McGill Law Journal ~ Revue de droit de McGill

PRINCIPLES-BASED SECURITIES REGULATION IN THE WAKE OF THE GLOBAL FINANCIAL CRISIS

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The recent global financial crisis contains cautionary lessons about the risks associated with principles-based regulation when it is not reinforced by an effective regulatory presence. Our response to the crisis, however, should not be a rush to enact more rules-based regulatory approaches. On the contrary, principles-based securities regulation offers more viable solutions to the challenges that such a crisis presents for contemporary financial markets regulation.

The author draws on the lesson of the global financial crisis to identify three critical factors for effective principles-based securities regulation. First, regulators must have the necessary capacity in terms of numbers, access to information, and expertise in order to act as an effective counterweight to industry. Second, regulation needs to grapple with the impact of complexity on financial markets and their regulation. Third, increased diversity among regulators and greater independence from industry are required to avoid conflicts of interest, overreliance on market discipline, and "groupthink". The paper calls for a continuing commitment to principles-based regulation, accompanied by meaningful enforcement and oversight.

La récente crise financière mondiale nous invite à tirer une leçon de prudence par rapport aux risques associés à une réglementation fondée sur des principes lorsque cette réglementation n'est pas renforcée par une présence réglementaire efficace. Nous ne devrions toutefois pas nous empresser d'adopter davantage de réglementations fondées sur des règles. Au contraire, la réglementation des valeurs mobilières basée sur des principes offre des solutions plus viables aux défis que pose une telle crise.

En se basant sur les leçons tirées de la crise financière mondiale, l'auteure identifie trois facteurs critiques pour assurer l'efficacité d'une réglementation des valeurs mobilières fondée sur des principes. Premièrement, les organismes régulateurs doivent disposer des moyens nécessaires en termes d'effectifs, d'accès à l'information et d'expertise s'ils veulent contrebalancer l'industrie de façon efficace. Deuxièmement, la réglementation doit être aux prises avec l'impact de la complexité sur les marchés financiers et sur leur réglementation. Troisièmement, une plus grande diversité des organismes de réglementation et une plus grande indépendance face à l'industrie sont requises pour éviter les conflits d'intérêts, la confiance excessive en la discipline du marché et la « pensée de groupe ». L'article appelle à un engagement continu envers la réglementation fondée sur des principes, accompagnée d'une application et d'une surveillance significatives.

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* Assistant Professor, Faculty of Law, University of British Columbia. Thanks to Julia Black, Amy Cohen, Sharon Gilad, Donald Langevoort, Saule Omarova, Jim Park, David Zaring, 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 (J.D. 2010, Faculty of Law, University of British Columbia) for exceptional research assistance.

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Citation: (2010) 55 McGill L.J. 257 ~ Référence : (2010) 55 R.D. McGill 257

Introduction

These remain early days to try to assess the impact of the global financial crisis (GFC) and 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 financial regulation was gaining traction in regulatory practice and policy circles.[1] 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 12 January 2009, recommending *inter alia* that Canada adopt a more principles-based approach.[2] On 22 June 2009, Doug Hyndman, long-time Chair of the British Columbia Securities Commission (BCSC), was appointed to a two-year term as chair of Canada's transition office for a new national securities regulator.[3] Hyndman, along with Vice Chair

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1 See U.K., Financial Services Authority, *Principles-Based Regulation: Focusing on the Outcomes That Matter* (London, U.K.: Financial Services Authority, 2007), online: Financial Services Authority <http://www.fsa.gov.uk> [FSA, *Focusing on the Outcomes*]; *History of the 2004 B.C. Securities Legislation*, online: British Columbia Securities Commission <http://www.bcsc.bc.ca> [BCSC, *2004 B.C. Securities*]; Cristie L. Ford, "New Governance, Compliance, and Principles-Based Securities Regulation" (2008) 45 Am. Bus. L.J. 1 at 12, n. 45 [Ford, "New Governance"]; Julia Black, Martin Hopper & Christa Band, "Making a Success of Principles-Based Regulation" (2007) 1 L. & Financial Markets Rev. 191 [Black, Hopper & Band, "Making a Success"]. *Cf.* Lawrence A. Cunningham, "A Prescription to Retire the Rhetoric of 'Principles-Based Systems' in Corporate Law, Securities Regulation, and Accounting" (2007) 60 Vand. L. Rev. 1411 [Cunningham, "Retire the Rhetoric"].

2 Canada, Expert Panel on Securities Regulation, *Creating an Advantage in Capital Markets: Final Report and Recommendations* (Ottawa: Department of Finance, 2009) at 17, online: Expert Panel on Securities Regulation <http://www.expertpanel.ca> [Expert Panel, *Capital Markets*].

3 Canada, Department of Finance, News Release, 2009-064 "Minister of Finance Announces Launch of Canadian Securities Regulator Transition Office" (22 June 2009),

Brent Aitken, has been the driving force behind the BCSC's principles-based approach and this experience will inevitably inform his approach 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.[4] A flurry of ambitious reform proposals followed. In March 2009, Lord Adair Turner released the *Turner Review*: *A Regulatory Response to the Global Banking Crisis* in the United Kingdom,[5] and major regulatory reform for financial markets has been proposed in both the United Kingdom and the United States.[6] Several major domestic and international policy bodies[7] and a number of scholars[8] have contributed to the conversation. Along with such reform

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online: Department of Finance Canada <http://www.fin.gc.ca>. The federal government is also seeking a reference opinion from the Supreme Court of Canada on the constitutionality of a national securities regulator. See Steven Chase & Rhéal Séguin, "Ottawa sets off constitutional battle over regulator" *The Globe and Mail* (17 October 2009) A1.

4 For a timeline of the crisis, see R.M. Schneiderman, "A Year of Financial Turmoil" *The New York Times* (11 September 2009), online: The New York Times <http://www.nytimes.com>.

5 U.K., Financial Services Authority, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (London, U.K.: Financial Services Authority, 2009), online: Financial Services Authority <http://www.fsa.gov.uk> [*Turner Review*].

6 See e.g. U.S., Department of the Treasury, *Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation* (2009), online: Financial Stability for the American Economy <http://www.financialstability.gov> [Department of the Treasury, *Financial Regulatory Reform*]; U.K., Her Majesty's Treasury, *Reforming Financial Markets* (London, U.K.: Her Majesty's Stationery Office, 2009), online: Her Majesty's Treasury <http://www.hm-treasury.gov.uk>.

7 See e.g. Switzerland, Bank for International Settlements, *79th Annual Report: 1 April 2008–31 March 2009*, online: Bank for International Settlements <http://www.bis.org>; Ana Carvajal *et al.*, *The Perimeter of Financial Regulation*, IMF Staff Position Note (SPN/09/07), online: International Monetary Fund <https://www.imf.org>.

8 See e.g. John C. Coffee Jr. & Hillary A. Sale, "Redesigning the SEC: Does the Treasury Have a Better Idea?" (2009) 95 Va. L. Rev. 707; Luigi Zingales, "A New Regulatory Framework: Three Agencies, Based on the Three Main Goals of Financial Regulation" *City Journal* 19:2 (Spring 2009), online: City Journal <http://www.city-journal.org>. Others have sounded more cautionary notes about the rush to reform. See generally Luca Enriques, "Regulators' Response to the Current Crisis and the Upcoming Reregulation of Financial Markets: One Reluctant Regulator's View" (2009) 30 U. Pa. J. Int'l L. 1147 (arguing that reforms are driven by public relations concerns); Saule Omarova & Adam Feibelman, "Risks, Rules, and Institutions: A Process for Reforming Financial Regulation" (2009) 39 U. Mem. L. Rev. 881 (raising concerns that reforms initiated during a period of crisis management may not be optimal, and suggesting a careful three-step approach to regulatory reform).

proposals came a turn, in some quarters, against principles-based regulation.[9]

This paper argues that the GFC does not discredit principles-based regulation, as this form of regulation is properly understood. On the contrary, principles-based securities regulation remains a viable and even necessary policy option: it offers solutions to the practical and theoretical challenges 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 the regulators can be to any form of regulation, including principles-based regulation. Adopting principles-based regulation does not mean doing away with rules. Rather, it is a particular approach to structuring regulation that includes rules. It gives legislatures the power to set high-level regulatory goals and outcomes, and leaves the articulation of processes and details to front-line 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 bare 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 inviting 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 an 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. Effective regulation should reflect an appropriately granulated understanding of different kinds of complexity and their effects, and reject the notion that innovation is by definition

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9 See e.g. Felix Salmon, "The US move to principles-based regulation" *Reuters* (17 June 2009), online: Reuters <http://blogs.reuters.com> (the author notes that in his newsroom, he is in "a minority of one" for continuing to advocate for principles-based regulation).

beneficial. It may also mean considering whether some regulatory requirements (e.g., 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, this paper suggests that the lack of diversity and independence among regulators and industry may have contributed to conflicts of interest, overreliance on market discipline, and "groupthink" in the run-up to the GFC. The appropriate 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.

I. Principles and Rules in Theory and Practice

Principles-based capital markets regulation has been a salient policy topic in recent years in many jurisdictions including Canada, the United States, and the United Kingdom.[10] In terms of actual practice, the U.K. Financial Services Authority (FSA) has been a thought leader on principles-based financial regulation.[11] In Canada, the province of British Columbia tried to promulgate a new, more principles-based *Securities Act* in 2004. Although that proposed act has not been brought into force, the

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10 See e.g. Crawford Panel on a Single Canadian Securities Regulator, *Blueprint for a Canadian Securities Commission*, Final Paper, online: Crawford Panel <http://www.crawfordpanel.ca> ("to provide Canadian capital markets with a competitive advantage globally, it is desirable to have as much principles-based regulation as is feasible" at 12) [Crawford Panel, *Blueprint*]; Task Force to Modernize Securities Legislation in Canada, *Canada Steps Up*, vol. 1, online: Task Force to Modernize Securities Legislation in Canada <http://www.tfmsl.ca> [Task Force, *Canada Steps Up*] (recommending that securities regulation be based "at every available opportunity" on "clearly enunciated regulatory principles which do not need a detailed set of interventionist rules for sound implementation" at 50); U.S., Department of the Treasury, *Blueprint for a Modernized Financial Regulatory Structure* (Washington: Department of the Treasury, 2008) at 106-16 (recommending a merged entity of Commodity Futures Trading Commission (CFTC) Securities and Exchange Commission (SEC) that adopts the CFTC's principles-based approach); Committee on Capital Markets Regulation, *Interim Report* (30 November 2006) at 8, online: Committee on Capital Markets Regulation <http://www.capmktsreg.org> (arguing that the SEC and self-regulatory organizations should move to a more "risk-based and principles-based" process).

11 FSA, *Focusing on the Outcomes*, *supra* note 1; Black, Hopper & Band, "Making a Success", *supra* note 1; Cristie Ford, "Principles-Based Securities Regulation" (2009), online: Expert Panel on Securities Regulation <http://www.expertpanel.ca/eng/reports/research-studies> [Ford, "Securities Regulation"]. Here, I describe the main components of the FSA regulatory approach as: a hybrid structure of rules and principles; consisting of extensive consultation with industry actors; a management-based, outcome-oriented, and risk-based regulatory approach; and an emphasis on compliance and supervision as opposed to *ex post* enforcement.

BCSC has since adopted a more principles-based approach to how it administers its existing act.[12] Derivative products in the United States and Canada also tend to be regulated in a more principles-based manner.[13] Most recently in Canada, as noted above, the Expert Panel chaired by the Honourable Tom Hockin has recommended that a proposed national securities regulator adopt a more principles-based approach to securities regulation.[14]

At the theoretical level, the distinction between rules and principles, and their relative advantages and disadvantages, have been quite well canvassed.[15] Generally speaking, rules are considered to have the advantages of being more precise and certain, but the consequent disadvantages of being potentially rigid, reactive, and insensitive to context and therefore inevitably over- or underinclusive. They may also promote or permit "loophole behaviour", and be more easily "gamed" by sophisticated actors. In comparison, principles are more flexible, more sensitive to context, and therefore potentially fairer when applied. On the other hand, principles can be uncertain, unpredictable, and difficult and costly to interpret. Because they allocate substantial decision-making to front-line decision-

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12 See British Columbia, *Submission of the British Columbia Securities Commission*, online: British Columbia Securities Commission <http://www.bcsc.bc.ca> [*BCSC Submission*].

13 See e.g. Walter Lukken, "It's a Matter of Principles" (Lecture delivered at the University of Houston's Global Energy Management Institute, 25 January 2007), online: Commodity Futures Trading Commission <http://www.cftc.gov>; Bill 77, *Derivatives Act*, 1st Sess., 38th Leg., Quebec, 2008 (assented to 20 June 2008), S.Q. 2008, c. 24 [*QDA*].

14 Expert Panel, *Capital Markets*, *supra* note 2 at 22. The Expert Panel also developed draft legislation for its national securities regulator. See "Draft Securities Act", online: Expert Panel on Securities Regulation <http://www.expertpanel.ca/eng/reports> ["Draft Securities Act"].

15 See especially Carol M. Rose, "Crystals and Mud in Property Law" (1988) 40 Stan. L. Rev. 577; Kathleen M. Sullivan, " The Justices of Rules and Standards", Foreward, *The Supreme Court, 1991 Term*, (1992) 106 Harv. L. Rev. 22; Pierre Schlag, "Rules and Standards" (1985) 33 UCLA L. Rev. 379; Frederick Schauer, "The Tyranny of Choice and the Rulification of Standards" (2005) 14 J. Contemp. Legal Issues 803; Antonin Scalia, "The Rule of Law as a Law of Rules" (1989) 56 U. Chicago L. Rev. 1175; Louis Kaplow, "Rules versus Standards: An Economic Analysis" (1992) 42 Duke L.J. 557; Duncan Kennedy, "Form and Substance in Private Law Adjudication" (1976) 89 Harv. L. Rev. 1685; Cass R. Sunstein, "Problems with Rules" (1995) 83 Cal. L. Rev. 953. Scholars working specifically in securities regulation, accounting, and tax have looked at how rules or principles affect industry behaviour, and how to choose between rules and principles in particular situations. See e.g. William W. Bratton, "Enron, Sarbanes-Oxley and Accounting: Rules versus Principles versus Rents" (2003) 48 Vill. L. Rev. 1023; James J. Park, "The Competing Paradigms of Securities Regulation" (2007) 57 Duke L.J. 625; Mark W. Nelson, "Behavioral Evidence on the Effects of Principles- and Rules-Based Standards" (2003) 17 Accounting Horizons 91.

makers, they can also permit arbitrary conduct and regulatory overreaching.

A simple example that has been used to illustrate the difference between rules and principles involves speed limits.[16] A speed limit framed as a rule will prohibit driving faster than a precise numerical limit (e.g., ninety kilometres per hour). The rule sets out, in advance and with precision, the boundary of acceptable conduct. This leaves very little discretion to the front-line decision-maker, who needs only to determine whether the car in question was exceeding that predetermined and non-negotiable limit. By contrast, a speed limit framed in principles-based terms would be something like a prohibition on driving faster than is "reasonable and prudent in all the circumstances." This was, in fact, how the state of Montana framed its speed limits for several years. The non-numerical "reasonableness" standard has the ability to take context—road and environmental conditions, time of day, driver's experience, etc.—into account. As a consequence, it also allocates substantial decision-making power to the front-line decision-maker, who must use her judgment to determine what "reasonable and prudent" driving constitutes in all the circumstances. It should be emphasized that speed limits involve very different background conditions than securities regulation does in terms of (among other things) the complexity of the subject matter, the scope for and fluidity of potential wrongdoing, and the expertise of the front-line decision-maker.[17] The two are not really analogous. That said, it is noteworthy that Montana repealed its principles-based speed limit in 1999, after the Montana

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[16] See Kaplow, *supra* note 15 at 559-60; Sullivan, *supra* note 15 at 58-59.

[17] 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 Part III.B ("Complexity and Prophylactic Rules") below. 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 a 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 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, as well, 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 15). Therefore, whether a regulatory system fosters clarity and predictability, for example, is not exclusively related to whether it is rules-based or principles-based. The real question is whether regulators and regulatees have a shared understanding of what the regulations entail.

Supreme Court held it to be so vague as to violate the Due Process clause of the state constitution.[18]

The terms are also useful at the systemic level, for describing practical regulatory approaches.[19] 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".[20] 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 statements of objectives.[21] 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 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.[22] Yet even within a system that is generally principles-based, rules will always serve an essential purpose in enhancing clarity at key junctures, and buttressing *ex post* enforceability.

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[18] See *State of Montana v. Rudy Stanko*, 1998 MT 321, 974 P.2d 1139, 292 Mont. 214. On the potential vagueness of principles in the securities law enforcement context, see Ford, "Securities Regulation", *supra* note 11 at 31-34.

[19] *Cf*. Cunningham, "Retire the Rhetoric", *supra* note 1; Ford, "New Governance", *supra* note 1 at 12, n. 45.

[20] FSA, *Focusing on the Outcomes*, *supra* note 1 at 4-5. For the sake of simplicity, this paper will simply refer to principles-based and rules-based approaches.

[21] See Black, Hopper & Band, "Making a Success", *supra* note 1 (identifying the distinction between bright-line rules and detailed rules).

[22] See e.g. British Columbia Securities Commission, *'08/'09 Annual Report*, online: British Columbia Securities Commission <http://www.bcsc.bc.ca>. The BCSC responded to the GFC as follows:

> 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.
>
> This is not to say that we should not consider rule changes ...
>
> 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 (*ibid.* at 3).

Rules and principles are also best understood as points on a continuum rather than discrete concepts, and there is a good deal of overlap and convergence among them.[23] 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, around eighty-eight per cent of the seventy-five written submissions from stakeholders to the Expert Panel were in favour of principles-based regulation.[24] But of these submissions, 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. A Time for Principles, A Time for Rules

Almost three decades ago, Colin Diver discussed what he called the "optimal precision" of administrative rules—meaning, the degree of specificity in statutory or regulatory drafting that would best avoid the worst problems of either imprecision or rigidity.[25] He identified three elements of regulatory precision: transparency (i.e., the words chosen have well-defined and universally accepted meanings within the relevant community); accessibility (i.e., the law can be applied to concrete situations without excessive difficulty); and congruence (i.e., the substantive content communicated by the words produces the desired behaviour). Not surprisingly, Diver found that no single "sweet spot" of precision exists. On some questions, flexibility and sensitivity to a particular context will be more important than certainty or the need to limit discretion. More general, principles-based drafting would make sense in that context. Elsewhere, a different mix would be called for. Diver also pointed out that these qualities are difficult to measure, and there are often direct trade-offs between

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

24 See "Written Submissions", online: Expert Panel on Securities Regulation <http://www.expertpanel.ca/eng/consultations>.

25 Colin Diver, "The Optimal Precision of Administrative Rules" (1983) 93 Yale L.J. 65. Diver does not use the terms "rules" and "principles", but his understanding of precision maps neatly onto the theoretical rules-versus-principles scholarship discussed above.

them. Therefore, settling upon a particular mix between rules and principles requires that choices be made, and public priorities be established.

In particular, where these lines are drawn depends on public priorities that the legislator has the mandate to establish. For example, a legislator who is concerned about regulatory overreach or lack of transparency in a particular area would see to it that the regulator had very little discretion (i.e., 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 (i.e., 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 rule-making 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, courts, or tribunals? Where does existing regulatory practice (whether principles-based or rules-based) seem to be well-established, to be working well, and to have created expectations on which stakeholders rely?[26] 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 (i.e., regulating effectively the many small, closely held public companies, or addressing the rumoured Canadian "market discount"[27]), which call for well-tailored and

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[26] See e.g. Lawrence A. Cunningham, "Principles and Rules in Public and Professional Securities Law Enforcement: A Comparative U.S.–Canadian Inquiry" in Task Force, *Canada Steps Up*, *supra* note 10, vol. 6, 253 at 299 (finding that in their enforcement actions, the National Association of Securities Dealers and the IDA—now the Financial Industry Regulatory Assocation and Investment Industry Regulatory Organization of Canada (IIROC)—invoke certain principles rather than existing rules).

[27] For a discussion of the Canadian "market discount", see e.g. The Hon. Peter de C. Cory, & Marilyn L. Pilkington, "Critical Issues in Enforcement" in Task Force, *Canada Steps Up*, *supra* note 10, vol. 6, 165,; Utpal Bhattacharya, "Enforcement and its Impact on Cost of Equity and Liquidity of the Market" in Task Force, *Canada Steps Up*, *supra* note 10, vol. 6, 131; Crawford Panel, *Blueprint*, *supra* note 10 at 12. For a review of some recent research challenging the existence of the Canadian discount, see Cécile

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 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 from the appropriate balance 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.[28] It is relevant that securities regulation is a disclosure-based system that relies heavily on ensuring reasonable access to information as a means for protecting investors. This suggests that congruence is important in this context: core definitions of materiality and disclosure should be broad and principles-based. Preventing fraud and minimizing "cosmetic" compliance and "loophole behaviour" are other areas where the over- or underinclusiveness of rules is particularly problematic. This is the rationale for broad statutory definitions of fraud and commissions' sweeping public interest powers.[29] Financial markets are also complex, fast-moving environments marked by constant product-level innovation. Principles are preferable in this environment when underpinned by effective information-gathering and analytical mechanisms,[30] since detailed rules may only add to complexity and opacity.[31] 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

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Carpentier, Jean-François L'Her & Jean-Marc Suret, "On the Competitiveness of the Canadian Stock Market" (2009) 24 B.F.L.R. 287 at 300-303.

28 See also Black, Hopper & Band, "Making a Success", *supra* note 1 at 200-201.

29 See *Committee for the Equal Treatment of Asbestos Minority Shareholders v. Ontario (Securities Commission)*, 2001 SCC 37, [2001] 2 S.C.R. 132 at para. 41, 199 D.L.R. (4th) 577 [*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 through their policies) should establish standards and explicit rationales for the application of public interest powers to ensure that they are exercised in a predictable way, as well as to ensure that those applying them consider relevant factors, do not consider inappropriate factors, and behave fairly.

30 See discussion in Part III.A ("Four Points on Regulatory Capacity") below.

31 See Steven L. Schwarcz, "Regulating Complexity in Financial Markets" (2010) 87 Wash. U. L. Rev. 211 [Schwarcz, "Regulating Complexity"]. Schwarcz cites the work of Richard Bookstaber (see *ibid.* at 224, n. 118).

commissions under administrative law,[32] 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.[33] 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. To uphold the rule of law, 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 relatively small matters.[34] Accessibility is also important if lay individuals will be interpreting the law on their own. This is a concern in capital markets like Canada, within which many small actors with limited compliance resources operate.[35] During a transitional stage between rules-based and principles-based regulation, for example, maintaining legacy rules may help keep compliance costs down. Finally, rules may be appropriate in situations where the regulator or statutory drafter is confident that it can devise an easy-to-describe, easy-to-verify, and fairly stable rule-based requirement that will serve as an effective

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32 See *Pezim v. British Columbia (Superintendent of Brokers),* [1994] 2 S.C.R. 557 at 596, 114 D.L.R. (4th) 385 [*Pezim*]; *Asbestos Minority Shareholders*, *supra* note 29 at para. 49.

33 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 disclosure possible. See "An Introduction to XBRL", online: XBRL International <http://www.xbrl.org/WhatIsXBRL>.

34 Kaplow, *supra* note 15. Kaplow also argues that the determining factor should be the frequency of regulated action. Where frequency is low, standards are preferable; where frequency is high, the costs of promulgating rules are justifiable (*ibid.* at 621). Trading rules are a good example of a rules-based treatment of high-frequency events.

35 See generally Christopher Nicholls, "The Characteristics of Canada's Capital Markets and the Illustrative Case of Canada's Legislative Regulatory Response to *Sarbanes-Oxley*" in Task Force, *Canada Steps Up*, *supra* note 10, vol. 4, 127. After the transitional stage, principles may prove much easier to implement than rules for smaller actors. Nicholls suggests that the small size of Canadian small-cap and micro-cap companies implies a more flexible regime, rather than a more rules-bound one (*ibid.* at 162).

proxy for a broader regulatory goal, such as ensuring good corporate conduct.[36]

B. Actual Principles-Based Securities Regulation: Key Characteristics

In producing a research report on principles-based regulation for the Expert Panel,[37] I reviewed and compared the following statutes with a view to determine how principles-based regulation differed from more rules-based regulation at the level of statutory drafting: (1) the Ontario *Securities Act* (*OSA*);[38] (2) Bill 38, the proposed British Columbia *Securities Act*, and associated proposed securities rules (collectively, the "B.C. Model");[39] (3) the Quebec *Derivatives Act* (*QDA*);[40] (4) the United Kingdom *Financial Services and Markets Act* (*FSMA*);[41] and (5) the United States *Commodity Futures Modernization Act* (*CFMA*).[42] 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.[43]

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36 Clayton P. Gillette, "Rules, Standards, and Precautions in Payment Systems" (1996) 82 Va. L. Rev. 181.

> Precise directives are more appropriate when we have the greatest confidence in our capacity to inform target actors (those at whom legal directives are aimed), to describe antisocial forms of behavior (so that target actors know the scope of permitted and prohibited activity), and to recognize the occurrence of such behavior (for purposes of enforcement). Uncertainty about any of these factors warrants the use of less precise formulations (*ibid.* at 185).

37 See Ford, "Securities Regulation", *supra* note 11.

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

39 Bill 38, *Securities Act*, 5th Sess., 37th Leg., British Columbia, 2004 (assented to 13 May 2004), S.B.C. 2004, c. 43, s. 203 [B.C. Bill 38]; "Securities Rules (proposed)" (21 June 2004) at Rules 93-104, 114-16, online: British Columbia Securities Commission <http://www.bcsc.bc.ca> [BCSC, "Securities Rules"].

40 *QDA*, *supra* note 13.

41 *Financial Services and Markets Act 2000* (U.K.), 2000, c. 8 [*FSMA*].

42 *Commodity Futures Modernization Act of 2000*, 7 U.S.C. § 1 (2000) [*CFMA*]. The report also occasionally considered the B.C. *Securities Act* that is in force.

43 See Julia Black, "Forms and Paradoxes of Principles Based Regulation" (LSE Law, Society and Economy Working Paper Series, WPS 13-2008, October 2008) at 12, online: <http://www.lse.ac.uk/collections/law/wps> [Black, "Forms and Paradoxes"]. Black distinguishes among the following: "formal" principles-based regulation, meaning principles in the rule books; "substantive" principles-based regulation, which has some of the operational elements of principles-based regulations but not principles on the rule books; "full" principles-based regulations, exhibiting both principles in the rule books and a principles-based operational approach; and "polycentric" principles-based regula-

Without claiming to be comprehensive, the report identified some overarching themes at the level of statutory drafting.[44] 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*)[45] reflects the same choices. For example, disclosure and fraud provisions tend to be drafted in a more principles-based manner because these are areas where congruence is essential (i.e., the definition of fraud must be able to capture even novel forms of fraudulent behaviour), and loophole behaviour cannot be tolerated. Compliance provisions also tend to be principles-based, for they require registrants to maintain effective systems and controls to manage the risks associated with their businesses, and prevent and detect internal wrongdoing.[46] 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.[47] The statutes are less detailed in areas that change quickly or that require specialized expertise. In general, these overarching commonalities accord

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tions, which is full principles-based regulations with the additional element of incorporating third parties into the regulatory process.

44 Note that the report compared statutes only. A comprehensive comparison of these regulatory regimes is neither feasible nor very helpful, given the number of different factors that go into the drafting of any statute. Just as importantly, national and multilateral instruments, regulations, and rules play central roles in real-life securities regulation. On this larger plane, this report concurs generally with Professor Stéphane Rousseau's description of which aspects of securities regulation are rule-based and which are principles-based, as referred to in the Brief submitted by the *Autorité des marchés financiers* to the Expert Panel on Securities Regulation. See Autorité des marchés financiers, *Single Regulator: A Needless Proposal* (Brief submitted to the Expert Panel on Securities Regulation, July 2008) at 26-27, online: Autorités des marchés financiers <http://www.lautorite.qc.ca>.

45 See "Draft Securities Act", *supra* note 14 at 3; *Securities Act*, R.S.A. 2000, c. S-4.

46 But see *QDA*, *supra* note 13, cls. 26-31, 61-62. See also British Columbia Securities Commission, *Registration Requirements and Exemptions*, National Instrument 31-103 (effective 28 September 2009) at 35 (Part 11), online: British Columbia Securities Commission <http://www.bcsc.bc.ca> [National Instrument 31-103].

47 For the best examples here, see *OSA*, *supra* note 38, ss. 3.5, 8-9; B.C. Bill 38, *supra* note 39, cls. 65, 70(2)-70(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, rule-driven structure persists. See e.g. *FSMA*, *supra* note 41, s. 13. The *QDA* is a more circumscribed statute that borrows many provisions from the Quebec *Securities Act* (R.S.Q. c. V-1.1), though it contains some process-based provisions (see e.g. *QDA*, *supra* note 13, ss. 115-17).

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 principles-based and rules-based regimes differ. Some differences are essentially stylistic. For example, principles-based regulation is consistent with 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.[48] 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.[49] Consistently with the principles-based approach, these principles are left to be translated into specific business-conduct expectations in context through techniques such as administrative guidance, enforcement example, the incorporation and dissemination of good or best practices, and ongoing communication between regulator and registrant.[50]

The most profound structural differences between the principles-based and rules-based statutes are found in two areas: (1) the proportion of decision-making and interpretive power that is explicitly left to be filled in through the rule-making function rather than statutory drafting; and (2) the proportion of outcome-oriented versus process-oriented statutory requirements.

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48 See B.C. Bill 38, *supra* note 39. Bill 38 would have replaced existing prospectus disclosure rules, short form prospectus provisions, the entire exempt market transaction structure, and existing continuous disclosure obligations (as they then were) with an overarching "Continuous 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.

49 The FSA refers to its set of principles as the *Principles for Businesses*. See FSA, *Handbook* (Ref. Code PRIN), online: FSA Handbook Online <http://fsahandbook.info>. B.C. Bill 38 would have contained a code of conduct for dealers and advisers. See BCSC, *Securities Regulation That Works: The BC Model,* "Dealers and Advisers Guide", online: British Columbia Securities Commission <http://www.bcsc.bc.a> at 32 [BCSC, "Dealers and Advisers Guide"]. The *CFMA* (*supra* note 42) and *QDA* (*supra* note 13) both refer to their principles as "Core Principles for Derivative Markets". Many of the principles contained in B.C.'s *Code of Conduct* have since found their way into the National Instrument 31-103 (*supra* note 46), though it also contains detailed rules.

50 For a more detailed description of these techniques and their use in ascribing content to regulatory principles, see Ford, "Securities Regulation", *supra* note 11 at 9-13.

All four of the statutes studied grant rule-making power to the regulator in question.[51] To be clear, securities law statutes in every jurisdiction contain notable principles-based provisions.[52] In contrast to regulators in other fields, securities regulators already have extensive notice-and-comment rule-making powers and enjoy substantial deference from courts on judicial review.[53] As between rules-based and principles-based systems, however, the difference lies in how much detail is provided in the statute, and how much is left to be filled in through the Authority's or Commission's rule-making. The difference between a traditional, rules-based approach to statutory drafting, and the B.C. version of principles-based drafting is strikingly illustrated in the Table of Concordance prepared by BCSC staff in September 2004.[54] Large portions of the *Securities Act* currently in force simply have no equivalent in the proposed B.C. legislation, in large part because the proposed legislation allocates the authority over more context-specific, detailed decision-making to the Commission, pursuant to its rule-making power.[55]

Consider, for example, Canadian prospectus requirements. Both Ontario and British Columbia (under both the existing *Securities Act* and the proposed legislation) require that issuers file a prospectus and obtain a receipt for it before distributing or offering a security. The statutes' overarching provisions are quite similar:[56]

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51 See *OSA*, *supra* note 38, s. 143; B.C. Bill 38, *supra* note 39, s. 170; *QDA*, *supra* note 13, ss. 174-75; *FSMA*, *supra* note 41, s. 138. Rule-making needs to be distinguished not only from statutes, but also from regulations, which, though subordinate, must go through the legislative process rather than be largely or entirely under the control of the regulator.

52 See e.g. *Securities Exchange Act of 1934*, 15 U.S.C § 78j (2000). See also Rule 10b-5-1, 17 C.F.R. § 240.10b-5 (2009) promulgated thereunder.

53 See *Pezim*, *supra* note 32; *Asbestos Minority Shareholders*, *supra* note 29.

54 See British Columbia Securities Commission, *Table of Concordance: Part I* (*Securities Act*, R.S.B.C. 1996, c. 418 to *Securities Act*, S.B.C. 2004, c. 43 (not in force)), online: British Columbia Securities Commission <http://www.bcsc.bc.ca> [BCSC, *Table of Concordance*].

55 See *Securities* Act, R.S.B.C. 1996, c. 418 [*BCSA*]. The other important factor was substantive reform under the proposed B.C. Model, especially including its Continuous Market Access approach (B.C. Bill 38, *supra* note 39).

56 *Ibid.*, ss. 18(1)-18(2); *BCSA*, *supra* note 55, ss. 61(1)-61(2); *OSA*, *supra* note 38, s. 53(1).

Bill 38[57] (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.
B.C. *Securities Act*[58] (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*[59]	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 such security, unless a preliminary prospectus and a prospectus have been filed and receipts have been issued for them by the Director.

Where the rules-based and principles-based approaches diverge, however, is in the additional details provided in the statute itself. In the OSA and the existing BCSA, the general requirement above is accompanied by additional provisions concerning, *inter alia*: amendments to preliminary and final prospectuses (each of which receives distinct treatment); certification requirements for issuers, directors, officers, underwriters, etc.; receipts; waiting periods; and distribution.[60] By contrast, the proposed B.C. legislation locates many of those issues within its proposed Securities

57 B.C. Bill 38, *supra* note 39.

58 *BCSA*, *supra* note 55.

59 *OSA*, *supra* note 38.

60 See *ibid*., ss. 57 (prospectus amendments), 58 (certificate by issuer), 59 (certificate underwriter), 61 (prospectus receipt), 65 (waiting period), Part XVI (distribution); *BCSA*, *supra* note 55, 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).

Rules, instead of in the proposed statute.[61] A similar shift toward greater reliance on Commission rule-making powers is evident in the proposed B.C. legislation around takeover and issuer bids, proxies, continuous disclosure, and primary market civil liability.[62]

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 BCSC expressed a preference for the term "outcomes-based" rather than "principles-based" to describe its approach.[63] Outcome-oriented regulation measures performance against regulatory goals, whereas process-based regulation measures compliance with detailed procedural requirements.[64] For example, both the *OSA* and

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61 See especially BCSC, "Securities Rules", *supra* note 39 at Rules 93-104, 114-16.

62 One of the wrinkles concerns where each principles-based regime locates its "core principles". See Ford, "Securities Regulation", *supra* note 11 at 60-65. British Columbia and the FSA issued their Code/Principles through rule-making, while the *CFMA* (*supra* note 42) and the *QDA* (*supra* note 13) chose to embed them directly into legislation. It seems that nothing substantive turns on the choice.

63 *BCSC Submission*, *supra* note 12 at 4. See also FSA, *Business Plan 2009/10* (London, U.K.: Financial Services Authority, 2009) at 9, online: Financial Services Authority <http://www.fsa.gov.uk>. These regulators prefer the terms "outcomes-oriented" or "outcomes-focused" primarily due to confusion around the term "principles-based", and 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.

Secondary market civil liability was not part of the existing *BCSA* in 2004, when the proposed legislation was drafted, so we cannot compare the structure there. Note also that the principles-based regimes diverge in terms of where they locate their "core principles". See Ford, "Securities Regulation", *supra* note 11 at 60-65. British Columbia and the FSA issued their Code/Principles through rule-making, while the *CFMA* (*supra* note 42), and the *QDA* (*supra* note 13) chose to embed them directly into legislation. All of these Codes/Principles are actually pitched at similar levels of precision (i.e., they are all cast in terms of high-level principles). There is no intention that they be regularly amended based on regulatory experience. Therefore purely in terms of regulatory design they should probably be part of the statute rather than the rules, although there may have been practical considerations at play as well. It seems that nothing substantive turns on the choice.

64 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. However, there are differences between the two concepts regarding the stage of firm conduct at which the regulator intervenes, but both place responsibility for detailed decision-making with

one part of the B.C. Model (its *Code of Conduct* for dealers and advisers)[65] contain provisions that try to ensure that customers receive timely disclosure of trades conducted on their account. The *OSA* establishes a strict procedure, whereas the B.C. *Code of Conduct* specifies only an outcome.[66] We see similar differences in their approaches to dealer conflicts of interest.[67]

Another example is account supervision by broker-dealer firms. In 2004, the BCSC 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 the proposed B.C. *Code of Conduct* for dealers and advisers.[68] The *Code of Conduct* would have required a firm to "[m]aintain an effective system to ensure compliance with this Code, all applicable regulatory and other legal requirements, and [its] own internal policies and procedures," and to "[m]aintain an effective system to manage the risks associated with [its] business."[69] The four firms studied were of the view that the IDA rules,[70] 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 behaviour—where they thought the biggest compliance risks arose. As a result of these perceived limitations and in response to 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

industry actors and give those actors the flexibility to design mechanisms that work for them based on their greater knowledge about their own businesses.

65 *Code of Conduct*, being Schedule of the BCSC "Securities Rules" (*supra* note 39) [*Code of Conduct*]. See also BCSC, "Dealers and Advisers Guide", *supra* note 49 at 32.

66 See *OSA*, *supra* note 38, s. 36; Christina Wolf, "Strong and Efficient Investor Protection: Dealers and Advisers under the BC Model", A Regulatory Impact Analysis (24 November 2003) at 72, online: British Columbia Securities Commission <http://www.bcsc.bc.ca> [Wolf, "Dealers and Advisers"].

67 See *OSA*, *supra* note 38, s. 39. Compare Wolf, "Dealers and Advisers", *supra* note 66 at 66 (Principle 6).

68 *Ibid.* at 48-57. Of course, primary responsibility for overseeing dealers and advisors is delegated to self-regulatory organizations (SROs), most prominently the IIROC and the Mutual Fund Dealers Association of Canada. Those SROs would have to be active participants in any change to a more principles-based approach.

69 See *Code of Conduct*, *supra* note 65, Principle 19. See also BCSC, "Dealers and Advisers Guide", *supra* note 49 at 31-32.

70 See generally *ibid.* at 13-15, 17.

study, developed its own parallel risk-based supervisory system.[71] The regulatory impact analysis concluded that relative to the existing system, British Columbia'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.[72] The point here is that outcome orientation has important implications on how regulators approach their task, and understand their mandate. By definition, outcome-oriented regulation accepts that there may be more than one means or 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. One of the reasons that outcome-oriented regulation is attractive is that it establishes a more direct relationship between regulatory goals and regulatory requirements. Outcome-oriented regulation translates regulatory goals directly and transparently into the outcomes that industry is required to meet. By contrast, process-oriented requirements that are developed by regulators in advance may not be perfectly tailored to regulatory goals, even though regulators possess less contextual information than industry actors do. 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 in areas where events are fast-moving and regulators on their own could not hope to keep up with the pace of innovation.

Fundamental to an outcome-oriented system is the existence or development of an "interpretive community"[73] that collectively develops, on a rolling basis, the detailed content of statutory principles. In order to func-

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71 For an example of the limitations that the firms found frustrating, see generally *ibid*. at 14-17.

72 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 in Part II ("The Global Financial Crisis") below.

73 Stanley Fish, *Is There A Text in This Class?: The Authority of Interpretive Communities* (Cambridge, Mass.: Harvard University Press, 1980); Julia Black, *Rules and Regulators* (Oxford: Clarendon Press, 1997) at 30-37 [Black, *Rules and Regulators*]; Julia Black, "Talking about Regulation" (1998) Public Law 77; Sol Picciotto, "Constructing Compliance: Game Playing, Tax Law, and the Regulatory State" (2007) 29 Law & Pol'y 11; Expert Panel, *Capital Markets*, *supra* note 2.

tion transparently and predictably, a principles-based system must build in mechanisms that allow regulators to communicate with industry about their expectations, and 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.

Principles-based securities regulation is thus 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 front-line 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 front-line regulators are limited in their access to information by comparison to the industries they regulate. In order to 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, and constantly evolving industry experience and regulatory rules add certainty on a rolling basis. In this formulation, principles-based regulation, as applied, avoids the biggest problems associated with both principles and rules at the level of theory. Moreover, it 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 is still idealized, and that its promise was not achieved in practice. How real-life experience fell short of expectations is described in the next part of this paper, followed by a discussion of three large lessons learned.

II. The Global Financial Crisis

At least three major arguments contend that the GFC does not represent even a superficial challenge to principles-based securities regulation. First, the most alarming problems originated with complex securitized products that were distributed through exempt private-market placements, entirely bypassing the public securities markets where the full panoply of regulatory safeguards would have applied. Second, the GFC has to do with gaps in regulation, far more than with drafting choices. Gaps in regulation, especially around prudential regulation of players in the so-called "shadow banking system" of the United States, were surely the most obvious and consequential aspect of regulatory failure.[74] The asset-backed commercial paper crisis in Canada in August 2007 revolved around paper sold under an exemption from securities regulation.[75] Credit-rating agencies, which failed utterly as gatekeepers,[76] were drastically underregulated.[77] Third, the GFC was a global event. The complex securitization technology that increased risky lending, decreased transparency, and multiplied and spread risk was not unique to principles-

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74 See Department of the Treasury, *Financial Regulatory Reform*, *supra* note 6; 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. 1327. 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 & Sale, *supra* note 8).

75 See *Prospectus and Registration Exemptions*, National Instrument 45-106, B.C. Reg. 269/2005, 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.

76 See Roger Lowenstein, "Triple-A Failure" *The New York Times Magazine* (27 April 2008) 36, online: The New York Times Magazine <http://www.nytimes.com/magazine>. See especially Frank Partnoy, "The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies" (1999) 77 Wash. U.L.Q. 619.

77 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 "nationally recognized statistical rating organizations" (NRSROs). The SEC imposes stringent requirements before an agency can be recognized as an NRSRO. This, coupled with high entry barriers, has produced a situation in which three agencies dominate the market for credit ratings. For further information on the regulation of credit-rating agencies in the United States, see U.S., Securities and Exchange Commission, *Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets*: *As Required by Section 702(b) of the Sarbanes-Oxley Act of 2002* (January 2003) at 5-10, online: Securities and Exchange Commission <http://www.sec.gov>. Legislation has recently been proposed in the United States to introduce additional regulatory oversight and to curb many of the failings associated with the current rating regime. See U.S., Bill H.R. 3817, *Investor Protection Act of 2009*, 111th Cong., 2009.

based jurisdictions.[78] Even within the core concerns of securities regulation, national systems traditionally described as rules-based—specifically, that of 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[79]) are legitimately being re-examined, they are being re-examined globally.

A. Risk and Reward: Devolution of Details to Industry

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 devolution is a central reason for the advantage of principles-based regulation over rules-based regulation in fast-moving environments. Devolution of the details to industry, however, 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 credit default swaps traded, following the passage of the *CFMA*.[80] Other past examples of devolution include Basel II[81] and, correspondingly, the United States Securities and Ex-

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78 On this technology, see e.g. McCoy, Pavlov & Wachter, *supra* note 74.

79 Steven L. Schwarcz, "Disclosure's Failure in the Subprime Mortgage Crisis" (2008) Utah L. Rev. 1109.

80 See Stephen Labaton & Timothy L. O'Brien, "Financiers Plan to Put Controls on Derivatives" *The New York Times* (7 January 1999) C1 (discussing the move towards self-regulation in derivative markets, prior to the GFC); Christopher Cox, "Testimony Concerning Turmoil in U.S. Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions" (Before the Committee on Banking, Housing, and Urban Affairs, United States Senate, 23 September 2008), online: U.S. Securities and Exchange Commission <http://www.sec.gov> (recognizing a lack of regulatory oversight in the market for credit default swaps and other derivative products).

81 Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (June 2004), online: Bank for International Settlements <http://www.bis.org>.

change Commission's (SEC) approval in 2004 of alternative net capital requirements for the leading investment banks under the Consolidated Supervised Entities Program (CSE Program).[82] 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.[83] Investment banks and others engaged in originating, structuring, and selling financial products engaged in breathtakingly bad behaviour. There was real dishonesty.[84] 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 efficient markets theory models[85] as well as limits of valuation models were ploughed under.[86] 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 to third parties, in a market eager to buy them.[87]

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82 U.S. Securities and Exchange Commission, "Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities", 69 Fed. Reg. 34,428 (21 June 2004) (to be codified at 17 C.F.R. pts. 200, 201), online: U.S. Securities and Exchange Commission <http://www.sec.gov>. See also Stephen Labaton, "Agency's '04 Rule Let Banks Pile Up New Debt" *The New York Times* (3 October 2008) A1 [Labaton, "Agency's '04 Rule"].

83 George Soros, "The worst market crisis in 60 years" *Financial Times* (23 January 2008) 15.

84 See e.g. Lowenstein, *supra* note 76; Les Christie, "Mortgage fraud still soaring: A crackdown on underwriting has failed to halt an explosion of fraudulent home loans" *CNNmoney.com* (26 August 2008), online: CNNmoney.com <http://money.cnn.com>.

85 For a discussion of the future of the "efficient-markets hypothesis", see "Efficiency and beyond" *The Economist* (16 July 2009), online: The Economist <http://www.economist.com> ["Efficiency and beyond"].

86 See e.g. Joe Nocera, "Risk Mismanagement: Were the Measures Used to Evaluate Wall Street Trades Flawed?" *The New York Times Magazine* (2 January 2009) 24, online: The New York Times Magazine <http://www.nytimes.com/magazine> (describing the oversimplification of the "value at risk" model in banking practice); Felix Salmon, "Recipe for Disaster: The Formula That Killed Wall Street" *Wired Magazine* (23 February 2009), online: Wired <http://www.wired.com> (describing oversimplification of Li's gaussian copula in banking practice).

87 Ben S. Bernanke, "The Global Saving Glut and the U.S. Current Account Deficit" (Remarks at the Sandridge Lecture, delivered at the Virginia Association of Economics,

At a structural level, banks 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.[88]

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,[89] 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. Firms innovated in structured products, not only to reflect increasing sophistication or in order to make their product more attractive to purchasers, but also sometimes to avoid regulation.[90] They avoided comparability in order to reduce transparency and make it harder for regulators to understand what they were selling.[91]

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, possessing the greatest con-

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Richmond, Va., 10 March 2005), online: Board of Governors of the Federal Reserve System <http://www.federalreserve.gov>.

88 Lucien A. Bebchuk & Holger Spamann, "Regulating Bankers' Pay" (2010) 98 Geo. L.J. 247. See also Michael Lewis, "The End" *Portfolio.com* (11 November 2008), online: Portfolio.com <http://www.portfolio.com> (blaming Wall Street excesses for the decision to take investment banks public).

89 See David Brooks, "Greed and Stupidity" *The New York Times* (3 April 2009) A29 (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 multifactorial and varies from one firm to another.

90 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": "Reform of regulation has to start by altering incentives" *Financial Times* (24 June 2009) 15.

91 See Julia Hoggett, "Crossing the Atlantic: Can Covered Bonds Gain Real Penetration in the United States?" in Jonathan Golin, ed., *Covered Bonds beyond* Pfandbriefe: *Innovations, Investment and Structured Alternatives* (London, U.K.: Euromoney Books, 2006) 320 at 323 (indicating the lack of legislation in the American market for covered bonds, which produces products that lack the standardization and comparability of their European counterparts). Recent legislative initiatives have shown an interest in standardizing certain over-the-counter (OTC) derivative products, in an effort to mitigate systemic risk. See e.g. Patricia White, "Over-the-Counter Derivatives" (Testimony before the Subcommittee on Securities, Insurance, and Investment, Committee of Banking, Housing, and Urban Affairs, 22 June 2009), online: Board of Governors of the Federal Reserve System <http://www.federalreserve.gov>.

textual 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.[92] What follows below is a dissection of the ways in which the self-regulatory regimes that gained so much traction in the past decade differ from 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 has slipped to in recent practice, and what aspects of it remain vital.

B. 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 in obscuring this distinction. 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 favour of principles-based regulation from Henry Paulsen, for example, tended to emphasize the free-market benefits and the reduced regulatory burden associated with the FSA approach—not its asserted regulatory oversight benefits.[93] Some, concerned about London's increased capital market share in the last few years, asserted 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.[94] London-based regulators naturally disputed this assessment.[95]

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92 Black, "Forms and Paradoxes", *supra* note 43 at 10.

93 See Department of the Treasury, "Remarks by Treasury Secretary Henry M. Paulson on the Competitiveness of U.S. Capital Markets, Economic Club of New York" (Press Release No. HP-174, 20 November 2006), online: Department of the Treasury <http://www.treas.gov>. See also Michael R. Bloomberg & Charles E. Schumer, "Sustaining New York's and the US' Global Financial Services Leadership" (McKinsey Report, 22 January 2007) at 13, online: NYC.gov <http://www.nyc.gov> (blaming the heavy regulatory burden in the United States for the shift in business to London).

94 See John Gapper & David Blackwell, "NYSE Chief says AIM must raise standards" *Financial Times* (26 January 2007) 8.

95 See e.g. Clara Furse, "SOX is not to blame—London is just better as a market" *Financial Times* (18 September 2006) 19; John Tiner, "Better Regulation: Objective or Oxymoron" (Speech delivered at the SII Annual Conference, 9 May 2006), online: Financial Services Authority <http://www.fsa.gov.uk>.

The March 2009 *Turner Review* insightfully describes the regulatory world view that failed to anticipate the problems identified above.[96] Lord Adair Turner, now FSA Chairman, was commissioned by the Chancellor of the Exchequer in October 2008 to review the causes of the financial crisis and to make recommendations about regulatory changes. According to the *Turner Review*, the FSA did not fail because it embraced principles-based regulation. Indeed, principles-based regulation is barely mentioned.[97] 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; market discipline could be trusted to contain risk; the primary responsibility for managing risk lay with senior management, not regulators, because senior management had better information; and consumers were best protected through unfettered and transparent markets, not product regulation or direct intervention.[98]

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 equate principles-based regulation unequivocally with self-regulation would be to misunderstand both. The two are not inconsistent, 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 interventionist, depending on how it is implemented, even though its effectiveness relies on pulling industry's own experience and information into regulatory expectations. Indeed, some opponents of principles-based regulation are primarily concerned about the possibility that such an approach would allow regulators to *over*reach, especially in the enforcement context.[99] 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.

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96 *Turner Review*, *supra* note 5.

97 This is notwithstanding premature and ultimately inaccurate reports by credible U.K. 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* (13 March 2009), online: Financial Times <http://www.ft.com>.

98 Equally fundamental, but best put in the category of regulatory gaps rather than regulatory approaches, was the failure in the oversight of systemic risk. See *Turner Review*, *supra* note 5 at 52.

99 See e.g. Briefing from Freshfields Bruckhaus Deringer, "FSA Principles-Based Regulation: What Should Firms Be Doing Differently?" (Briefing, February 2007) at 2, online: Freshfields Bruckhaus Deringer <http://www.freshfields.com>.

Principles-based regulation as properly understood inevitably requires a robust and capable public role, including meaningful enforcement.[100] 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,[101] co-regulation,[102] enforced self-regulation,[103] or "responsive regulation".[104] New governance and its vari-

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[100] Ford, "New Governance", *supra* note 1. "[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" (*ibid.* at 32). See also Cristie L. Ford, "Toward a New Model for Securities Law Enforcement" (2005) 57 Admin. L. Rev. 757 (arguing for continued focus on enforcement within new governance scholarship).

[101] Ford, "New Governance", *supra* note 1 (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 concerns about whether the GAAP (Generally Accepted Accounting Principles) in the United States 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 & 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, Sabel, and Simon 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, Sabel, and Simon describe. See also Ford, "New Governance", *supra* note 1 at 30, n. 111.

[102] Edward J. Balleisen & Marc Eisner, "The Promise and Pitfalls of Co-Regulation: How Governments Can Draw on Private Governance for Public Purpose" in David Moss & John Cisternino, eds., *New Perspectives on Regulation* (Cambridge, Mass.: Tobin Project, 2009) 127.

[103] John Braithwaite, "Enforced Self-Regulation: A New Strategy for Corporate Crime Control" (1982) 80 Mich. L. Rev. 1466.

[104] Ian Ayres & John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford: Oxford University Press, 1992). I am not suggesting that these perspectives are coterminous in terms of precisely how "top-down" or "bottom-up" they are designed to be, among other things. For a description of the difference between co-regulation and (enforced) self-regulation in the European Union, see e.g. Linda Senden, "Soft Law, Self-Regulation and Co-Regulation in European Law: Where Do They Meet?", online: (2005) 9:1 Electronic Journal of Comparative Law <http://www.ejcl.org>. 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

ants are not the same as self-regulation.[105] According to its proponents, new governance scholarship exists explicitly for the purpose of making the public state more, not less, central and relevant.[106] To use Jerry Mashaw's recent formulation, new governance represents a different balance between the available public, market, and social mechanisms for ensuring accountability, putting greater emphasis on the latter two.[107] 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 to best enforce self-regulatory models is a matter of some debate. Different models exist. *Ex post* enforcement actions play a much larger role in U.S. securities regulation than they do in the United Kingdom, where the focus is more on *ex ante* supervision and compliance work.[108] The impact of civil liability also needs to be considered.[109] When it

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identify an effective regulatory method located between rigid and unresponsive command-and-control regulation on one hand, and voluntary self-regulation on the other.

105 See e.g. On Amir & Orly Lobel, "Stumble, Predict, Nudge: How Behavioral Economics Informs Law and Policy", Book Review, (2008) 108 Colum. L. Rev. 2098 at 2132-36.

106 See e.g. Michael C. Dorf & Charles F. Sabel, "A Constitution of Democratic Experimentalism" (1998) 98 Colum. L. Rev. 267; Jody Freeman, "The Private Role in Public Governance" (2000) 75 N.Y.U. L. Rev. 543; William H. Simon, "Optimization and its Discontents in Regulatory Design" (unpublished paper on file with author). But see Martha Minow, "Public and Private Partnerships: Accounting for the New Religion" (2003) 116 Harv. L. Rev. 1229; Donald F. Kettl, *Government by Proxy: (Mis?)managing Federal Programs* (Washington, D.C.: CQ Press, 1987); H.W. Arthurs, "The Administrative State Goes to Market (and Cries 'Wee Wee Wee' all the Way Home)" (2005) 55 U.T.L.J. 797.

107 Jerry L. Mashaw, "Accountability and Institutional Design: Some Thoughts on the Grammar of Governance" in Michael W. Dowdle, ed., *Public Accountability: Designs, Dilemmas and Experiences* (Cambridge, U.K.: Cambridge University Press, 2006) 115.

108 John C. Coffee Jr., "Law and the Market: The Impact of Enforcement" (Columbia Law and Economics Working Paper No. 304, March 2007), online: Columbia Law School Center for Law & Economic Studies <http://www.law.columbia.edu/center_program/law_economics> (identifying the United States as an "outlier" in the frequency and magnitude of its enforcement actions); Howell E. Jackson & Mark J. Roe, "Public and Private Enforcement of Securities Laws: Resource-Based Evidence" (2009) 93 J. Financial Econ. 207 at 236.

109 Some have also argued that principles-based regulation is not viable in the United States because of the extraordinary civil liability risks in this jurisdiction. See Peter J. Wallison, "Fad or Reform: Can Principles-Based Regulation Work in the United States?" (Financial Services Outlook, June 2007), online: American Enterprise Institute for Public Policy Research <http://www.aei.org>. This is probably less of a concern in Canada. There may be a risk, however, 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. See Ford, "Securities Regulation", *supra* note 11 at 24-25.

comes to principles-based regulation, Black is probably correct when she writes that "principles need enforcement to give them credibility but over-enforcement can lead to their demise."[110] A growing body of scholarship considers how to make enforced self-regulatory systems effective and credible using supervision, outcome-oriented problem solving, negotiated compliance, and firm penetration through compliance audits.[111] 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.[112] Once at the enforcement stage, especially when dealing with cases based on violation of a principle alone, successfully bringing enforcement actions calls for substantial confidence and fortitude on the part of regulators. Enforcement staffers must also be watchful for potential procedural fairness concerns.[113]

The GFC represents an important lesson for some new governance scholarship, some of which has not always been particularly interested in how theory plays out in practice.[114] 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 from 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. These recommendations take as a starting point that principles-based regulation must be buttressed by meaningful regulatory oversight, and then they move beyond that to a closer review of what accountability

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110 Black, "Forms and Paradoxes", *supra* note 43 at 29.

111 See e.g. Malcolm K. Sparrow, *The Regulatory Craft: Controlling Risks, Solving Problems, and Managing Compliance* (Washington, D.C.: Brookings Institution, 2000) (describing problem-solving techniques in enforcement); Ayres & Braithwaite, *supra* note 104; Robert Axelrod, *The Evolution of Cooperation* (New York: Basic Books, 1984) (on "tit-for-tat"). Comply-or-explain protocols, such as those on corporate governance under the E.U. Combined Code, may also be instructive, along with the historical story of the evolution of compliance analysis following the Barings Bank disaster. See Janet Dine, "The Regulation of Derivatives: Identifying Difficulties and Creating Models of Regulation" in Alastair Hudson, ed., *Modern Financial Techniques, Derivatives and Law* (London, U.K.: Kluwer Law International, 2000) 135 at 151-54.

112 Ayres & Braithwaite, *supra* note 104.

113 See Ford, "Securities Regulation", *supra* note 11 at 32-34.

114 Amy J. Cohen, "Negotiation, Meet New Governance: Interests, Skills, and Selves" (2008) 33 Law & Soc. Inquiry 503 at 514-15, 529-30.

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.

III. Lessons Learned and Steps Forward

A. Four Points on Regulatory Capacity

It turns out, though there was no doubt, that how principles are *implemented* is at least as important as how legislation is drafted.[115] 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 development of an interpretive community that defines the content of that provision.[116] What is required is a regulator who is capable of functioning as an independent and credible member within that interpretive community—that is, a regulator who has a clear sense of her distinct role as a voice on behalf of the public interest. Moreover, because so much interpretive discretion rests in the regulator's hands, regulatory capacity, training, judgment, and philosophy are critically important to effective implementation. It is therefore crucial to think carefully about the structure through which principles will be translated 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.[117] 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 rule-making where appropri-

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[115] Indeed, implementation may be more important than optimal statutory design, given that both the FSA (U.K.) and the BCSC have adopted more principles-based approaches, notwithstanding enabling statutes that are not particularly principles-based. See FSA, *Focusing on the Outcomes*, *supra* note 1 (discussing the FSA regulatory philosophy); BCSC, *2004 B.C. Securities*, *supra* note 1 ("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").

[116] Black, *Rules and Regulators*, *supra* note 73. See also Expert Panel, *Capital Markets*, *supra* note 2.

[117] See Robin Ford, "Principles-Based Regulation: Financial Services Authority (U.K.)" in Task Force, *Canada Steps Up*, *supra* note 10, vol. 7, 101 at 105-108, (describing the former BCSC Commissioner's experience with change management at the FSA, including obstacles the FSA faced in implementing an outcome-oriented, principles-based system and the tools the FSA used to help staff adjust).

ate.[118] 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 (which evolve) as opposed to potentially static industry standards allows regulatory expectations 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.

1. Lesson One: Effective Regulatory Capacity Requires Adequate Number of Staff

At the first and most fundamental level, regulatory capacity in this new environment requires an adequate number of staff. As 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 firms, at least around certain issues or situations.[119] Yet, as the Northern Rock debacle in the United Kingdom highlighted, the FSA was far from adequately staffed.[120] Its Major Retail Groups Division was reduced by some twenty staff between 2004 and 2008, notwithstanding the 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.[121]

The example of the SEC's CSE Program is even more striking.[122] Its Division of Trading and Markets had only seven staffers and no executive

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118 See e.g. Black, Hopper & Band, "Making a Success", *supra* note 1.

119 See *ibid.* (describing U.K. Treat Customers Fairly rules, which require registrants to demonstrate that they are in fact treating customers fairly at every stage).

120 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 FSA Internal Audit Division, *The Supervision of Northern Rock: A Lessons Learned Review* (March 2008), online: Financial Services Authority <http://www.fsa.gov.uk> [FSA, *Northern Rock*].

121 *Ibid.*

122 This is also a story of a regulatory gap. The CSE Program was *voluntary*, reportedly designed as a response to the fact that no U.S. agency had regulatory authority over certain investment-bank holding companies. See *SEC's Oversight of Bear Stearns and Related Entities: The Consolidated Supervised Entity Program*, Report No. 446-A, (Chairman Cox's comments, 25 September 2008) at 81, online: Securities and Exchange Commission <http://www.sec.gov> [*SEC Oversight*].

director, yet since March 2007, it was charged with overseeing five otherwise unregulated major broker-dealer firms that formed the backbone of the American-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 the division's subject firms in the eighteen months prior to the collapse of Bear Stearns in September 2008.[123] This lack of oversight 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 had been delegated to industry. As we all now know, the firms' models, which assessed largely illiquid assets operating in the absence of both price discovery and backstop prudential regulation, proved woefully inadequate.

2. Lesson Two: Regulators Must Have Transparent and Reliable Information about Industry

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 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 demonstrates, simple information collection is a crucial first step. The post-mortem 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 assess accurately the risk that the bank posed. Supervisors were found not to have been "proactive in ensuring there was a robust process allowing them a complete picture of issues."[124] The post-mortem analysis of the CSE Program recorded similar weaknesses. Among other things, the analysis identified 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 divi-

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[123] *Ibid.* at 49-50.

[124] FSA, *Northern Rock*, *supra* note 120 at 7. 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" (*ibid.* at 4). But see Norma Cohen & Chris Giles, "War game saw run on Rock" *Financial Times* (30 May 2009) [Cohen & Giles, "War game"] (reporting that the FSA had conducted "war games" in 2004 that identified the systemic risk that Northern Rock posed).

sions.[125] In a system where information is power, such as in the regulation of the sale of complex 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 developing and communicating 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 a carefully designed "enforcement pyramid" approach that also includes other supervisory strategies, as well as civil and criminal enforcement.[126]

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[125] *SEC Oversight*, *supra* note 122 at 37-41. The SEC's failures in oversight do not appear to be limited to the CSE Program. That agency's review of its failure to detect and prevent Bernard Madoff's fraud also records that Mr. Madoff's funds were overseen by inexperienced or unsuitably skilled staff who conducted inadequate examinations, failed to verify information, and failed to respond to "red flags". Additionally, investigations were delayed, questions were left unresolved, and SEC offices failed to communicate with each other. See *Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme: Report of Investigation Case*, Report No. OIC-509, Public Version, (31 August 2009), online: Securities and Exchange Commission <http://www.sec.gov> [SEC, *Investigation of Failure*]. The SEC's post-Madoff reforms include many of the initiatives recommended here, such as conducting surprise exams, recruiting staff with specialized experience, improving staff training, and seeking more resources. See "The Securities and Exchange Commission Post-Madoff Reforms", online: Securities and Exchange Commission <http://www.sec.gov>. Donald Langevoort has described the SEC's failings around the Madoff scandal sympathetically (though by no means optimistically) as a function of chronically inadequate resources. See Don C. Longevoort, "The SEC and the Madoff Scandal: Three Narratives in Search of a Story" Mich. St. L. Rev. [forthcoming in 2010].

[126] Ayres & Braithwaite, *supra* note 104. See also Ford, "New Governance", *supra* note 1. 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" (*ibid.* at 54, n. 170). See also Poonam Puri, "Enforcement Effectiveness in the Canadian Capital Markets: A Policy Analysis" (Presentation given to Capital Markets Institute, Rotman School of Management, University of Toronto, 14 June 2005), online: Rotman School of Management <http://www.rotman.utoronto.ca>.

3. Lesson Three: Regulators Must Independently Scrutinize Information

Third, regulators in a principles-based system must have the capacity to scrutinize information independently.[127] This requires considerable capacity in terms of information management systems. 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 through increased 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 front-line supervision teams by focusing on the complex models used by banks to gauge financial risk.[128] As one commentator observed, the 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."[129]

The need to hire "PhD rocket scientists" may seem peculiar, given that flawed quantitative analysis by in-house bank economists so drastically exacerbated the GFC in the first place.[130] The fact that quantitative analysis has been abused, misapplied, and overgeneralized in the past, however, does not mean that banks will not use it in the future. In spite of its theoretical limitations and the recent catastrophe, quantitative analysis continues to have substantial predictive value, and it will continue to serve as 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, financial innovation

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[127] See Ford, "Securities Regulation", *supra* note 11 at 23.

[128] The FSA implemented a "supervisory enhancement program" in response to the failure of Northern Rock. See Hector Sants, "The FSA's Supervisory Enhancement Programme, in Response to the Internal Audit Report on Supervision of Northern Rock" (26 March 2008), online: Financial Services Authority <http://www.fsa.gov.uk>. See also *Turner Review*, *supra* note 5 (describing the FSA's new approach as "intensive supervision" at 88). Lord Turner describes intensive supervision as entailing significantly 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.

[129] Jennifer Hughes, "FSA admits failings over Northern Rock" *Financial Times* (26 March 2008), online: Financial Times <http://www.ft.com>.

[130] See Nocera, *supra* note 86; Salmon, *supra* note 86.

continues.[131] A regulator who does not have the capacity to challenge firms' models will not have the capacity to engage in an important ongoing conversation.

4. Lesson Four: Regulators Must Have Healthy Skepticism about Industry

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.[132]

B. Complexity and Prophylactic Rules

One of the striking lessons of 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 that complexity is plausibly the "greatest financial market challenge of the future."[133] He first describes the complexity in the assets that underlie modern structured financial products, which are overladen with complexity in the design of the structured products themselves and exacerbated by complexity in modern financial markets. He then 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, where events tend to amplify each other and move rapidly into crisis mode.[134] 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 unrealistic 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

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131 One post-GFC innovation in securitization is based on "life settlements". See Jenny Anderson, "New Exotic Investments Emerging on Wall Street" *The New York Times* (6 September 2009) A1.

132 See Part III.C ("Building Independence and Diversity into the Regulatory Architecture") below.

133 Schwarcz, "Regulating Complexity", *supra* note 31 at 2-3.

134 *Ibid.* at 7-32.

their costs and benefits, both to real economies and financial markets as a whole and to various constituencies.

Some of the complexity deriving from innovation in structured product design 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 become outweighed by their overall costs. As suggested in the *Turner Review*, 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."[135] In retrospect, some recent forms of financial innovation delivered few benefits but permitted rent-seeking and contributed to significantly increased systemic risk.[136] As noted in the *Turner Review*,

> 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 fifteen years], was not required to deliver credit 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.[137]

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 supports innovation, 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.[138] 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 already underlying uncertainty (e.g., around a new or extraordinarily complex prod-

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135 *Turner Review*, *supra* note 5 at 47.

136 *Ibid.* at 109.

137 *Ibid.* at 47.

138 The argument is reminiscent of Ronald Dworkin's defence of a written constitution as building strong fences around fundamental rights. See Ronald Dworkin, *A Bill of Rights for Britain* (London, U.K.: Chatto & Windus, 1990). I believe that rules are only putatively immovable. More precisely, rules can provide temporary or superficial clarity, but under the surface they are as much the subject of contestation and change as are principles. See Dorf & Sabel, *supra* note 106 at 446-52.

uct or line of business) or where there is no metric for evaluating something across institutions (e.g., a compliance program, a product, or a risk), the problem can be exacerbated.[139] "[R]isky shift" can occur,[140] especially when markets are experiencing a bubble or when competitive pressures push actors toward greater risk-taking.[141] Without countervailing, independent-minded regulatory power to push back against self-interested industry conduct, the "creep" may run downwards—toward 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 Jack Coffee and Hillary Sale have argued, even an optimal regulatory model will not work if it is too complex for regulators to implement.[142] In 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. This consideration may weigh especially heavily where we can identify that additional complexity resulting from structured product design innovation is of diminishing 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, innovation, congruence, and prospectivity.

Capital requirements are a concrete example of where firms with more rigid requirements weathered the acute phase of the fall 2008 credit

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[139] William S. Laufer, "Corporate Liability, Risk Shifting, and the Paradox of Compliance" (1999) 52 Vand. L. Rev. 1343 at 1390-91.

[140] "Risky shift" is part of a broader phenomenon of group polarization, referred to as "choice shift" in more recent academic work, though in this case the narrower term "risky shift" applies. See e.g. James H. Davis, "Group Decision and Social Interaction: A Theory of Social Decision Schemes" (1973) 80 Psychological Review 97 at 107-10. See also Sushil Bikhchandani, David Hirshleifer & Ivo Welch, "A Theory of Fads, Fashion, Custom, and Cultural Change as Informational Cascades" (1992) 100 J. Political Econ. 992.

[141] See Michiyo Nakamoto & David Wighton, "Bullish Citigroup is 'still dancing' to the beat of buy-out boom", *Financial Times* (10 July 2007) 1 (quoting Charles Prince saying, "as long as the music is playing, you've got to get up and dance").

[142] Coffee & Sale, *supra* note 8 at 55 (indicating that optimal rules may be beyond the effective capacity of many bureaucracies to implement).

crisis better.[143] As has been well documented, Canadian capital requirements for financial institutions are comparatively high, and tend to be even exceeded by the actual practice of Canadian banks. Asset-to-capital ratios are capped at a comparatively low level.[144] Canadian financial institutions' overall success in weathering the GFC has been often attributed to these regulatory restrictions.[145] Another example, beyond the rules-versus-principles conversation, is contract term standardization. Especially with respect to derivative contracts, standardization can help rein in complexity, subject innovation to a degree of price discovery and oversight, and make derivatives easier to regulate.[146]

To use Colin Diver's terms, capital requirements may be an area in which, taking into account all the factors (e.g., poor regulatory oversight, gaps in regulation, etc.), transparency and accessibility prove 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 regula-

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143 Andrea Beltratti & René M. Stulz, "Why Did Some Banks Perform Better During the Credit Crisis?: A Cross Country Study of the Impact of Governance and Regulation" (European Corporate Governance Institute, Finance Working Paper No. 254/2009), online: European Corporate Governance Institute <http://www.ecgi.org> (finding that banks in countries with stricter capital requirement regulations and more independent supervisors performed better in the July 2007–December 2008 period).

144 See e.g. Kevin G. Lynch, "Public Policy Making in a Crisis: A Canadian Perspective" (Speech delivered to the Hertie School of Governance, Berlin, Germany, 7 May 2009), online: Privy Council Office <http://www.pco-bcp.gc.ca>.

145 But see Lev Ratnovski & Rocco Huang, "Why Are Canadian Banks More Resilient?" (IMF Working Paper WP/09/152, July 2009) at 4, online: International Monetary Fund <https://www.imf.org> (identifying the "key determinant" of Canadian banks' success as having a larger base of insured retail depositors). Other factors contributing to the success of Canadian banks include steadier housing prices, a more unified regulatory structure, and the fact that mortgage lenders in Canada tend to hold the mortgages they extend. See Lynch, *supra* note 145; Ratnovski & Huang, *supra* at 16-18; Fareed Zakaria, "Worthwhile Canadian Initiative" *Newsweek Magazine* 153:7 (16 February 2009) 31.

146 Most OTC derivative contracts are documented under standard forms, known as Masters, created by the International Swaps and Derivatives Association, Inc. (ISDA) (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, require standardized OTC derivatives contracts to be cleared by a derivatives-clearing organization regulated by the CFTC or the SEC, and require banks to have their standardized contracts centrally cleared and traded over regulated exchanges. Dealers 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 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: Department of the Treasury <http://www.ustreas.gov>.

tory principle, then the (ultimately superficial) certainty provided by (inevitably imperfect) rules will still prove 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 systemic stability and efficiency. Rules around capital requirements, like much of prudential regulation, are so fundamental to 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, which are 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.[147]

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 a 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

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[147] See 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 576-78; Lisa T. 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 St. 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 to address power disparities. On one end of the spectrum 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-term best interests of equality-seeking groups. See e.g. Cohen, *supra* note 114 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 opinions could exist as to their optimal degree of flexibility in real-life applications.

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.[148] Complexity is worrisome right now in part because, as was the case in the frozen credit markets in the autumn of 2008, we do not know what we do not know. In time, based on greater understanding, we may be able to develop a more sophisticated approach to complexity (with more and different safeguards in place) that 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 prophlylactic, not permanent, rules. Prophylactic rules are clear and generally overdrawn requirements, like the *Miranda* rights-reading requirement for 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.[149] 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.[150]

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. Rigid rules will paper over uncertainty, forcing difficult interpretations underground—or alternatively forcing rule revisions through legis-

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[148] Jeffrey M. Lipshaw, "The Epistemology of the Financial Crisis: Complexity, Causation, Law, and Judgment" (2010) 19 S. Cal. Interdisciplinary L.J. 299.

[149] The term derives from American constitutional law theory and is controversial in that context. *Miranda v. Arizona* held that certain warnings must be given before a suspect's statement made during custodial interrogation could be admitted in evidence (384 U.S. 436, 86 S. Ct. 1602 (1966)). The decision invited legislative action to protect the constitutional right against coerced self-incrimination, but it 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*, but its prophylactic nature was severely narrowed and the warning requirement was constitutionalized (530 U.S. 428, 120 S. Ct. 2326 (2000) [*Dickerson*]). For a new governance perspective on prophylactic rules, see Dorf & Sabel, *supra* note 106 at 452-59.

[150] In *Dickerson* (*supra* note 149), arguments concerning costs and workability for law enforcement personnel were successfully made in support of upholding the *Miranda* warning requirements, notwithstanding the "undeniabl[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'": *Dickerson v. United States*, 530 U.S. 428, 120 S. Ct. 2326 (2000) (Brief for the United States), online: United States Department of Justice <http://www.justice.gov/osg/briefs>.

lative 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, in which neither the precise ultimate goal nor the means for achieving it can be determined in advance.[151] 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 this paper's recommendations thus far, principles-based regulation requires considerable regulatory capacity in order to be credible. 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 United Kingdom, and of the SEC's CSE Program in the United States. 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 capital requirements, for example, 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.

C. 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.[152] This paper suggests that we should instead consider recent lessons about macro-level regulatory design. The task now (the completion of which is beyond the scope of this

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[151] See Charles F. Sabel & William H. Simon, "Destabilization Rights: How Public Law Litigation Succeeds" (2004) 117 Harv. L. Rev. 1016 at 1019-20; Dorf & Sabel, *supra* note 106.

[152] See *Turner Review*, *supra* note 5 at 39 (challenging the efficient market hypothesis); Edmund L. Andrews, "Greenspan Concedes Error on Regulation" *The New York Times* (24 October 2008) B1 (testimony of Alan Greenspan, observing a "mistake" in assuming rational actors); "Efficiency and beyond", *supra* note 85.

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 these 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.[153] The shift itself is not determinative of choices between, for example, industry self-regulation or intensive supervision.[154] Nevertheless, it has practical implications for these 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[155] between British Columbia's existing and proposed *Securities Acts*. It serves as 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 front-line 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 is as a product of the marginalization of overarching regulatory design considerations in favour of overly broad 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 that those agencies were impartial and accountable.[156] Regulators were not an effective counterweight to the banks in the Northern Rock[157] and CSE Program exam-

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[153] This is the case whether the replacement happens through explicit statutory drafting or through choices at the level of implementation. See *supra* note 50 and accompanying text.

[154] See discussion in Part II.B ("Enforced Self-Regulation and Principles-Based Regulation") above.

[155] See BCSC, *Table of Concordance*, *supra* note 54.

[156] See Lowenstein, *supra* note 76; Partnoy, *supra* note 76.

[157] See FSA, *Northern Rock*, *supra* note 120. See also *supra* note 124 and accompanying text. 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 challenge and scrutinize appropriately the information provided by Northern Rock. For example, the audit

ples.[158] In retrospect, programs like the CSE are paradoxes. On one hand, regulators delegated risk assessment to firms explicitly *because* they 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,[159] or because they had no choice given their lack of regulatory mandate from legislators[160] (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 overreliance on market discipline point to a troubling question that applies not only to the Northern Rock failure or the CSE Program, but also to much of the bond and securities markets. The question 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,[161] 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.[162] Much has been written in the United States

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identified a number of instances in which supervisors failed to conduct a "comprehensive analysis of the risks inherent in the [Northern Rock] business model" (FSA, *Northern Rock*, *supra* 120 at 30). See also *Turner Review*, *supra* note 5 (discussing "intensive supervision" at 88-89).

158 See *SEC Oversight*, *supra* note 122. See also *supra* note 125 and accompanying text.

159 See *Turner Review*, *supra* note 5 (criticizing the FSA for adopting a "laissez-faire" mentality); Stephen Labaton notes that "[t]he 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" (Labaton, "Agency's '04 Rule", s*upra* note 82).

160 *SEC Oversight*, *supra* note 122 at 81-82 (Chairman Cox's Comments justifying the CSE Program on the basis that it was voluntary and the SEC did not otherwise have a mandate to regulate the CSE).

161 John C. Coffee Jr., *Gatekeepers: The Professions and Corporate Governance* (Oxford: Oxford University Press, 2006).

162 John Armour & David A. Skeel Jr., "Who Writes the Rules for Hostile Takeovers, and Why? The Peculiar Divergence of U.S. and U.K. Takeover Regulation" (2007) 95 Geo. L.J. 1727 at 1730, 1767-77; Donald C. Langevoort, "The SEC, Retail Investors, and the Institutionalization of the Securities Markets" (2009) 95 Va. L. Rev. 1025 (arguing, con-

about the positions of public power occupied by individuals formerly working in the private sector, and the potential adverse effects on public policy.[163]

In a provocative 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.[164] 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 to regulate 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.[165] Beyond these important arguments

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trary to this paper, that "light touch" regulation is more likely to be successful in small and socially interconnected sectors).

163 Alumni of the investment bank Goldman Sachs have occupied key government positions not only in the United States, but also at the Bank of Canada (e.g., Governor Mark Carney), and the World Bank (e.g., President Robert Zoellick). See Jenny Anderson & Landon Thomas Jr., "Goldman Sachs Rakes In Profit in Credit Crisis" *The New York Times* (19 November 2007) A1 [Anderson & Thomas, "Goldman Sachs"]. The Obama administration has not been immune from allegations that it was not aggressive enough in its reform of the financial industry as a result of overly close ties to that industry. See e.g. Heidi Przybyla, "Obama Embrace of Wall Street Insiders Points to Politic Reforms" *Bloomberg* (19 November 2008), online: Bloomberg <http://www.bloomberg.com>; Joe Hagan, "Tenacious G" *New York Magazine* (26 July 2009), online: New York Magazine <http://nymag.com>.

164 Simon Johnson, "The Quiet Coup" *The Atlantic* (May 2009), online: The Atlantic <http://www.theatlantic.com>.

165 But see Stavros Gadinis, "The SEC and the Financial Industry: Evidence from Enforcement against Broker-Dealers" (Harvard Law and Economics Discussion Paper No. 27, August 2009), online: Social Science Research Network <http://papers.ssrn.com> (finding that the SEC favours defendants associated with big firms compared to defendants associated with smaller firms, and hypothesizing that either resource constraints or a desire to favour prospective employers may explain this systematic bias); Maria M. Correia, "Political Connections, SEC Enforcement and Accounting Quality" (Rock Cen-

about agency capture is a subtler worry about perspective. As Joseph E. Stiglitz has observed, "[i]f 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."[166] Neither gatekeepers nor regulators will serve their function effectively if they are not firmly rooted in an independent source of authority and meaning that 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 built-in 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 behavioural 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.[167] Internal diversity may also influence a firm's stance toward risk-taking, as suggested by Michael Lewis's analysis of Icelandic banks and culture,[168] as well as studies of the influence of gender in the financial services industry.[169] Enforced self-regulation also stands the best chance of success

ter for Corporate Governance, Stanford University, Working Paper No. 61, 1 July 2009), online: Social Science Research Network <http://papers.ssrn.com> (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 the findings of the Office of the Inspector General in the Madoff case: the Office of the Inspector General found no evidence of improper influence or inappropriate relationships with Madoff, but noted that SEC staffers' awareness of Madoff's stature played an ancillary role in their work See SEC, *Investigation of Failure*, *supra* note 125 at 373-89.

166 Joseph E. Stiglitz, "Principles for a New Financial Architecture" (Reference Document for the Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System), online: United Nations <http://www.un.org>.

167 See Anderson & Thomas, "Goldman Sachs", *supra* note 163; Przybyla, *supra* note 163 (suggesting that Goldman Sachs's behaviour has been contrary to that of its competitors, but that its internal culture is actually conformist and homogeneous).

168 Michael Lewis, "Wall Street on the Tundra" *Vanity Fair* (April 2009), online: Vanity Fair <http://www.vanityfair.com>.

169 Linda McDowell, *Capital Culture: Gender at Work in the City* (Oxford: Blackwell, 1997); Paola Sapienza, Luigi Zingales & Dario Maestripieri, "Gender Differences in Financial Risk Aversion and Career Choices Are Affected by Testosterone" (24 August 2009), online: Proceedings of the National Academy of Science <http://www.pnas.org>.

when industry actors genuinely care about their broader reputations, which requires commitments and allegiances beyond one's own firm and industry.[170] 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 both their own advantage and the advantage of an enforced self-regulatory approach.

This suggests a few specific reform recommendations. To begin with, careful 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 or is not participating in the interpretive community, and what is required to build checks and balances into the system's functioning.[171] Credit rating agencies are an obvious example. If they are to continue to fulfill a central role as reputational intermediaries, they 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 on 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 behavioural cascades within their industry, and they may want to give additional recognition or leeway to the views of industry outliers when a cascade appears to be developing.[172] 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, a 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

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170 Balleisen & Eisner, *supra* note 102 at 131. Balleisen and Eisner describe the other prerequisites to effective co-regulation as: "the relevance of flexibility in regulatory detail" (*ibid.*), "the existence of sufficient bureaucratic capacity and autonomy on the part of nongovernmental regulators" (*ibid.*), "the degree of transparency in the regulatory process" (*ibid.*), and "the seriousness of accountability" (*ibid.*).

171 For an example that assesses American institutions along these lines, see Jeffrey J. Rachlinski & Cynthia R. Farina, "Cognitive Psychology and Optimal Government Design" (Symposium, "Getting Beyond Cynicism: New Theories of the Regulatory State") (2002) 87 Cornell L. Rev. 549.

172 Regulators in a principles-based system can influence industry behaviour in a variety of ways, such as public recognition of good practices or reduced regulatory oversight for firm-developed approaches that carry indicia of reliability.

expertise is not necessarily politically or socially neutral, and expertise-based models can 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 from that based on technical expertise: it derives its legitimacy from its collaborative, dialogic experience, and it operates on the basis that pragmatic, learning-by-doing experience is a more reliable foundation than abstract theory for regulatory policy development.[173] 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 a certain degree of trust can exist. At the same time, too much homogeneity limits the range of imaginable possibilities.[174] 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.[175] For the Expert Panel as well, principles-based regulation needs to be supported by greater investor participation guarantees in the form of an independent investor panel and dedicated investor issues groups.[176] Broader stakeholder participation does not guarantee good regulatory outcomes, of course. The FSA's Consumer and Practitioner Panels did not prevent the Northern Rock debacle.[177] Stakeholder participation also introduces its own significant challenges.[178] At the same time, one may ask what might

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[173] Amar Bhidé makes a persuasive case for common sense, experience-based decision-making over "make-believe models": Amar Bhidé, "An Accident Waiting to Happen" (2009) 21 Critical Review 211 at 212.

[174] See e.g. Jon Elster, ed., *Deliberative Democracy* (Cambridge, U.K.: Cambridge University Press, 1998).

[175] Black, "Forms and Paradoxes", *supra* note 43 at 23-24. In this article, Black particularly mentions 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.

[176] Expert Panel, *Capital Markets*, *supra* note 2 at 36-37. Elsewhere, Black has also emphasized the importance of consumer voice. See Julia Black, "Involving Consumers in Securities Regulation" in Task Force, *Canada Steps Up*, *supra* note 10, vol. 6.

[177] The *FSMA* requires the FSA to consult practitioners (i.e., registrants) and consumers, to establish a Practitioner Panel and a Consumer Panel, and to consider their representations. See *FSMA*, *supra* note 41, ss. 8-11.

[178] Poorly managed, participatory processes can degenerate into interest-group politics and unprincipled horse-trading, as well as reproducing existing power imbalances. Exper-

have happened had the secret "war games" that revealed the risks that Northern Rock posed to systemic stability been made public back in 2004.[179]

Conclusion

The GFC contains cautionary lessons about the risks associated with principles-based regulation when it is not reinforced by a meaningful regulatory presence. However, the response cannot be a knee-jerk reversion to either a more rules-based or a more command-and-control approach. Principles-based regulation accompanied by input from industry was a direct response to a situation where regulators were underinformed, always playing catch-up, and made fools 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.

Furthermore, we should not imagine that a return to older regulatory strategies will avoid future frauds. There is no hope of putting the genies of financial innovation and complexity back into the bottle. Under conditions of such extreme uncertainty, ongoing interpretation of underlying principles is the only feasible option. Facially 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 can adapt in a transparent and accountable way. By contrast, rules must evolve either through time-consuming statutory amendment, or through selective or no enforcement that conceals the exercise of substantial regulatory discretion.

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tise and information can serve as an important counterweight to these urges. While success is 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, eds., *Designing Deliberative Democracy: The British Columbia Citizens' Assembly* (Cambridge, U.K.: Cambridge University Press, 2008).

179 Cohen & Giles, "War game", *supra* note 124. According to this 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 have enhanced existing regulatory capacity.

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 must increase regulatory resources, develop a thoughtful response to complexity (including a place for prophylactic rules), and consciously incorporate 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 approach to securities regulation.[180]

[180] Expert Panel, *Capital Markets*, *supra* note 2 at 19-22.