-based approach to regulation.

- *Concerns and possibilities in developing some form of principles-based national regulatory structure*

For both the FSA and the European Union, the development of overarching principles was a pragmatic response to the challenges of trying to impose a regime on top of, or superceding, several pre-existing and different regimes. In the U.K., the prior regulators were amalgamated into the FSA. At the E.U., nation-state regulators continued to be the main law-developers, meaning that Union-level principles must still undergo a “translation” process into national law.¹¹⁵ Creating a new, overarching regulator presents very real challenges but, if the E.U. experience is any guide, it may still be the simpler option.

Promulgating a principles-based model act at the national level does not by itself reduce the possibility of differences in *application* from jurisdiction to jurisdiction.¹¹⁶ On the upside, this permits sensitivity to the uniqueness of different provinces. On the downside, the decision may be made that some of this uniqueness is not desirable. A model act that is implemented in substantially different ways across the country, by regulators that do not interact with each other closely, may mean that differences in enforcement priorities and regulatory expectations remain just as significant, but become less visible. In other words, legacy divergences in approach fall “under the radar,” and are expressed in implementation and enforcement practices rather than written law.

If coherence from jurisdiction to jurisdiction is a priority, some kind of communicative/oversight infrastructure is needed. This is especially true for a principles-based regulatory approach, because so much is left up to implementation. Implementing principles-based regulation consistently across Canada would put significant demands on communication structures between regulators, and would seem to require more regular and closer contact between regulators than the existing passport system permits.

- *Challenges and advantages to working with principles-based regulation within a passport system*

When British Columbia started to consider its proposed more principles-based legislation, around 2004, there was concern about whether or not B.C. principles mapped onto more rule-based regimes elsewhere. Indeed, the desire to pursue harmonization was behind that province’s decision to put the legislation on hold.

¹¹⁵ Karel Lannoo & Matthias Levin, “Securities Market Regulation in the E.U.: The Relation Between the Community and Member States” (2003) Wise Persons’ Committee to Review the Structure of Securities Regulation in Canada, *Final Report: It’s Time*, Research Studies at 103-136, online: <http://www.wise-averties.ca/reports/WPC_4.pdf> [Lannoo].

¹¹⁶ See e.g. Mary Condon, “The Use of Public Interest Enforcement Orders by Securities Regulators in Canada” (2003) Wise Persons’ Committee to Review the Structure of Securities Regulation in Canada, *Final Report: It’s Time*, Research Studies at 411-454, online: <http://www.wise-averties.ca/reports/WPC_9.pdf>.

Model acts have been used with substantial success in federal systems, as a way of ensuring some consistency between jurisdictions on matters that are within the jurisdiction of a subnational unit (e.g., provinces/territories, or states). The Uniform Commercial Code in the United States is a prominent example. In Europe, harmonization has taken place more through E.U. directives than model acts, though scholars have advocated for a model Company Law Act.¹¹⁷ A principles-based model act would give provincial and territorial regulators a lodestar by which to orient their own practices, increasing harmonization and facilitating interprovincial mutual recognition.

Seen from another perspective, a principles-based model act could also *reduce* the pressure to harmonize distinct provincial regimes. It could create space for those regional differences that are significant in terms of recognizing each region's uniqueness, but not significant to the degree that they adversely affect the regulation of Canadian capital markets. If each regulator is abiding by common principles, reinforced by meaningful enforcement and outcome-oriented measures of success, then some differences in approach, or methodology, between jurisdictions may become acceptable.¹¹⁸ The overarching principles would give investors comfort about relying on Canadian oversight of capital markets, irrespective of local differences.

Again, the success of the project depends on having good information about what is happening in each jurisdiction. This requires mandating transparency among regulators, and between regulators and market participants, to demonstrate that enforcement is meaningful where required; that the regulator is not "captured" by its constituency; and that a lack of enforcement actions within a jurisdiction signals that problems are being managed proactively, not that a culture of silence or willful blindness has taken root.

Power, proportionate regulation and participation

Questions of proportionality and the treatment of smaller market participants are inextricably linked with larger questions of power and voice, and this is even more true under a principles-based approach than it would normally be. Because principles-based regulation involves a collaborative evolution of regulatory standards, the risk is that only larger or more powerful actors will exercise the opportunities for participation. Open-ended principles can become locations for the exercise of informal, non-transparent, "back room" power. The problem needs to be considered from the perspective of two stakeholder groups in particular: consumers, and small firms.

- *Consumers*

Broad stakeholder participation can be incorporated at the initial stage of regulatory design, when legislative proposals are being developed. The BCSC and the OSC have engaged consumers in consultations and town hall meetings in the past. The difference with a principles-based system, however, is that the content of the principles will *continue* to be filled in through actual practice over time. The laws-as-written will include less detail. Unless the regulatory structure builds in opportunities for ongoing

¹¹⁷ Theodor Baums & Paul Krüger Andersen, "The European Model Company Law Act Project" (2008) ECGI - Law Working Paper No. 97/2008, online: <<http://ssrn.com/abstract=1115737>>.

¹¹⁸ This rationale underlies the "new approach" of minimal harmonization in the E.U. Lannoo, *supra* note 115 at 110-111.

participation by a broader range of interests, more sophisticated parties will have more control over the process of developing content for those principles. More powerful and engaged parties will be in a better position to persuade, or even pressure, regulators to advance their interests at the expense of others’.

A number of options exist to facilitate consumer engagement with regulation. As Professor Julia Black pointed out in her report to the Allen Task Force a few years ago, consumer involvement in the regulatory process can take four main forms: information, education, consultation, and participation. A strategy for engaging consumers should be multi-faceted and should reflect the purposes (including improving democratic accountability, building trust and confidence, expanding the available information base, and improving the quality of regulatory decision making) for which involvement is sought.¹¹⁹ Improving consumer input into the system on an ongoing basis requires dedicated resources for investor education. Many Canadian securities commissions already engage in investor education initiatives, but it may be necessary to re-evaluate their adequacy under a principles-based system. Transparency in decision making is another crucial component. Regulators may also want to actively seek input and develop relationships with organizations and individuals that operate on behalf of consumers and investors, and/or that advocate for stronger corporate governance, ethical practice or corporate social responsibility standards.

- *SMEs and smaller regulated actors*

Small actors can present challenges for regulators, in that they do not generally possess the resources to focus explicitly on compliance.¹²⁰ Neil Gunningham and Darren Sinclair have pointed out that many small- and medium-sized enterprises (“SMEs”) operate at the margins of profitability and cannot afford to devote many resources to non-bottom-line issues.¹²¹ They also often lack awareness and expertise; they may not have integrated compliance priorities into their business decisions; and they are likely to be less frequently inspected because as a group they are numerous, but each individual SME presents a relatively low risk.

Complex, detailed, process-based rules that require market participants to comply with detailed reporting obligations can be onerous and ill-suited to SMEs. For example, accountability mechanisms that may make sense when dealing with a complex corporate hierarchy will not necessarily work for smaller firms or corporations. Imposing onerous compliance obligations on smaller firms can adversely affect their ability to compete. Overly burdensome accountability requirements, combined with limited resources, can also set up a conflict between the corporation’s profit-generating business and its “overhead” compliance processes. It may also be that rules-based regulatory systems are

¹¹⁹ Julia Black, “Involving Consumers in Securities Regulation” (2006) Task Force to Modernize Securities Legislation in Canada, *Final Report: Canada Steps Up*, vol. 6, at 545-668, online: TFMSL <http://www.tfmsl.ca/docs/Volume6_en.pdf>.

¹²⁰ There are surely material ways in which a regulator’s treatment of a small issuer should be different than its treatment of a small registrant, since registrants are subject to more regular scrutiny. For purposes of this report, however, it is adequate to treat small issuers and small registrants together. They are referred to collectively as SMEs.

¹²¹ Neil Gunningham & Darren Sinclair, *Leaders and Laggards: Next Generation Environmental Regulation* (Sheffield, UK: Greenleaf Publishing, 2002) at 13-40.

more likely to catch relatively innocent technical mistakes by less sophisticated actors, because they are more adept at catching technical violations. SMEs may be more likely to comprise these easy targets. Truly sophisticated “bad actors” are less likely to make technical rule violation mistakes, while still violating the spirit of the law.

On the other hand, critics of principles-based regulation argue that a principles-based regime could also impose a heavy compliance burden on SMEs. Depending on how it is structured and implemented, principles-based regulation could require all firms to implement costly and elaborate internal compliance controls to achieve regulatory goals, and to independently develop completely new systems based on detailed assessments of their businesses and their associated risks. In addition, a principles-based regulatory regime may impose additional competitive pressures on smaller firms because larger industry actors with greater capacity to innovate are rewarded in such a system.

Neither principles-based nor proportionate regulation can completely deal with the different resources available to small and large market participants. However, proportionate regulation and principles-based regulation can work together to be more sensitive to the needs of SMEs, and to at least reduce the disproportionate impact of compliance costs on smaller actors. The special situation of SMEs under principles-based regulation calls for a tailored response, which may involve several elements. Key features might include:

- Modified regulatory requirements for SMEs. Principles-based regulation is designed to be flexible. It can mean different things to different market sectors in a way that detailed, process-based rules cannot. Specifically, regulators would not have to issue blanket exemptions to smaller firms from the law-as-written.
- Risk-based regulation. The FSA’s more principles-based regulatory system works in tandem with a risk-based approach. The FSA has made a conscious policy decision to spend fewer regulatory resources on SMEs, because each individual SME poses a relatively small risk to investors and the market. Canadian capital markets are characterized by a large proportion of smaller issuers and registrants and a risk-based calculation would presumably prompt a similar conclusion here. However, the precise allocation of resources may have to be different, given the relative larger proportion of issuers and registrants in Canada that can be considered SMEs.
- Existing rules as a “quasi safe harbour.” The FSA example demonstrates that the shift to a principles-based system, in practice, is more evolutionary than revolutionary. Pre-existing rules continue to provide a baseline, and change happens at the margins. Under a hybrid rules/principles approach, firms are allowed to rely on pre-existing rules, where they do not have (or do not choose to devote) the resources to interpreting the principles afresh. Under the FSA model, if a firm chooses to use the principles rather than the rules, it must convince the FSA that its alternative method of doing something is likely to achieve the same regulatory goal. The FSA then uses its exemptive authority to deactivate

the operative rule, while giving effect to the operative principle and the firm's proposed innovation. This approach conserves each firm's resources, allowing a firm to make incremental modifications to a compliance rule as it learns about what works. A hybrid rules / principles system may also allay industry fears about regulatory discretion and overreaching under a purely principles-based regime. At the same time, market participants that want to rely on the principles must share their proposals with the regulator, which gives the regulator on-the-ground, real-time information about emerging good practices. Regulators can then share information about those good practices with other industry actors, including smaller or less well-resourced ones, who can benefit from the innovations without having to develop entirely new systems on their own. However:

- The existing rules must be relatively satisfactory and consistent with regulatory goals.
 - Industry actors cannot be allowed to rely strategically on existing detailed rules, falling back on principles only if and when the regulator decided to challenge the conduct in question. It must be clear that industry actors are expected to abide by regulatory principles as well. In appropriate cases enforcement sanctions must be available for violation of principles alone, even for SMEs.
 - SMEs that rely on rules are depriving themselves of the opportunities for innovation and streamlining that principles provide. Additional regulatory resources (see below) could help them leverage the system's flexibility.
- Support for smaller market actors. Compared with detailed and process-based requirements, principles-based and outcome-oriented requirements may allow smaller market actors to use their resources more effectively, with some assistance from regulators and others. This may take one or more forms. For example, there may be a role for trade associations and other industry actors in communicating "best practices". Best practices are the most effective and efficient means to achieve regulatory standards – they are not just the most comprehensive or elaborate means of achieving ever-increasing compliance standards. In addition, ongoing communication from regulators, including communication about good practices, could be helpful. The nature and quality of guidance provided is especially important for SMEs. Regulators need to exercise restraint in issuing guidance, to keep it clear and well-integrated, and to ensure that it is easily accessible and comprehensible.

PART 2. IMPLEMENTATION

How other jurisdictions have approached moving toward a more principles-based approach

Perhaps the most surprising element of the move toward a more principles-based approach to securities regulation in the jurisdictions covered here is the relatively small role that statutory drafting plays. The B.C. example is the most striking, since it has implemented a principles-based approach even though the statute that was meant to provide the principles has not come into force. However, the FSA experience is similar. The *Financial Services and Markets Act* came out of the work of the U.K.'s Better Regulation Task Force, and the FSA's Principles for Business were an early innovation, but in its early days the FSA did not see itself as a principles-based regulator (or a proportionate one), so much as a risk-based, outcome-oriented, cost-effective, consultative, and management-based one.¹²² The principles-based turn came later.¹²³ Anecdotally, one hears that there is sometimes some functional "disconnect" between the regulator's earlier risk-based methodology and its more recent principles-based perspective, even though the two are not inconsistent in theory. This highlights the need to be aware of staff capacity, training, and culture needs during a transitional process of this magnitude.¹²⁴

The most challenging part of creating the FSA was not changing its regulatory approach – it was trying to amalgamate its various constituent regulators. Interestingly, in the interest of maintaining continuity and a "good standard of regulation during the transitional period,"¹²⁵ the FSA was created before it was actually given regulatory power. The FSA was launched in 1997, but was not given its own statutory source of power until December 2001.¹²⁶ During the early transitional phase, the FSA sought to maintain broad continuity of individual firms' relationships with regulatory staff where possible. Pre-existing rules were maintained, legacy staff were offered common terms of employment, and regulatory responsibilities were transferred to the new regulator through a series of interim arrangements. The seeds for the FSA's principles-based

¹²² See e.g. U.K., Financial Services Authority, Annual Reports and Business Plans for 2002-2003; U.K., Financial Services Authority, *Financial Services Authority: An Outline* (London: 1997), at 31-33, online: FSA <<http://www.fsa.gov.uk/pubs/policy/launch.pdf>> [*Outline*]; *New Regulator*, *supra* note 41.

¹²³ An early reference to a less prescriptive, more principles-based approach appears in U.K., Financial Services Authority, Consultation Paper, No. 185, *The CIS Sourcebook – A new approach* (London: 2003), online: FSA <<http://www.fsa.gov.uk/pubs/cp/cp185.pdf>>. The frequency of use of the term "more principles-based" has increased by orders of magnitude by late 2006 or early 2007. See e.g. U.K., Financial Services Authority, Press Release, "FSA Business Plan focuses on more principles-based regulation" (6 February 2007), online: FSA <<http://www.fsa.gov.uk/pages/Library/Communication/PR/2007/019.shtml>>.

¹²⁴ See Robin Ford, *supra* note 61.

¹²⁵ Howard Davies, (Remarks at the FSA Launch Conference, 28 October 1997), online: FSA <<http://www.fsa.gov.uk/Pages/Library/Communication/Speeches/1997/SP02.shtml>>.

¹²⁶ The FSA was established via the *FSMA*, *supra* note 30. The Act replaced much of the previous legislation, including the Financial Services Act 1986, the Banking Act 1987 and the Insurance Companies Act 1982 under which banks, insurance companies and other financial services firms had been authorized and supervised.

approach were sewn in these early days, in response to the need to amalgamate regimes across several different, pre-existing regulatory entities.¹²⁷

How legislation is structured to incorporate more principles

Striking the balance between rules and principles in statutory drafting

No workable system consists entirely of rules, or of principles. A principles-based approach to securities regulation looks to principles first when it makes sense to do so, and resists trying to solve new problems simply by promulgating additional detailed rules. Even within a principles-based system, however, rules continue to have their place in providing further clarity and enhancing enforceability.

Establishing a balance between rules and principles involves decisions about priorities and concerns. In some areas, flexibility/tailoring will be more important than certainty/limiting discretion. In others, the reverse will be true. Where these lines are drawn depends on what the legislative drafter wants to achieve. For example, a legislature that was concerned about regulatory overreaching or lack of transparency would ensure that the regulator had very little discretion (i.e., expectations were cast as rules rather than principles and were enshrined in the statute) when it came to such things as access to information, the handling of complaints, or accountability to parliament. A legislature that was concerned about individual rights would limit discretion (i.e., would craft rules not principles) regarding hearings, procedural fairness, and consultation/participation rights. A legislature that was concerned about ensuring that the regulator could keep up with fast-moving events would give that regulator principles, not rules, to work with and would devolve substantial decision-making to the regulator's rule-making power. A legislature that was concerned about ensuring a high correlation between regulatory goals and effective application to particular cases would ensure that the regulator had the power to flesh out the content of principles, rather than trying to draft specific details in advance.

Important external considerations also come into play. For example, how much scope does the legislature want to leave to the interpretation of regulators, as well as potentially of courts or tribunal(s)? Where does existing regulatory practice (whether principles-based or rule-based) seem to be well-established, to be working well, and to have created expectations on which stakeholders rely?¹²⁸ Would a particular drafting approach foster harmonization between existing regulatory regimes, or nudge regulatory practice in a new direction? Are there particularly important issues for the proper functioning of Canadian capital markets (e.g., regulating effectively the many small, closely held public companies, or addressing the Canadian market discount), which call for well-tailored and highly adaptive (i.e., principles-based) solutions? Does the political will exist to move

¹²⁷ *Designing*, *supra* note 32 at 4-6 .

¹²⁸ E.g. Lawrence A. Cunningham, "Principles and Rules in Public and Professional Securities Law Enforcement: A Comparative U.S. – Canada Inquiry," Task Force to Modernize Securities Legislation in Canada, *Final Report: Canada Steps Up* (Toronto: Investment Dealers Association of Canada, 2006), vol. 6, at 253-342, online: TFMSL <http://www.tfmsl.ca/docs/Volume6_en.pdf> (finding that in their enforcement actions, the NASD and the IDA, now FINRA and IIROC, invoke certain principles rather than existing rules).

decisively away from the status quo on specific issues? What messages does Canada want to convey to the international community?

American academic Colin Diver has discussed the importance of precision in statutory drafting in terms of three underlying priorities: transparency (i.e., the words chosen have well-defined and universally-accepted meanings within the relevant community), accessibility (i.e., the law can be applied to concrete situations without excessive difficulty or effort), and congruence (i.e., the substantive content of the message communicated by the words produces the desired behaviour). However, he points out that it is difficult to measure these qualities, and that there are often tradeoffs between them.¹²⁹ Drawing on Diver's analysis, these are some considerations that might go into choosing between rules and principles in the context of securities regulation:

- *Use more rule-like construction:*
 - Where noncompliance is especially harmful and transparency is especially important – e.g., in defining the outer edges of impermissible behaviour, or in safeguarding important rights (participation, procedural fairness)
 - – but be careful not to fall back to rules simply because enforcement would be difficult or costly, in effect pursuing simple technical violation cases because they are simple, not because their pursuit is important to reaching regulatory goals.
 - – be careful not to create a system that can be “gamed” or subject to “loophole behaviour” by sophisticated actors around important areas such as prevention of fraud.
 - Where costs of applying the rule can become high and accessibility is important – e.g., because the law is applied by large numbers of frontline bureaucrats, because the law needs to be interpreted by lay individuals, or where the regulator needs to manage large numbers of relatively small matters (e.g., trading rules or new product development).¹³⁰
 - – but be careful not to use rules to cabin the discretion of individuals simply because of a general distrust in frontline staffers or market actors, at an unjustifiable cost to effectiveness or congruence with regulatory goals.
 - – be careful not to impose high compliance costs on smaller market actors
 - – be careful not to stifle innovation
 - Where the drafter has some comfort that a clear rule can serve as an effective proxy for good corporate conduct – e.g., because regulatory

¹²⁹ Colin Diver, *The Optimal Precision of Administrative Rules*, 93 *Yale L J* 65 (1983).

¹³⁰ Kaplow also argues that the determining factor should be the frequency of regulated action. Where frequency is low, standards are preferable, and where high, the costs of promulgating rules are justifiable. Kaplow, *supra* note 3.

expectations are easily verifiable, easy to describe, and/or events are not fast-moving¹³¹

- Where consistency in form is important (e.g. for comparability across documents)
- As a legislative response to concerns about regulatory expertise, capture, overreaching, or rent-seeking
- *Use more principles-like construction:*
 - Where the over- or under-inclusiveness of rules would be particularly problematic, and where flexibility and congruence are especially important – e.g., in preventing fraud and minimizing “cosmetic” compliance and “loophole” behaviour
 - – but be sure to establish some standards/rationales for the application of the principle, to ensure that the principles are basically predictable, and that those applying it consider relevant factors, do not consider inappropriate ones, and behave fairly.
 - Where the costs of rulemaking in advance can be considerable – e.g., when trying to reach agreement among disparate legislatures, when it is not possible to develop useful rules in advance because events are fast-moving, or when contextual knowledge is especially important
 - – but ensure that this does not amount to just an abdication of responsibility to develop usefully specific guidelines
 - Where a flexible approach is needed to ensure good corporate conduct – e.g., with regard to internal compliance processes, corporate culture, risk assessment by management¹³²
 - – but be careful not to impose high compliance costs on smaller market actors
 - For internal agency standards – because internal resource allocation issues are more effectively handled on a flexible, internal basis and because other oversight mechanisms exist there.
 - As a reflection of legislative faith in regulatory expertise, objectivity, fairness, and capacity.

¹³¹ Clayton P. Gillette, “Rules, Standards, and Precautions in Payment Systems” (1996) 82 Virg. L. Rev. 181, 185-86 (“Precise directives are more appropriate when we have the greatest confidence in our capacity to inform target actors (those at whom legal directives are aimed), to describe antisocial forms of behavior (so that target actors know the scope of permitted and prohibited activity), and to recognize the occurrence of such behavior (for purposes of enforcement). Uncertainty about any of these factors warrants the use of less precise formulations.”)

¹³² Edward Rubin, “The Myth of Accountability and the Anti-Administrative Impulse” (2005) 103 Mich. L. Rev. 2073 at 2131-34 (arguing for open-ended formulations where the regulator “knows the result it is trying to achieve but does not know the means for achieving it, when circumstances are likely to change in ways that the [regulator] cannot predict, or when the [regulator] does not even know the precise result that she desires.”)

Common themes: topics that lend themselves to rules or principles-based treatment

Are there areas of securities law or regulation that particularly lend themselves to principles-based regulation? To rules?¹³³ To prepare this section we reviewed and compared the Ontario *Securities Act* (“*OSA*”);¹³⁴ Bill 38, the proposed British Columbia *Securities Act* and associated proposed Securities Rules (collectively, the “B.C. Model”);¹³⁵ the Québec *Derivatives Act* (“*QDA*”);¹³⁶ and, the *FSMA*.¹³⁷ The *OSA* was chosen to represent the legislative status quo across Canada, although of course there are statutory differences from province to province. The Quebec and British Columbia statutes are generally understood to be more principles-based. The *FSMA* was not explicitly principles-based when it was drafted, but the FSA has used its statutory mandate to develop a world-leading model of principles-based regulation. What follows is a brief sketch of some overarching themes for statutory drafting purposes.¹³⁸

It turns out that certain topics are likely to be treated in a more principles-based or rules-based way, almost regardless of drafting approach. This is not to say that the choice between rules- and principles-based approaches is not a meaningful one. It is. Even for a topic that clearly lends itself to a rules-based or principles-based approach, the statutes vary in just how far to the rules-based or principles-based ends of the spectrum they move. Differences in overall style of drafting and the preference for regulatory mechanism (e.g., rules versus legislation, outcome-oriented versus process-oriented), discussed in the next section, are also an important part of understanding how legislation can be more or less rules- or principles-based.

However, our review suggests that, *looking only at the statutes*, select topics may be treated in a more or less principles- or rules-based way along the following spectrum:

¹³³ Of course, many important rules are subdelegated to the SROs, and they need to be active participants in developing solutions.

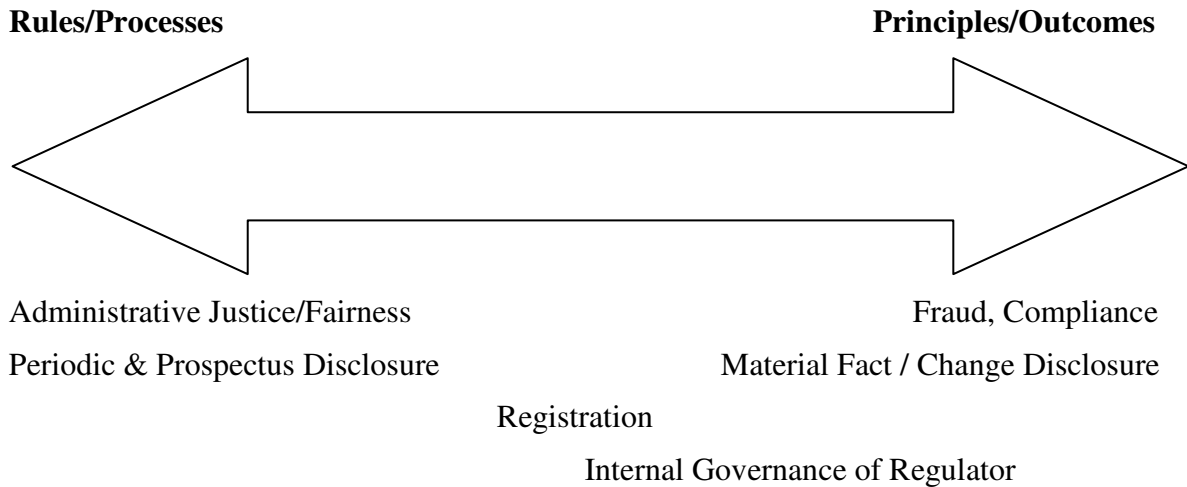
¹³⁴ *Securities Act*, R.S.O. 1990, c. S.5 [*OSA*].

¹³⁵ Bill 38, *supra* note 20; *Securities Rules*, B.C.S.C. (21 June 2004) [proposed], at Part 4, Divisions B, C, F (Rules 93-104, 114-16), online: BCSC <<http://www.bpsc.bc.ca/uploadedFiles/BCN2004-31-Proposed%20Rules.pdf>> [*Securities Rules*].

¹³⁶ *Derivatives Act*, S.Q. 2008, c. 24 [*QDA*].

¹³⁷ *FSMA*, *supra* note 30.

¹³⁸ A comprehensive comparison of these four statutes is neither feasible nor very helpful, given the number of different factors that go into any statute’s drafting. Just as importantly, National and Multilateral Instruments, regulations, and rules play central roles in real-life securities regulation. On this larger plane, this report concurs generally with Professor Stéphane Rousseau’s description of which aspects of securities regulation are rule-based, and which are principles-based, referred to in the Brief submitted by the Autorité des marchés financiers to this Expert Panel. Autorité des marchés financiers, *Single Regulator: A Needless Proposal* (Expert Panel on Securities Regulation, 2008), at 26, online: AMF <http://www.lautorite.qc.ca/userfiles/File/Publications/secteur-financier/Memoire-commission-unique-07-08_ang.pdf>.



Disclosure Requirements: The distinction between periodic and prospectus disclosure requirements, which tend to be more rules-based, and material fact / change disclosure requirements, which tend to be more principles-based, provides an interesting illustration. Drafting periodic and prospectus disclosure requirements in rules-based terms ensures that these documents are presented in a regular and consistent form for the benefit of investors. In this area, certainty and comparability in form are more important than regulatory flexibility. On the other hand, material fact / change disclosure tends to be treated in a more principles-based way, overall, because it requires issuers to exercise their judgment about what events are material to their businesses – something the regulator will not know much about, and something that cannot be put on a predetermined disclosure timetable. (Obviously there are various caveats to the bright lines being drawn here.) Using a principles-based approach to material fact / change disclosure makes sense. However, it may be that timely and prospectus disclosure could also be managed in a more principles-based way (i.e., “in a prospectus, issuers must disclose all information relating to the business, operations or securities of a mutual fund that a reasonable investor would consider important in making a decision to buy the security”) – especially considering that existing prospectus disclosure does not work that well to help average retail investors make decisions about their investments. As technology improves, for example through the mandated use of XBRL,¹³⁹ consistency in form may be seen as less important than ensuring the most effective possible disclosure.

Administrative Justice and Procedural Fairness: Every securities scheme has provisions that govern administrative proceedings, such as hearings and investigations, and they are all substantially process-based and rule-oriented.¹⁴⁰ This makes sense,

¹³⁹ Extensible Business Reporting Language (“XBRL”) attaches computer readable “tags” to issuers’ financial information, which makes it easier for consumers of that information to find, compare, and analyze it. Online: XBRL <<http://www.xbrl.org/>>.

¹⁴⁰ The best examples here are *OSA*, *supra* note **Error! Bookmark not defined.**, ss. 3.5, 8-9; and Bill 38, *supra* note 20, ss. 65, 70(2), (3), 75. The *FSMA* and *QDA* do not contain direct analogues. Because the *FSMA* establishes an independent oversight body, the Financial Services and Markets Tribunal, it treats administrative proceedings somewhat differently. However, the process-based and rule-driven structure

because transparency is important when it comes to individuals' ability to understand and exercise their rights; fundamental participatory and fairness rights are at stake; a regulator should not have a lot of discretion around creating fair procedures limiting its own power; and because fair hearing and investigation rules are a fairly good way to ensure fair regulatory conduct.

Fraud, Misrepresentation, Market Manipulation and Compliance: The statutes are also fairly consistent in how they treat fraud. Unlike the administrative justice provisions, however, statutory drafting around fraud tends to be open-ended and principles-based. This makes sense, if one considers the myriad forms that fraudulent activity can take, and the need for statutory provisions that are flexible and that can be tailored to capture the behaviour. It would be impractical to try to define the complete range of fraudulent activity via detailed, *ex ante* rules. Drafting differences between the more “rule-based” *OSA* and the other statutes do not seem to be material. No statute tries to define fraudulent or market-manipulating conduct in specific terms.¹⁴¹

Compliance provisions – which require registrants to maintain effective systems and controls to manage the risks associated with their businesses, and prevent and detect internal wrongdoing – also tend to be principles-based (though the function is generally sub-delegated to self-regulatory organizations.)¹⁴² The statutory public interest powers under *OSA* section 127 and equivalents are also commonly invoked to deal with fraud. The BCSC has prepared regulatory impact studies that are relevant to each of these topics. With respect to compliance, that Commission conducted a regulatory impact study that compared the detailed, process-based account supervision requirements established by the IDA with the more outcome-oriented ones imagined under the B.C. Model's Code of Conduct for Dealers and Advisors.¹⁴³ With respect to the public interest power and enforcement of principles-based securities regulation, the B.C. report looked at the *Cartaway* case, in terms of how it would have been pursued under the existing public interest powers or under the principles-based Code of Conduct for Dealers and Advisors.¹⁴⁴

persists. See e.g. *FSMA*, *supra* note 30, Schedule 13. The *QDA* is a more circumscribed statute that borrows many provisions from the Québec *Securities Act*, though it contains some process-based provisions at ss. 115-117.

¹⁴¹ *OSA*, *ibid.*, ss. 126.1, 126.2; Bill 38, *ibid.*, ss. 27, 28; *QDA*, *supra* note **Error! Bookmark not defined.**, s. 151; *FSMA*, *ibid.*, s. 397. All statutes also contain offence provisions and prohibitions on misrepresentation that are similar in flavour.

¹⁴² But see *QDA*, *ibid.*, ss. 26-31, 61-62.

¹⁴³ *Strong*, *supra* note 72. The BCSC's report analyzes the impact of the B.C. Model on four firms that are members of the IDA (now IIROC). According to the BCSC analysis, the firms felt that the IDA-mandated reviews contributed significantly to their regulatory burden without providing meaningful investor protection. The BCSC argued that relative to the existing system, the B.C. Model, based on its Code of Conduct for Dealers and Advisors, would improve investor protection, allow firms to achieve regulatory objectives in the ways that are most efficient for their businesses, and reduce compliance costs.

¹⁴⁴ *Enforcement*, *supra* note 106. The report concluded that in the circumstances of that case, the Code of Conduct – though still principles-based – would have actually provided more clarity and certainty than the existing public interest powers did. The report also analyzed Commission decisions for the two years prior to its publication and compared the provisions used against provisions in Bill 38. It found that most of the requirements in Bill 38 would be readily enforceable because they would require measurable outcomes, use

Administration, resource allocation, and internal governance: Each of the *OSA*, the proposed B.C. legislation, and the *FSMA* contain provisions regarding internal regulatory governance and resource allocation. In general, these provisions are cast in terms of high-level principles. They give the relevant regulator the authority to administer their Act, to appoint staff and delegate panels, and to collect and expend resources for their own administration.¹⁴⁵ This makes sense, given that the independent regulator itself is in a much better position to make internal resource allocation decisions and address its own governance. However, and also predictably, more detailed and mandatory provisions apply when it comes to financial accountability and the relationship between regulatory revenue and consolidated revenue. The statutes are not identical, but both the Ontario and B.C. Commissions must make certain payments into consolidated revenue,¹⁴⁶ are at least somewhat restricted in their borrowing power,¹⁴⁷ and must produce financial reports and accounting.¹⁴⁸

Registration of Persons and Securities: Colin Diver suggests that registration of persons should fall on the more principles-based end of the spectrum, because registration and licensure does not deter or influence conduct, and it try to make predictions about future conduct about which little can be known at the time of licensing.¹⁴⁹ Indeed, each of the statutes considered here takes a fundamentally principles-based approach to regulation, leaving the details to rule-making (or to regulation under the *QDA*).¹⁵⁰ The statutes are less consistent when it comes to registration of securities. Prospectuses and offering memorandums are treated differently under, for example, the *OSA* and the proposed B.C. legislation. One may interpret the difference as a choice between rules and principles, but it is more accurate to describe it as a choice between mediums: the *OSA* covers details that in British Columbia, under the B.C. Model, would be covered through rule-making. The choice of medium, between statute and rule-making, is discussed further below.

Meaningful differences: where rules- and principles-based approaches differ

The discussion about specific topics, above, should not obscure the fact that at a systemic level, principles-based regulation looks different, and operates differently, from more rules-based regulation. Some key differences are described below. What is clear, though, is that a move toward more principles-based regulation does not represent a change in the underlying priorities of securities regulation. The Terms of Reference for the Expert Panel on Securities Regulation describe these as ensuring efficient and

objective tests that were already familiar to adjudicators, or deal with areas in which a rich understanding existed of what constitutes acceptable and unacceptable conduct.

¹⁴⁵ See e.g. *OSA*, *supra* note **Error! Bookmark not defined.**, ss. 3.2(2), 3.2(3), 3.4(1), 3.6; Bill 38, *supra* note 20, ss. 135(2), 138-140, 144(3). The *QDA* does not contain similar provisions, because they are covered through the Quebec *Securities Act*.

¹⁴⁶ *OSA*, *ibid.*, s. 3.4(2); Bill 38, *ibid.*, s. 144(2)

¹⁴⁷ The *OSA*, *ibid.*, leaves primary borrowing power with the Minister and/or Lieutenant Governor in Council under s. 3.3(1)-(4), whereas B.C.'s proposed Bill 38, *ibid.*, s. 148 grants primary borrowing power to the BCSC subject to the approval of the Lieutenant Governor in Council.

¹⁴⁸ *OSA*, *ibid.*, ss. 3.9, 3.10; Bill 38, *ibid.*, s. 149.

¹⁴⁹ Diver, *supra* note 129 at 79.

¹⁵⁰ The *FSMA* is structured too differently to permit direct comparison, but see *OSA*, *supra* note **Error! Bookmark not defined.**, ss. 25, 26; Bill 38, *supra* note 20, ss. 14-16; *QDA*, *supra* note **Error! Bookmark not defined.**, ss. 54, 58.

competitive capital markets that contribute to economic growth and prosperity; ensuring market integrity and the protection of investors; and reducing systemic risk.

Rule-making powers versus statutory requirements: All four statutes grant rule-making power to the regulator they are concerned with.¹⁵¹ Compared to enabling statutes in other areas of administrative law, their rule-making powers are considerable. As between the more rules-based and principles-based systems, however, the difference lies in how much detail is provided in the statute, and how much is left to be filled in through the Authority’s or Commission’s rule-making. Taking a two-tiered approach can also help provide both flexibility (in the legislation) and more certainty (through rules and application), but actual practice really matters. How the regulator chooses to manage its rule-making authority (i.e., through guidance, emphasizing communication with industry, exercising restraint in promulgating detailed rules, trying to stay flexible and outcome-oriented) is the real difference between a principles-based and a rules-based regime at the level of practice.

A striking visual illustration of the difference between the existing approach and the B.C. version of a more principles-based one is in the Table of Concordance that that province’s Securities Commission staff prepared in September 2004.¹⁵² Large chunks of the 1996 Act simply have no equivalent in the proposed B.C. legislation, partly because of a decision to make detailed decision making by way of rules, rather than legislation. (The other important factor is the different regulatory approach under the B.C. Model, which would have made substantive changes to regulation, for example under its Continuous Market Access approach.)¹⁵³

For example, each of the proposed B.C. legislation, the *OSA*, and the existing *BCSA* recognize the need for initial disclosure from issuers in the form of a prospectus. The statutes’ overarching provisions are quite similar:

Bill 38 (the proposed B.C. legislation)	<p>18 (1) A person must not make an offering of a security unless a prospectus for the security has been filed and the Commission has issued a receipt for the prospectus.</p> <p>(2) A prospectus filed under subsection (1) must be in the required form.</p>
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¹⁵¹ See *OSA*, *supra* note **Error! Bookmark not defined.**, s. 143; Bill 38, *supra* note 20, s. 170; *QDA*, *supra* note **Error! Bookmark not defined.**, ss. 174-75; *FSMA*, *supra* note 30, s. 138.

¹⁵² Table of Concordance, *Securities Act*, R.S.B.C. 1996, c. 418 to *Securities Act*, S.B.C. 2004, c. 43, online: BCSC <http://www.bcsc.bc.ca/uploadedFiles/TableofConcordance_Part1.pdf>.

¹⁵³ Bill 38 would have replaced existing prospectus disclosure rules, short form prospectus provisions, the entire exempt market transaction structure, and existing continuous disclosure obligations – as they then were – with an overarching “Continuing Market Access” structure. Continuous Market Access would have required all companies accessing the British Columbia capital markets simply to disclose all “material information” (here, replacing “material fact” and “material change”) on a real-time basis. Canadian securities regulators have since taken a collective step in this direction through National Instrument 44-101 concerning short form prospectuses. *Short Form Prospectus Distributions Amendment Instrument*, O.S.C. NI 44-101, (2005) 28 O.S.C.B. 84. Other B.C. Model innovations included firm-only registration (which was abandoned before the project as a whole was abandoned), secondary market liability (which was later resurrected), and enhanced enforcement powers.

<p><i>B.C. Securities Act, R.S.B.C. 1996 (in force)</i></p>	<p>61 (1) Unless exempted under this Act, a person must not distribute a security unless</p> <p>(a) a preliminary prospectus and a prospectus respecting the security have been filed with the executive director, and</p> <p>(b) the executive director has issued receipts for the preliminary prospectus and prospectus.</p> <p>(2) A preliminary prospectus and a prospectus must be in the required form.</p>
<p><i>Ontario Securities Act</i></p>	<p>53 (1) No person or company shall trade in a security on his, her or its own account or on behalf of any other person or company if the trade would be a distribution of the security, unless a preliminary prospectus and a prospectus have been filed and receipts have been issued for them by the Director.</p>

Where the proposed B.C. legislation diverges from the other two is in the additional detail provided. The *OSA* and the existing *BCSA* go on to make specific provisions concerning, among other things, amendments to preliminary and final prospectuses; certificates of issuers and underwriters; receipts, waiting periods, and distribution. The proposed B.C. legislation has no equivalent provisions. Any detail it does require (modified to reflect a somewhat different approach to initial disclosure documents) is contained in their Securities Rules rather than in the proposed statute.¹⁵⁴ Provisions in the proposed B.C. legislation on takeover and issuer bids, proxies, continuous disclosure, and primary market civil liability, among other areas, demonstrate a similar approach.¹⁵⁵

Outcome-oriented versus process-oriented structure: Legislation can also be structured to be more outcome-oriented, and less process-oriented. For example, both the *OSA* and the B.C. Model (through its Code of Conduct, not the statute) contain provisions that try to ensure that customers receive timely disclosure of trades conducted on their account. However, the *OSA* establishes a strict procedure whereas the B.C. Model only specifies an outcome:

<p><i>Ontario Securities Act</i></p>	<p>36 (1) Every registered dealer who has acted as principal or agent in connection with any trade in a security shall promptly send by prepaid mail or deliver to the customer a written confirmation of the transaction, setting forth,</p> <p>(a) the quantity and description of the security;</p> <p>(b) the consideration;</p> <p>(c) whether or not the registered dealer is acting as principal or agent;</p> <p>(d) if acting as agent in a trade, the name of the person or</p>
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¹⁵⁴ See especially *Securities Rules*, *supra* note **Error! Bookmark not defined.**, at Part 4 Divisions B, C, F (Rules 93-104, 114-16).

¹⁵⁵ One of the wrinkles concerns where each principles-based regime locates its “core principles,” as set out in Appendix 1. B.C. and the FSA issued their Code/Principles through rule-making, while the *CFMA* and the *QDA* embed them directly into legislation. It seems that nothing substantive turns on the choice.

	<p>company from or to or through whom the security was bought or sold;</p> <p>(e) the date and the name of the stock exchange, if any, upon which the transaction took place;</p> <p>(f) the commission, if any, charged in respect of the trade; and</p> <p>(g) the name of the salesperson, if any, in the transaction.</p>
B.C. Code of Conduct for Dealers and Advisers (proposed)	<p>8 Ensure that each client is provided on a timely basis with the records that a reasonable client would consider important respecting all transactions that you conduct on the client's behalf and on the status of the client's account.</p>

We see similar differences in their approaches to dealer conflicts of interest:

Ontario <i>Securities Act</i>	<p>39 (1) Where a registered dealer, with the intention of effecting a trade in a security with any person or company other than another registered dealer, issues, publishes or sends a circular, pamphlet, letter, telegram or advertisement, and proposes to act in the trade as a principal, the registered dealer shall so state in the circular, pamphlet, letter, telegram or advertisement or otherwise in writing before entering into a contract for the sale or purchase of any such security and before accepting payment or receiving any security or other consideration under or in anticipation of any such contract.</p>
B.C. Code of Conduct for Dealers and Advisers (proposed)	<p>17 Disclose promptly to the client any information that a reasonable client would consider important in determining your ability to provide objective service or advice.</p>

Codes of Conduct and Principles for Business: One of the key pieces of a principles-based approach seems to be the development of high level principles guiding the conduct of regulated entities. The Appendix to this report sets out and compares the regulatory principles that the principles-based regulators discussed here variously refer to as the Principles for Business (FSA), the Code of Conduct for Dealers and Advisors (B.C.), or the Core Principles for Derivative Markets (*CFMA* and *QDA*). Along with reflecting an outcome-oriented approach to regulation, these Codes and Principles represent a foundational set of touchstones to guide the relationship and frame communications between regulator and regulatee.

Stylistic and Structural Differences: Principles-based regulation is also often accompanied by a move toward plain language drafting. Sometimes it also imagines streamlined processes, as the proposed B.C. legislation originally did, with its proposals for firm-only registration and continuous market access.

Recommendations

This report concludes with the following recommendations to the Expert Panel on Securities Regulation. Canada should:

- Move toward a more principles-based approach to securities regulation, as defined here (i.e., giving thought to implementation as well as drafting).
- For statutory drafting purposes, develop a set of criteria, reflecting legislative priorities and appropriate choices in regulatory design, for deciding when to use rules and when to use principles.
- Foster mechanisms that help market participants understand regulatory expectations, and that build an “interpretive community” – i.e., well-designed administrative guidance, ongoing communication with industry, education for stakeholders, and collaboration with third parties such as investor advocates or industry associations.
- Work toward developing a regulatory culture that matches the needs of the new environment in terms of expertise and approach.
- Design an effective and appropriate enforcement structure, closer to the U.K. approach than the more enforcement-heavy American one.
- Pay particular attention to small firms. Implement a proportionate and risk-based regulatory scheme, provide education and support, including through third parties, and develop appropriate consultation and participation mechanisms.
- Build in ways to facilitate consumer engagement on an ongoing basis. Options include developing something like the U.K.’s consumer panels, dedicating resources for investor education, emphasizing the need for transparency and accessibility in regulation, and fostering appropriate relationships with consumer advocacy groups.

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Appendix

Regulatory Principles Comparison

	Financial Services Authority	British Columbia Securities Commission	Commodity Futures Modernization Act	Autorité des Marchés Financiers	Autorité des Marchés Financiers
	Principles for Business	Code of Conduct [proposed]	Core Principles for Derivative Clearing Organizations	Québec Derivatives Act – Core Principles for Derivatives Markets [proposed]	Québec Derivatives Act [enacted]
Integrity	<ul style="list-style-type: none"> A firm must conduct its business with integrity. 	<ul style="list-style-type: none"> Act fairly, honestly, and in good faith and in the best interests of your client. 		<ul style="list-style-type: none"> Dealers and advisers are required to act in good faith and with honesty and loyalty in their dealings with clients. 	<ul style="list-style-type: none"> Dealers, advisers and representatives must at all times meet the accepted standards of integrity and fairness in the derivatives industry [s.64].
Skill, Care and Diligence	<ul style="list-style-type: none"> A firm must conduct its business and organize its affairs with due skill, care and diligence. 	<ul style="list-style-type: none"> Exercise the degree of care, diligence, and skill that a reasonably prudent person would exercise in the circumstances. Take reasonable steps to ensure that every representative working for your firm is suitable for work in the securities industry and is appropriately supervised. Ensure that your compliance function possesses the technical competence, adequate resources, 	<ul style="list-style-type: none"> A firm shall have reasonable discretion in establishing the manner in which it complies with the core principles. A firm shall have adequate financial, operational, and managerial resources to discharge its responsibilities. Enter into and abide by the terms of all appropriate and applicable domestic and international information-sharing agreements. 	<ul style="list-style-type: none"> A regulated entity must take reasonable care to organize and control its affairs responsibly and effectively, with adequate risk management systems. An applicant for registration or approval must demonstrate competence, integrity and solvency and must satisfy the regulatory requirements. 	<ul style="list-style-type: none"> A recognized regulated entity must use information processing systems of sufficient capacity to enable it to carry out operations safely and reliably [s.27]. A recognized regulated entity must organize and control its activities diligently and effectively [s.29]. Dealers and advisers must organize and control their affairs diligently and effectively [s.61]. Representatives must furthermore meet the standards of diligence and competence that govern

		<p>independence, and experience necessary for the performance of its functions.</p>			<p>their conduct and, to that end, maintain an appropriate level of knowledge relating to derivatives [s.64].</p>
<p>Management and Control</p>	<ul style="list-style-type: none"> • A firm must organize and control its affairs effectively. 	<ul style="list-style-type: none"> • Separate underwriting functions from the firm’s trading and advising functions. • Maintain an effective system to ensure compliance. Maintain an effective system to manage the risks associated with your business. 	<ul style="list-style-type: none"> • A firm shall have the ability to manage the risks associated with discharging its responsibilities, through the use of appropriate tools and procedures. • Have rules and procedures designed to allow for efficient, fair , and safe management of events when members or participants becomes insolvent or otherwise default on their obligations. • Maintain adequate arrangements and resources for the effective monitoring and enforcement of compliance with rules and for resolution of disputes. • Establish and maintain a program of oversight and risk analysis to ensure automated systems function properly and have adequate capacity and security. • Establish appropriate standards for 	<ul style="list-style-type: none"> • Governance practices should be clear and transparent to fulfill public interest requirements and to support the objectives of owners and participants. • A regulated entity must establish procedures to detect any problem that might arise from a member’s default. • A regulated entity must adopt appropriate procedures for the drafting, adopting and amendment of its rules and for ensuring compliance therewith. • A regulated entity must adopt rules granting itself the power to suspend trading and modify trading conditions when necessary in order to ensure an orderly market. 	<ul style="list-style-type: none"> • The governance practices of a recognized regulated entity must be clear and transparent. They must serve the interests of its members or of market participants while also serving the public interest [s.26]. • A recognized regulated entity must make operating rules to govern its activities and the activities of its members or of market participants. It must also, in its internal by-laws, include appropriate procedures for making and amending those rules [s.19]. • The operating rules of a recognized regulated entity must include a complaint examination procedure that allows for timely, fair and equitable resolution of disputes involving the entity [s.21].

			determining eligibility of agreements, contracts, or transactions submitted to the firm.		
Prudence	<ul style="list-style-type: none"> • A firm must conduct its business and organize its affairs with prudence. • A firm must maintain adequate financial resources. 			<ul style="list-style-type: none"> • A regulated entity must at all times maintain adequate financial resources for its operations. 	<ul style="list-style-type: none"> • A recognized regulated entity must at all times have adequate financial and human resources to carry on its activities effectively and exercise any powers delegated to it by the Authority [s.30]. • Dealers and advisers must have adequate financial resources to honour their business commitments at all times and deal with the risks to which their business is exposed [s.62].
Market Conduct	<ul style="list-style-type: none"> • A firm must observe proper standards of market conduct. 	<ul style="list-style-type: none"> • Comply with all relevant laws and regulations that govern you. • Do not engage in conduct that would bring the reputations of the securities markets into disrepute. Take all reasonable steps to determine whether a client's actions threaten the integrity of the securities market. 	<ul style="list-style-type: none"> • Avoid adopting any rule or taking any action that results in any unreasonable restraint of trade. 	<ul style="list-style-type: none"> • A regulated entity must establish and ensure compliance with rules and procedures to ensure the financial integrity of market trading. 	<ul style="list-style-type: none"> • Dealers, advisers and representatives must refuse to act on behalf of a client if they have reasonable grounds to believe that the trade in question is unlawful or is likely to bring the derivatives market into disrepute [s.66].
Customers: General	<ul style="list-style-type: none"> • A firm must pay due regard to the interests of its 	<ul style="list-style-type: none"> • Take reasonable steps to learn and keep current your knowledge of the 	<ul style="list-style-type: none"> • Maintain an adequate record of the flow of funds associated with each transaction the firm 	<ul style="list-style-type: none"> • A regulated entity must establish adequate and transparent membership criteria in order to 	<ul style="list-style-type: none"> • Dealers and advisers must make reasonable efforts to achieve best execution of the orders received from a

	<p>customers and treat them fairly.</p>	<p>essential facts about the identity, reputation, and financial circumstances of each client.</p> <ul style="list-style-type: none"> • Disclose promptly to the client any information that a reasonable client would consider important in determining your ability to provide objective service or advice. • Create and use adequate procedures for handling client complaints effectively. Disclose complaint procedures to clients. 	<p>clears.</p> <ul style="list-style-type: none"> • Establish appropriate admission and continuing eligibility standards for members of and participants in the organization. 	<p>ensure fair and equitable access.</p> <ul style="list-style-type: none"> • A regulated entity must adopt and enforce rules prohibiting market abuse and manipulation, fraud and deceptive trading in order to ensure a fair and equitable market. Procedures for monitoring, investigating and instituting legal proceedings should be established to ensure adequate and appropriate pre- and post-trade transparency. • A regulated entity must adopt a process for handling complaints. 	<p>client [s.68].</p> <ul style="list-style-type: none"> • Dealers and advisers must provide equitable resolution of complaints filed with them [s.74].
<p>Communications With Clients</p>	<ul style="list-style-type: none"> • A firm must pay due regard to the information needs of its clients and communicate information to them in a way which is clear, fair and not misleading. 	<ul style="list-style-type: none"> • Keep each client informed of all information that a reasonable person would consider important to the business relationship. • Ensure that each client is provided on a timely basis with the records that a reasonable client would consider important respecting all transactions that you conduct on the client's behalf and on 	<ul style="list-style-type: none"> • Make information concerning the rules and operating procedures governing the clearing and settlement systems available to market participants. 		

		<p>the status of the client's account.</p> <ul style="list-style-type: none"> • Ensure that all disclosure you prepare and provide to clients uses plain language. • Provide clients with the information necessary to make informed investment decisions. 			
Conflicts of Interest	<ul style="list-style-type: none"> • A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client. 	<ul style="list-style-type: none"> • Resolve all significant conflicts of interest in favour of the client using fair, objective, and transparent criteria. • Develop procedures for resolving conflicts of interest and disclose them to the client. 			<ul style="list-style-type: none"> • Dealers, advisers and representatives must avoid placing themselves in situations of conflict of interest such that their ability to serve their client impartially is affected [s.71].
Customers: Relationships of Trust	<ul style="list-style-type: none"> • A firm must keep faith with any customer who is entitled to rely upon its judgment. • A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled 	<ul style="list-style-type: none"> • Hold in confidence all information acquired in the course of your relationship with the client, unless the client consents to the disclosure. • Maintain the proficiency and exercise the skill and diligence necessary to properly advise and serve clients. • Take reasonable steps to learn and keep current your knowledge of the 			<ul style="list-style-type: none"> • In dealing with clients and executing the mandates clients entrust to them, dealers, advisers and representatives must act with honesty and loyalty, and exercise all the care that may be expected of a knowledgeable professional in the same circumstances [s.65].

	to rely upon its judgment.	general investment needs and objectives of each client and the client's risk tolerance.			
Client's Assets	<ul style="list-style-type: none"> • A firm must arrange adequate protection for client's assets when it is responsible for them. 	<ul style="list-style-type: none"> • Safeguard any client monies you hold and ensure they are used for their intended purpose. 	<ul style="list-style-type: none"> • Have standards and procedures designed to protect and ensure the safety of member and participant funds. • Establish and maintain emergency procedures and a plan for disaster recovery. 	<ul style="list-style-type: none"> • A regulated entity must adopt and make use of appropriate systems for effective operational performance, including with respect to security, reliability, capacity and emergency planning. 	<ul style="list-style-type: none"> • A recognized regulated entity must implement appropriate risk management procedures for the transactions carried out via its facilities or systems by the entity, by its members or by market participants, so as to ensure the security, performance and continuous accessibility of those facilities or systems [s.28].
Relations with Regulators	<ul style="list-style-type: none"> • A firm must deal with its regulators in an open and cooperative way. • A firm must disclose to the FSA promptly anything relating to the firm of which the FSA would reasonably expect notice. 	<ul style="list-style-type: none"> • Notify the Commission immediately of any significant change in the information relating to your organization or business. 	<ul style="list-style-type: none"> • Provide to the Commission all information necessary for the Commission to conduct the oversight function of the firm. • Maintain records of all activities related to the business in a form and manner acceptable to the Commission. 	<ul style="list-style-type: none"> • A regulated entity must deal with the AMF in an open and cooperative way, and must disclose to the AMF appropriately any information of which the AMF would reasonably expect notice. 	<ul style="list-style-type: none"> • A recognized regulated entity must provide the Authority with periodic, timely and other disclosure of information, to the extent and in accordance with the conditions set out in its recognition decision [s.36]. • A recognized regulated entity must communicate to the Authority any information relating to its activities that may be useful to the Authority in exercising its functions and powers and that the Authority might reasonably expect to receive [s.37].