A Proposal for Principle-Based Securities Regulation for Canada

by

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Abstract

This paper argues in favour of principle-based securities regulation for Canada. The author examines the current state of Canadian securities regulation and why change is needed. The author then examines the characteristics of principle-based regulation and contrasts it against rule-based regulation while exposing the advantages and disadvantages of both regulatory models. In proposing a principle-based model for Canadian securities regulation, the author looks to the use of this type of regulation in the capital markets of certain Canadian provinces, the United States and the United Kingdom and then examines certain attributes of Canadian capital markets that have to be considered in the application of principle-based securities regulation to Canada. In supporting principle-based regulation as the modern form of securities regulation, the author discusses lessons learned from the global financial crisis and how those lessons can be applied in the promotion of principle-based securities regulation for Canada.
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1 Introduction

It is my intention in this paper to argue in favour of a principle-based regulatory regime for Canadian securities regulation. In light of the federal government’s proposed creation of a national securities regulator for Canada, the time is now for Canada to rethink its approach to securities regulation.\(^1\) Securities regulation should move away from the layered and heavily rule-based regime that exists in Canada today, to one that is more flexible and not an over-burdensome volume of rules.\(^2\) The strongest example of the use of principle-based securities regulation in Canada is that of the British Columbia Securities Commission (“BCSC”). In 2004, the BCSC introduced Bill-38 to the British Columbia legislature promulgating the creation of a new principle-based Securities Act and regime for the province of British Columbia.\(^3\) The proposed Securities Act did not come into force due to the changes that were taking place in Canadian securities regulation which have ultimately led up to and have formed part of the federal government’s current move towards a national securities regulator for Canada. Despite this, the BCSC continued at the time, and does so

\(^1\) On May 26, 2010 the Canadian federal government released its proposed Canadian Securities Act available online at: http://www.fin.gc.ca/drleg-apl/csa-lvm.pdf (website last visited on June 30, 2010). The proposed Canadian Securities Act is built on provincial securities regulation and harmonizes existing legislation in the form of a single statute. It benefits from the work of the Expert Panel on Securities Regulation and other reform efforts, and reflects domestic and international best practices. It proposes significant improvements in terms of governance, adjudication, financial stability, and regulatory and criminal enforcement, and provides a wide scope of authority to regulate financial instruments and participants in capital markets.


\(^3\) Bill-38, Securities Act, 5th Sess., 37th Parl., British Columbia, 2004 (assented to 13 May 2004). (Bill-38)
today, to operate and move forward under a more principle-based securities regulatory regime. With the recent creation of the Canadian Securities Transition Office by the federal government, led by the ex-Chair of the BCSC, it is likely that principle-based philosophy will become part of a national securities regulatory model for Canada.\(^4\)

The impending creation of this national securities regulator for Canada is the driving force behind this paper. In this paper I explore the principle/rule-based dichotomy and put forth an argument in favour of a principle-based securities regulatory regime for Canada. This paper will explore the current securities regulatory regime that operates in Canada. Currently, securities regulation in Canada comes under the jurisdiction of the provinces and territories and their respective securities’ commissions. The regulation by commissions is further compounded by regulation by national organizations like the Canadian Securities Administrators (“CSA”) and self-regulatory organizations like the Investment Industry Organization of Canada (“IIROC”) and the Mutual Fund Dealers Association (“MFDA”).\(^5\) It is my intention in this paper to show how multi-layered the current securities regulatory regime is in Canada and why change is needed not only on an operational level but also on more of a theoretical and practical level. This change should involve a move towards more principles and less rules.

\(^4\) See the Canadian Securities Transition Office website online at: http://www.csto.ca/en/default.aspx (website last visited on June 30, 2010).

\(^5\) See the Canadian Securities Administrators website online at: http://www.securities-administrators.ca/ (website last visited on June 30, 2010).
By way of background and in support of my argument for principle-based securities regulation, this paper will explore the nature of and what is meant by a “more principle” or “more rule” based regulatory approach. I argue that regulatory systems are neither wholly rule-based nor principle-based but rather composed of one more than the other and lie on a principle/rule-based continuum. The BCSC and the United Kingdom’s Financial Services Authority6 (“FSA”) will be used as the main regulatory examples of a working principle-based securities regime. This paper will highlight important criteria of a principle-based regime as well as its advantages and drawbacks. I will use certain examples in this paper to support my argument in favour of a principle-based regime for Canadian securities regulation as well as explore the regulation of the derivatives market in the United States7 and Québec8 and highlight the use of principle-based regulation in the ever-growing and at times opaque derivatives market.

This paper will also take into consideration the status of Canada as a federation; one that operates under a constitutionally entrenched division of powers regime between the federal and provincial/territorial governments. Currently, Canadian securities regulation, as per the

6 See the Financial Services Authority website online at: http://www.fsa.gov.uk/ (website last visited on June 30, 2010).
7 See the U.S. Commodity Futures Trading Commission website online at: http://www.cftc.gov/ (website last visited on June 30, 2010).
8 The derivatives market is regulated in the province of Québec by the Autorité des Marchés Financiers (“AMF”). See the AMF website online for information on the regulation of derivatives at: http://www.lautorite.qc.ca/projets-speciaux/encadrement-derive.en.html (website last visited on June 30, 2010)
Constitution, operates at the provincial/territorial level. Whether Canada can have a federal regulator for securities is a question currently waiting to be determined by the Supreme Court of Canada. Without exploring the constitutional questions in this paper, I intend to argue that assuming a national securities regulator will someday exist in Canada; a principle-based regime would be a better model of securities regulation. To support this argument I will take into consideration, amongst other things, the regional diversity that exists in the Canadian securities market place that I believe will more easily be supported by a principle-based regime and allow for regional and provincial/territorial interests to be maintained at a national level.

This paper will also explore the recent global financial crisis and its impact on the progress that has been made to promote principle-based securities regulation globally. I argue in this paper that although critics have proposed that we now need more rules in response to the global financial crisis, it is actually a better time to push forward with principle-based securities regulation. In fact, I argue that the lessons learned from the recent financial crisis promote such a notion.

2 The Current Canadian Securities Regulatory Framework and the Need for Change

Before developing my argument in favour of a principle-based securities regime for Canada and exploring the rules versus principles debate, it is necessary to address the current status of the Canadian securities regulatory framework. Currently, Canadian securities regulation

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is governed by provincial/territorial securities commissions,\textsuperscript{10} self-regulatory organizations\textsuperscript{11} and organizations like the CSA that create a layered network of overlapping and complex regulations, policies and rules. A Canadian securities and/or mutual fund dealer could technically be regulated by the State (i.e. provincial police and RCMP in criminal offences related to securities under the authority of the \textit{Criminal Code}\textsuperscript{12}), provincial/territorial securities regulators (i.e. the Ontario Securities Commission), self-regulatory organizations (i.e. the IIROC, MFDA) and stock exchanges (i.e. the Toronto Stock Exchange, TSX Venture Exchange). At present, Canadian securities regulation is in a state of flux. Proponents of a national securities regulator for Canada argue that Canada cannot be competitive in the global marketplace with its current fragmented securities regime. Canada’s international competitiveness is undermined by its regulatory complexity and its lack of one regulatory voice amongst global competitors. It is argued that Canada suffers from weak and inconsistent enforcement and investor protection. Wrongdoers go frequently unpunished and adjudication is highly delayed. Policy development is slow and rigid. The need for consensus amongst jurisdictions currently can result in a lack of uniformity, over-regulation with layers of rules upon rules and stagnant policy development. Members of the

\textsuperscript{10} For example in Ontario it is the Ontario Securities Commission, in Alberta it is the Alberta Securities Commission, in Québec it is the Autorité des Marchés Financiers and in Nunavut it is the Superintendent of Securities.

\textsuperscript{11} Examples are the Investment Industry Regulatory Organization of Canada ("IIROC") and the Mutual Fund Dealers Association of Canada ("MFDA").

Canadian securities industry continually argue that the system is too costly, duplicative and ineffective and that regulatory burden impedes capital formation.\textsuperscript{13}

Canada’s fragmented regulatory regime has resulted in the inconsistent and inefficient enforcement of securities laws across the country. While there are times when provincial and territorial regulators seek to conduct joint investigations and prosecutions where possible, the reality is that the jurisdiction of and penalties that may be imposed by each regulator are prescribed in different local statutes.\textsuperscript{14} Furthermore, some jurisdictions lack the enforcement budget necessary to thoroughly investigate all potential breaches of securities laws.\textsuperscript{15}

Despite these weaknesses in Canadian securities regulation, strengths do exist. The main strengths are the proximity of regulators to the capital market participants in each jurisdiction and the development of expertise in specific industry sectors. The existing system does benefit from the innovation that arises from multiple regulators that are free to pursue their own policies. The same is true for responsiveness to local and regional issues although these issues do normally transcend provincial/territorial boundaries. It has been argued that effective enforcement requires a degree of local presence to receive investor complaints, conduct investigations and react quickly to infractions. The proximity of a regulator to those

\textsuperscript{13} Supra note 2 at 25.

\textsuperscript{14} From time to time regulators in more than one jurisdiction hold joint enforcement proceedings but these proceedings are difficult to coordinate, raise jurisdictional complications and are therefore uncommon.

it regulates allows the regulator to know the capital market participants in its jurisdiction. A local presence also facilitates dealings between the regulator, issuers and intermediaries. This allows for an ease in communication between the regulator and the regulated where perspectives can be shared, mutual understanding can take place and issues can be resolved cooperatively. These are important characteristics of the current Canadian regulatory structure that should be preserved under any regime. Even if Canada were to have a single regulator, a decentralized enforcement model allowing for local enforcement offices across the country would be preferable to a more centralized enforcement model.

Development of sectoral expertise is another advantage of the current Canadian regulatory structure. Contact with capital market participants, when combined with the concentration of specific industries within a jurisdiction, has enabled the development of centres of regulatory expertise. According to the Wise Persons Committee Research Study conducted in 2008, the existence of local infrastructures for capital-raising in various provinces could be inferred where there is a critical mass of issuers of a certain type of industry or market capitalization. This concentration allows local securities regulators as well as professionals such as investment bankers, lawyers and accountants to develop expertise in and be responsive to the needs of these issuers. Thus the existing system has facilitated the

17 Ibid. at 416.
18 Supra note 2 at 19.
development of regulatory expertise which should be preserved irrespective of what type of regulatory model is followed in Canada.

Along with provincial and territorial securities regulators, other organizations have grown to play a pivotal role in Canadian securities regulation. As a voluntary umbrella organization of Canada’s provincial and territorial securities regulators, the CSA was created to carry out its objective of improving, coordinating and harmonizing the regulation of Canada’s capital markets. The CSA provides a forum for Canada’s thirteen provincial and territorial securities regulators to improve the regulation of Canadian capital markets. It aims to achieve consensus on policy decisions which affect Canadian capital markets as well as work collaboratively with the industry in the delivery of regulatory programs across Canada such as the review of continuous disclosure requirements and the implementation of the passport system (“Passport System”). Working through the forum of the CSA in the more recent years, Canada’s securities regulators have improved our fragmented regulatory regime and thus, the CSA has been one of Canada’s best attempts at creating a national platform for securities regulation. The CSA has harmonized a significant amount of securities laws and streamlined the prospectus filing, application and registration processes for issuers and registrants seeking to do business in Canada particularly in multiple provincial jurisdictions. The CSA also promulgates national policies and regulatory instruments that are incorporated into provincial regulatory regimes.

One of the CSA’s initiatives to promote harmonization involved the creation of the Passport System. The Passport System includes all provincial/territorial securities regulators except for the Ontario Securities Commission (“OSC”).\(^{20}\) It provides a single window of access to Canada’s capital markets for domestic and foreign issuers. It enables market participants, for instance, to clear a prospectus or obtain a discretionary exemption and to also register as a dealer or adviser, by obtaining a decision from the securities regulator in their home province or territory and have that decision apply in all other jurisdictions. Effective September 28, 2009, with the implementation of the CSA’s National Instrument 31-103,\(^{21}\) the final stage of the Passport System was implemented by all member provinces in Canada.

In addition to rules and polices promulgated by the CSA, capital market participants in Canada can also be subject to self-regulatory organizations such as the IIROC and the MFDA. Both these organizations add another layer of securities regulation to the capital market industry. The IIROC is a national self-regulatory organization which oversees all investment dealers and trading activity on debt and equity markets in Canada. Created in 2008 through the consolidation of the Investment Dealers Association of Canada and Market

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\(^{20}\) See OSC Notice 11-904 Request for Comment Regarding the Proposed Passport System (March 28, 2007) online at: http://www.osc.gov.on.ca/en/15619.htm (website last visited on June 30, 2010). The OSC chose not to implement the Passport System in Ontario. As such, Ontario is not a party to the Memorandum of Understanding to implement the Passport System that was entered into by other provinces and territories. The Ontario Government indicated that it is not prepared to participate in the Passport System without a roadmap, with reasonable timelines, to get to a common securities regulator. The Passport System according to the OSC is based on rule-making powers that the passport members have or expect to receive through statutory amendments. These statutory amendments have not been enacted in Ontario.

\(^{21}\) See the CSA website online at: http://www.securities-administrators.ca/registration.aspx?id=858 (website last visited on June 30, 2010).
Regulation Services Inc., the IIROC sets regulatory and investment industry standards, protects investors and sets out to strengthen market integrity while fulfilling its mandate of maintaining efficient and competitive Canadian capital markets. The IIROC operates under recognition orders from the CSA and is subject to regulatory oversight and regular operational reviews. It is formally recognized as a self-regulatory organization by the various provincial securities commissions across Canada as well as Québec’s Autorité des Marché Financiers (“AMF”). The IIROC carries out its regulatory responsibilities through setting and enforcing rules regarding the proficiency, business and financial conduct of dealer firms and their registered employees and through setting and enforcing market integrity rules regarding trading activity on Canadian equity markets.

With regards to the mutual fund industry’s regulator, the MFDA is the national self-regulatory organization that governs the distribution side of the Canadian mutual fund industry. The MFDA was established in 1998 as a CSA initiative. It regulates the operations, standards of practice and business conduct of its members and representatives with a mandate to enhance investor protection and strengthen public confidence in the Canadian mutual fund industry. Like the IIROC, the MFDA is formally recognized as a

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22 The securities regulatory authorities of British Columbia, Alberta, Ontario, Québec, Saskatchewan and Newfoundland and Labrador have delegated to the IIROC the authority to grant registration under provincial securities legislation. The British Columbia Securities Commission, Alberta Securities Commission, Saskatchewan Financial Services Commission and the Superintendent of Securities of Newfoundland and Labrador have delegated the authority to grant registration to both IIROC Dealer Members and their individual employees or agents. The Ontario Securities Commission and Autorité des Marchés Financiers du Québec have delegated authority to registered individual employees and agents only.

23 See the IIROC’s website online at: http://www.iiroc.ca/ (website last visited on June 30, 2010).
self-regulatory organization by the various provincial securities commissions across Canada as well as the AMF.  

A capital market participant ultimately could be registered with the various securities commissions, the IIROC and the MFDA depending on what type of business is being conducted by that market participant. This can and often does lead to onerous and multi-layered compliance on behalf of the market participant with rules, regulations and policies that have to be complied with at every regulatory level.

Despite the valiant and positive efforts made by organizations like the CSA, the IIROC and the MFDA directed towards streamlining and harmonizing Canada’s securities regulatory regime, the fact still remains that the Canadian system is cumbersome, layered and does not have one voice on a global scale. Whether a national securities regulator can rectify these inherent weaknesses remains to be seen. Proponents of a national securities regulator for Canada state that moving to one securities regulator which administers one set of rules and laws and charges one set of fees will allow for a more efficient system not to mention that Canada will be more competitive on a global level. Canada remains one of the only developed countries without a national securities regulator. These proponents also assert that centralization no matter how it is done is better than what exists now but that simply may not

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24 The MFDA’s Members are mutual fund dealers that are licensed with provincial securities commissions. The MFDA is formally recognized as a self-regulatory organization by the provincial securities commissions in Alberta, British Columbia, Nova Scotia, Ontario, Saskatchewan, New Brunswick and Manitoba. An application for recognition is pending before the Superintendent of Securities of Newfoundland and Labrador. The MFDA has also entered into a co-operative agreement with the Autorité des Marchés Financiers and actively participates in the regulation of mutual fund dealers in Québec.
be the case. Whether the Canadian securities market operates under the harmonized model that currently exists or under a national regime, time and effort will be required to coordinate and achieve consensus among the provinces and territories. Differences will always exist among provinces in rules and regulatory approaches. Whilst those differences can be narrowed somewhat, as shown by the creation of the Passport System for example, regional diversity and inherent differences in provincial/territorial capital markets will always exist. Taking these realities into consideration, I argue that the question truly lies in whether a different type of approach to regulation is required, that is whether a principle-based approach under a national or the existing regulatory regime is the better approach for Canada.

The reasons to support this argument are more fully explored in this paper. Firstly, I argue that a principle-based securities regulatory regime for Canada is the more modern and global approach. Although this approach has been criticized, it is the preferred approach to securities regulation in the United Kingdom; it is being explored as the preferred method in the European Union and is the choice for securities regulation in British Columbia.

Secondly, I argue that a principle-based regulatory model requires and promotes more regulatory accountability and responsibility.

Thirdly, I argue that with regard to Canadian capital markets, one with diverse regional interests and capital raising needs, the need for a more principle as opposed to more rule-based approach is the preferred one. I argue that more efficient provincial/federal cooperation will take place under a more principle-based approach to securities regulation. It
is simpler to negotiate and implement a set of principles amongst the differing provinces than to agree on a strict regime of rules.

Fourthly, I argue that a principle-based regime encourages and demands an open level of communication between the regulator and the regulated industry. That is, investment firms are on the front line dealing with the reality of the capital marketplace. They have firsthand knowledge of investment products and structures and are for the most part the innovators of financial products. One of the critical features of a principle-based regime, as will be addressed further in this paper, is the necessity for communication between the regulator and the regulated. The more knowledge shared with regulators about current firm activities, financial products and compliance mechanisms in place within the industry, the more efficient and selective a regulator can be in enforcing regulations or prioritizing enforceable matters. Ultimately, I argue that the more knowledge gained by the regulator the easier it is to make informed enforcement decisions and minimize risks that may occur. As will be explored further, enhanced enforcement is of key importance to the success of a principle-based model.

Lastly, and with regard to the recent financial crisis of 2008/2009, critics of the principle-based approach to securities regulation have argued that the financial crisis occurred because we did not have enough rules. Major financial market regulatory reform has been proposed in both the United States and the United Kingdom. Several major domestic and international policy bodies and a number of scholars have contributed to the reform argument. I argue that in our eagerness to find blame, we must not overlook or discredit a principle-based approach to securities regulation. In fact, I argue that as that form of regulation is properly understood, it remains a viable and even more necessary policy option that offers solutions to the real-life
and also theoretical challenges that the financial crisis presents to modern financial markets regulation.

3 The Principle/Rule-based Continuum

In advancing my argument for principle-based securities regulation I will first look to how this type of regulation has been defined by scholars and in practice how it differs from the opposing rule-based regulatory regime. I will consider advantages and disadvantages that arise from the application of a principle-based regulatory regime as well as take a look at what I believe is one of the more problematic areas associated with this type of regulation, the concept of regulatory capture. Upon exploring these points and even taking into consideration the problem of regulatory capture, I argue that the nature, advantages of and application of a principle-based regulatory model is what makes it the better choice for securities regulation in Canada.

3.1 Principles versus Rules

When law makers make legal pronouncements they must decide not only what the substance of the law will be but more so in what form the law will take, either as rules or standards/principles.25 The nature of rules is that they state a determinate legal result that follows from one or more triggering facts whereas principles or standards require legal decision makers to apply a background principle or set of principles to a particular set of

facts in order to reach a legal conclusion.\textsuperscript{26} A number of scholars have used this principle/rule-based dichotomy as a vehicle for evaluating the structural and analytical choices that go into law making.\textsuperscript{27} In reality, systems of regulation are combinations of rules and principles that may be either more rule or more principle-based. Rules, although acknowledged to make up the backbone of any regulatory system, are not perfect in their own right. Particularly in the ever-changing securities regulatory arena, principles and rules must come together in the creation and successful execution of a regulatory regime.

Many of the major arguments made by scholars when comparing rules to principles relate to the relative certainty of rules and flexibility of principles and the costs of these regulatory choices for regulators and the regulated industry. For example, on the one hand, the argument is that rules promote precision, formal equality, predictability, uniformity and judicial restraint. They promote greater net social welfare gains, provide fixed consequences for actions and reduce the likelihood of bias and abuse of power by decision makers.\textsuperscript{28} Rules also come with their drawbacks. They can be reactive as opposed to proactive in nature, inflexible particularly in industries where change is a constant, and costly to create and enforce. They can also be over and under-inclusive, restrict communication between the


regulator and the regulated industry and can encourage “loophole” like behaviour and “checklist” style approaches to legal compliance.

On the other hand, proponents of principle-based regulation state that principles provide decision makers with the ability to make their own choices, promote substantive equality and justice, reduce arbitrariness, are flexible and can adapt to changing circumstances over time.\textsuperscript{29} Principle-based systems also promote accountability on the part of the decision maker and allow decision makers to tailor their treatment to the facts of particular cases. Principles can be disadvantageous in that they can be unpredictable, uncertain and costly for individuals to interpret and for decision makers to enforce and they can be manipulated by the industry that they regulate.\textsuperscript{30} The problems of industry manipulation and regulatory capture are discussed further on in this paper.

Many differences exist between rules and principles on a theoretical and practical level. At this point, I wish to illustrate by example, how these differences come into play in the realm of statutory drafting. A striking comparison of the difference between the level of statutory detail that exists between the rule-based and principle-based approach follows in the example


\textsuperscript{30} Ibid.
of prospectus requirements as required under the Ontario Securities Act\textsuperscript{31} ("OSA"), the proposed B.C. legislation, Bill-38\textsuperscript{32}, and the B.C. Securities Act\textsuperscript{33} ("BCSA").\textsuperscript{34}

\textbf{Comparison of Prospectus Requirements under the OSA, Bill-38 and the BCSA:}

\begin{tabular}{|l|l|}
\hline
\textbf{Ontario Securities Act} & \textbf{s.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 \\
\hline
\textbf{B.C. Securities Act} & \textbf{s.61 (1)} Unless exempted under this Act, a person must not distribute a security unless \\
& (a) a preliminary prospectus and a prospectus respecting the security have been filed with the executive director, and \\
& (b) the executive director has issued receipts for the preliminary prospectus and prospectus. \\
& (2) A preliminary prospectus and a prospectus must be in the required form. \\
\hline
\end{tabular}

\textsuperscript{31} Securities Act, R.S.O. 1990, c. S.5. (OSA)

\textsuperscript{32} Supra note 3.

\textsuperscript{33} Securities Act, R.S.B.C. 1996, c.418. (BCSA)

\textsuperscript{34} The information comparing the BCSA to the proposed B.C. legislation, Bill-38, has been taken from the Table of Concordance that B.C. Securities Commission staff prepared in September 2004 comparing the BC Securities Act, R.S.B.C. 1996, c.418 to the proposed Securities Act, S.B.C. 2004, c.43 (Bill-38) available online at http://www.bcsc.bc.ca/uploadedFiles/TableofConcordance_Part1.pdf (website last visited on June 30, 2010).
Bill-38

\textbf{s.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.

\textbf{(2)} A prospectus filed under subsection (1) must be in the required form.

Each of the proposed B.C. legislation (Bill-38), the OSA and the BCSA recognize the need for initial disclosure from issuers in the form of a prospectus. The statutes’ overarching provisions are substantively quite similar; however where the more principle-based Bill-38 diverges from the other two pieces of legislation is in the additional detail provided further on in the OSA and BCSA’s legislation. The OSA and BCSA have further provisions with regard to amendments to preliminary and final prospectuses, certificates of issuers, receipts, waiting periods and distribution. Bill-38 has no equivalent provisions. Any further detail required to support certain provisions in Bill-38’s legislation is provided for in its Securities Rules\textsuperscript{35} rather than in the proposed statute. Other areas in Bill-38 demonstrate a similar approach and illustrate the flexibility and less prescriptive nature inherent with principle-based securities regulation.

The BCSC, in support of Bill-38’s principle-based regime, argued that the complex rules characteristic of the existing BCSA prospectus regime did not help innocent investors or stop

fraudulent activity and it proposed that more effective tools for this purpose were investor education, compliance reviews and enforcement action.\(^{36}\)

Another notable area of change brought forward by Bill-38 concerned the regulatory oversight of compliance processes and procedures and was embodied in the establishment of a code of conduct for dealers and advisors (“Code of Conduct”).\(^{37}\) The Code of Conduct effectively replaced detailed rules of conduct for dealers and advisors with an overarching code consisting of twenty-eight rules arranged under eight broad principles. The Code of Conduct provisions imparted a sense of generality and the use of high-level language to ultimately allow for more flexibility and freedom in industry compliance.

Focusing on principle-based regulation in its general context, the success of principle-based regulation depends on how it is implemented and on the institutional framework that supports it. There must be mutual trust between participants in the regulatory regime and a strong flow of communication between the regulators and those regulated. While principles are necessary for principle-based regulation to work, they are by no means wholly sufficient.\(^{38}\) The industry needs to go beyond minimal compliance with regulatory


requirements. Outcomes and goals have to be clearly communicated by the regulator and the enforcement regime has to be predictable.

In sum, principle-based regulation requires, where possible, moving away from dictating through detailed, prescriptive rules and shifting regulatory activity towards setting desirable regulatory outcomes based on principles and outcome-focused rules.39

3.2 The Balance between Principles and Rules

I argue that no viable system of regulation consists entirely of rules or principles but rather lies on a continuum taking in more rules or principles into its regulatory structure. The FSA has clearly articulated its regulatory approach as a “more principle-based” one and I agree with this articulation. Legislative drafters can choose to regulate the same issues by way of different proportions of detailed checklists, bright-line rules or open-ended goal statements. With this in mind, principle-based regulation is cast with guidance and directives with a higher level of generality as opposed to its rule-based counterpart where precision and concise detail with more complex directives are the norm.

Principle-based regulation is not about replacing rules with principles or leaving businesses to their own devices without regulatory guidance or oversight. It is a distinct regulatory

approach which is neither entirely based on rules nor principles but rather lies closer to the principles end of the continuum between those two extremes. 40

Relying on this principle/rule-based continuum, the question then becomes one of how to strike the best balance between rules and principles in establishing a successful securities regulatory model. Of course in some areas of securities regulation flexibility will be more important than certainty and where those lines are drawn will depend on what is the desired outcome of the legislation. For example, where there is the concern over regulatory over-reaching or a lack of transparency, regulations may be cast as rules rather than principles in favour of the regulated industry to restrict regulatory discretion. The opposite is true where the legislature wants to ensure that the regulator will be able to keep up with fast-moving changes in the industry. In those cases principles would be the better option in guiding regulators’ actions. Other important considerations such as how much interpretive scope does the legislature want to leave to the regulators, courts and tribunals? Would a particular drafting approach foster harmonization between existing regulatory regimes or is change needed? In the Canadian context for instance, important issues like regulating small, closely held public companies or addressing the Canadian market discount, calls for more principle-based solutions? What message does Canada want to convey to the international community about its approach to securities regulation?

Irrespective of whether legislation is drafted in a more principle or rule-based manner, statutory drafting must be clear and concise to ensure it is effective. Statutory drafting must be transparent, well-defined and universally accepted and understood by the group it impacts. It must be accessible, that is, the law must be applied without excessive difficulty or effort, and it must be congruent in the sense that the substantive content of the regulatory language used produces the desired behaviour. Based on these criteria, there might be situations in which it is better to choose rules over principles and vice versa. Regulation may be drafted in a more rule-based manner where for instance noncompliance is especially harmful and transparency is important or where the legislative drafter has some comfort that a clear rule can act as a proxy for good corporate conduct. Alternatively, regulation may be drafted in a more principle-like manner for instance where the cost of rule-making in advance can be considerable or as a reflection of regulatory faith in regulatory expertise, fairness and capacity.

As part of the research study conducted for the Expert Panel on Securities Regulation’s Final Report it was uncovered that there are areas of securities law and regulation that lend


43 Supra note 40.
themselves to a more principle or rule-based approach.\textsuperscript{44} According to the study, provisions that govern disclosure requirements for prospectuses and administrative proceedings such as hearings and investigations are drafted and more effectively applied in a rule-based manner. Provisions that deal with fraud, misrepresentation, compliance, internal regulatory governance and resource allocation are drafted in a more principle-based way and allows for more regulatory discretion in applying these types of provisions.

There are areas in Canadian securities regulation that I argue could benefit from a more principle-based approach. NI 31-103, which has been incorporated into securities acts across the country and set outs registration requirements, is one area that provides a good example of this. Even though the registration and proficiency requirements under NI 31-103 were created to promote harmonization across the country, the proficiency requirements for instance do not leave much flexibility for the industry to work within. There are specific timeframes within which an individual must have worked within the industry before applying for registration in certain categories irrespective of whether the individual may have had previous experience prior to that time frame or become quite seasoned in a certain area of expertise. Compare this to the FSA’s way of treating industry proficiency requirements where the industry is allowed to use its judgment and balance years of work experience with proficiency requirements to arrive at what are suitable qualifications. The FSA evaluates whether an individual is “fit and proper” to practice in the industry by assessing the

\textsuperscript{44} The research study involved the comparison of the Ontario Securities Act, R.S.O. 1990, c. S.5, Bill-38 (the proposed British Columbia Securities Act and associated Securities Rules), the Québec Derivatives Act, S.Q. 2008, c.24 and the Financial Services and Markets Act 2000 (U.K.), 2000, c.8
individual using its Fit and Proper Test for Approved Persons (“Fit and Proper Test”). The FSA’s Fit and Proper Test takes a more holistic and multi-factorial approach to assessing an approved persons’ competency to practice rather than the checklist approach currently used in Canada.

Another area that I argue could benefit from a more principle-based approach is that of capital requirements of firms. In Ontario for instance, the OSC requires a registered firm to calculate and report its excess working capital and report to the regulator if it falls below zero for two days in a row. In general, this rule seems wise and appropriate. However, apart from applying a strict calculation, this one-size-fits-all requirement does not take into account anything else about the registered firm like size, resources and other factors that may actually show that the firm is in financial health and can support a capital deficiency for a certain period of time without causing undue risk to itself or the investing public. The FSA for example has been able to address the issue of capital requirements in a much more principle-based way that I argue would allow other factors to be taken into consideration before finding a firm in regulatory default. Once again, the FSA’s holistic approach to adequate firm resources takes a look at many factors in deciding whether a firm is actually at risk of not being able to carry on its functions from a capital requirement perspective. Condition

\[45\] FSA Handbook FIT 2.2 Competency and Capability. In determining the person’s competency and capability the FSA will have regard to training and competency requirements as well as whether the person has demonstrated by experience and training whether the person is suitable to perform their role, available online at: http://fsahandbook.info/FSA/html/handbook/FIT/2/2 (website last visited on June 30, 2010).
allows the FSA to look at whether a firm has adequate resources in relation to the specific regulated activity it wishes to carry on. In assessing what is adequate for a particular firm, the FSA looks at the quantity, quality and availability of financial and non-financial resources and means of managing risk. These means may include capital, provisions against liabilities, holdings of or access to cash, other liquid assets, human resources as well as other effective means by which to manage risks. This principle-based approach with regards to capital requirements allows for the regulator to take into account other factors that are not necessarily quantitative in nature that may alert a regulator to potential risks that would not otherwise be seen by the strict performance of a capital deficiency calculation.

As is shown by the above examples, effective securities regulation needs to reflect and relay regulatory objectives without being over-burdensome on the regulated industry. It also needs to take into account when rules and principles best serve their regulatory purpose and how best to balance the two.

### 3.3 The Application of Principle-based Securities Regulation

The best way to understand and gauge the success of a principle-based securities regulatory model is to look to current examples like that of the BCSC’s proposed regulatory model in Bill-38 (“BC Model”) and the FSA’s current regulatory regime. The BC Model and the FSA’s regime illustrate what factors are important in the operation of a viable principle-based model and can be used as guidance for a proposed Canadian securities regime. The BC Model and the FSA’s regime illustrate that although statutory drafting is important in

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designing a functional principle-based regulatory regime; true success of this type of regime derives itself primarily from regulatory practice.

Taking from the examples of the BC Model and the FSA’s way of practice, the first key factor for success involves a shift from what we have grown accustomed to in modern securities regulatory culture. Rather than focusing on specific requirements, a principle-based regulator focuses on broad themes that are articulated in a dynamic way. In redefining its regulatory model, the regulator needs to accept industry input and be able to manage incoming information. Principle-based regulation requires intensive interaction with the regulated industry and the use of sophisticated problem solving methods and self-reflective analysis to do the challenging and complex work of picking important problems and solving them. Principle-based regulation requires regular and ongoing communication with the industry. This allows for the regulator to move with and learn from the industry. The FSA for example, consults with industry and consumers in developing its guidance and shares information about good practices with industry stakeholders. The regulator, in providing guidance, should ensure that it does not become over-reaching resulting in potential prescriptiveness or “regulatory creep” and be seen by the industry as a way of creating de facto rules. Regulatory changes should be subject to the use of a notice-and-comment rule

[47] M. Sparrow, *The Regulatory Craft: Controlling Risks, Solving Problems and Managing Compliance* (Washington: Brookings Institution Press, 2000) at 109-122. Note that M. Sparrow’s work on best practices in regulation is relevant to the discussion on principle-based securities regulation as his work was highly influential for the BCSC for several years particularly with regard to the research surrounding Bill-38 and the proposed principle-based securities regime for British Columbia.
making scheme to avoid the potential for regulatory abuse of power with regards to regulatory rule making.\textsuperscript{48}

The second key factor for success under a principle-based securities regime is that registrants and issuers have the flexibility to design effective processes based on their own understandings and experiences within their industry. Firms and companies should be given 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 principle-based regulation offers.\textsuperscript{49} Changes in the manner or expression of requirements may impose a burden on the industry and substantive changes need to be accompanied by reasonable lead times by the regulator so that the industry can make the appropriate adjustments.\textsuperscript{50} A good example of the use of reasonable lead time by a regulator is with the current implementation of the new registration regime under National Instrument 31-103 (“NI-31-103”).\textsuperscript{51} Part 16 of NI-31-103 allows for the industry to make its transition into complying with the new registration rules after a year or for some categories after two years. This way the regulator

\textsuperscript{48} Administrative guidance has not been the subject of much litigation in Canada with the exception of the case of \textit{Ainsley Financial Corporation v. Ontario Securities Commission}, 14 O.R. (3d) 280, [1993] O.J. No. 1830 where this case stood for the principle that a regulator cannot do an “end run” around notice and comment procedures, ostensibly creating new sets of rules without administrative safeguards.

\textsuperscript{49} \textit{Supra} note 39 at 4.


\textsuperscript{51} \textit{Supra} note 21.
gives the industry the flexibility to implement the new rules into their compliance regime with ample time to make the necessary changes.

The third key factor is that structures need to be developed that allow the regulator to gather useful information, analyze it effectively, learn from it, share it and feed it back into regulatory decision making. At the FSA, this function is fulfilled by its Operations Business Unit.52 The regulator should be in a position where it can share industry knowledge and leverage the information to assess risk more reliably, to support industry learning and to provide clear regulatory objectives.

The fourth key factor for principle-based regulation is that it is focused on outcomes rather than processes. This factor is crucial in keeping the system flexible and dynamic. The FSA emphasizes the link between principle-based regulation and outcome-oriented regulation and it revises its rule book continuously to be more industry responsive and less process-oriented.53

The fifth key factor is for the regulator to be trustworthy and competent and to be viewed by the industry as such. Regulatory conduct should be as transparent as possible. Enforcement should be predictable and defensible. Market participants should be able to predict with

52 See the U.K., Financial Services Authority “Operations Business Unit”, online at: http://www.fsa.gov.uk/pages/About/Who/Management/Services/index.shtml (website last visited on June 30, 2010).

53 Supra note 39. The FSA emphasizes that the rules it is interested in discontinuing are those that are “detailed” and “process oriented.” The rules it sees as most useful in the principle-based context are those that “will not focus on a specific process that a firm should undertake, but an endpoint that should be achieved.”
some level of certainty whether or not their actions will be found to breach a principle. Regulators working within a principle-based model should ensure that enforcement is done in an outcome-oriented way rather than interpret enforcement guidelines in a way that produces rigid, non-negotiable expectations for the industry.\(^{54}\)

The sixth and final factor in establishing a successful principle-based model is for the regulator to be able to maintain control over its own process and interpretation of its principles. The regulator must have the power to promulgate rules and guidance and must have some level of control in adjudicating its principle-based actions.\(^{55}\) A principle-based regulator should also be concerned with the impact of civil liability on its ability to define its own principles. It has been suggested that it is exactly for this reason that an American-style approach to civil liability can make principle-based regulation unworkable.\(^{56}\) On this matter, the FSA has argued that 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 is not desirable for “civil litigations between private parties to become the engine driving the interpretation of principles.”\(^{57}\)

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\(^{54}\) *Supra* note 38 at 198.

\(^{55}\) The FSA tends to settle its principle-based actions and also makes extensive use of compliance and other methods before initiating the enforcement stage.


I argue that taking into account the requirements of a successful principle-based securities regime as well as the advantages that such a regime provides in terms of its potential responsiveness to capital market diversity and change, principle-based securities regulation is the preferred mode of regulation. Capital markets are becoming increasingly more sophisticated and dynamic and I argue that principles rather than rules, allow for more effective adaptability and cooperation between regulators and the industry. That being said, one of the greatest advantages of a principle-based model, being the heightened interaction between the regulator and the industry, can also be one of the most problematic areas of this type of regulation. The problem of regulatory capture, which may arise as a product of the close interaction between a regulator and the industry it regulates, is explored further in the next section of this paper.

3.4 The Problem of Regulatory Capture

There is no doubt that regulation is instituted primarily for the protection and benefit of the public at large.58 We would like to think that the government or some omnipotent power is keeping an eye on industry watchdogs and ensuring that true social benefit is being served by regulation. After all, any industry by virtue of operating in the public domain, acquires

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. BCSC, “Investor Remedies in Securities Legislation” British Columbia: New Legislation Project, (2004) at 8-10, online at: http://www.bcsc.bc.ca/uploadedFiles/RIA_Investor.Remedies (1).pdf (website last visited on June 30, 2010).

regulation and regulation is equally designed not only for the benefit of the public at large but also for the benefit of the industry which it regulates.\footnote{Ibid.} On a theoretical level, regulation fulfills its purpose and does so without industry influence. In practice however, the story can be quite different.

The financial crisis of 2008/2009, which is discussed further on in this paper, illustrated how a high level of regulatory interaction with the industry, one of the argued advantages of a more principle-based regulatory regime, was what ultimately led to the financial crisis. Regulators relied on the industry to self-police. Credit rating agencies, immune from regulatory scrutiny up until now, created financial industry standards that were ultimately manipulated by the financial industry in its favour. Regulators in turn relied on the industry. Regulators are also influenced by the industry through politics. Looking at the issue of regulatory capture through the eyes of a public choice theorist, regulatory politics can easily be influenced by the power of industry which can then lead to a system where regulatory action or inaction is manipulated by the industry it regulates.\footnote{Sydney A. Shapiro, “Keeping the Baby and Throwing out the Bath Water: Justice Breyer’s Critique of Regulation” (1995) 8 Admin.L.J. Am.U. 721.} It has also been argued that regulators rely heavily on industry knowledge and resources, which inevitably puts the regulator in a vulnerable position.

So how can regulatory capture be controlled or deterred? Apart from increasing the amount of resources that are available to regulators, some theorists believe that regulators must be
given an incentive for good regulatory behaviour and argue for the regulation of regulators. 61

According to this line of reasoning, the government for instance could regulate the behaviour of its agent, in this case a regulator, by investing in monitoring technologies to monitor its behaviour and by making regulatory funding a function of its behaviour. This theory of course assumes that industry influence would have no impact on the government and not create a form of “government capture” which would inevitably just trade one form of regulatory capture for another. Other theorists believe that the responsibility for eliminating the possibility of regulatory capture should be placed on the industry. The industry should build in internal mechanisms for external risk management and have third party monitors to approve and watch over decisions and potential regulator/industry conflict of interest. 62

In keeping with the FSA’s principle-based model, which builds in oversight of its own regulatory behaviour and accountability, I argue in favour of regulatory monitoring which I believe would best promote regulatory accountability and deter regulatory capture. Principle-based regulation builds incentives for the industry to better manage its own risks. Industry participants who manage their own risks and are accountable for their behaviour become industry leaders. In turn these leaders build more business based on their industry and regulatory reputation. This creates an incentive for the industry to abide by regulatory standards and be accountable for its behaviour with other market participants and with regulators. I argue that regulatory oversight is not only needed for purposes of regulatory


accountability and to ensure that regulators are doing their jobs right, but more importantly for monitoring any potential developments that may lead to regulatory capture. Regulatory oversight can be achieved either by a government monitoring function or by a third-party agent ultimately reporting to the government. What is clear is that regulatory structures should allow for effective monitoring and evaluation of the performance and effectiveness of regulators, including determining whether regulatory capture exists in a particular regulatory arena.

4 Current Use of Principle-based Regulation

4.1 The United Kingdom’s Financial Services Authority

Without a doubt, the global leader in principle-based securities regulation is the United Kingdom’s FSA. Operating under the Financial Services and Markets Act, 2000 (“FSMA”), the FSA’s move towards a more principle-based style of regulation began in 2001, not long after the FSA was created. The FSA is an independent non-governmental body financed by financial market members through their membership in the FSA. The British government is responsible for the overall scope of the FSA’s regulatory activities and powers and the FSA regulates most financially related institutions such as banks, insurance companies and securities firms.

The FSMA stipulates four statutory objectives which govern and guide the activities of the FSA. These four objectives are: the maintenance of market confidence, enhancing public

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63 U.K. Financial Services and Markets Act 2000, 2000 Chapter 8 (FSMA)

64 See the FSA website “Who are we?” online at: http://www.fsa.gov.uk/Pages/About/Who/index.shtml (website last visited on June 30, 2010).
awareness of the financial system, securing the appropriate degree of protection for consumers and reducing the extent to which it is possible for regulated activity to be used for purposes of financial crime.\textsuperscript{65} The FSA describes “better regulation” as a method of finding better ways to secure these objectives by means of three basic approaches. These approaches are: being risk-based in its approach to regulation, being sensitive to the costs of regulation and being more principle-based in general.\textsuperscript{66}

Expanding on its principle-based approach, the FSA functions on a comprehensive philosophy about regulation that affects not only the industries which it regulates but also its own processes. With regards to its own functions and processes, the FSA is guided by its six principles of good regulation which include the promotion of innovation and competition, respect for management judgment, restrictions in proportion to benefits and the maintenance of a strong financial services market.\textsuperscript{67}

\begin{itemize}
\item \textit{Supra} note 55, FSMA s.2 (2).
\item In pursuing its functions under the FSMA, the FSA is required to have regard to what the FSA refers to as its “principles of good regulation”. These principles are: (1) Efficiency and economy, the need for the FSA to use its resources in the most efficient and economic way; (2) Role of Management, holding senior management of firms responsible and administering a proportionate level of regulatory intervention; (3) Proportionality, the restrictions imposed on the industry must be proportionate to the benefits expected from those restrictions; (4) Innovation, fostering innovation in connection with regulated activities; (5) International character, the FSA takes into account the international aspects of financial services in cooperating with non-domestic regulators and (6) Competition, the need to minimize the adverse effects of competition that may be created by the regulator and fostering positive competition between firms in the industry.
\end{itemize}
With regard to the regulated industry, the FSA’s regulatory structure is built on eleven core principles that focus on results or outcomes for the regulated firms. These eleven high-level Principles for Businesses\(^{68}\) govern what is expected of financial services firms. Amongst these Principles for Businesses a firm must conduct its business with integrity, due skill, care and diligence. It must maintain adequate financial resources and observe proper market conduct standards. With regards to its clients, under the Principles for Businesses a firm must treat its customers fairly and pay due regard to the information needs of its clients and manage conflicts of interest fairly. A firm must also deal with its regulator in an open and cooperative way. These principles have been described by the FSA as a “set of axiomatic statements that articulate what action and behaviours we expect from firms and which provide the very backbone of our regulatory regime. Critically they focus on what the regulations are trying to achieve and so are expressed in terms of outcomes rather than processes or procedures”.\(^{69}\)

Since its inception and in respecting the need for cooperation between the regulator and the regulated industry, the FSA has simplified and reorganized its rules and principles to live up to its principle-based mandates. Between 2002 and 2005 for example, the FSA replaced substantial amounts of its detailed Handbook\(^{70}\) rules with shorter, high-level requirements

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\(^{70}\) The FSA Handbook (Handbook) is available online at: http://fsahandbook.info/FSA/html/handbook/ (website last visited on June 30, 2010). It includes amongst the Principles for Businesses which is part of the
often accompanied by regulatory guidance. During this period of overhaul, the FSA changed its rules relating to listed companies, reduced the length of its rules by 40% and added six listing principles plus guidance to the Handbook. In 2006 it began its industry consultations on simplifying its rules relating to dealings with retail customers and it began to replace the detailed obligations in its existing money laundering requirements with streamlined provisions focusing on ensuring that firms had effective risk management systems and controls and that firms’ senior management took responsibility for managing money-laundering risks.\textsuperscript{71}

In fulfilling one of the principle-based mandates of regulatory accountability, the FSA has consulted with industry on many occasions to ensure that what the industry needs is consistent with the FSA’s regulatory intentions.\textsuperscript{72}


\textsuperscript{72} For example, in 2004, a group of trade associations published industry guidance on their understanding of the FSA’s rules with respect to “trading ahead of investment” research. The FSA publicly confirmed that the guidance was consistent with the regulator’s intent in its publication “Better Regulation Action Plan: What we
In terms of its own internal process, the FSA emphasizes consultation with the public and industry. The FSA consults with industry on many aspects of its operations and even streamlined its enforcement manuals based on industry consultations in 2007.\textsuperscript{73}

When the FSA decided in around 2001 to move towards a more principle-based system of regulation it was cited as changing the balance in its regulatory system between principles and more detailed rules. The reasons given for this rebalancing were: (a) the FSA’s prescriptive standards proved to be inadequate in preventing misconduct on their own; (b) the volume and complexity of the FSA standards made them not only a barrier to market entry but also a barrier to compliance; (c) prescriptive rules diverted industry attention towards “letter-of-the-law” or “loop-hole” compliance rather than complying with the purpose of the rules or standards; (d) many issues were not adequately dealt with through prescriptive standards or without creating an overly complex system; and (e) maintaining a set of standards to respond to growing market sophistication and complexity unduly burdened the system of resources. The FSA’s observations about the shortcomings of a rule-based system of regulation hold true to the current state of securities regulation in many jurisdictions including the United States and Canada.

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Although the benefits of principle-based regulation are vast according to the FSA, it is also clear that this type of regulation does present challenges and the FSA is committed to minimizing these challenges in continued promotion of its principle-based model. The FSA ensures that its form of regulation will be delivered through a continuous process of change both for the regulator and the regulated and that challenges like uncertainty about regulatory requirements will be addressed through regulatory guidance and ongoing communication between the regulator and the industry.

One thing is certain, in proposing a principle-based securities regulatory model for Canada, lessons can be learned and challenges addressed drawing on the experience of the FSA.

### 4.2 The British Columbia Securities Commission

In following the FSA’s lead and inspired by the work of Malcolm Sparrow, a professor, regulatory expert and advocate of principle-based regulation, the BCSC began its hunt for a better way of securities regulation for its province. On April 15, 2003, the BCSC published a new draft Securities Act, rules and regulations (collectively referred to as the BC Model). The BC Model was comprised of four volumes and over 425 pages that embodied the BCSC’s commitment to a new way of regulating its securities markets. This was a major step in the process that had begun in October of 2001 to replace the current B.C. Securities Act with a more modern and effective type of regulation. The BC Model, in the form of Bill-

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74 *Supra* note 45.

75 *Supra* note 3.
38, was introduced into the B.C. Legislative Assembly and received Royal Assent in May of 2004.

According to the BCSC, its BC Model was a product of a series of regulatory impact analyses and public comment against the backdrop of the debate in Canada concerning whether securities regulation should be based primarily on core principles rather than detailed rules. Ultimately the BC Model did not become law in Canada due to the continued evolution of the Canadian securities industry particularly in light of the growing momentum of the Passport System as well as the pressing issue of the creation of a national securities regulator. The BC Model would however have established one of the most comprehensive principle-based securities regimes in securities regulation in North America. The lack of force of law behind the BC Model did not stop the BCSC’s resilient advocacy of its principle-based model. The BCSC currently takes the position that its focus is on applying the principle-based approach to how the province administers securities legislation. As I argued earlier in this paper, there is no doubt that the BC Model will have an effect on Canadian securities regulation especially with the BCSC’s ex-Chair currently in charge of leading the transition towards a national securities regulator for Canada. In fact, B.C.’s principle-based and outcome-oriented approach has already had an effect across Canada through BC’s agency and presence at the negotiating table alongside other provinces as part of the CSA’s regulatory process. For example, as a result of B.C.’s advocacy of a more

76 Supra note 28 at 3.
77 BCSC, “Moving ahead with Regulatory Reform in British Columbia (March 2005), online at: http://www.bcsc.bc.ca/uploadedFiles/Moving_Ahead.pdf (website last visited on June 30, 2010).
principle-based regime for Canadian securities regulation, the CSA enacted a national instrument in reflection of certain principle-based prospectus related components of the B.C. Model which is now in effect across Canada.\textsuperscript{78}

In support of its model, the BCSC argued that prescriptive requirements emphasize the wrong things. They force firms to focus on detailed compliance rather than to exercise sound judgment with a view to the best interest of their client and the market. Detailed and top-down requirements stifle the regulatory system and reflect a one-size fits all industry practice which I argue is an important consideration for the Canadian market as it is one rich in industry diversity and is “small-issuer” dense. \textsuperscript{79}

Implicit in the BC Model is its outcome-oriented approach and its transition into a new way of perceiving the role of compliance and enforcement.\textsuperscript{80} Industry involvement in the development and shaping of the content of new rules is an integral part of achieving successful outcomes through a principle-based model. Principle-based regulation takes a more results-oriented approach to public administration which includes devolution to

\textsuperscript{78} Bill-38 would have done away with prospectuses entirely for issuers that were already in the public market and that were keeping their disclosures up to date (the Continuous Market Access model). With the promulgation of the CSA’s National Instrument 44-101 concerning short-form prospectuses, the reporting issuer now may file a streamlined short-form prospectus as long as that issuer (with equity securities listed and posted for trading on an eligible exchange) is up to date in its periodic and timely disclosure filings in all jurisdictions in which it is a reporting issuer.

\textsuperscript{79} Supra note 36.

\textsuperscript{80} The BC Model supported this new approach with enhanced enforcement and public interest powers which included a legislative prohibition on unfair practices, the Commission’s power to disgorge and provisions that allowed any person who believed another has contravened Bill-38 to apply to the Commission to hold a hearing.
industry, risk-based management, transparency and accountability through continual re-evaluation of regulatory performance.

A key concern of principle-based regulation, along side the issue of regulatory capture, is its effective enforcement. One of the greatest criticisms of principle-based regulation is the enforcement of principles rather than bright-line rules. The argument is that enforcing principles can be viewed as somewhat arbitrary where the regulator can pick and choose based on its principles as to which cases are enforced and which are not. The FSA addresses this issue by stating that firms need to be able to reasonably predict the regulator’s reactions and the regulator must work with the firms to provide clarity about regulatory outcomes. This requires continuous communication with the industry to create predictability when it comes to the enforcement of regulatory principles. 81

In addressing the concern of effective and predictable enforcement, the BCSC conducted a study as part of the process that ultimately created Bill-38. 82 The purpose of the study was to see if the principle-based regime presented in Bill-38 could be enforced as effectively as the current B.C. Securities Act. The study analyzed the BCSC’s decisions and settlements in 2002 and 2003 to determine the provisions most commonly relied on during that period to

81 Supra note 40 at 22.
enforce the current legislation\textsuperscript{83}. The study then compared those provisions to the corresponding provisions in Bill-38.\textsuperscript{84} The study also analyzed how enforcement actions that relied on the BCSC’s general public interest jurisdiction could be handled under Bill-38. And finally the study analyzed the enforcement challenges presented by provisions in Bill-38 that were not present in the current legislation.

The conclusion of the study showed that the most significant enforcement actions taken under the current legislation would continue to be supported by corresponding provisions in Bill-38. Of all contraventions, ninety-two percent were in areas in which the requirements under Bill-38 were nearly identical or substantially similar to the current legislation or had a similar bright-line test. For some types of conduct, for instance conduct involving conflicts of interest, Bill-38 would provide a more specific basis for enforcement action than the

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\textsuperscript{83} Between January 1, 2002 and November 14, 2003, (“Research Period”) the BCSC rendered two decisions and entered into fifteen settlements relating to registrant misconduct. The sixty-six contraventions of the current legislation in those decisions (stated here from most to least frequent) involved know your client and suitability, fair dealing with clients, supervision, illegal distributions, prudent business practices, misrepresentation and other. In the Research Period, the BCSC rendered ten decisions and entered into twenty-two settlements relating to the misconduct of reporting issuers, their management and others. The sixty-five contraventions of the current legislation in those decisions (stated here from most to least frequent) involved misrepresentations, illegal distributions, trading or advising without being registered, breaches of directors’ duties, failure to file insider reports, fraud, market manipulation, insider trading and failure to disclose material change.

\textsuperscript{84} Combining the results (see \textit{infra} note 75), sixty-seven percent of the total contraventions were in areas where the language in Bill-38 was substantially similar or nearly identical to that used in the current legislation. Twenty-five percent of the total contraventions were in the areas of illegal distributions and trading and advising without registration which would be bright-line contraventions under Bill-38. Eight percent of the total contraventions were in areas where there are provisions in Bill-38 that replace or correspond to the relevant provisions in the current legislation.
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current legislation. Most of the new requirements in Bill-38 would be readily enforceable because they would require measurable outcomes, use objective tests that are familiar to adjudicators or deal with areas in which there was a rich pre-existing understanding of what constitutes acceptable and non-acceptable behaviour. The BCSC concluded that based on their study, Bill-38 would provide a solid foundation to take enforcement action against market misconduct; at least as solid as the regime used under the current legislation and even more so in some important areas.\textsuperscript{85}

Ostensibly, the BCSC study addresses and substantially alleviates the concern that principle-based regulation is incapable of being effectively enforced as well as or even better than the existing rule-based regime.

### 4.3 Derivative Market Regulation

Principle-based regulation has also found its way into the complex world of derivatives. It is being used in the regulation of derivatives by the AMF in Québec via the Québec Derivatives Act\textsuperscript{86} (“QDA”) as well as by the CFTC in the United States via the Commodity Futures Modernization Act\textsuperscript{87} (“CFMA”). Before examining how the AMF and CFTC regulate derivatives using principle-based regulation, a brief explanation of the nature of derivatives is necessary.

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\textsuperscript{85} Supra note 74. \textsuperscript{86} Québec Derivatives Act, R.S.Q., 2008, c. I-14.01 (QDA) \textsuperscript{87} Commodity Futures Modernization Act, 7 U.S.C. § 1 2000 (CFMA)
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A derivative can generally be described as an instrument or contract whose value depends on or is derived from something else such as a commodity, reference rate or index. Derivatives can broadly be classified into two categories: exchange-traded and over-the-counter (“OTC”) derivatives. Exchange-traded derivatives are traded through intermediaries such as exchanges, based on standardized exchange contracts with the intermediary as the counterparty. OTC derivatives are privately negotiated bilateral contracts entered into between the contracting parties directly (typically based on standardized agreements and contractual terms, such as those developed by the International Swaps and Derivatives Association, Inc.). OTC derivatives are largely entered into between sophisticated parties (such as financial institutions or similar entities) for the purposes of hedging financial or portfolio risks or for diversifying portfolios of assets. It is argued that the highly unregulated OTC derivatives market catalyzed the financial crisis of 2008/2009. Derivative market reform is needed so that regulators may better address new products, trading practices and the interrelationship between the derivatives markets and the cash markets.

Historically in Canada, the treatment of exchange-traded derivatives under securities legislation has been inconsistent in part because of differing regulatory and industry views as to whether a derivative is a “security” or not for purposes of securities legislation.

88 See the International Swaps and Derivatives Association, Inc. website at: http://www.isda.org/ (website last visited on June 30, 2010).

89 Supra note 40, “Improving the Regulation of Derivatives in Canada”. Highly leveraged, light regulated entities (i.e. hedge funds), competing in largely unregulated OTC derivatives markets, are an important factor behind the global financial crisis. It is generally recognized that, in many countries, regulation of derivatives markets has failed for some time to take into account new types of products and trading practices. 
Derivatives in Canada are regulated through securities regulatory authorities only in the provinces of Alberta, British Columbia, Manitoba, Ontario and Quebec. Alberta and British Columbia can be grouped together as they take a similar approach. The approach taken by Ontario and Manitoba is also similar but differs from that taken in British Columbia and Alberta and British Columbia regulate derivatives through their securities legislation. The legislation regulates exchange-traded derivatives based on the concept of “exchange contracts”. Exchange contracts are not included in the definition of “security” but are regulated through securities legislation by the imposition of registration requirements for dealers and advisors and the regulation of those exchanges on which exchange contracts are traded (pursuant to recognition requirements for such exchanges). Unlike exchange-traded derivatives, while OTC derivatives are generally included in the definition of “security”, the application of most aspects of securities legislation to OTC derivatives is clawed back through broadly applicable blanket exemptions. Shortcomings with this approach include the difficulty in determining whether a particular type of derivative is or is not regulated as a security, particularly on account of the evolving nature of the derivatives industry versus the comparatively static approach to how they are attempted to be captured under securities regulation.

In Ontario and Manitoba the approach is quite different. Exchange-traded derivatives are not regulated under securities legislation and are governed by separate commodity futures legislation that applies to commodity futures contracts and options. Commodity futures legislation in these provinces generally governs commodity futures by imposing registration or recognition requirements on exchanges operating in the province and by imposing dealer and advisor registration requirements with respect to trading or advising on commodity futures contracts traded on recognized exchanges. A commodity futures contract that is not traded on a recognized exchange constitutes a “security” for the purposes of securities legislation. With respect to OTC derivatives, the application of securities regulation is not clear. While the definition of “security” is not as broad as it is in Alberta and British Columbia, so as to clearly capture OTC derivatives, there is a lack of consensus as to whether particular types of OTC derivatives, such as those that involve the physical settlement of equities or debt securities, are “securities” for securities law purposes. Despite such uncertainty in the law however, the better view is that cash-settled OTC derivatives would not likely be characterized as securities, whereas OTC derivative transactions that will or may require the physical delivery of an underlying security could be regulated as an act in furtherance of a trade. With respect to a physically-settled OTC derivative, however, it is unlikely it would be characterized as a security separate from the underlying interest to which it relates. To the extent that an exchange-traded derivative (that is not traded on a recognized exchange) or an OTC derivative does fall within the scope of “securities”, it is generally exempt from prospectus and registration requirements.
Alberta. Lastly, Québec, with the recent passing of the QDA, has introduced yet a third approach in Canada to derivates regulation.

The QDA applies to both exchange-traded and OTC derivatives. This Act imposes recognition and registration requirements on intermediaries as well as registration requirements on dealers and advisors. Notably however, OTC derivatives and transactions involving “accredited counterparties”\(^{92}\) are carved out from the application of most of the substantive provisions of the legislation.\(^{93}\) The QDA is the first comprehensive standalone derivatives legislation to be adopted in Canada. The QDA is notably principle-based legislation. In a press release, the AMF commented that the legislation “transfers the responsibility for establishing the most effective means of assuming legislative obligations to market participants and other regulated entities”.\(^{94}\) As the legislation is still in its early stages of use, its application as principle-based regulation has yet to be seen however much of the language used in the QDA is principle-based in that it leaves broad discretion to dealers and advisers for example in how they ensure proper registration of those carrying on

\(^{92}\) Supra note 78, QDA s.3.

\(^{93}\) Ibid. QDA s.7.

business under their employ\textsuperscript{95}, how they carry and manage their business\textsuperscript{96} and how they monitor and enforce proper conduct and deal with client conflict.\textsuperscript{97}

Looking to the United States, derivatives are regulated by the CFTC under the legislative authority of the CFMA. The CFTC regulates derivatives under a principle-based model. There are a few points that are worth mentioning about the CFTC’s regulatory history. The CFTC’s philosophy has not been constant over time. Rather, it has reflected the policy of the individual CFTC Commissioners and staff and as such has waivered between more rule and more principle-based at certain times throughout the life of the organization. The CFTC’s culture has been thought to be far more based on economics rather than law, particularly when compared to the U.S. Securities and Exchange Commission’s (“SEC”) culture, which it frequently is.\textsuperscript{98} It is argued that the “economic” considerations that are part of the CFTC’s

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  \item \textsuperscript{95} Supra note 84, QDA, ss.54-60.
  \item \textsuperscript{96} Ibid. QDA, ss.61-62, for example, s.61 “Dealers and advisers must organize and control their affairs diligently and effectively. To that end, they must put in place procedures to facilitate compliance with this Act and ensure that their books, registers and records are kept in such a manner that they may be audited”.
  \item \textsuperscript{97} Ibid. QDA, ss. 63-77, for example, s.64 “Dealers, advisers and representatives must at all times meet the accepted standards of integrity and fairness in the derivatives industry” and s.74 “Dealers and advisers must provide equitable resolution of complaints filed with them. To that end, they must each adopt a policy dealing with .....”
  \item \textsuperscript{98} Although the role of economists is a greater role at the CFTC than at the SEC, that role is nevertheless relatively small as compared to the lawyers. Indeed, as former CFTC Commissioner Gary Seever wrote in 1979, “lawyers dominate the makeup of most agency staffs and they have been more efective within the agencies than economists.” Gary Seever, A Regulator’s Perspective on Regulatory Research, 61 Am. J. of Agricultural Economics 787 (1979). That perspective applied to the CFTC then and still applies today, notwithstanding the appointment during the interim of several commissioners and chairmen with PH.Ds in economics. As compared with the SEC, which ironically recently hired the former chief economist of the
\end{itemize}
culture and practice, lend themselves to more of a principle-based regulatory practice rather than a rule-based one.

Prior to the enactment of the CFMA, the CFTC operated under the authority of the Commodity Exchange Act\textsuperscript{99} ("CEA"). In December of 2000, President Clinton signed into law the CFMA which overhauled the CEA and ushered in sweeping changes to the regulation of derivatives in the U.S. in response to industry desire for change and more so in OTC derivative market regulation. The CFMA created a flexible and principle-based approach to derivatives regulation and replaced the "one-size-fits-all" prescriptive approach that previously reigned. Under this principle-based model, the regulation of futures and options trading was tiered based upon the types of product trades and the level of sophistication of the participants trading them. Core principles allowing participants to use different approaches to achieve statutory requirements replaced rules prescribing the means for achieving a specific mandate. A self-certification process was put into place to allow exchanges to implement new products and rules without prior CFTC approval and legal certainty was provided for with regards to certain OTC derivatives.\textsuperscript{100}

\textsuperscript{99} U.S., Commodity Exchange Act, Ch. 545, 49 Stat. 1491, enacted June 15, 1936.

\textsuperscript{100} R. Zwirb, “Chronology of CFTC Regulatory Philosophy” (May 1, 2008) at 5, online at : http://www.cadwalader.com/assets/article/050108ZwirbCFTCRegPhilo.pdf
In a speech given by the CFTC Commissioner at the time, Mr. Walter Lukken, he stated that a principle-based approach to derivative regulation has the advantage of being flexible for both the regulated and the regulator.\textsuperscript{101} Although the regulatory mission remains static over time, the means for achieving it evolve as innovation occurs or circumstances change. Principle-based regulation, being risk based, is advantageous because it inherently requires regulators to incorporate cost/benefit judgments into their decision making. Focusing on risk allows regulators to prioritize their responsibilities and leverage limited resources to their best advantage.\textsuperscript{102} Lastly, principle-based oversight has a significant advantage over rule-based regimes because it drastically enhances the regulator’s ability to work cooperatively with other regulators around the world. Because principles focus on outcomes and risk, regulatory jurisdictions are able to make this analysis without getting bogged down in whether the methods and means are exactly the same. Principles have been an effective yardstick at the CFTC in helping to make determinations on whether to recognize foreign exchanges in the U.S.\textsuperscript{103}

\textsuperscript{101}Walt Lukken, “It’s a Matter of Principles”, Keynote Address before the University of Houston’s Global Energy Management Institute’s 5\textsuperscript{th} Annual Trading and Marketing Conference (January 25, 2007).

\textsuperscript{102}For example, regulators can task their audit staff according to risk, spending time on firms that pose the greatest threat to the integrity of the marketplace and devoting less time on firms whose failure would be less likely to cause a contagion event or harm customers. This approach also provides greater incentive and accountability for firms in managing their risk in a more comprehensive and qualitative manner, instead of relying on a checklist of rules promulgated by a regulator.

\textsuperscript{103}For example, in February of 2006, the all-electronic ICE Futures exchange, headquartered in London and regulated by the U.K.’s FSA, began trading a light crude oil futures contract in direct competition with the pit-traded crude benchmark of the New York Mercantile Exchange (NYMEX) utilizing a CFTC recognition letter to allow U.S. customers to directly trade this product. Listing of the ICE Futures light crude contract was
Along the way the CFTC has encountered its ups and downs. In the period following the enactment of the CFMA, a number of developments rattled the energy trading markets including the collapse of Enron, scandals involving wash trading and false price reporting by energy traders and allegations of energy price manipulation by certain hedge funds. In response to these market failures calls have been made to restore regulation in areas that the CFMA either excludes or exempts from CFTC jurisdiction, most notably swap and energy transactions subject to certain exemptions under the CEA that some refer to as the “Enron Loophole”.\textsuperscript{104} The CFTC has also been criticized for not regulating exempt commercial markets (ECMs) sufficiently if at all. ECMs and swaps that trade on those markets undoubtedly played a significant role in the financial crisis of 2008/2009. Oddly enough, in

unique from a regulatory perspective because it was the first to peg itself to an existing U.S. regulated futures contract. This caused concerns amongst CFTC surveillance staff that regulators were not able to observe the entirety of a trader’s position on both markets, widening the possibility of trading abuses. Under a rule-based approach the CFTC might have required ICE Futures to register in the U.S. regardless of its regulatory status in the U.K. Such an approach would have resulted in duplicative regulation without furthering the public mission but principle-based oversight allowed a more tailored resolution enabling the CFTC to determine whether British law is broadly comparable to the principles set out for U.S. exchanges. In this case, the CFTC requested that ICE Futures provide the CFTC with access to its books and records, submit to U.S. jurisdiction and have in place information sharing and cooperative market surveillance between the CFTC and the FSA. As a result the CFTC and the FSA now share trading data, allowing a more comprehensive regulatory view of the crude oil market and a coordinated enforcement effort should problems arise.

\textsuperscript{104} In October of 2007, long after the wake of the Enron scandal that was exposed in 2001; the CFTC conducted a hearing to examine the oversight of trading in regulated futures exchanges and exempt commercial markets (“ECMs”). At the hearing, the Commissioner, Mr. Bart Chilton, calls for closing the “Enron Loophole” that allows energy products traded on ECMs to operate without regulatory oversight similar to exchange-traded products, while Commissioner, Mr. Michael Dunn questioned whether it made sense to continue to place “large swaths of the energy derivatives markets beyond the key elements of the CFTC’s jurisdiction.
October of 2007, the CFTC delivered to Congress a report that included recommendations to increase the oversight of some trading activity on ECMs that would effectively extend the agency’s jurisdictional reach to areas that the CFMA had just seven years prior sought to keep from regulation.\(^{105}\) Arguably these issues have more to do with the scope of the CFTC’s regulatory jurisdiction rather than whether principle-based regulation is serving its full purpose in derivative market regulation. OTC derivative regulation is currently the subject of and awaiting legislative reform.\(^{106}\)

In light of the current issues facing the CFTC as well as the potential merger between itself and the SEC,\(^{107}\) the CFTC vehemently stands by its regulatory principle-based approach

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\(^{106}\) On August 11, 2009, the Treasury Department sent to the U.S Congress proposed legislation titled the “Over-the-Counter Derivatives Markets Act of 2009.” The Treasury Department stated that under this proposed legislation “the OTC derivative markets will be comprehensively regulated for the first time.” To accomplish this “comprehensive regulation”, the proposed legislation would repeal many of the provisions of the CFMA, including all of the exclusions and exemptions that have been identified as the “Enron Loophole.” While the proposed legislation would generally retain the “legal certainty” provisions of the CFMA, it would establish new requirements for parties dealing in non-“standardized” OTC derivatives and would require that “standardized” OTC derivatives be traded through a regulated trading facility and cleared through regulated central clearing. The proposed legislation would also repeal the CFMA’s limits on SEC authority over “security-based swaps.” On December 11, 2009, the House passed H.R. 4173, the so-called Wall Street Reform and Consumer Protection Act of 2009, which included a revised version of the Treasury Department’s proposed legislation that would repeal the same provisions of the CFMA noted above. At that time, similar legislation was pending in the Senate. In late April, 2010, debate began on the floor of the Senate over their version of the reform legislation.

\(^{107}\) In response to the U.S. Department of the Treasury’s Blueprint for a Modernized Financial Regulatory Structure published March 2008, online at: http://www.ustreas.gov/press/releases/reports/Blueprint.pdf,
which allows for industry innovation and competition to flourish and for the regulator to respond not only to domestic issues but global issues more efficiently.

5 Considerations of the Canadian Securities Marketplace

In support of my argument in favour of a principle-based securities regime for Canada, consideration will have to be given to the unique nature of the Canadian securities marketplace. Irrespective of whether Canada moves forward with a national securities regulator, principle-based securities regulation is the better form of regulation for the Canadian securities market for the following reasons: principle-based regulation allows for more efficient synchronization and consideration of the various regional capital market interests and expertise, it is more responsive to modern day securities regulatory issues and it promotes Canada’s presence and competitiveness in the global securities arena. I intend to expand on these arguments in this section.

Canada’s capital market is a small market, comprised of less than 4.0% of the total global market capitalization. Across the provinces and regions Canada’s capital markets are diverse and aggregate into certain areas of expertise. In Canada, local infrastructures for generating

(website last visited on June 30, 2010), calling for the merger of the CFTC with the SEC, CFTC Acting Chairman Walt Lukken at the time, issued a statement cautioning that any regulatory reform effort must preserve the benefits of the CFTC’s principle-based model and recognize the distinct functions of the futures markets and mission of the CFTC. He also urged policy makers to first consider modernizing the laws that govern the securities markets to that similar to the futures laws before contemplating unification.
capital exist for certain industries and levels of market capitalization.\textsuperscript{108} For instance, Alberta has developed an expertise in oil and gas, British Columbia in micro-cap issuers and Ontario in financial services.\textsuperscript{109} Certain expertise also exists in more than one province. Both British Columbia and Ontario have expertise in mining, Ontario, Québec and British Columbia in communication and media, Ontario and Québec for life sciences and British Columbia, Ontario and Alberta all have expertise in small-cap issuers. The existence of specific areas of expertise however does not limit economic activity associated with these industries to their local or host provinces. Rather, the activities of issuers within a province with a certain expertise level have impact outside the boundaries of the host province. More so, most local regulatory responsiveness to those issuers’ activities is not the product of local and regional distinctiveness. So the argument for maintaining separate regional securities commissions to uphold local expertise cannot truly be sustained. Rather, existing local and regional differences can be accommodated under different regulatory models whether national or regional and/or principle-based, without appreciable differences in regulatory outcomes.\textsuperscript{110}

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\item A local infrastructure for generating capital is defined as a geographic region where there is a critical mass of issuers of a certain type or level of market capitalization. This allows for local securities regulators and professionals such as investment bankers, lawyers and accountants to develop an expertise and respond to the needs of such issuers.
\item Ibid. The argument is not asserting that in considering alternatives to the current regulatory structure or approach, local regulatory expertise should not be considered. A uniform securities law model and a passport
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With regard to the size of Canadian public companies, they are bifurcated into a modest number of large companies and a larger group of small companies. The group of small companies is disproportionately situated in B.C. and Alberta. Canadian companies also are substantially smaller in absolute dollar terms than their American counterparts and they tend to be closely held relative to American and British companies.\textsuperscript{111}

Analysts of the Canadian securities market have stated that Canadian securities regulation should be more focused on 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. It has further been observed that the number of small and thinly traded Canadian companies suggests that share price manipulation ought to be a key securities regulatory focus and that lighter or more flexible regulation which may be suitable for the U.S. small-cap companies, could prove over-burdensome for significantly smaller Canadian small-cap companies.\textsuperscript{112}

model would allow for existing regulatory expertise to be maintained within existing local regulatory commissions. A single regulator (whether based on provincial or federal action) could if properly designed (for example, along industry line and/or regional offices) maintain existing expertise. A single regulator could also allow for a consolidation of scattered expertise.


With regard to the small and mid-sized enterprises that make up the majority of Canadian companies, they can present challenges for regulators in that they do not generally possess the resources to focus explicitly on compliance. Many of these companies operate at the margins of profitability and cannot afford to devote many resources to non rule-based types of regulatory issues. They often lack awareness and expertise and even though individually they represent a low regulatory risk, collectively and as part of the majority of Canadian corporate reality, they warrant substantial regulatory consideration. In reality, current complex and detailed rule-based regulation that requires market participants for instance, to comply with detailed reporting obligations, can be quite onerous and ill-suited for these types of companies. Although principle-based regulation cannot directly address the resource issue that exists with these types of companies, it can promote more sensitivity to their needs and reduce the disproportionate impact that compliance costs would have on these companies via the flexible and tailored nature of principle-based regulation.

On a global scale, it is noted that an international market discount applies for Canadian listed companies based on a perception of regulatory failures of securities enforcement in Canada. This global perception is an important factor to consider from the view point of international investment in corporate Canada. It can be argued that this perception of

114 Supra note 40 at 39.
regulatory failure or lack of cohesive enforcement leads to investor uncertainty and is a product of the fragmented rule-based securities regulatory structure that exists in Canada today. In considering this perception, I argue that principle-based regulation operating under some type of a national or national/provincial regime, could be the best way to address not only the Canadian “market discount” but more so the lack of robust and efficient synchronization that exists in Canadian securities regulation today.\footnote{Using the U.K and Europe as examples, for both the FSA and the E.U. the development of overarching principles was a pragmatic response to the challenges of trying to impose a regime on top of, or superseding, several pre-existing and different regimes. In the U.K. the prior regulators were amalgamated into the FSA. At the E.U., the nation-state regulators continued to be the main law developers, meaning that the Union-level principles must still undergo a “translation” process into national law. Creating a new, overarching regulator presents some challenges but if the E.U. is any example, it may still be the simpler option.} Although worries about certainty and predictability under a principle-based regime are real ones, principles are effective if when implemented they are transparent, non-arbitrary and limit within reason, the discretion of regulators.\footnote{Supra note 44 at 31.} This builds certainty into the regulatory system and in turn builds investor confidence. The Canadian “market discount”, I argue is a symptom of the larger problem of a lack of investor confidence in the enforcement and stability of the Canadian securities regulatory regime. Promulgating a principle-based model in Canada at the national level for instance does not by itself reduce the possibility of differences in application of those principles from province to province or territory to territory however, it would promote sensitivity and recognition of the uniqueness of those different regions much more effectively than the rule-based regime that exists today.\footnote{Supra note 16 at 411-454.} A principle-based securities
regime would give provincial and territorial regulators, whether operating under a national or national/regional hybrid regime, a compass by which to orient their own practices, increase harmonization and facilitate interprovincial mutual recognition. Argued from another perspective, a principle-based model could also reduce the pressure to harmonize distinct provincial regimes and 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 effective enforcement and outcome-oriented measures of success, then differences in approach or methodology between jurisdictions become acceptable.¹¹⁹

I argue that by following a more principle-based regime, Canada will be applying a more modern approach to securities regulation. It will be able to position itself at a more level playing field amongst its global market partners, particularly the U.S. A more streamlined approach to securities regulation could make Canada a North American listing destination of choice if a regulatory approach like principle-based regulation gives it a competitive advantage.¹²⁰


¹²⁰ Supra note 42.
Clearly, if Canadian securities regulation were to become more principle-based, the Canadian capital markets would become more competitive on a global scale and attract more investment from foreign jurisdictions. An important ingredient in enhancing international competitiveness is the ability to influence the international regulatory system in which a market operates so that the regulatory system supports that country’s institutions. A common criticism of the fragmented Canadian system of regulation is that Canada does not speak with one voice on the international stage and hence might not be as effective in protecting Canada’s interests. Although in virtually every international forum the international community has the highest regard for Canada’s system of financial sector regulation, Canadian securities regulation, although well respected, fails to exert influence in the international arena. Canada’s voice is often lost in the abyss of provincial ones. Principle-based regulation applied on the Canadian front may help give it a voice on the international front as well by building cohesiveness and uniformity into the Canadian system which will allow it to speak the same regulatory language as other principle-based securities regulators.

6 Upholding Principle-based Regulation in Spite of the Global Financial Crisis

chaired by the Honourable Tom Hockin and struck in February of 2008, was created with the mandate of providing independent recommendations on how to improve the structure, content and enforcement of securities regulation in Canada. The Expert Panel released its final report in January of 2009 and recommended amongst other things that Canada adopt a more principle-based approach.\textsuperscript{122} In June of 2009, Mr. Doug Hyndman, the long time Chair of the BCSC was appointed as the Chair of Canada’s Transition Office for a new national securities regulator and could be expected to bring his commitment to the principle-based approach to his role.

In the time between the Expert Panel’s creation and final report, the global financial crisis became a reality. Global credit markets froze, stock market values plummeted, Wall Street investment banks collapsed, major financial institutions were bailed out on an unprecedented scale and financial regulatory systems internationally were cast into doubt.\textsuperscript{123} Understandably so, the global financial crisis put the global economy on red alert. As the days and months passed, regulators and the financial world in multiple jurisdictions gained a better understanding of the who, what, when, where and why of the crisis and naturally they questioned the validity and security of the pre-crisis structure of regulation.

Almost as a knee-jerk reaction, regulatory reform proposals flowed. Among them, the Chairman of the U.K’s FSA, Lord Adair Turner, released in March of 2009 “The Turner

\textsuperscript{122} Supra note 40 at 17.

Review: A Regulatory Response to the Global Banking Crisis”.  

Since the beginning of the financial crisis, major financial markets’ regulatory reform has been a buzz on a global level, most notably in the United Kingdom and the United States. Along with these proposals came a turn by some, including a number of scholars and domestic and international policy bodies, against principle-based regulation.

I argue that the financial crisis is not a product of the choice or type of regulatory system in place in the pre-crisis era nor is it an opportunity to discredit principle-based regulation as it is properly understood. Rather, I argue that in the wake of the financial crisis, principle-based regulation remains a viable and even more necessary regulatory option which can offer solutions to the challenges that the financial crisis presented and will continue to present to modern financial markets regulation. I argue that the financial crisis is a lesson about what happens when regulators fail to participate actively and skeptically in an “interpretive community”. In the absence of meaningful regulatory oversight and engagement, regulatory gaps will undoubtedly ensue. The global response should not be about creating an onslaught of more rules. Financial markets are too complex and forward-moving to be

126 Fundamental to principle-based regulation is the development of a functional and effective level of communication between industry, regulators and other stakeholders to forge ongoing development of the content of regulatory principles.
regulated in a manner of command and control. I argue that the financial crisis has in fact taught us three important lessons that are supported by a principle-based model. Firstly, regulators need to have adequate capacity in terms of human capital, access to information, expertise and perspective in order to successfully counterbalance the regulated industry as the content of principles in a principle-based system grows and develops. Secondly, regulators have to understand the impact of complexity on financial markets and their regulation. Regulators must develop an expertise in the kinds of complexities that exists and be mindful of their effects. The notion that innovation is in and of itself beneficial needs to be rejected. Lastly, I argue that the lack of diversity and independence among regulators and industry contributed to conflicts of interest and over-reliance on market discipline and these factors certainly created part of the ill-conditions leading up to the financial crisis.

Without delving too deeply into the causes of the financial crisis, a few things can be stated with regards to what contributed to its evolution. There is no doubt that one of the factors that led to the financial crisis is the increased complexity of investment products available for distribution on the exempt market. Complex securitized products like credit default swaps were distributed through exempt market private placements and thus were able to bypass public securities market regulation.\footnote{127} This led to the creation of the so-called “shadow-banking” system in the U.S., which is a clear example of prudential regulatory failure.\footnote{128} In

\footnote{127} Supra 115 at 21. 
\footnote{128} Patricia A. McCoy, Andrey D. Pavlov & Susan M. Wachter. “Systemic Risk through Securitization: the Result of Deregulation and Regulatory Failure” (2009) 41 Conn. L. Rev. 493. It was noted that the SEC, which had primary oversight of most Wall Street investment bank functions was not well equipped to conduct prudential financial regulation.
Canada, the asset backed commercial paper crisis of August 2007 revolved around the selling of investment products under an exemption from securities regulation.\(^{129}\) Regulators also failed to properly regulate and indiscriminately depended on credit rating agencies which in their own right failed as gatekeepers and greatly contributed to the evolution of the financial crisis.\(^{130}\)

Needless to say, the impact of the financial crisis was felt on a global scale. With banking and securities markets growing and operating beyond geographic boundaries, and technology enabling long distance risky lending, the financial crisis spread like wildfire and understandably affected banking and securities markets on a global scale. The financial crisis was indeed a global event and was not unique to principle-based jurisdictions. In fact, national systems described as being more rule-based like those of the U.S. (i.e. the SEC) did not fare better than their principle-based counterparts in the U.K. (i.e. the FSA).

Principle-based regulation is based on a robust and capable public role which includes meaningful enforcement and ongoing communication between the regulator and the industry.

\(^{129}\) See *Prospectus and Registration Exemptions*, NI 45-106, (12 September 2005) at s. 2.35. This instrument exempts trades in commercial paper maturing not more than one year from the date of issue and having an approved credit rating from an approved credit rating agency.

\(^{130}\) Credit rating agencies in Canada and the U.S. historically have operated with relatively very little regulatory scrutiny. In the U.S. oversight has fallen upon the SEC which has chosen to rely on ratings from “Nationally Recognized Statistical Rating Agencies” (NRSRA). The SEC imposes stringent requirements before any agency can be recognized as a NRSRA. This coupled with high entry barriers has produced a situation where three agencies dominate the market for credit ratings. Legislation has recently been proposed in the U.S. to introduce additional regulatory oversight and curtail many of the failings associated with the current rating system.
The development of an “interpretive community” is what allows principle-based regulation to grow and thrive. At its most basic level, regulatory capacity in a principle-based environment must consist of an adequate number of staff. Principle-based regulation may be more hands-off in terms of its approach but that does not mean that it requires fewer regulatory resources. Depending on how a regulator chooses to implement a principle-based model, the regulator may require intensive interaction with the industry at least on certain issues and needs to have adequate quality and quantity of staff to support this interaction.  

Regulators in a principle-based system must also have the ability to obtain transparent and reliable information about the industry they regulate. Without a doubt, industry actors have better and more up-to-date information on their operations than regulators do. That being said, it is how industry uses this information that guides the substance of its interactions with regulators. With its advantageous access to information, industry can choose to share this information in a full and fair manner or it can give into its ability to cast facts and information in a favourable light for the industry making products look as attractive as possible and reducing regulatory oversight. In a system which relies on extensive and forthright sharing of information between regulator and industry and where information is

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131 As an example of inadequate staffing, the FSA’s Major Retail Groups Division was reduced by about 20 staff members between 2004 and 2008, notwithstanding that division’s responsibility for substantial and complex FSA priorities such as Basel, and the Treating Customers Fairly initiative in addition to its core firm risk assessment duties. The FSA acknowledged a high turnover of FSA staff directly supervising the Northern Bank matter as well as inadequate number of staff and very limited direct contact with bank executives among the reasons for its unacceptable regulatory performance. See U.K., FSA, Internal Audit Division, “The Supervision of Northern Rock: A Lesson Learned Review” (2008), online at: http://www.fsa.gov.uk/pubs/other/nr_report.pdf (website last visited on June 30, 2010).
power, a regulator without the ability to obtain such information accurately is not in a position to provide effective regulation. This is a potential drawback of the principle-based system which places much reliance on industry sharing knowledge and expertise with the regulator. The need for regulator expertise to level out the playing field is apparent in this context and has been brought into focus as one of the lessons of the global financial crisis.

Regulators in a principle-based system must also have the capacity to independently scrutinize information. This requires considerable capacity in terms of information management systems, quantitative expertise and industry experience. Regulators should be seeking out and employing the same high-level experts that the bank and other financial institutions are hiring to keep their expertise at the same standard as the industry. This will enable the regulators to develop sufficient confidence in their own judgment while still being objective about the industry they regulate. Independence and objectivity are difficult problems to address and as such can lead to the very real problem of regulatory influence.

Another important lesson from the financial crisis is how much of an impact complex products can have on the financial markets. In order for effective regulation to take place it has never been clearer that regulators need to acquire a heightened level of understanding.

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132 The FSA’s response to the Northern Rock matter may be instructive to Canada as it contemplates moving toward principle-based securities regulation. The FSA plans to enhance its supervisory teams which include adding more staff, better training, mandatory minimum number of staff per high-impact institution and close contact between senior staff and the biggest firms. It also plans to improve the quality of staff, hiring risk specialists to support frontline teams by focusing on complex models used by banks to assess risk. This is part of the FSA’s “supervisory enhancement program” online at: http://www.fsa.gov.uk/pubs/other/enhancement.pdf (website last visited on June 30, 2010).
about these products. Complexity will no doubt be the greatest financial market challenge of
the future. Complexities in the products, their design and the market for these products
can lead to inappropriate lending standards, failures of disclosure, a lack of transparency and
comprehension. All of these complexities can lead to the creation of a system characterized
by intimate causal links between different industries within the financial and securities
markets that can create a grave domino effect if something were to go wrong as was proven
by the financial crisis. Realistically, complexity in financial markets at this point in time will
just continue to grow. It is up to regulators to develop a clearer and more detailed
understanding of how complexity manifests itself and why. Regulators should also evaluate
the varieties of complexities in terms of their cost and benefits to individual and systemic
economies. In fact the global financial crisis has shown us just how much more effective and
needed principle-based regimes are in identifying and understanding complexities of the
market and building principles and rules to govern and contain those complexities.

The last point I wish to address on lessons learned from the financial crisis is that regulators
need to remain independent of the industry in order to objectively fulfill their regulatory role.
Too much faith in market discipline was undoubtedly a factor that led to the under-regulation
of the financial markets and over-reliance on the industry to police itself. Great weight was
also placed on the opinions of credit rating agencies without ensuring that those agencies

complexity lies in the assets that underlie modern structured financial products, overlaid with complexity in the
design of the products and heightened by the complexity that exists in modern financial markets.
were in fact impartial and accountable.\textsuperscript{134} Conflict of interest was prevalent. British regulatory and financial services communities are characterized by social overlap\textsuperscript{135} and much has been published about the positions of public power in the U.S. occupied by individuals formerly working in the private sector and the potential adverse effects on public policy.\textsuperscript{136} One commentator has argued that one of the causes of the financial crisis in the U.S. was that the financial industry was dominated by oligarchs with ties to the government.\textsuperscript{137} As I argued earlier with regards to regulatory capture, lack of regulatory independence and enhanced industry influence poses a real threat to providing effective and objective regulation. I am not arguing that individuals with industry experience be barred from taking on regulatory positions. The benefits are abundant in employing regulators with industry experience particularly when operating under a principle-based system. The


\textsuperscript{136} Alumni of former investment bank Goldman Sachs have occupied key roles not only in the U.S. government but also at the Bank of Canada (Governor Mark Carney) and the World Bank (President Robert Zoellick). The Obama Administration is also not been immune from allegations that it was not aggressive enough in its reform of the financial industry as a result of too-close ties the industry. See Heidi Przybyla, “Obama Embrace of Wall Street Insiders Points to Politic Reforms” (19 November 2008) online at: http://www.bloomberg.com/apps/news?pid=20601070&sid=aWSz2kUxdTiU (website last visited on June 30, 2010).

concern is with the regulator losing its objective perspective. Neither gatekeepers nor regulators will serve their function best if they are not firmly rooted in an independent source of authority. This independence can easily be thwarted by allegiances made with those that the regulator oversees. Anchoring itself in independence, the regulator can better resist the pull of industry influence, something that is especially dangerous in principle-based regulation because of the degree of built-in fluidity.\textsuperscript{138}

Upon reflection, the global financial crisis taught us lessons about the risks associated with principle-based regulation when not supported by meaningful regulation; one where regulatory presence is strong and pervasive. The response to the financial crisis cannot be reactionary but must be thoughtful. Reversion must not be made to a more rule-based approach just because it is our familiar regulatory default. More rules means the stifling of innovation, the provoking of further “loophole” like behaviour and the imposition of more costs at the expense of regulatory flexibility. Innovation and complexity in the financial markets will continue to grow and it is a matter of how efficiently the regulatory world grows with it. Principle-based regulation should be thought of as a solution to the problems presented by the financial crisis and the better method for regulating modern capital markets.

\section*{Conclusion}

This paper argues for principle-based securities regulation for Canada. It is the preferred mode of securities regulation. Why? Because capital markets are constantly changing, becoming more diverse, complex and more global as time goes on. Change in the securities

\textsuperscript{138} \textit{Supra} note 123 at 46.
industry is a constant. As such, the regulation of the securities industry has to be fluid, flexible and cooperative. Regulators have to be in constant communication with the industry, learning about products and services offered by the industry in order to fully understand how to protect the investing public. Likewise, the industry has to be cooperative and forthright with regulators as opposed to competitive and elusive. Cooperation breeds mutual trust and respect and out of these, a principle-based system of regulation works in optimal form creating rules and principles that both regulators and the industry are content with.

For Canada, principle-based regulation is the better form of regulation. It allows for recognition of the diversity of the Canadian markets, respect for the sensitivities of provinces, territories and the nation as a whole, and will allow Canada to become fully competitive in the global arena. The time is now for Canadian securities regulation to operate on a more modern platform; one that promotes international recognition and ultimately increased international investment.

From a global perspective, and learning from the lessons that the recent financial crisis taught us, rule-based securities regulation does not immunize us from market failure. It is not the best way to regulate an industry that is constantly creating novel financial products and services that are becoming more and more complex. Now more than ever, in the aftermath of the financial crisis, principle-based regulation should be viewed as the answer to many of the short comings that exist in securities regulation today.
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