Principles-Based Securities Regulation in the Wake of the Global Financial Crisis

Cristie L. Ford
Introduction

These remain early days to try to assess the impact of the global financial crisis (GFC), and the impact of subsequent regulatory reform efforts, on national and transnational financial markets regulation. That said, it is important to continue to assess events “on the fly” given how quickly reform efforts are evolving, how uncertain the future continues to be, and how pressing the need is to implement reforms in Canada and abroad.

This paper considers a particular aspect of regulatory design: principles-based regulation. It seeks to re-examine (and indeed to restate the case for) principles-based securities regulation, in light of the GFC and related developments. It argues against an overly hasty rush to more rules-based formulations. Prior to the onset of the crisis, the concept of more principles-based regulation was

---

1 Thanks to Julia Black, Amy Cohen, Sharon Gilad, Donald Langevoort, Saule Omarova, Jim Park, David Zaring, and the anonymous reviewers enlisted by the McGill Law Journal for very helpful comments on earlier drafts, and to Christina Wolf and Ami Iaria of the B.C. Securities Commission for stimulating background conversations. Thanks, also, to Sam Cole, UBC Law JD 2010, for exceptional research assistance.
based financial regulation was gaining traction in regulatory practice and policy circles. In Canada, steps were being taken to develop more principles-based securities regulation under the leadership of a proposed new national securities regulator. The federal government’s Expert Panel on Securities Regulation (Expert Panel), chaired by the Honourable Tom Hockin, was struck in February 2008 with a mandate to provide independent recommendations on how to improve the structure, content, and enforcement of securities regulation in Canada. It released its final report on January 12, 2009, recommending inter alia that Canada adopt a more principles-based approach. On June 22, 2009, Doug Hyndman, long time Chair of the British Columbia Securities Commission, was appointed to a two year term as Chair of Canada’s Transition Office for a new national securities regulator. Mr. Hyndman, along with Vice Chair Brent Aitken, has been the driving force behind the B.C. Securities Commission’s principles-based approach and could be expected to bring that commitment to his new role.

In the interim between the Expert Panel’s creation and its final report, of course, global credit markets froze, stock market values went into free fall, Wall Street investment banks collapsed, major financial institutions were

---


bailed out on an unprecedented scale, and financial regulatory systems internationally were cast into doubt.\(^5\) A flurry of ambitious reform proposals followed. Among others, in March 2009 Lord Adair Turner released the Turner Review in the United Kingdom, subtitled “a regulatory response to the global banking crisis,”\(^6\) and major financial markets regulatory reform has been proposed in both the United Kingdom and the United States.\(^7\) Several major domestic and international policy bodies\(^8\) and a number of scholars\(^9\) have contributed to the conversation. Along with this came a turn, in some quarters, against principles-based regulation.\(^10\)

This paper argues that the GFC does not discredit principles-based regulation, as that form of regulation is properly understood. On the


contrary, principles-based securities regulation remains a viable and even necessary policy option, which offers solutions to the real-life and theoretical challenge that the GFC presents to contemporary financial markets regulation. What the crisis actually demonstrates is how damaging a laissez-faire mindset on the part of regulators can be to any form of regulation, including principles-based regulation. Principles-based regulation does not mean doing away with rules. Rather, it is a particular approach to structuring regulation. It gives legislatures the power to set high-level regulatory goals and outcomes, and leaves the articulation of processes and details to frontline regulators in collaboration with industry itself. Fundamental to principles-based regulation is the development of a functional and effective “interpretive community” that includes industry participants, regulators, and other stakeholders in ongoing communication around the content of regulatory principles.

The experience of the GFC is a lesson about what happens when regulators fail to participate actively and skeptically in that interpretive community. Principles-based regulation is premised on concepts of “co-regulation,” or “enforced self-regulation,” but the GFC illustrates how such models can slide into self-regulation in the absence of meaningful regulatory oversight and engagement. Our response should not be to re-embrace more rules-based regulatory approaches. Financial markets are too fast-moving and complex to be regulated in a command-and-control manner, and the risk of Enron-style “loophole behaviour” associated with rules is too great. Instead, we can draw on the lesson of the GFC to identify three critical success factors for effective principles-based securities regulation.

First, regulators need to have the necessary capacity in terms of numbers, access to information, expertise, and perspective to act as effective counterweight to industry as the content of principles is developed. Second, regulation needs to grapple with the impact of complexity on financial markets and their regulation. This means developing an appropriately granulated understanding of kinds of complexity and their effects, and rejecting the notion that innovation is by definition beneficial. It may also mean considering whether some regulatory requirements (such as capital requirements) are best cast as bright line “prophylactic rules,” which at least in the short term may limit complexity and conserve regulatory resources. Finally, the paper suggests that the lack of diversity and independence among regulators and industry may have contributed to conflicts of interest, over-reliance on market discipline, and “groupthink” in the run-up to the GFC. The response may be a move away from an expertise-based, technocratic model toward a more broadly participatory one. The paper closes with a call for a continuing commitment to principles-based regulation, accompanied by the indispensable implementation piece – meaningful enforcement and oversight.
Principles and Rules in Theory and Practice

Principles-based capital markets regulation has been a hot policy topic in recent years in many jurisdictions including Canada, the United States, and the United Kingdom.11 In terms of actual practice, the U.K. Financial Services Authority (FSA) has been a thought leader on principles-based financial regulation.12 In Canada, the province of British Columbia tried to promulgate a new, more principles-based Securities Act in 2004 and has since adopted a more principles-based approach to how it administers its act.13 Derivative products in the United States and Canada also tend to be regulated in a more principles-based manner.14 Most recently in Canada,


A famous example used to describe the difference between rules and principles involves speed limits.\footnote{17}{\textsuperscript{17} See Kaplow, \textit{ibid.}, at 559-60; Sullivan, \textit{ibid.}, at 58-59.} A rule based speed limit will prohibit driving faster than, for example, 90 km/h. A principle based formulation might prohibit drivers from driving faster than is “reasonable and prudent in all the circumstances.”\footnote{18}{\textsuperscript{18} In the years prior to 1974, and from 1995 to 1999, Montana utilized a non-numerical “resonable and prudent” speed limit. The limit was subsequently repealed, when found to be so vague as to violate the Due Process Clause of the Montana Constitution. See \textit{State of Montana v. Rudy Stanko}, 1998 MT 321 (Montana Sup. Ct.). On the potential vagueness of principles in the securities law enforcement context, see Ford, Expert Panel, \textit{supra} note 12, at 31-34.} In this way, rules generally determine, in advance and with precision, what conduct is permissible. The frontline decision-maker (here, a police officer) only has to answer a factual question: was this particular individual driving faster than 90 km/h? By contrast, under a
principles-based system, the frontline decision-maker also needs to decide what conduct is permissible; that is, whether in all the circumstances (including road and environmental conditions, time of day, traffic, condition of car, experience of driver, etc.) the individual in question was driving in a what the police office would consider to be a reasonable and prudent manner. Rules are generally considered to be more precise and certain, but may be rigid, reactive, over- or under-inclusive, and insensitive to the needs of particular situations. They can also be “gamed” and promote “loophole” behaviour. Principles are more flexible, more sensitive to context, and potentially fairer, but they can be uncertain, unpredictable, and difficult to interpret for those subject to them. They can promote arbitrary conduct and over-reaching by regulators.19

The terms are also useful at the systemic level, for describing real life regulatory approaches.20 No workable system consists entirely of rules or of principles, but different systems can be comparatively more rules- or principles-based – a point the FSA has made by calling its world-leading approach simply “more principles-based.”21 Statutory drafters and regulators can choose to regulate the same issues by way of different proportions of detailed checklists, bright line rules, or open-ended goal statements.22 In the context of statutory drafting, principles-based regulation means legislation that contains more directives that are cast at a higher level of generality. A principles-based system looks to principles first and uses

---

19 This paper contests the idea that rules are more certain than a principles-based system that is supported by a well-functioning interpretive community and adequate regulatory capacity; see infra, “Complexity and Prophylactic Rules.” However, it does not contest the idea that rules are more certain and principles more flexible in the abstract – i.e., in the absence of a mechanism such as careful, structured, ongoing multiparty dialogue for working out the content of principles in a responsible manner. Of course, even under ideal conditions application will influence theory in direct and indirect ways. For example, through application to real-life situations, principles acquire specific content on a constant, ongoing basis. Decision-makers may also interpret a rule “up” or “down” (making it look more like a principle or more like a detailed rule) to make it fit a specific situation. Principles, also, when interpreted by multiple human beings in multiple situations, may lose their high level character, slide closer to rules, get fuzzy around the edges, and otherwise drift and change. See e.g. Schauer, supra note 16. Therefore, whether a regulatory system fosters clarity and predictability, for example, is not entirely related to whether it is rules-based or principles-based. The real question is whether regulator and regulatees have a shared understanding of what the regulations entail.


21 Focusing on the outcomes, supra note 2, at 4-5.

22 See Black, “Making a Success,” supra note 2, identifying the distinction between bright line rules and detailed rules.
them, instead of detailed rules, wherever feasible. When confronted with a new situation, a principles-based system first determines whether it can be regulated under existing principles, and it resists the temptation to create new, purpose-built rules. Yet even within a system that is generally principles-based, rules continue to have their place in providing further clarity and enhancing enforceability.

Rules and principles are also best understood as points on a continuum, not discrete concepts, and there is a good deal of overlap and convergence between them. Any complex regulatory system will be (and should be) an amalgam of rules and principles. Here, the public perception of “principles-based regulation” exhibits considerable confusion. For example, 87.5% of the 75 written submissions from stakeholders to the Expert Panel were in favour of principles-based regulation. But of these, a substantial number seemed to assume that principles-based and rules-based regulation were at opposite extremes, and that a move to a more principles-based system meant substantially eliminating rules, no matter how efficient or necessary they might be. Several stakeholders argued forcefully against exclusively principles-based or rules-based approaches, even though no such drastic move was being proposed.

**A time for principles, a time for rules**

American academic Colin Diver has discussed the importance of precision in statutory drafting in terms of three underlying priorities: transparency

---

23 See e.g. British Columbia Securities Commission, “Message from the Chair,” Annual Report 08/09 (2009), at 3 (on responses to the GFC: “To the extent that market professionals misrepresented the features or risks of investment products, or sold unsuitable investments to unsophisticated investors, we already have rules against that type of conduct. Rather than devising new rules for what is already illegal, we need to maintain and adapt our compliance and enforcement processes to detect and deter this activity. [...] Any new rule, however, should be based on thorough analysis that shows it to be the best option for achieving a desired regulatory outcome. All too often, policymakers start with the presumption that a situation demands new rules, and they lose focus on other options like enforcing existing requirements that could deal with the problem more quickly and effectively.”).


(i.e., the words chosen have well-defined and universally-accepted meanings within the relevant community), accessibility (i.e., the law can be applied to concrete situations without excessive difficulty or effort), and congruence (i.e., the substantive content of the message communicated by the words produces the desired behaviour). In some areas, flexibility and tailoring to particular context will be more important than certainty and the need to limit discretion. In others, the reverse will be true. However, Diver points out that it is difficult to measure these qualities, and that there are often tradeoffs between them. Establishing a balance between rules and principles involves decisions about priorities and concerns.

In particular, where these lines are drawn depends on public priorities that the legislator has the mandate to establish. For example, a legislator that is concerned about regulatory overreaching or lack of transparency in a particular area would see to it that the regulator had very little discretion (that is, that expectations are cast as rules rather than principles and are enshrined in a statute) when it comes to such things as access to information, the handling of complaints, or accountability to parliament. A legislator concerned about individual rights would limit discretion (that is, would craft rules not principles) regarding hearings, procedural fairness, and participation or consultation rights. A legislator concerned about ensuring that the regulator can keep up with fast-moving events would give that regulator principles, not rules, to work with and would devolve substantial decision-making to the regulator’s rulemaking power. A legislator concerned about ensuring a high correlation between regulatory goals and effective application to particular cases would ensure that the regulator had the power to flesh out the content of principles on a rolling basis, rather than trying to draft specific details in advance.

Important external considerations also come into play. For example, how much scope does the legislator want to leave to the interpretation of regulators, as well as potentially of courts or tribunal(s)? Where does existing regulatory practice (whether principles-based or rule-based) seem to be well-established, to be working well, and to have created expectations on which stakeholders rely? Would a particular drafting approach foster harmonization between existing regulatory regimes, or nudge regulatory practice in a desirable new direction? Are some issues particularly

important to the proper functioning of Canadian capital markets (e.g., regulating effectively the many small, closely held public companies, or addressing the rumoured Canadian “market discount”)\(^{28}\), which call for well-tailored and highly adaptive – that is, principles-based – solutions? On what specific issues does the political will exist to move decisively away from the status quo? What messages does Canada, through its regulatory regime, want to send internationally? All of this requires that \textit{policy makers} develop a set of criteria reflecting policy calculations for deciding when to use rules and when to use principles.

Context also matters. An appropriate balance between rules and principles in securities regulation may look quite different than in other regulatory arenas. The nature of the industry being regulated, the roles of the various players in it, and the risks associated with that area of conduct will inform the regulatory design process.\(^{29}\) It is relevant that securities regulation is a disclosure-based system, which relies heavily on ensuring reasonable access to information as a means for protecting investors. This suggests that congruence is important in this context, so that core definitions of materiality and disclosure should be broad and principles-based. Another area where the over- or under-inclusiveness of rules is particularly problematic, and where flexibility and congruence are especially important, is preventing fraud and minimizing “cosmetic” compliance and “loophole” behaviour. This is the rationale for broad statutory definitions of fraud, and commissions’ sweeping public interest powers.\(^{30}\) Financial markets are also


\(^{29}\) See also Black, “Making a Success,” \textit{supra} note 2, at 200-201.

\(^{30}\) \textit{Committee for Equal Treatment of Asbestos Minority Shareholders v. Ontario (Securities Commission)}, [2001] 2 S.C.R. 132 at para. 41 [Asbestos Minority Shareholders]; Anita Anand, “Carving the Public Interest Jurisdiction in Securities Regulation: Contributions of Justice Iacobucci” (2007) 57 U.T.L.J. 293. Even considering the substantial deference to securities commissions, courts (and commissions themselves through their policy) should establish standards and explicit rationales for the application of public interest powers to ensure that they
complex, fast-moving environments marked by constant product-level innovation. Principles recommend themselves in this environment, when underpinned by effective information-gathering and analytical mechanisms, since detailed rules may only add to complexity and opacity. Principles also make sense where a flexible approach is needed to ensure good corporate conduct – for example, with regard to internal compliance processes, corporate culture, or risk assessment by management. Like the deference accorded to securities commissions under administrative law, principles-based regulation also reflects legislative faith in regulatory expertise, objectivity, fairness, and capacity.

One can also identify situations where rules may make particular sense in securities regulation. Consistency in form is important in disclosure documents, for example, to make it easier for potential investors to compare investments. Prospectus requirements should therefore contain detailed form requirements. Securities commissions are also powerful administrative agencies, with broad mandates and the ability to impose heavy sanctions. For rule of law reasons, process requirements associated with investigatory powers and enforcement conduct should be clearly set out. Provisions around notice, rights to hearings, time limits, and procedural fairness should presumptively be more rules-based. Rules also make sense where the sheer cost of applying a principle outweighs the principle’s flexibility benefits – for example, where the regulator needs to manage large numbers of

---

31 See discussion below, “Four Points on Regulatory Capacity.”
33 Edward Rubin, “The Myth of Accountability and the Anti-Administrative Impulse” (2005) 103 Mich. L. Rev. 2073 at 2131-34 (arguing for open-ended formulations where the regulator “knows the result it is trying to achieve but does not know the means for achieving it, when circumstances are likely to change in ways that the [regulator] cannot predict, or when the [regulator] does not even know the precise result that she desires”); see also Ford, “New Governance,” supra note 2.
34 Colin Diver has suggested that registration of persons should fall on the more principles-based end of the spectrum, because registration and licensure does not deter or influence conduct, and tries to make predictions about future conduct about which little can be known at the time of licensing. Diver, supra note 26, at 79.
36 As technology improves, for example through the mandated use of Extensible Business Reporting Language (“XBRL”), consistency in form may be seen as less important than ensuring the most effective possible disclosure. See online: XBRL <http://www.xbrl.org/>.
relatively small matters. Accessibility is also important if lay individuals will be interpreting the law on their own. This is a concern in capital markets like Canada, in which many smaller actors with more limited compliance resources operate. During a transitional stage between rules-based and principles-based regulation, for example, maintaining legacy rules may help keep compliance costs down. Rules may also be especially appropriate where the statutory drafter has some comfort that a clear rule can serve as an effective proxy for good corporate conduct – for example, because regulatory expectations are easily verifiable, easy to describe, and because events are not fast-moving.

**Actual Principles-Based Securities Regulation: Key Characteristics**

In producing a research report on principles-based regulation for the Expert Panel, this author reviewed and compared the Ontario *Securities Act* ("OSA"), Bill 38, the proposed British Columbia *Securities Act* and associated proposed Securities Rules (collectively, the “B.C. Model”), the
Québec Derivatives Act (“QDA”);41 the United Kingdom’s Financial Services and Markets Act (“FSMA”);42 and the United States’ Commodity Futures Modernization Act (“CFMA”)43 with a view to determining how principles-based regulation differed from more rules-based regulation at the level of statutory drafting. (The report also occasionally considered the enforce B.C. Securities Act.) The OSA was chosen to represent the legislative status quo across Canada. The Quebec statute and the B.C. Model are generally understood to be more principles-based. The FSMA was not explicitly principles-based when it was drafted, but the FSA adapted its statutory mandate to develop a world-leading model of principles-based regulation.44

Without claiming to be comprehensive, the report identified some overarching themes at the level of statutory drafting.45 There were several commonalities across regulatory schemes, regardless of whether the regime was more rules- or principles-based, and the draft securities act issued by the Expert Panel (based as it was on the existing Alberta Securities Act)46 reflects the same choices. For example, disclosure and fraud tend to be drafted in a more principles-based manner, because these are areas where congruence is essential (that is, the definition of fraud must be able to capture even novel forms of fraudulent behaviour) and loophole behaviour cannot be tolerated. Compliance provisions – which require registrants to

---

41 QDA, supra note 14.
42 Financial Services and Markets Act 2000 (U.K.), 2000, c. 8 [FSMA].
43 Commodity Futures Modernization Act of 2000, 7 U.S.C. §1 [CFMA].
44 See Julia Black, “Forms and Paradoxes of Principles-Based Regulation” (2008) at 12, online: <http://www.scribd.com/doc/14726527/Forms-and-Paradoxes-of-Principles-Based-Regulation-by-Julia-Black> [Black, “Forms and Paradoxes”] (distinguishing “formal PBR,” meaning principles in the rule books; “substantive PBR,” which has some of the operational elements of PBR but not principles on the rule books; “full PBR,” exhibiting both principles in the rule books and a principles-based operational approach; and “polycentric PBR,” which is full PBR with the additional element of incorporating third parties into the regulatory process).
45 Note that the comparison was of statutes only. A comprehensive comparison of these regulatory regimes is neither feasible nor very helpful, given the number of different factors that go into any statute’s drafting. Just as importantly, National and Multilateral Instruments, regulations, and rules play central roles in real-life securities regulation. On this larger plane, this report concurs generally with Professore Stéphane Rousseau’s description of which aspects of securities regulation are rule-based, and which are principles-based, referred to in the Brief submitted by the Autorité des marchés financiers to the Expert Panel on Securities Regulation. Autorité des marchés financiers, Single Regulator: A Needless Proposal (Expert Panel on Securities Regulation, 2008), at 26, online: AMF <http://www.lautorite.qc.ca/userfiles/File/Publications/secteur-financier/Memoire-commission-unique-07-08_ang.pdf>.
46 See Draft Securities Act, supra note 15, at 3.
maintain effective systems and controls to manage the risks associated with their businesses, and prevent and detect internal wrongdoing — also tend to be principles-based.\footnote{But see QDA, supra note 14, ss. 26-31, 61-62. See also the compliance provisions in National Instrument 31-103, Registration Requirements and Exemptions (advanced notice, effective September 28, 2009), online: BCSC <http://www.bcsc.bc.ca/uploadedFiles/securitieslaw/policy3/N131-103_Advance_Notice.pdf>, at Part 11.} More detailed rules cover topic areas where power is uneven and transparency is not otherwise ensured, or where fairness and basic administrative law underpinnings are at stake. For example, every securities scheme has provisions that govern administrative proceedings, such as hearings and investigations, and they are all substantially process-based and rule-oriented.\footnote{The best examples here are OSA, supra note 39, ss. 3.5, 8-9; and Bill 38, supra note 40, ss. 65, 70(2), (3), 75. The FSMA and QDA do not contain direct analogues. Because the FSMA establishes an independent oversight body, the Financial Services and Markets Tribunal, it treats administrative proceedings somewhat differently. However, the process-based and rule-driven structure persists. See e.g. FSMA, supra note 42, Schedule 13. The QDA is a more circumscribed statute that borrows many provisions from the Québec Securities Act, though it contains some process-based provisions at ss. 115-117.} The statutes are less detailed around areas that change quickly or that require specialized expertise.\footnote{For the full report see Ford, Expert Panel, supra note 12.} In general, these overarching commonalities accord with the Diver analysis as to where transparency, flexibility, or congruence should be the dominant concerns.

The Expert Panel research report also identified particular ways in which more principles-based and rules-based regimes differ. Some differences are essentially stylistic. For example, principles-based regulation is commonly accompanied by a move toward plain language drafting. Other differences, while consistent with a principles-based regulatory philosophy, are not essential to it. In particular, the proposed B.C. legislation originally imagined much more streamlined processes in its proposals for firm-only registration and continuous market access.\footnote{Bill 38, supra note 40, would have replaced existing prospectus disclosure rules, short form prospectus provisions, the entire exempt market transaction structure, and existing continuous disclosure obligations – as they then were – with an overarching “Continuing Market Access” structure. Continuous Market Access would have required all companies accessing the British Columbia capital markets simply to disclose all “material information” (here, replacing “material fact” and “material change”) on a real-time basis. Other B.C. Model innovations included firm-only registration (which was abandoned before the project as a whole was abandoned), secondary market liability (which was later resurrected), and enhanced enforcement powers.} Another element common to the principles-based statutes considered is the inclusion of a small number of
high level principles guiding the conduct of regulated entities.\textsuperscript{51} Consistent with the principles-based approach, how exactly those principles translate into specific business conduct expectations in context is left to be filled in through techniques such as administrative guidance, enforcement example, the incorporation and dissemination of good or best practices, and ongoing communication between regulator and registrant.\textsuperscript{52}

Structurally, the most profound differences between the more principles-based and more rules-based statutes are in two areas: the proportion of decision making and interpretive power that is explicitly left to be filled in through the rulemaking function, rather than statutory drafting; and the proportion of outcome-oriented versus process-oriented statutory requirements.

All four statutes studied grant rulemaking power to the regulator in question.\textsuperscript{53} To be clear, securities law statutes in every jurisdiction contain notable principles-based provisions.\textsuperscript{54} By contrast to regulators in other fields, securities regulators already have extensive notice-and-comment rulemaking powers and enjoy substantial deference from courts on judicial review.\textsuperscript{55} As between the more rules-based and principles-based systems, however, the difference lies in how much detail is provided in the statute, and how much is left to be filled in through the Authority’s or Commission’s rulemaking. A striking visual illustration of the difference between the existing approach and the B.C. version of a more principles-based one is in the Table of Concordance that that province’s Commission staff prepared in September 2004.\textsuperscript{56} Large chunks of the Securities Act currently in force would simply have no equivalent in the proposed B.C.

\textsuperscript{51} The FSA refers to its set of principles as the “Principles for Business”; B.C.’s Bill 38 would have contained a “Code of Conduct for Dealers and Advisors”; and, the CFMA and QDA both refer to theirs as “Core Principles for Derivative Markets.” Many of the principles contained in B.C.’s Code of Conduct have since found their way into National Instrument 31-103, supra note 47, though that Instrument also contains detailed rules.

\textsuperscript{52} For a more detailed description of these techniques and their use in ascribing content to regulatory principles, see Ford, Expert Panel, supra note 12 at 9-13.

\textsuperscript{53} See OSA, supra note 39, s. 143; Bill 38, supra note 40, s. 170; QDA, supra note 41, ss. 174-75; FSMA, supra note 42, s. 138. Rulemaking needs to be distinguished not only from statutes, but also from regulations, which though subordinate must go through the legislative process rather than being largely or entirely under the control of the regulator itself.

\textsuperscript{54} See e.g. s. 10 of the Securities Exchange Act of 1934, 15 U.S.C. §78a, and Rule 10b-5 promulgated thereunder.

\textsuperscript{55} See Pezim, supra note 34; Asbestos Minority Shareholders, supra note 30.

legislation, substantially because of a decision to make detailed decision making by way of rules, rather than legislation. (The other important factor, as noted above, was substantive reform under the proposed B.C. Model, including especially its Continuous Market Access approach.)

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

| Bill 38 (the proposed B.C. legislation) | 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.  
(2) A prospectus filed under subsection (1) must be in the required form. |
|----------------------------------------|---------------------------------------------------------------|
| B.C. Securities Act, R.S.B.C. 1996 (in force) | 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. |
| Ontario Securities Act | 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. |

Where the proposed B.C. legislation diverges from the other two is in the additional detail provided. The OSA and the existing BCSA go on to make specific provisions concerning, among other things, amendments to

57 Bill 38, supra note 40, s. 18; Securities Act, R.S.B.C. 1996, c. 418, s. 61; OSA, supra note 39, s. 53.
preliminary and final prospectuses, certificates of issuers and underwriters, receipts, waiting periods, and distribution. The proposed B.C. legislation has no equivalent provisions. Any detail it does require is contained in its proposed Securities Rules, not the proposed statute. Provisions in the proposed B.C. legislation on takeover and issuer bids, proxies, continuous disclosure, and primary market civil liability, among other areas, demonstrate a similar shift.

The second major distinguishing feature of more principles-based legislation is that it tends to be structured in a more outcome-oriented, as opposed to process-oriented, manner. The notion of outcome-oriented regulation is so connected to the principles-based approach that in its submission to the Expert Panel, the B.C. Securities Commission expressed a preference for the term “outcome-oriented” rather than “principles-based” to describe its approach. Outcome-oriented regulation measures performance against regulatory goals, whereas process-based regulation measures compliance with detailed procedural requirements. For example, both the OSA and the

58 See OSA, supra note 39, ss. 57 (prospectus amendments), 58 (certificate of issuer), 59 (certificate of underwriter), 61 (prospectus receipt), 65 (waiting period), Part XVI (distribution); BCSA, ibid., as at 2004, ss. 66 [repealed] (preliminary prospectus amendment), 67 [repealed] (prospectus amendment), 68 [repealed] (certificate of issuer), 69 [repealed] (certificate of underwriter), 65 (prospectus receipt), 78 (waiting period), Part XI (distribution).
60 One of the wrinkles concerns where each principles-based regime locates its “core principles,” as set out in Ford, Expert Panel, supra note 12, Appendix. B.C. and the FSA issued their Code/Principles through rulemaking, while the CFMA, supra note 43, and the QDA, supra note 41, chose to embed them directly into legislation. It seems that nothing substantive turns on the choice.
61 Submission, supra note 13. See also U.K., Financial Services Authority, Business Plan 2009/10 (London: 2009) at 9, online: FSA <http://www.fsa.gov.uk/pubs/plan/pb2009_10.pdf> Note that these regulators prefer the terms “outcome-oriented” or “outcomes-focused” primarily due to confusion around the term “principles-based,” not because they see the terms as interchangeable. Principles-based and outcome-oriented regulation are different concepts and should not be conflated. For example, one could have a system that is rule-based and outcome-oriented. However, principles-based and outcome-oriented regulation share philosophical convictions about the purposes of regulation and the most effective means for achieving regulatory goals.
62 In actual practice, there is no necessary disconnect between outcome-oriented regulation and a third approach that some scholars call management-based regulation. See Cary Coglianese & David Lazer, “Management-Based Regulation: Prescribing Private Management to Achieve Public Goals” (2003) 37 Law & Soc’y Rev. 691 [Coglianese]. There are differences between the two concepts in terms of at what stage of firm conduct the regulator intervenes, but both place responsibility
proposed B.C. Code of Conduct for Dealers and Advisors contain provisions that try to ensure that customers receive timely disclosure of trades conducted on their account. However, the OSA establishes a strict procedure whereas the B.C. Code only specifies an outcome. We see similar differences in their approaches to dealer conflicts of interest.

Another example is account supervision by broker dealer firms. In 2004 the B.C. Securities Commission commissioned a regulatory impact analysis that compared the detailed, process-based account supervision requirements established by the Investment Dealers Association (IDA), as it then was, with the more outcome-oriented requirements imagined under one part of the B.C. Model, its Code of Conduct for Dealers and Advisors. The Code would have required a firm to “maintain an effective system to ensure compliance with the Code, other legal requirements, and its own internal policies and procedures,” and to “maintain an effective system to manage the risks associated with its business.” The four firms studied were of the view that the IDA rules, which mandated transaction-based daily and monthly reviews, contributed significantly to their regulatory burden without providing meaningful investor protection. From their perspective, the reviews were duplicative, rigid, and worst of all not effective in detecting abuses characterized by patterns of behavior, which is where they thought the biggest compliance risks arose. As a result of these perceived limitations and in response what the firms described as concerns about civil
liability, reputation, and good business practice, each of the firms had already, by the time of the study, developed its own parallel risk-based supervisory system.68 The regulatory impact analysis concluded that relative to the existing system, B.C.’s proposed Code of Conduct would, by permitting firms to focus their energies on their effective internal risk management systems, improve investor protection, allow firms to innovate to achieve regulatory objectives in the ways that were most efficient for their businesses, and reduce compliance costs.

We return to some of the difficulties associated with reliance on internal risk models below.69 The point here is that outcome orientation has important implications for the approach to regulation. By definition, outcome-oriented regulation accepts that there may be more than one means (i.e., more than one process) to achieve a regulatory goal. It transfers decision making about process from regulators to industry. The essential assumption underlying both principles-based and outcome-oriented regulation is that legislators and regulators are in the best position to develop regulatory goals, but may not be in the best position to devise process-based means for achieving those goals. Outcome-oriented regulation is attractive because it establishes a more direct relationship between regulatory goals and regulatory requirements. It therefore makes more efficient use of regulatory and industry resources. By contrast, process-oriented requirements that are developed by regulators in advance, even though regulators possess less contextual information than industry actors, may not be perfectly tailored to regulatory goals. Process-oriented regulation can also permit market participants to abide by the letter of the law while ignoring its spirit. This is especially the case when it comes to highly complex instruments, or areas where events are fast-moving and regulators on their own could not hope to keep up with the pace of innovation.

Fundamental to this system is the existence or development of an “interpretive community”70 that collectively develops, on a rolling basis, the detailed content of statutory principles. In order to function transparently and predictably, a principles-based system must build in mechanisms that allow regulators to communicate with industry about their expectations, and

68 Ibid. at 14-17.
69 Reliance on internal risk management analysis in the context of Basel II and the Consolidated Supervised Entities Program at the United States Securities and Exchange Commission are discussed below, see “The Global Financial Crisis.”
that both allow and require industry to speak openly and regularly with regulators about their processes. Communication can take place through a number of channels including official administrative guidance, speeches, “no action” or “Dear CEO” letters, compliance audits, comments on industry standards, or specific enforcement actions. Over time, such communication can help develop an interpretive community that understands regulatory expectations, and can usefully interpret regulatory pronouncements about “reasonableness” or “effectiveness” in different situations.

What principles-based securities regulation means, then, is a particular way of structuring regulation, not a decision to do away with rules. Principles-based regulation is based on the conviction that while legislators and statutory drafters have the public legitimacy to establish broad regulatory goals, they are not in the best position to develop detailed guidelines for industry conduct, especially in fast-moving arenas like securities regulation. Those powers are allocated to frontline regulators at the Securities Commissions, whose expertise derives from their proximity to industry and whose accountability derives from the notice-and-comment aspect of their rulemaking powers. Moreover – and this is the crucial point today – even those frontline regulators are limited in their access to information by comparison to the industries they regulate. In order to stay remain relevant and informed about fast-moving industry practice, to keep regulation sufficiently flexible, and to avoid inhibiting productive innovation, regulators need to establish open and perpetual communication lines with industry. They need to use industry’s own good and best practices to add the “meat” of detail to the “bones” of their principles-based regulatory expectations.

Described another way, principles-based regulation is a two-tiered approach, in which principles-based legislative drafting provides flexibility, to which constantly evolving industry experience and regulatory rules add certainty on a rolling basis. In this formulation, principles-based regulation in practice avoids the biggest theoretical problems associated with both principles and rules, and can produce more effective regulation by ensuring that the party that has access to the best information is the one that provides the detail on any particular issue. What the GFC may suggest to us is that this “beyond theory” perspective in turn is still idealized, and that its promise was not achieved in reality. How real life experience fell short of expectations is described in the next section, followed by a discussion of three large lessons learned.
The Global Financial Crisis

There are at least three major arguments to make that the GFC does not represent even a superficial challenge to principles-based securities regulation. To begin with, the most alarming problems originated with complex securitized products that were distributed through exempt market private placements, entirely bypassing the public securities markets where the full panoply of regulatory safeguards would have applied. Second, the GFC has far more to do with gaps in regulation than with drafting choices. Gaps in regulation, especially around prudential regulation of players in the so-called “shadow banking system” in the United States, were surely the most obvious and consequential aspect of regulatory failure. The asset backed commercial paper (ABCP) crisis in Canada in August 2007 revolved around paper sold under an exemption from securities regulation. Credit rating agencies, which failed utterly as gatekeepers, were drastically under-regulated. Third, the GFC was a global event. The complex securitization

71 See Financial Regulatory Reform, supra note 71; 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 [McCoy]. Observers have also pointed out that the SEC, which had primary oversight of most Wall Street investment bank functions, was not well equipped to conduct prudential financial regulation. Coffee, “Redesigning the SEC,” supra note 9.

72 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.


74 Historically, credit-rating agencies in Canada and the United States have operated with relatively little regulatory scrutiny. In the United States, oversight has largely fallen upon the SEC, which has chosen to rely solely on ratings from “Nationaly Recognized Statistical Rating Agencies” [NRSRO]. The Commission imposes stringent requirements before an agency can be recognized as a NRSRO this, coupled with high entry barriers, has producing a situation in which three agencies dominate the market for credit ratings. For further information on the regulation of credit-rating agencies in the U.S. see Securities and Exchange Commission, Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets (2003), online: SEC <http://www.sec.gov/news/studies/credratingreport0103.pdf> at 5-10. Legislation has recently been proposed, in the U.S., to introduce additional regulatory oversight and curb many of the failings associated with the current rating regime. See U.S., Department of the Treasury, Investor Protection Act 2009 [proposed], online:
technology that increased risky lending, decreased transparency, and multiplied and spread risk was not unique to principles-based jurisdictions. Even within the core concerns of securities regulation, national systems traditionally described as rules-based (specifically, the United States) demonstrably fared no better than the more principles-based system at the United Kingdom’s FSA. While many specific components of financial and securities regulation, ranging from prudential regulation and systemic risk analysis to the basic usefulness of the existing disclosure-based model are legitimately being re-examined, they are being re-examined globally.

Where the GFC should provoke reflection, however, is with regard to the role of devolution to industry. Here, the GFC does represent a challenge (though I would argue not a fundamental one) to principles-based regulation. Principles-based regulation works by devolving the details of regulation to industry, on the assumption that industry has the best information and is in the best position to both assess and bear its own risks. While not essential to principles-based regulation, this is a central reason for its advantage over rules-based regulation in fast-moving environments. But devolution of the details to industry went on to play a central role in enabling some of the most painfully aggravating conditions associated with the U.S. subprime mortgage meltdown. This need not have been the case. Crucially, devolution does not automatically imply weak public oversight. Nevertheless, devolution accompanied by an ideology of self-regulation contributed to insufficient oversight of the massive expansion of the over-the-counter market for derivatives within which CDSs traded, following the passage of the CFMA. Another example was Basel II, and

75 See e.g. McCoy, supra note 71.
correspondingly the United States Securities and Exchange Commission’s approval, in 2004, of alternative net capital requirements for the leading investment banks under the Consolidated Supervised Entities Program (the CSE Program). These initiatives allowed banks and investment banks to maintain capital reserves based on their own internal risk assessment models, with very little scrutiny from regulators.

Regulatory faith in industry actors’ competence, if not literally their bona fides, proved to have been misplaced to catastrophic effect. George Soros has charged that the GFC reflects a “shocking abdication of responsibility” on the part of regulators. Investment banks and others engaged in originating, structuring and selling financial products engaged in breathtakingly bad behaviour. There was real dishonesty. The firms also made grave errors in safeguarding even their own interests. In the hands of in-house financial economists, academic caveats about the limitations of EMT models as well as limits of valuation models were ploughed under. Predictable psychological irrationalities seem to have been at work within firms, including groupthink, overconfidence, self-serving biases, and excessive faith in “hard” numbers, which were not accounted for in the regulatory decision to devolve the details to industry. There is also a strong public choice narrative: banks had little incentive to behave prudently in building tranches of consumer debt-based securities because they sold them

Committee on Banking Supervision, online: BIS <http://www.bis.org/publ/BCbs107.pdf>.


82 For a discussion of the future of the “efficient-markets hypothesis” see “Efficiency and Beyond” The Economist (16 July 2009), online: Economist <http://www.economist.com/displaystory.cfm?story_id=14030296> [“Efficiency and Beyond”].

onto third parties, in a market eager to buy them. At a structural level, they may have focused on short term gain at the expense of long term value because they were public corporations, not partnerships, and because bank CEOs were compensated based on short term earnings.

Regulators also seem to have underestimated the degree to which industry actors would try to avoid or circumvent regulatory oversight. Whether out of short term self-interest, economic pressure, or simple lack of understanding, firms within the CSE Program that applied the alternative net capital requirements valued illiquid assets too generously, underestimated long tail risks, and maintained inadequate capital buffers, all the while arguing that their behaviour was reducing rather than exacerbating risk. They innovated in structured products, not only reflecting increasing sophistication or in order to make their product more attractive to purchasers, but also sometimes to avoid regulation. They avoided comparability in order to reduce transparency and make it harder for regulators to understand what they were selling.

86 David Brooks, “Greed and Stupidity” The New York Times (2 April 2009), online: NY Times <http://www.nytimes.com/2009/04/03/opinion/03brooks.html> (contrasting two theories explaining decision-making failures at financial institutions). Precisely why financial institutions managed risk so poorly is an important question, the answer to which is also multi-factorial and variable from one firm to another.
87 This may be the least of it. As Martin Wolf has pointed out, “an enormous part of what banks did in the early part of this decade – the off-balance-sheet vehicles, the derivatives and the ‘shadow banking system’ itself – was to find a way round regulation.” Martin Wolf, “Reform of regulation has to start by altering incentives” Financial Times (U.K.) (23 June 2009).
88 See Jonathan Golin, Covered Bonds: Beyond Pfandbriefe – Innovations, Investment and Structured Alternatives (London: Euromoney Books, 2006), at 323, indicating the lack of legislation in the American market for covered bonds, which produces products which lack the standardization and comparability of their European counterparts. Recent legislative initiatives have seen an interest in standardizing certain OTC derivative products, in an effort to mitigate systemic
Each of these factors, even in isolation, represents a considerable challenge to what Julia Black has termed the “regulatory Utopia,” within which the self-examining, responsible firm, which possesses the greatest contextual information, helps to elaborate the content of principles-based regulation through ongoing dialogue with a flexible and outcome-oriented regulator, in the service of the mutual goal of optimized regulation. 89 What follows below is a dissection of the ways in which the self-regulatory regimes that gained so much traction in the past decade are not the same thing as principles-based regulation, when buttressed by an active regulatory presence. Only after we have a sense of the underlying structure of the principles-based project can we assess what it slipped to in recent practice, and what aspects of it remain vital.

**Enforced Self-Regulation and Principles-Based Regulation**

Principles-based regulation is not the same thing as self-regulation. Nevertheless, the distinction between principles-based regulation and self-regulation has not always been adequately emphasized. Competition between jurisdictions for increasingly mobile global capital played a role here. Large financial firms’ ability to relocate to more “competitive” regulatory environments provoked regulators and policy makers to focus on the costs of substantive regulation. The rhetoric of principles-based regulation became enmeshed with the rhetoric of efficiency and the need to control the regulatory burden. Arguments in favor of principles-based regulation from Henry Paulsen, for example, tended to emphasize the free market benefits and reduced regulatory burden associated with the FSA approach – not its asserted regulatory oversight benefits. 90 Some, concerned about London’s increased capital market share in the last few years, asserted risk, see e.g. Patricia White, “Over-the-counter derivatives” (Testimony before the Senate Subcommittee on Securities, Insurance, and Investment, 22 June 2009), online: Federal Reserve <http://www.federalreserve.gov/newsevents/testimony/white20090622a.htm>. 89 Black, “Forms and Paradoxes,” supra note 44 at 9. 90 Henry M. Paulson Jr., “Remarks by Treasury Secretary Henry M. Paulson on the Competitiveness of the U.S. Capital Markets” (Delivered at the Economic Club of New York, 20 November 2006), online: Treasury <http://www.treas.gov/press/releases/hp174.htm>; see also “Sustaining New York’s and the US’ Global Financial Services Leadership” (2007), online: <http://www.abanet.org/buslaw/committees/CL116000pub/materials/library/NY_Schumer-Bloomberg_REPORT_FINAL.pdf> (blaming the heavy regulatory burden in the US for the shift in business to London).
that its success with principles-based approach was the result of lower standards and lax oversight under principles-based regulation, especially in its junior market.91 (London-based regulators naturally disputed this.)92

The March 2009 Turner Review is insightful in describing the regulatory worldview that failed to anticipate the problems identified above.93 Lord Adair Turner, now the FSA’s Chairman, was commissioned by the Chancellor of the Exchequer in October 2008 to review the causes of the financial crisis and make recommendations about regulatory changes. According the Turner Review, the FSA did not fail because it embraced principles-based regulation. Indeed, principles-based regulation is barely mentioned.94 Instead, Lord Turner ascribes blame to flaws in FSA philosophy – that is, to a hands-off, market-based regulatory approach that assumed that markets were generally self-correcting and market discipline could be trusted to contain risk; that primary responsibility for managing risk lay with senior management not regulators, because they have better information; and that consumers were best protected through unfettered and transparent markets, not product regulation or direct intervention.95

Lord Turner is correct to draw a distinction between the FSA’s stance in favour of industry self-regulation, and its principles-based approach. To unequivocally equate principles-based regulation with self-regulation would be to misunderstand both. The two are not inconsistent, but nor are they synonymous. Self-regulation refers to the degree of public intervention in private industry. Neither principles-based nor rules-based regulation guarantees any particular stance toward self-regulation. Principles-based regulation is a particular regulatory approach that may or may not be highly

93 Turner Review, supra note 6.
94 This notwithstanding premature and ultimately inaccurate reports by credible UK media sources that principles-based regulation would be abandoned. See Peter Thal Larsen & Jennifer Hughes, “Sants Takes a Fresh View of Regulator’s Principles,” Financial Times (U.K.) (13 March 2009) online: FT <http://www.ft.com/cms/s/0/6ecc49d0-0f70-11de-ba10-0000779fd2ac.html>.
95 Just as fundamental, but best put in the category of regulatory gaps rather than regulatory approaches, was failure in the oversight of systemic risk. See Turner Review, supra note 6, at 52.
interventionist, depending on how it is implemented, even though it relies for its effectiveness on pulling industry’s own experience and information into regulatory expectations. Indeed, some opponents to principles-based regulation are most concerned about the possibility that such an approach would allow regulators to over-reach, especially in the enforcement context. Whether a principles-based approach amounts to lax regulation, overzealous regulation, or (impossibly) pitch perfect regulation is a function of how, and how well, it is implemented.

Principles-based regulation as properly understood has always been based on a robust and capable public role, including meaningful enforcement. Principles-based regulation is not code for a position that promotes allowing industry to do an end-run around the regulator. It is a conceptually consistent outgrowth of the loose group of regulatory perspectives variously known as new governance, co-regulation, enforced self-regulation, or

97 Ford, “New Governance,” supra note 20, at 32-33 (“a credible enforcement function writ large (meaning both compliance oversight and prosecution where needed) is a necessary component of principles-based and outcome-oriented regulation”); see also Cristie Ford, “Toward a New Model for Securities Law Enforcement” (2005) 57 Admin. L. Rev. 757 [Ford, “Toward a New Model”] (arguing for continued focus on enforcement within new governance scholarship).
98 Ford, “New Governance,” ibid (arguing that principles-based securities regulation is a new governance innovation.) The term “principles-based regulation” is the dominant one in securities regulation, likely for path dependent reasons stemming from post-Enron worries about whether U.S. GAAP rules were too rules-based. However, some scholars would argue that new governance methods transcend the rules-versus-principles debate. See Kathleen G. Noonan, Charles F. Sabel, and William H. Simon, “Legal Accountability in the Service-Based Welfare State: Lessons from Child Welfare Reform,” (2009) 34 Law & Soc. Inquiry 523, at 536-37, 554-56 (arguing that new governance, or “experimentalist,” practice resolves “the rules/standard antimony” debate through a “simultaneous emphasis on articulation and flexibility”). In spite of differences in terminology and emphasis, the fully articulated version of what I call principles-based regulation is not in tension with what Noonan et al describe. These authors find it most useful to frame the phenomenon as a pragmatic, practical method that bypasses an unproductive theoretical conversation. I find it most useful to focus on principles-based regulation as a first-order decision that reflects an appreciation of the relative capacities of legislative drafters, regulators, and industry actors. Nevertheless, my version of principles-based regulation calls for careful attention to implementation mechanisms that pull detailed industry knowledge into the articulation of those principles, in a way that is strongly similar to what Noonan et al describe. See also Ford, “New Governance,” ibid., at 30, n. 111.
Responsive regulation. New Governance and its variants are not the same thing as self-regulation. For its proponents, new governance scholarship exists explicitly for the purpose of making the public state more, not less, central and relevant. To use Jerry Mashaw’s recent formulation, new governance represents a different balance between the available public, market, and social mechanisms for ensuring accountability, which puts greater emphasis on the latter two. It imagines a different role for the regulator than rules-based, command-and-control regulation does. However, it does not suggest that public accountability, in the form of state action, could ever be ignored.

How exactly enforced self-regulatory models are best enforced is a matter of some debate. Different models exist. Ex post enforcement actions play a

101 Ian Ayres & John Braithwaite, Responsive Regulation: Transcending the Deregulation Debate (Oxford: Oxford University Press, 1992) [Ayres]. I am not suggesting that these perspectives are coterminous in terms of, among other things, precisely how “top down” or “bottom up” they are designed to be. For a description of the difference between co-regulation and (enforced) self-regulation in the European Union, for example, see Linda Senden, “Soft Law, Self-Regulation and Co-Regulation in European Law: Where Do They Meet?” (2005) 9 Electronic Journal of Comparative Law, <http://www.ejcl.org/91/art91-3.html>. A full dissection of the differences is beyond this paper’s scope. The point for present purposes is that each of these approaches, like principles-based regulation, tries to identify an effective regulatory method located in between rigid and unresponsive command-and-control regulation on one hand, and voluntary self-regulation on the other.
much larger role in U.S. securities regulation than they do in the U.K., which focuses more on ex ante supervision and compliance work. The impact of civil liability also needs to be factored in. When it comes to principles-based regulation, Julia Black is probably correct when she states that “principles need enforcement to give them credibility but over-enforcement can lead to their demise.” A growing body of scholarship exists concerning how to make enforced self-regulatory systems effective and credible using supervision, outcome-oriented problem solving, negotiated compliance, and firm penetration through compliance audits. Enforcement in a principles-based system (including referral for criminal prosecution if necessary) likely works best as the culmination of a series of such interactions with an industry actor, ratcheted up through an enforcement pyramid approach. Once at the enforcement stage, especially when dealing with cases based on violation of a principle alone, bringing enforcement actions successfully calls for substantial confidence


106 Some have also argued that principles-based regulation is not viable in the United States because of the extraordinary civil liability risks in that jurisdiction. Peter J. Wallison, “Fad or Reform – Can Principles-Based Regulation Work in the United States?” (2007) American Enterprise Institute for Public Policy Research, online: AEI <http://www.aei.org/docLib/20070611_21829JuneFSOg.pdf>. This is probably less of a worry in Canada. There may be a risk, though, that courts will become closely involved in defining the meaning of principles if civil liability becomes the driving force for such interpretations. This will affect the regulator’s ability to develop those principles within the regulatory sphere. Ford, Expert Panel, supra note 12, at 24-25.


109 Ayres, ibid.
and fortitude on the part of regulators. Enforcement staffers must also be watchful for potential procedural fairness concerns.\textsuperscript{110}

The GFC represents an important lesson for some new governance scholarship, which has not always been particularly interested in how theory plays out in practice.\textsuperscript{111} Indeed, the shortfall between the promise of an inspiring theoretical model and its application to real-life regulation makes the problem more, not less, important to solve. What was missing in many aspects of financial regulation, in retrospect, was meaningful accountability. The pressing questions now are why pre-GFC systems did not incorporate adequate public accountability mechanisms, and how principles-based securities regulation in Canada might avoid similar pitfalls. What follows are three recommendations for charting a path forward for principles-based regulation in Canada in the wake of the GFC. They take as a starting point that principles-based regulation must be buttressed by meaningful regulatory oversight, and move beyond that to a closer review of what accountability demands. The recommendations focus on problems of complexity and capacity, and the compromising effect that a lack of diversity and independent-mindedness can have on effective regulatory oversight.

Lessons Learned and Steps Forward

Four Points on Regulatory Capacity

It turns out, as if there was ever any doubt, that how principles are implemented is at least as important as how legislation is drafted.\textsuperscript{112} As observed earlier, certainty in a principles-based regulatory regime has less to do with how a particular provision is drafted, and more to do with the

\textsuperscript{110} See Ford, Expert Panel, \textit{supra} note 12, at 32-34.


\textsuperscript{112} Indeed, implementation may be more important than optimal statutory design, given that both the UK’s FSA and the B.C. Securities Commission have adopted more principles-based approaches notwithstanding enabling statutes that are not particularly principles-based. See \textit{Focusing on the outcomes, supra} note 2 (discussing the FSA regulatory philosophy); \textit{History, supra} note 2 (stating that “although the 2004 act is not in force, the BCSC has moved ahead with changing [its] regulatory processes and approach in much the same way [it] would have done under the 2004 act”).
development of an interpretive community that defines the content. What is required is a regulator that is capable of functioning as an independent and credible member – that is, that has a clear sense of its distinct role as a public-interested voice – within that interpretive community. Moreover, because so much interpretive discretion rests in the regulator’s hands, regulatory capacity, training, judgment, and philosophy are centrally important to effective implementation. It is therefore crucial to think carefully about the structure through which principles will translate into regulatory practice.

Working well with principles-based regulation requires considerable changes to traditional regulatory culture. Moving to a new model would take time, and training. A principles-based regulator focuses on defining broad themes, articulating them in a flexible and outcome-oriented way, accepting input from industry, and managing incoming information effectively. This requires expertise, a more ongoing communicative relationship with industry, restraint in providing administrative guidance, and the continued use of notice-and-comment rulemaking where appropriate. Principles-based regulation relies on good and best practices emerging from industry to help define the content of principles-based regulatory requirements. Using good and best practices, as opposed to industry standards, allows regulatory standards to evolve and remain flexible. It also builds in a learning process for both regulators (who are learning from industry about what works in different contexts) and regulatees (who are learning from each other.) This shift in emphasis does not, however, require that regulators “roll over and play dead” in the face of industry demands.

At the most fundamental level, regulatory capacity in this new environment means having an adequate number of staff. As Julia Black has pointed out, principles-based regulation (like risk-based regulation) may be more hands-off in its approach to the details, but this does not mean that it requires fewer regulatory resources. Depending on choices about implementation, principles-based regulation may actually require intensive interaction with

113 Black, Rules and Regulators, supra note 19; see also Expert Panel, supra note 3.
115 See e.g. Black, “Making a Success,” supra note 12.
firms, at least around certain issues or situations. Yet, as the Northern Rock debacle in the U.K. highlighted, the FSA was far from adequately staffed. Its Major Retail Groups Division was reduced by some 20 staff 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 work.

The example of the SEC’s CSE Program is even more striking. Its Division of Trading and Markets had only seven staffers and no Executive Director, yet since March 2007 was charged with overseeing five otherwise-unregulated major broker-dealer firms, which formed the backbone of the U.S.-based shadow banking industry, based on an alternative capital adequacy method. One of the effects of understaffing was that Trading and Markets staff had not completed any inspections of its subject firms in the 18 months prior to the collapse of Bear Stearns in September 2008. This would have been problematic in any event, but it was even more catastrophic in an outcome-oriented system where so much of the detailed procedural design for achieving regulatory goals was delegated to industry. As we all know now, the firms’ models, which assessed largely illiquid assets operating in the absence of price discovery and in the absence of backstop prudential regulation, proved to be woefully inadequate.

Second, regulators must have the ability to obtain transparent and reliable information about the industry actors they oversee. Even today, there can be no disputing that industry actors have better and more up-to-date information on their operations than regulators could hope to obtain. The larger firms also have far superior resources. Yet, these same actors have an

---

116 See ibid. (Re: U.K. Treat Customers Fairly rules, which require registrants to demonstrate that they are in fact treating customers fairly at every stage.)
117 The FSA acknowledged extraordinarily high turnover of FSA staff directly supervising the bank, inadequate numbers of staff, and very limited direct contact with bank executives among the reasons for its “unacceptable” regulatory performance. See U.K., Financial Services Authority, Internal Audit Division, “The Supervision of Northern Rock: A Lessons Learned Review” (2008), online: FSA <http://www.fsa.gov.uk/pubs/other/nr_report.pdf> [“Northern Rock”].
118 Ibid.
119 This is also a regulatory gap story. The CSE Program was voluntary, reportedly designed as a response to the fact that no US agency had regulatory authority over certain investment bank holding companies. Securities and Exchange Commission, Office of Inspector General, Office of Audits, “SEC’s Oversight of Bear Stearns and Related Entities: The Consolidated Supervised Entity Program” (2008), Report No. 446-a, online: SEC <http://www.sec.gov/about/oig/audit/2008/446-a.pdf>, at 81 [“SEC’s Oversight”] (Chairman Cox’s Comments).
120 “SEC’s Oversight,” supra note 119, at 49-50.
interest in casting facts to their advantage, in making their products look as attractive as possible, and in reducing regulatory oversight where possible. Again, as hard experience at the FSA and the SEC demonstrate, simple information collection is a crucial first step. The postmortem account of regulatory failure in the Northern Rock case identified a number of instances in which the FSA failed to collect, or did not have access to the information necessary to accurately access the risk that bank posed. Supervisors were found not to have been “proactive in ensuring there was a robust process that meant they built up a complete picture of issues.”

The postmortem analysis of the CSE Program recorded similar weaknesses. Among other things, that report identifies instances in which the CSE staff failed to adequately track material issues in regulated firms, approved changes to capital requirements before completing full inspections, and failed to exchange information with other SEC divisions. In a system where information is power, such as in the regulation of the sale of complex

---

121 “Northern Rock,” supra note 117. The findings of an internal audit into the FSA’s conduct in the Northern Rock affair demonstrated “a level of engagement and oversight by supervisory line management below the standard we would expect for a high impact firm,” at 4. But see Norma Cohen & Chris Giles, “Northern Rock Risk Revealed in 2004” Financial Times (U.K.) (30 May 2009), online: Financial Times <http://www.ft.com/cms/s/0/4cc9637a-4c8a-11de-a6c5-00144feabde0.html?nclick_check=1> [“Northern Rock Risk”] (reporting that the FSA had conducted “war games” in 2004 that identified the systemic risk that Northern Rock posed.)

derivative instruments, a regulator without the ability to obtain direct
information effectively cedes the field to those it regulates.

Principles-based regulation in conditions of complexity requires that
regulators have and use robust investigatory powers where necessary, and
that they conduct regular and adequate compliance audits. Like staffing
adequacy and information gathering capability, effective compliance
mechanisms are even more central in a principles-based environment.
Compliance efforts give regulators access to essential, fine-grained
information about particular firms, and promote regulatory credibility and
engagement with industry. They are an important tool for communicating
and developing the precise content of principles-based requirements to
industry actors. As noted above, they are also part of a coordinated,
multifaceted oversight approach for public companies and regulated entities,
Based on carefully designed “enforcement pyramid” approach that also
includes other supervisory strategies, as well as and civil and criminal
enforcement.123

Third, regulators in a principles-based system must have the capacity to
independently scrutinize information. This requires considerable capacity in
terms of information management systems.124 It also calls for quantitative
expertise and industry experience. The FSA’s responses to Northern Rock,
and its challenges in meeting them, may be instructive to Canadian
securities regulators as they contemplate moving toward more principles-
based regulation. The FSA plans to enhance its supervisory teams (meaning
more staff, better training, a mandatory minimum number of staff per high-
impact institution, and closer contact between senior staff and the biggest
firms.) It also plans to improve the quality of its staff, hiring risk specialists
to support frontline supervision teams by focusing on the complex models
used by banks to gauge financial risk.125 As one commentator observed, the

123 Ayres, supra note 100; see also Ford, “New Governance,” supra note 20, at 54,
n. 170 (Consistent with the so-called enforcement pyramid, the BCSC’s Capital
Markets Regulation Division uses a risk-based matrix to assess the risks presented
by different industry actors, and it accords more leeway to firms that have
demonstrated compliance bona fides). See also Poonam Puri, “Enforcement
Effectiveness in the Canadian Capital Markets: A Policy Analysis,” (Presentation
given to Capital Markets Institute, Rotman School of Business, University of
Toronto, 14 June 2005), online:
<http://www.rotman.utoronto.ca/cmi/papers/Puri%20CMI%20Enforcement%20Pre
sentation.ppt>.
124 See Ford, Expert Panel, supra note 12, at 23.
125 The FSA implemented a “supervisory enhancement program” in response to the
failure of Northern Rock. “The FSA’s Supervisory Enhancement Programme, in
response to the Internal Audit Report on supervision of Northern Rock,” (2009),
online: FSA <http://www.fsa.gov.uk/pubs/other/enhancement.pdf>. See also
regulator will now be pursuing “the same PhD rocket scientists the banks are chasing. … As Northern Rock shows, it’s not just about evaluating the problems, but having the people who can follow them up and forcefully make the case to the bank.”

The need to hire “PhD rocket scientists” may seem peculiar, given that flawed quantitative analysis by in-house bank economists so drastically exacerbated the global financial crisis in the first place. But the fact that quantitative analysis has been abused, misapplied, and overgeneralized in the past does not mean that banks will not use it in the future. In spite of its theoretical limitations and the recent example of real-life catastrophe, quantitative analysis continues to have substantial predictive value, and it will continue to be a central tool for financial industry actors. Securitization has brought too many benefits, and too much profit in good times, for modern financial markets to eschew it in the future. Indeed, innovation continues. A regulator that does not have the capacity to really challenge firms’ models will not have the capacity to engage in an extremely important ongoing conversation.

Finally, in addition to having the numbers, the information, and the analytical skills, regulatory staffers must have sufficient confidence in their own judgment and a healthy degree of skepticism about industry. This difficult problem is discussed further below.

**Complexity and Prophylactic Rules**

One of the striking lessons from the GFC has been the impact of complexity on the financial markets, and the degree to which existing regulatory structures failed to manage those effects. Steven Schwarcz even suggests,

---

*Turner Review, supra* note 6 at 88, describing the FSA’s new approach as “intensive supervision.” Lord Turner describes intensive supervision as entailing much greater resources devoted to the supervision of high impact firms, more intense focus on business strategies and system-wide risks, more focus on technical competence of FSA supervisors, more focus on the details of bank accounting, and greater willingness to reach judgments about the overall risks that firms are running.


See Nocera, *supra* note 83; Salman, *supra* note 83.


See *infra* “Building Independence and Diversity into the Regulatory Architecture.”
plausibly, that complexity is the “greatest financial market challenge of the future.”130 He describes complexity in the assets that underlie modern structured financial products, overlaid with complexity in the design of the structured products themselves, and exacerbated by complexity in modern financial markets. He examines how these multiple complexities can lead to inappropriate lending standards, failures of disclosure, a lack of transparency and even comprehensibility, and – perhaps most difficult to manage – the creation of a complex system characterized by intricate causal relationships and a “tight coupling” within credit markets, in which events tend to amplify each other and move rapidly into crisis mode.131 Prior to the GFC, there was a general failure by all concerned to appreciate the myriad interrelated ways in which complexity can impair markets and financial regulation.

It is not realistic to think that we can now unwind complexity from our financial markets. Instead, we must develop a more comprehensive and fine-grained understanding of how complexity manifests and for what reasons. Schwarcz’s incisive analysis of the sources of complexity is a first step. We should also be evaluating varieties of complexity in terms of their costs and benefits, to real economies and financial markets as a whole and to various constituencies.

Looking at complexity deriving from innovation in structured product design, some is the result of increasing sophistication and fine-tuning, and has considerable beneficial effects for investors. After a certain point, however, either by design or in effect, the overall benefits flowing from ever-increasing complexity come to be outweighed by their overall costs. As the Turner Review suggested, the GFC has challenged the “underlying assumption of financial regulation in the US, the UK and across the world … that financial innovation is by definition beneficial, since market discipline will winnow out any unnecessary or value destructive innovations.”132 On the contrary, in retrospect, some recent forms of financial innovation delivered few benefits, but permitted rent-seeking and contributed to significantly increased systemic risk.133 As the Turner Review noted,

it seems likely that some and perhaps much of the structuring and trading activity involved in the complex version of securitised credit [over the last ten to 15 years], was not required to deliver credit

131 Ibid. at 7-32.
132 Turner Review, supra note 6, at 47.
133 Ibid. at 109.
intermediation efficiently. Instead, it achieved an economic rent extraction made possible by the opacity of margins, the asymmetry of information and knowledge between end users of financial services and producers, and the structure of principal/agent relationships between investors and companies and between companies and individual employees.”\(^{134}\)

One of the common arguments in favour of principles-based regulation is that it supports innovation. While this continues to be an important value, more thought needs to go into precisely how it does so, to what point innovation confers net benefits, and to whom those benefits flow. A fundamental risk associated with principles-based regulation is that, in the absence of the (at least putatively) immovable markers that rules represent, there will be “creep” around the meaning of a term.\(^{135}\) Without regulatory oversight to ensure that terms are interpreted in a reasonable and accountable manner, self-interested actors can be expected to define terms in their own interest. Where there is underlying uncertainty anyway – for example, around a new or extraordinarily complex product or line of business – or where there is no metric for evaluating something (a compliance program, a product, a risk) across institutions, the problem can be exacerbated.\(^{136}\) The notorious “risky shift”\(^{137}\) can occur, especially when markets are experiencing a bubble or competitive pressures push actors toward greater risk-taking.\(^{138}\) Without countervailing, independent-minded

\(^{134}\) Ibid at 47.

\(^{135}\) The argument is reminiscent of Ronald Dworkin’s defence of a written constitution as building fences well around fundamental rights. Ronald M. Dworkin, A Bill of Rights for Britain (London: Chatto & Windus, 1990). I say that rules are only putatively immovable. More precisely, rules can provide temporary or superficial clarity, but under the surface they are as subject to contestation and change as principles are. Consider Dorf, supra note 103, at 446-52.


<http://www.ft.com/cms/s/0/80e2987a-2e50-11dc-821c-0000779f2ac.html> quoting Charles Prince (“As long as the music is playing you need to get up and dance”).
regulatory power to push back against self-interested industry conduct, the “creep” may run downwards – to more risk, less transparency, less systemic stability, and less consumer protection.

Meaningful regulatory oversight is therefore an important consideration, and complexity makes that oversight harder to achieve. We know now that our financial regulatory approaches were not built to handle the effects of complexity and constant innovation that characterize modern financial markets. Principles-based and collaborative regulation is, of course, a response to those very phenomena. But as John Coffee and Hillary Sale have argued, even an optimal regulatory model will not work if it is too complex for regulators to implement.139 In the terms of the rules-versus-principles debate, this means taking into account both theory and implementation when deciding how to structure particular regulatory provisions. Ease of implementation by regulators may be an important consideration. It may weigh especially heavily where we can identify that additional complexity resulting from structured product design innovation is of marginal utility. There may be contexts in which (subject to the caveats below) rules’ greater ability to contain complexity helps justify a rules-based formulation over a principles-based one, notwithstanding the significant costs to flexibility and innovation, congruence, and prospectivity.

Capital requirements are a concrete example in which firms with more rigid requirements weathered the acute phase of the fall 2008 credit crisis better.140 As has been well documented, Canadian capital requirements for financial institutions are comparatively high, and tend even to be exceeded by the actual practice of Canadian banks. Asset-to-capital ratios are capped at a comparatively low level.141 Canadian financial institutions’ overall success in weathering the GFC has been often attributed to these regulatory restrictions.142 Another example, beyond the rules-versus-principles

139 Coffee, “Redesigning the SEC,” supra note 9, at 55 (indicating that optimal rules may be “beyond the effective capacity of many bureaucracies to implement”).
142 But see Lev Ratnovski and Rocco Huang, “Why Are Canadian Banks More Resilient?” IMF Working Paper WP/09/152 (July 2009), online: IMF
conversation, is contract term standardization. Especially with respect to derivative contracts, standardization can help cabin complexity, make innovation subject to a degree of price discovery and oversight, and make derivatives easier to regulate.143

To use Colin Diver’s terms, capital requirements may be an area where, taking into account all the factors operating (poor regulatory oversight, gaps in regulation, etc.), transparency and accessibility proved to be more important than perfect congruence. In other words, if there is no clear and forceful regulatory voice in the interpretive community around a regulatory principle, then the (ultimately superficial) certainty provided by (inevitably imperfect) rules will still prove to be more valuable than the flexibility and contextuality provided by principles. This is especially the case when one considers to whom benefits have flowed. The benefits of flexibility will flow to those in a position to apply the principles. When there is no close conversation with regulators about, for example, what constitutes meaningful disclosure with respect to complex structured products in the retail market, then firms developing those products will decide on the meaning of disclosure principles in light of their own interests.

We should also consider the role that particular regulatory requirements play in overall system stability and efficiency. Rules around capital requirements, like much of prudential regulation, are so fundamental to


143 Most OTC derivative contracts are documented under standard forms, known as Masters, created by the International Swaps and Derivatives Association, Inc., online: ISDA <www.isda.org>. The United States Department of the Treasury recently presented a bill to Congress that would significantly augment private standardization initiatives. The Treasury’s bill would allow bank regulators to establish margin and capital requirements for banks entering into derivatives contracts; would require standardized OTC derivatives contracts to be cleared by a derivatives clearing organization regulated by the CFTC or the SEC; and would require banks to have their standardized contracts centrally cleared and traded over regulated exchanges. Dealers, also, would no longer be able to directly trade standardized derivatives contracts among themselves. They would be required to use an exchange or equivalent trading platform. See U.S., Department of the Treasury, Press Release TG-261, “Administration’s Regulatory Reform Agenda Reaches New Milestone: Final Piece of Legislative Language Delivered to Capitol Hill” (11 August 2009), online: Treasury <http://www.ustreas.gov/press/releases/tg261.htm>.
effective functioning of the system that they should not necessarily be subject to contestation, innovation, and potential “creep” through collaborative regulatory practice. The analogy in democratic theory would be to participation rights, seen by some to be so fundamental to deliberation that they should not themselves be subject to the risk of erosion in the process of that deliberative exercise.\textsuperscript{144}

We should be careful not to overstate the lesson here. The fact that systems with rigid, mandatory capital requirements performed better during the financial crisis does not mean that such capital requirements will necessarily be better than any more flexible alternative, or that we can generalize from capital requirements to other areas of financial regulation. We did not learn that rigid capital requirements are better than any mechanism we could possibly imagine. They may not even be better than the CSE program might have been, had it been buttressed by adequate regulatory capacity. Rigid requirements impose costs, too. What we learned is that rigid capital requirements worked better than the flawed and basically unaccountable capital adequacy system that was in place under, for example, the SEC’s CSE Program.

It is helpful to see our current struggles with complexity as epistemological ones.\textsuperscript{145} Complexity is worrisome right now in part because, like the frozen credit markets in fall 2008, we do not know what we do not know. In time, based on greater understanding, we may be able to develop a more

\textsuperscript{144} E.g., Joanne Scott & Susan Sturm, “Courts as Catalysts: Re-Thinking the Judicial Role in New Governance” (2007) 13 Colum. J. Eur. L. 565 at 567; Lisa Alexander, “Stakeholder Participation in New Governance: Lessons From Chicago’s Public Housing Reform Experiment” (2009) 16 Geo. J. on Poverty L. & Pol’y 117 at 127-28, 180-84; Douglas NeJaime, “When New Governance Fails” (2009) 70 Ohio State L.J. 323. There is an analogous debate in new governance scholarship about the degree of “hard law” background measures needed (or assumed to exist) to safeguard participatory rights or address power disparities. On one end of the continuum are those who believe that, human nature being what it is, substantial participation- and equality-oriented hard law protections are essential preconditions to the proper functioning of any deliberative model. On the other end are those who worry that hard law principles are fundamentally inconsistent with the deliberative project, if not actually meaningless, and are not necessarily in the long run best interests of equality-seeking groups. See e.g. Cohen, supra note 101, at 543, n. 47. Even assuming that capital requirements and other prudential measures are of this fundamental nature in relation to financial markets’ operation, a range of reasonable opinion could exist as to their optimal degree of flexibility in real-life applications.

sophisticated approach to complexity, with more and different safeguards in place, which does not seem to force us to choose so starkly between flexibility and systemic stability. In other words, existing bright line capital requirements should be seen as prophylactic, not permanent, rules. Prophylactic rules are clear and generally overdrawn requirements, like the Miranda rights-reading requirement on police in the United States, which serve as placeholders to protect an important interest until and unless a better, more tailored method for achieving the same end can be implemented. A “better” approach to capital requirements would have to improve flexibility and congruence, but not at the expense of the transparency, accountability, and ease of application that rigid requirements provide in this crucial aspect of financial markets regulation.

Prophylactic rules are helpful in keeping essential systems functioning and in conserving regulatory resources. However, under conditions of underlying factual uncertainty, rigid rules cannot resolve that uncertainty. They will paper over uncertainty, forcing difficult interpretations underground – or alternatively forcing rule revisions through legislative processes that are far too cumbersome to be serviceable in “live,” fast-moving systems. Principles-based regulation is a more promising long term response to extreme complexity and consequent uncertainty, because it allows us to examine and discuss its effects explicitly, directly, and openly.

New governance generally is about designing the problem-solving architecture required for handling situations of extreme uncertainty, where

---

146 The term derives from American constitutional law theory, and is controversial in that context. Miranda v. Arizona, 384 U.S. 436 (1966), held that certain warnings must be given before a suspect’s statement made during custodial interrogation could be admitted in evidence. The case invited legislative action to protect the constitutional right against coerced self-incrimination, but stated that any legislative alternative must be “at least as effective in appraising accused persons of their right of silence and in assuring a continuous opportunity to exercise it.” Ibid., at 467. The Miranda warning requirement was upheld in Dickerson v. United States, 530 U.S. 428 (2000) [Dickerson], but its prophylactic nature was severely narrowed and the warning requirement was constitutionalized. For a new governance perspective on prophylactic rules, see Dorf, supra note 103, at 452-59.

147 In Dickerson, ibid., arguments about costs and workability for law enforcement personnel were made successfully in support of upholding the Miranda warning requirements, notwithstanding the “undeniable[e] instances in which the exclusionary rule of Miranda imposes costs on the truth-seeking function of a trial, by depriving the trier of fact of ‘what concededly is relevant evidence.’” Brief for the United States, Dickerson v. United States, online: DOJ <http://www.justice.gov/osg/briefs/1999/0responses/99-5525.resp.html>; Dickerson, ibid., at 442.
determined in advance.148 This is the kind of environment in which it makes sense to enlist the context-specific knowledge of a broad band of stakeholders in a collective, comparative, learning-by-doing regulatory project, while not being naïve about the impact of self-interest and power.

To summarize the recommendations thus far: in order to be credible, principles-based regulation requires considerable regulatory capacity. It requires greater regulatory capacity in terms of numbers, resources, and expertise than has been allocated to it in some of the infamous examples of regulatory failure in the past two years – the failure of Northern Rock in the UK, and of the the SEC’s CSE Program. At the same time, one should be realistic about regulatory capacity when designing a regulatory regime. One should not design a system that is too complex for actual regulators to implement. Bright line prophylactic rules, along with contract term standardization and other similar techniques, can help to conserve regulatory resources. Such rules around, for example, capital requirements will be useful in the near future as we continue to grapple with the implications of complexity in the financial markets. Over the long term, however, a credible, principles-based, collaborative structure will be more robust and effective.

Building Independence and Diversity into the Regulatory Architecture

A principles-based approach also has repercussions for the deep structure of regulation. For many, the GFC represents a fundamental challenge to the efficient market hypothesis, and indeed to the very place of economic theory in developing public policy.149 This paper would like to suggest that we consider, instead, recent learning about macro-level regulatory design. The task now (the completion of which is beyond the scope of this paper) is to identify the structural and dialogical components that are essential to ensuring that the principles-based regulatory architecture is robust and credible. Chief among those components are mechanisms to ensure parties’ accountability and to validate information.

---


Principles-based regulation replaces many tightly defined, statutorily entrenched, and hard-to-revise legislative requirements with an ongoing, information-based, pragmatic dialogue about good practices and regulatory goals. The shift itself is not determinative on choices between, for example, industry self-regulation or intensive supervision. Nevertheless, it has practical implications for those policy choices. Under principles-based regulation, many of the bulwarks of detailed statutory law are replaced by more easily revisable requirements. Recall the Table of Concordance between British Columbia’s existing and proposed Securities Acts – a clear illustration of the volume of detailed decision making that is moved out of the statute and into rule making under a principles-based approach. At its best, principles-based regulation therefore makes possible a more sophisticated, informed, collaborative, flexible, and transparent development of regulatory goals and means. At the same time, such a deliberative, iterative process increases the number of “moving parts,” and makes the act of law-making more porous to external social forces and trends. What must replace detailed statutory precommitments is serious attention to the capacities, predispositions, and situation of frontline decision makers, and to how the various participants in the interpretive community can be expected to function together.

One way to think about the GFC was as a product of the marginalization of overarching regulatory design considerations in favour of overbroad faith in market discipline. There were obvious gaps in shadow banking industry regulation. Great weight was placed on the shoulders of credit rating agencies, without adequate thought to ensuring those agencies were impartial and accountable. Regulators were not an effective counterweight against the banks in the Northern Rock and CSE Program examples. In retrospect, programs like the CSE are paradoxes: on one hand, regulators delegated risk assessment to firms explicitly

---

150 This is the case whether it happens through explicit statutory drafting, or through choices at the level of implementation. See discussion, supra note 53.
151 See discussion, supra, “Enforced Self-Regulation and Principles-Based Regulation.”
152 See supra note 56.
153 See Lowenstein and Partnoy, supra note 72.
154 See “Northern Rock,” supra note 117; see also discussion, supra note 121. The internal audit into the conduct of the FSA, during its supervision of Northern Rock, identified a number of situations in which FSA staff failed to appropriately challenge and scrutinize information provided by Northern Rock. For example, the audit identified a number of instances in which supervisors failed to conduct a “comprehensive analysis of the risks inherent in the [Northern Rock] business model,” at 30. See also discussion of “intensive supervision,” Turner Review, supra note 6, at 88-89.
155 See “SEC’s Oversight,” supra note 119; see also discussion, supra note 122.
did not and could not possess the knowledge those firms had about their own operational risks. Yet, the compensatory steps that might have reduced the knowledge gap and ensured more meaningful oversight – compliance audits, close supervision by adequate numbers of well-trained staff – were not taken. Whether because the regimes’ regulator-level architects accepted too unthinkingly the laissez-faire ethos of recent years, or because they had no choice given their lack of regulatory mandate from legislators (and these two are connected), regulatory programs like the SEC’s CSE program lacked a commitment to a robust public role in either design or implementation.

Both the conflict of interest story and the over-reliance on market discipline point to a troubling question that applies not only to the Northern Rock failure or the CSE Program, but to much of the bond and securities markets. That is, from which quarter exactly was the independent critical thinking supposed to come? Jack Coffee’s memorable insight that the “gatekeepers” were one of the weak links that led to the Enron debacle resonates again today, but it needs to be generalized. These are industries that are tightly enmeshed with their regulators and reputational intermediaries. Credit rating agencies were remunerated handsomely for giving good ratings to mortgage-backed securities. British regulatory and financial services communities are characterized by considerable social overlap. Much has been written about the positions of public power in the United States occupied by individuals formerly working in the private sector, and the potential adverse effects on public policy.

---

156 See Turner Review, supra note 6, criticizing the FSA for adopting “laissez faire” mentality; Stephen Labaton, “Agency’s ’04 Rule Let Banks Pile Up New Debt,” The New York Times (2 October 2008) (noting that “the commission’s decision effectively to outsource its oversight to the firms themselves fit squarely in the broader Washington culture of the last eight years under President Bush”).

157 “SEC’s Oversight,” supra note 119, (Chairman Cox’s Comments), justifying CSE program on the basis that it was voluntary and the S.E.C. did not have a mandate to regulate CSEs otherwise.


160 Alumni of the former investment bank Goldman Sachs have occupied key positions not only in the United States government, but also at the Bank of Canada (Governor Mark Carney) and the World Bank (President Robert Zoellick). See
In a provocative recent article in *The Atlantic* magazine, Simon Johnson has argued that one of the causes of the financial crisis in the United States was that the financial industry was dominated by oligarchs with ties to government.161 Drawing on his experience working with developing nations at the International Monetary Fund, Johnson predicted that the power of the oligarchs would also impede economic recovery because the necessary bold steps toward industry would not be taken. The author concludes that a destabilizing total collapse could be the “cleanse we need” and that piecemeal steps taken to avoid confrontation with the oligarchs would only prolong the pain. Without accepting that a “cleanse” is the necessary course, Johnson’s experience underscores how damaging the lack of an external, skeptical perspective can be when operating on an industry-wide (or even economies-wide) scale.

This paper does not argue that individuals with industry experience should be barred from assuming positions of responsibility overseeing those industries. The benefits of employing regulators with industry experience, in terms of expertise, perceived legitimacy with industry, and persuasive force, are irreplaceable. Nor does this paper focus on the possibility that industry-regulator ties will consistently compromise prosecutions and enforcement actions.162 Beyond these important arguments about agency


162 But see Stavros Gadinis, “The SEC and the Financial Industry: Evidence from Enforcement against Broker-Dealers” (2009) Harvard Law and Economics Discussion Paper No. 27, online: SSRN <http://ssrn.com/abstract=1333717> (finding that the SEC favors defendants associated with big firms compared to defendants associated with smaller firms, and hypothesizing that either resource constraints or a desire to favor prospective employers may explain this systematic bias); Maria M. Correia, “Political Connections, SEC Enforcement and Accounting Quality” (2009) Rock Center for Corporate Governance at Stanford University Working Paper No. 61, online: SSRN <http://ssrn.com/abstract=1458478> (finding that firms with low accounting quality have greater political expenses on average, and that politically connected firms may face less SEC enforcement action and lower sanctions). Note, also, the finding of the SEC’s Office of the Inspector General in the Madoff case. The OIG found no evidence of improper influence or inappropriate relationships with Mr. Madoff, but noted that SEC staffers’ awareness
capture is a subtler worry, about perspective. As Joseph Stiglitz has observed, “if those who are supposed to regulate the financial markets approach the problem from financial markets’ perspectives, they will not provide an adequate check and balance.”163 Neither gatekeepers nor regulators will serve their function effectively if they are not firmly rooted in an independent source of authority and meaning, which is in active tension with their allegiances “within the circle” of those they oversee. Such anchors help them resist the pull of groupthink, cascades, and collective confusion that can take hold within a particular community – phenomena that are especially dangerous in principles-based regulation because of the degree of in-built fluidity.

An absence of diversity in perspective may also have implications for an industry’s ability to self-regulate. Leaving aside regulatory failure, one may ask why investment banks themselves did such a poor job of quantifying and managing the risks they were running. In multiple and intricately connected ways, firm culture can affect the degree to which a firm is capable of acting independently in the face of competitive pressures and behavioral cascades. Goldman Sachs famously managed to avoid some of the worst excesses in mortgage-backed securities, arguably as a result of its culture of “contrary thinking” relative to the rest of its industry.164 Internal diversity may also influence a firm’s stance toward risk-taking, as Michael Lewis’s analysis of Icelandic banks and culture,165 and studies of the influence of gender in the financial services industry,166 suggest. Enforced self-regulation also stands the best chance of success when industry actors

164 See Anderson, supra note 160; Przybyla, supra note 160. The latter article suggests that Goldman Sachs’ behavior has been contrary in relation to its competitors, but that its internal culture is actually conformist and homogeneous.165 Michael Lewis, “Wall Street on the Tundra”, Vanity Fair (April 2009), online: <http://www.vanityfair.com/politics/features/2009/04/iceland200904>.

genuinely care about their broader reputations, something that requires commitments and allegiances beyond one’s own firm and industry. All of this should lead us to wonder whether institutions that draw on a broader range of perspectives may be better able to maintain some cognitive distance from group pathologies, to their own advantage and to the advantage of an enforced self-regulatory approach.

This suggests a few specific reform recommendations. To begin with, conscious thought needs to be given to how the various pieces of a principles-based regulatory approach will function together; where each actor’s strengths and vulnerabilities lie, who is and is not participating in the interpretive community, and what is required to build checks and balances into the system’s functioning. Credit rating agencies are an obvious example, and if they are to continue to fulfill a central role as reputational intermediaries they obviously need to be more independent and better regulated than they recently have been. Regulators should also consider making hiring decisions based not only on applicants’ relevant industry and legal expertise, but also with a view to whether applicants seem to have sufficient confidence and independence of mind (however obtained) to keep them mindful of their distinct public role in the face of well-resourced and coordinated action from industry. Regulators in a principles-based or enforced self-regulatory regime should also watch for groupthink and behavioral cascades within their industry, and may want to give additional recognition or leeway to the views of industry outliers when a cascade seems to be developing. This may ultimately call for a richer description of the relationships between capital markets actors and the other crucial social, institutional, and historical milieus in which they are embedded – to understand which actors might “keep their heads” and how to ensure their participation to that end.

Finally, diversity of perspectives is important to principles-based regulation at the macro level. Principles-based regulation will not function well if it is purely technocratic, closed, and expertise-based. Technical expertise is not necessarily politically or socially neutral, and expertise-based models can

---

167 Balleisen, supra note 99. Balleisen and Eisner describe the other prerequisites to effective co-regulation to be the relevance of flexibility in regulatory detail; the existence of sufficient bureaucratic capacity and autonomy on the part of nongovernmental regulators; the degree of transparency in the regulatory process; and, the seriousness of accountability.

168 For an example that assesses American institutions along these lines, see Jeffrey J. Rachlinski & Cynthia R. Farina, “Cognitive Psychology and Optimal Government Design” (2002), 87 Cornell L. Rev. 549.

169 Regulators in a principles-based system can influence industry behavior in a variety of ways, including public recognition of good practices, or reduced regulatory oversight for firm-developed approaches that carry indicia of reliability.
shut down useful discussion. By contrast, principles-based regulation is a system whose evolution depends not on modelling, but on ongoing dialogue with stakeholders based on their real-life experience. Principles-based regulation is actually a different model: it derives its legitimacy from its collaborative, dialogic experience, and operates on the basis that pragmatic, learning-by-doing experience is a more reliable foundation than abstract theory for regulatory policy development.\footnote{Amar Bhidé makes a persuasive case for commonsensical, experience-based decision making over “make-believe models” in Amar Bhidé, “An Accident Waiting to Happen,” (2009) 21 Critical Review 211.} The quality of the decisions that emerge from its collaborative process, as well as the basic legitimacy of that process, require broad participation. It also matters whether the interpretive community that is engaged in filling in the details around a principles-level regulatory requirement is sufficiently inclusive and diverse. That community must have enough common ground that its constituent parts can speak to each other, and that a certain degree of trust can exist. At the same time, too much homogeneity limits the range of possibilities capable of being imagined.\footnote{See e.g. Jon Elster, \textit{Deliberative Democracy} (Cambridge, U.K.: Cambridge University Press, 1998).} This calls for a regulatory architecture that specifically builds in opportunities for all key stakeholders to participate.

For Julia Black, principles-based regulation at its fullest is a polycentric process that pulls in a wide variety of stakeholders.\footnote{Black, “Forms and Paradoxes,” \textit{supra} note 44, at 23-24. In this article Black mentions in particular trade associations and industry representatives, nominated advisers (NOMADs) on the London Stock Exchange’s junior market, the Alternative Investment Market (AIM), and consultants and advisors including lawyers.} For the Expert Panel, as well, principles-based regulation need to be supported by greater investor participation guarantees, in the form of an independent investor panel and dedicated investor issues groups.\footnote{Expert Panel, \textit{supra} note 3, at 36-37. Elsewhere she has also emphasized the importance of consumer voice, see Julia Black, “Involving Consumers in Securities Regulation” (2006) Task Force to Modernize Securities Legislation in Canada, \textit{Final Report: Canada Steps Up}, vol. 6, at 545-668, online: TFMSL <http://www.tfmsl.ca/docs/Volume6_en.pdf>.} Broader stakeholder participation does not guarantee good regulatory outcomes, of course. The U.K. FSA’s Consumer and Practitioner Panels did not prevent the Northern Rock debacle.\footnote{The \textit{FSMA} requires the FSA to consult practitioners (i.e., registrants) and consumers, to establish a Practitioner Panel and a Consumer Panel, and to consider their representations. See \textit{FSMA}, \textit{supra} note 42,ss. 8-11.} Stakeholder participation also introduces its own significant
challenges. At the same time, one may ask what might have happened, had the secret “war games” that revealed the risks that Northern Rock posed to systemic stability been made public back in 2004.

**Conclusion**

The GFC contains cautionary lessons about the risks associated with principles-based regulation, when not reinforced by a meaningful regulatory presence. However, the response cannot be a knee-jerk reversion to a more rules-based or a more command-and-control approach. Principles-based regulation accompanied by input from industry was a response to a situation where regulators were under-informed, always playing catch-up, and made fools of not only by Enron-style corporations engaging in loophole behaviour, but also (to harken back to the negative image of 1970s bureaucracies) by their own rigid, seized-up processes. The costs of a system that is too rule-based are also considerable: it can stifle innovation, create loopholes and loophole-oriented behaviour, drive uncertainty “underground” and make problem-solving less explicit, and impose costs related to inflexibility. Principles-based regulation needs to be understood as a response to those very real problems.

Nor should we imagine that a return to older regulatory strategies would avoid future frauds. There is no hope of returning the genies of innovation and complexity in structured products to the bottle. Under conditions of such extreme uncertainty, ongoing interpretation of underlying principles is the only feasible option. Facialy straightforward rules cannot make a complex situation simple. Detailed rules will be out of date by the time they are drafted. Principles are attractive because they can adapt to emerging events, and in a transparent and accountable way. By contrast, rules must evolve either through time-consuming statutory amendment, or through

---

175 Where poorly managed, participatory processes can degenerate into interest group politics and unprincipled horse-trading, and can reproduce existing power imbalances. Expertise and information can serve as an important counterweight to these urges. While not easy to achieve, an ever-growing body of scholarship and practice around deliberative decision making has helped to identify critical success factors and best practices. An internationally significant experiment in deliberative democracy took place in British Columbia in 2004, around electoral system redesign. See Mark E. Warren & Hilary Pearse, *Designing Deliberative Democracy: The British Columbia Citizens’ Assembly* (Cambridge, U.K.: Cambridge University Press, 2008).

176 “Northern Rock Risk,” supra note 121. According to that article, FSA regulators concluded at the time that they could not force Northern Rock and HBOS to change their practices. Actively pulling in other stakeholders may also enhance existing regulatory capacity.
selective or non-enforcement that conceals the exercise of substantial regulatory discretion.

However, thought needs to be given to how principles-based regulation perpetuates or even amplifies existing structural flaws in regulation. To be effective, principles-based regulation calls for increasing regulatory resources, developing a thoughtful response to complexity (including a place for prophylactic rules), and consciously incorporating a broader and more independent range of perspectives into the regulatory discussion. As Canada’s Expert Panel well appreciated, careful implementation and meaningful enforcement are everything in building a strong principles-based regulatory approach.177

---

177 Expert Panel, supra note 3, at 19-22.