

June 30, 2003

## **Executive Summary**

Market Regulation Services Inc. (RS) believes that regulators should take the opportunity provided by the Wise Persons' Committee's (WPC) review of securities regulation in Canada to step back and assess how well our current *approach to regulation* is working - in addition to evaluating the best structure and governance models going forward. By *approach*, RS means the principles that guide regulators and the way the system operates. Such an appraisal will assist authorities in identifying a suitable structure to best support the delivery of effective and efficient securities regulation in Canada.

RS believes the primary needs of the securities regulation system are:

- 1) to reduce the overall size, complexity and cost of regulation
- 2) to establish a clear set of national regulatory priorities
- 3) to concentrate regulatory programs and resources on fixing priority problems

The RS submission makes the following points:

1. Regulation needs to be looked at from the standpoint of the user, not the suppliers of regulation services. Investors, issuers and intermediaries want "one-stop shopping" for regulatory services.
2. The current system is complicated, costly and often frustrating to navigate. Its incentives are for regulators to do more, not less. Over the years, securities regulation has continued to expand and grow – and this growth shows no signs of abating.
3. Regulators have too many priorities and initiatives. It appears that the system requires stronger checks and balances in order to ensure that regulatory initiatives respond to a real need, demonstrate value to stakeholders and are delivered efficiently.
4. Regulation is reactive – it responds to serious problems **after** the investor has been hurt. Enforcement is often a time-consuming, resource-intensive and punitive regulatory tool that is always brought after a problem has occurred and, therefore, after investors and the integrity of the market have been harmed.
5. The CSA has initiated many beneficial reforms aimed at making rules uniform and streamlining processes. Nevertheless, the system remains fragmented in many significant respects. Canada's patchwork approach to reform contrasts starkly with the strategic approach taken in other countries, including Australia and the UK.

The basic purpose of securities regulation is to reduce risks to investors and other market users. By allowing so many considerations other than this core mandate to drive agendas, regulators reduce their focus on major risks to investors and nurture a system whose cost and complexity threatens to make our markets uncompetitive. Regulatory efficiency and effectiveness are central to being competitive.

RS believes the WPC should address the need for better checks and balances, or systems of accountability, in the regulatory system. We suggest that this exercise include self-regulatory organizations (SROs), such as RS, that form an integral part of the overall securities regulation regime. The SROs represent part of the cost of the system, and our priorities and programs are integrated with the CSA's. As such, it would make sense for SROs to look at further consolidation in order to exploit obvious synergies, reduce overheads and, most importantly, develop an industry-wide perspective on regulatory priorities.

### ***Prescription: Risk-based Regulation***

If regulators take a more forward-looking view of major risks, chances will be considerably increased of tackling problems before investors are harmed. Regulators need to look at the main regulatory risks in the market and view them across the whole spectrum of the securities industry.

RS believes the system would benefit greatly from the use of a disciplined *framework of analysis* that would enable all stakeholders, including governments and regulators, to assess the strengths and weaknesses of the current system based on its core purpose or mandate. RS suggests that an ideal framework for this purpose is to examine the securities regulation system based on risk management principles.

This approach would involve several steps common to risk analyses:

- 1) Identify key risks posed to investing public, market integrity and financial soundness of the investment business
- 2) Assess the potential impact of these risks
- 3) Assess how effectively the system is currently controlling these risks - and how efficient current programs are
- 4) Identify potential new programs and tools that could mitigate risks more effectively or efficiently
- 5) Prioritize the key risks facing securities markets

After a risk framework for the industry has been completed, a firm foundation will be created on which to design an appropriate regulatory structure to deliver the right regulatory responses in the most effective manner. Such a review will enable governments, regulators and other stakeholders to assess the strengths and weaknesses of the current system in a dispassionate way - and help to limit the amount of conflict based on politics, jurisdiction, personalities and turf.

A risk-based approach takes regional needs into account but assigns responsibilities based on capabilities rather than geography. The analysis will help to streamline the system by closing gaps and reducing overlap and should encompass the value or cost effectiveness of regulatory programs and tools, with a view to allocating regulatory resources efficiently. Most importantly, a risk-based approach helps authorities decide who should do what.

RS believes that reassessing the regulatory approach based on risk may well be the key to successfully dealing with Canada's regulatory structure. Taking a new perspective on old issues may help the WPC challenge some of the "sacred cows" in the system and lead to real progress in regulatory reform.

## ***Introduction***

The Wise Persons' Committee has asked what structural models will best enable Canada to achieve the main objectives of securities regulation. Market Regulation Services Inc. (RS) believes that regulators should also reassess how well our current *approach to regulation* is meeting these objectives. By approach, we mean the principles that guide regulators and the way the system operates. In our view, we should take the opportunity provided by the Committee's review to step back and assess how well our securities regulation system is working, in addition to assessing its structure and governance.

The reason for this is that RS believes the approach to regulation is at least as important as the structure in determining how effectively the system is meeting its main objectives. An assessment of the current regulatory approach should also assist the authorities in identifying a suitable structure to best support the delivery of effective and efficient securities regulation.

The analysis of our current regulatory approach and structure should begin with the first question posed by the Committee: what are the key strengths and weaknesses of the current structure? This submission outlines a number of specific strengths and weaknesses but, in addressing this question, RS believes that the Committee's review should be driven by the big picture. In our view, the three primary needs of Canada's regulatory system are to:

- 1) reduce the overall size, complexity and cost of regulation;
- 2) establish a clear set of national regulatory priorities; and
- 3) concentrate regulatory programs and resources on fixing the priority problems.

These needs are not structural, although structural changes will help to address them. Rather, these needs reflect the wishes of investors, issuers and intermediaries who use the system. Regulators in many countries are responding to the needs of users in order to improve the competitiveness of their financial systems, but in Canada the needs of governments and regulators often appear to supersede the needs of users.

All sectors of the financial industry have experienced significant consolidation over the last two decades, both across and within the traditional four pillars. The industry has adapted to the rapidly changing nature of the economy, capital markets and competition. It is increasingly dominated by large financial institutions, in particular the major banks that operate in most sectors of the industry, across Canada and often internationally.

The regulatory system that supervises the industry has been static by comparison. The regulators remain fragmented on federal/provincial, inter/provincial and functional lines, leaving a consolidated industry to deal with a myriad of regulatory bodies. The rules, interpretations, procedures and approaches to regulation differ, sometimes subtly and sometimes substantively. The result is a system that is complicated, costly and often frustrating to navigate. Since the system is not user-friendly, it increases direct and indirect costs for participants, while discouraging new entrants, especially foreign market participants.

## ***The Ever-growing Regulatory Burden***

In addition to the complexity, we are witnessing an ever-expanding regulatory burden, with regulators seemingly competing with both domestic and international colleagues to introduce best practices, best-of-breed systems and leading edge regulatory and risk management programs. Over the years, securities regulation has continued to expand and grow to the point that even a small firm with a straightforward business needs to have compliance officers and lawyers on call continuously. One mis-step can be very costly and it is fairly easy to make an honest mistake in a very complicated regulatory system. This growth shows no signs of abating.

In the aftermath of the Enron, WorldCom and a series of other corporate debacles that exposed serious fraud and misconduct, the regulatory pendulum has swung strongly back towards more rules, stronger supervision and tighter regulation. The scope of this change can be seen in the Sarbanes-Oxley Act, Ontario's Bill 198, new rules governing research analysts and the introduction of new accounting rules, disclosure requirements and corporate governance standards.

Of course, RS agrees that a strong regulatory response to these problems is warranted. Clearly, when the market is infected with criminal fraud, rampant violations of accounting standards, dishonest research reports and suspect corporate governance, a vaccine is required. If these events did not produce a strong regulatory response, there would be something wrong with the system. It is a very good example of how the system responds to excesses by swinging the regulatory pendulum towards tighter regulation.

But it also illustrates how regulation is reactive. It responds to serious problems after serious harm and losses for investors have occurred. While the excesses of the high technology-driven market bubble were unfolding, regulators were busy completing the reforms that flowed from the last debacle, like the new rules for mining companies following the Bre-X Minerals scandal. In addition, there is always a wide-ranging regulatory agenda to pursue, as we improve processes, expand the breadth and thoroughness of programs and adopt new rules and policies.

The problem with our current approach is not in aiming to set high standards and observe sound principles of regulation. It is not a question of trying to compete by flying below the radar screens set in competing jurisdictions. Rather, the issue is that too many priorities are being set across too many regulators without sufficient regard for the need, value and cost-effectiveness of new initiatives. While hindsight is always 20 / 20, it is fair to ask ourselves whether Canada's regulators are taking the most effective approach and are properly structured to identify and respond efficiently to major problems in the making, so we can at least start to deal with them before they spin out of control.

To reiterate, we believe there are two questions to address: one about regulatory approach and the other about regulatory structure. One cannot address the needs of the regulatory system simply by changing the regulatory structure. Reforming the structure will only provide a platform to improve regulation and make it more efficient. Regulatory structure is similar to corporate governance -- sound governance is a means to an end, but it is not a substitute for a sound business plan. It is an enabler. A better regulatory structure will not create better regulation by itself. As an example, some fear that a federal body would unleash another round of new regulatory proposals and programs, increasing the regulatory burden further. Therefore, it is necessary to consider changes in how we organize our programs and regulate on the front lines at the same time as we address structure.

The Committee's review provides an opportunity to reflect from a broad perspective on how well our current approach is working. RS believes there are clear signs of a need to step back and assess the need for and value of the current plethora of rules, regulations, programs and compliance requirements, and the approach that creates them.

One of the major concerns is the total cost of the system. The Financial Services Authority (FSA) in the UK has compared the total cost of regulation in major jurisdictions.<sup>1</sup> It is telling that the FSA report notes that "Canada's dual level of jurisdiction and the numerous regulatory entities at both levels" makes it not possible to "present the full costs of regulation". Also, the costs of self-

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<sup>1</sup> FSA Annual Report 2002-03, Appendix 8.

regulatory organizations (SROs) are not included although the Canadian system relies on the SROs to perform many functions.<sup>2</sup> This in itself is a warning signal.

The FSA estimates that the total cost of Canadian financial regulation, including prudential regulation and market regulation of banking, securities and insurance, is about 84.4 million pounds (C\$187.8 million), versus the UK's own regulatory cost of about 249 million pounds (C\$562.5 million) for a market many times Canada's size that is also a global financial centre. France, with a market two to three times the size of Canada's, spends just 77.1 million pounds (C\$174.2 million). Approximately 1,655 people are employed in Canada to regulate the financial services sector versus 2,971 in the UK, and 887.5 in France. (See Appendix 1.)

But the truly shocking point about these numbers is that they only represent the direct costs of regulation – they do not cover all of the added costs to investors, issuers and intermediaries of dealing with our complicated regulatory system.

Pierre Godin, Chair of the Commission des valeurs mobilières du Québec (CVMQ), demonstrated how complicated the system is by putting all of the rules and laws CVMQ administers on a desk at the recent annual conference of the Investment Dealers Association of Canada (IDA), leaving a 13-inch stack of rulebooks. He said that in 1990, the stack was less than half as high and, at the current growth rate, it would be between 17 inches and 20.5 inches high by 2010. This kind of trend is clearly untenable.

At the same meeting, Frank Laferriere, COO of Berkshire Group, said the rate of change in regulatory requirements is becoming too difficult for small firms to manage. Berkshire is a fairly small firm but has three VPs looking after compliance.

There is a strong case to be made that Canadian regulators are trying to do too much -- not only in terms of new rules and compliance programs, but also in non-core areas, such as investor education and public communications. Investment Executive reported in June that the Ontario Securities Commission (OSC) and British Columbia Securities Commission (BCSC) both have multi-million dollar surpluses in their education funds, which receive all monetary penalties imposed by the Commissions.<sup>3</sup> They are having difficulty finding initiatives to spend this money on because so many institutions are in the investor education game, from the not-for-profit Commissions and SROs to the Canadian Securities Institute, a private sector entity capable of providing these kinds of services. Would it not be sensible to streamline this effort into one national organization in order to clarify the message for investors and maximize the return on our collective investment in education? The drive to be active on all fronts has clouded the regulatory landscape and made it more difficult for the regulators to identify the biggest issues or risks in the system, and to set clear priorities accordingly.

The issue is not just about the total number of regulators, how they are governed and work together and the overall volume of regulatory activity. It is equally about setting a limited list of clear priorities: the need to focus the considerable human and financial resources that Canada's financial regulation community has the luxury to possess on the major problems that need fixing. This means the problems that are core to our mandates: practices and activities that pose a threat to the welfare of investors, or that have a negative impact on the efficiency and competitiveness of Canada's capital markets. In the words of Howard Davies, Chairman of the UK Financial Services Authority, "Unless you have a clear idea of why you regulate, then you run serious risks of being deflected into unprofitable and unjustifiable areas."

One of the reasons that the system produces so many competing priorities is that each regulator produces its own set of priorities – not only the provincial Commissions, but also the SROs.

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<sup>2</sup> The Report suggests Australia's costs and staffing are slightly higher than Canada's, but Canada's costs and staffing exclude the regulatory costs of the IDA, RS, MFDA and ME. Australia's costs and staff include all regulation costs and staff of ASX, which performs a full range of SRO functions.

<sup>3</sup> Investment Executive, June 2003

Regulators do review and discuss priorities frequently, with the result that numerous priorities are set. Not only does each regulator set priorities, each department of each regulator has priorities to promote and pet projects to pursue. A lot of good ideas are developed, and it is difficult to turn them down, especially if the resources are available to pursue them and the body has a “public interest” mandate. The Commissions that have achieved self-funding status do have significant resources at their disposal.

It is particularly difficult to arrive at a consensus on priorities across so many initiatives in an organization like the Canadian Securities Administrators (CSA). Often, trade-offs are made that permit everyone’s priorities to move forward at the same time. It appears that the system needs a discipline to distil a manageable set of real needs and priorities.

Another growth area for the Commissions that is of particular concern to the SROs is SRO oversight – essentially, the task of overseeing the programs and decisions of organizations like the IDA, RS and TSX. The purpose of oversight is to ensure that the self-regulators are doing a proper job, and that the inherent conflicts of interest in self-regulation do not interfere with the SROs’ responsibility to act in the public interest. But oversight programs have become increasingly detailed and intrusive. Today, we often see a second layer of policy analysis and decision-making at the Commission level, which duplicates SRO processes and often results in the Commissions substituting the SRO’s decision with their own, to conform to their own view of the issue. This results in costly duplication of regulatory processes. At the same time, it reduces the benefits that self-regulation is supposed to provide, such as responding to market changes in a timely manner, leveraging the expertise of industry participants, and relying on the industry to shoulder many of the costs of regulation directly. In Canada, the fact that oversight is carried out on a co-operative basis by the CSA means that we also lose much of the benefit of having national SROs -- the only bodies that can act across Canada.

When RS was created, the board structure was carefully negotiated among the IDA, TSX and CSA to ensure an independent board. The board is not controlled by either the IDA or TSX - the joint owners of RS - and half of the directors are “public directors” who are independent of the marketplaces which have retained RS’s services and investment dealers participating on such marketplaces. Yet the CSA’s approach to oversight remains the same as for other SROs, notwithstanding RS’s independent governance.

As an example of how detailed the system can get, in mid-2002 RS proposed a fee change that shifted who pays our regulation fees, resulting in a fee increase of about 4% for some dealers. The change was vetted by the RS Rules Advisory Committee (made up of members who pay the fees), our Finance & Audit Committee (twice), our Board of Directors (twice) and then sent out for public comment. After the comment period expired, the CSA requested it go out for further comment. In May of this year, the change was finally approved by the CSA, but the collective time and effort spent on this issue by staff of RS, the commissions and the dealers was enormous relative to the significance of the change. As well, the change was approved for one year only, necessitating RS to conduct another review in a year’s time – at additional time and expense – to extend the fee change.

There is no question that SROs need to be supervised. Given the conflicts inherent in self-regulation, Commission oversight is essential to maintaining SROs’ credibility. The question is, at what point do we reach the point of diminishing marginal returns in resources devoted to oversight on one hand - and the point where the negative impact on self-regulation exceeds the benefits of more thorough oversight on the other? RS believes that costs versus benefits of this level of supervision should be assessed based on the level of risk presented by each SRO, and compared to the other major risks that the CSA must deal with. If the system was based on risk management principles, we believe the time and effort devoted to oversight would be reduced.

## **Regulatory Accountability**

Consequently, it is RS's view that the Wise Persons' Committee should address the need for better checks and balances, or systems of accountability, in the regulatory system. As former OSC Chairman Jim Baillie noted in his submission to the OSC's Five-Year Review Committee, "Regulate only to the minimum extent needed to respond to an identified policy concern. This might seem so obvious as not to require a statement, but I am constantly amazed at the extent to which regulatory initiatives are adopted in various aspects of our society without articulating this criterion or using it as a test to determine the appropriate scope of the regulation."

The reason for this is that the current system's incentives are mainly to do more, not less. These incentives include:

- 1) The fact that priorities are driven by regulators and regulatory staff, who have an interest in expanding programs and activities and are not impacted by the costs;
- 2) Investors, and often issuers and intermediaries as well, demand regulatory action when it serves their interests, since the direct benefits to them will exceed their share of the costs;
- 3) A lack of effective political accountability to provincial ministries and legislatures, because securities regulation is seen as a field requiring specialized expertise with little political currency;
- 4) The lack of rigorous cost / benefit analysis in proposals for new rules and regulatory programs; and
- 5) The fact that regulators are not subject to clear measures of performance or efficiency.

The issue seems to be one of accountability and fiscal discipline in setting the regulatory agenda. Politicians, who are ultimately responsible for all regulatory agencies, rely on the experts at the Commission level to advise the Minister on the needs and importance of their own roles as regulators. In many provinces, this includes the need to maintain local control over regulation. The federal government has had little appetite for offending the provinces by promoting federal intrusion into a well-entrenched constitutional power that is not important to the electorate.

Another reason for regulatory growth is a significant increase in resources available to the major Commissions that have obtained self-funding status. These Commissions, and the OSC in particular, have significantly increased their budgets and staffing. While this has enabled overdue and necessary improvements to their operations and programs to be made, the problem is that the regulators have not justified the increased costs by relating them to specific benefits of more effective regulation.

A study on self-funding by the Fraser Institute noted, "The transfer of the control to the commissions themselves left them with limited accountability with respect to their spending and their financial affairs overall.... After the change, greater spending by the commissions had little opportunity cost to [government] and, possibly, some benefit for the relevant decision makers, the commissioners themselves." The author recommended that provincial auditors should periodically conduct performance, or value-for-money audits on Securities Commissions, which is currently being done in many areas of government.<sup>4</sup>

Ontario's Crawford Committee<sup>5</sup> did address the issue of regulatory need or value, to a degree. Their report recommended that the OSC conduct empirical studies to assess the effectiveness, costs and benefits of proposed rules. Cost-benefit analysis of rule proposals is required under

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<sup>4</sup> Commissions Unbound: The Changed Status of Securities Regulators in Canada, November 2001, John Chant, Special Adviser, Neil Mohindra, Senior Economist.

<sup>5</sup> Five-Year Review Committee Final Report, Reviewing the Securities Act (Ontario), March 21, 2003

the Act, but has rarely been provided with substantive quantitative analysis. The Committee also proposed that the Government consider studying specific aspects of the OSC's operations, along the lines of reviews of SEC operations carried out by the General Accounting Office of the US Congress. The latter point echoes the Fraser Institute's suggestion.

The recommendations noted above would be useful improvements, but RS believes that we need to go beyond these limited steps and assess the cost effectiveness and value of regulatory programs and regulatory tools themselves. Some of the financial and other disciplines that businesses and even governments have to live with are weaker in the regulatory system, especially in financial services regulation, given the size and wealth of the industry. It is now more important than ever to ensure that the regulatory system is accountable given the Commissions' increasing rulemaking authority, enforcement powers and resources. The checks and balances that are needed to ensure effective accountability and that might cause a real shift in the regulatory system need to be strengthened.

### ***Efforts at Reform***

Surveys of market participants show they are exasperated with the growing costs and inefficiencies of Canada's regulatory system, and are tired of the never-ending debate about how to change the system. The securities industry has consistently voiced its concerns over the direct financial costs and the negative impact on Canada's competitive position of the current regulatory system. The industry is very concerned about costs, but at the same time rationalizes additional costs as part of the cost of doing business because it does not appear that the system can be changed.

In recent years the provincial Securities Commissions have responded to these concerns with a number of constructive initiatives to reduce the cost and complexity of the system. Much progress has been made in areas such as mutual reliance on one agency to clear prospectuses and several other forms of applications, adoption of uniform policies and regulations, creation of national systems and databases for disclosure and registration, and so on. In spite of these achievements, a lot of inefficiencies and unnecessary costs remain. Not least are the costs and the considerable time involved in co-ordinating all of these policy, rulemaking, program and technology initiatives among the 13 Commissions and their governments. Co-ordinating day-to-day activities of the Commissions on functions ranging from processing applications, filings, investigations, enforcement cases and so on significantly increases the number of people involved in a matter. The delays inherent in this consensus-based system also come with a serious price tag in terms of regulatory responsiveness.

The CSA's latest initiative is the uniform securities legislation (USL) project, which will make the law uniform in all the provinces. The amount of work involved to accomplish this is huge, but the objectives of the project are fairly limited. As the BCSC has pointed out, the project does not attempt to improve the law or repair problems with it, let alone reassess the overall approach to securities regulation as B.C. is advocating. The objective is simply to make all the acts a mirror of each other, and it still permits provinces to opt out of uniform regulation if they believe this is important. Furthermore, the project does not address the fact that what investors, issuers and intermediaries really want is "one-stop shopping" for all regulatory services. At least theoretically, this would also reduce fees to the end user because the cost of services would fall.

As the Committee is aware, a group of six provincial finance ministers recently released a discussion paper on ways to streamline the regulatory system. So far, they have only been able to agree on proposing a "passport system" that would allow issuers and dealers to access markets across Canada based on unified rules. This would be an improvement, but the limited scope of the agreement is also a lost opportunity. The idea still leaves enforcing the rules to each province, and does not deal with the numerous other Commission services and functions, or the

fee structure. As the Ontario Government noted in the paper, “Ontario believes that this model does not go far enough in addressing the concerns of national and international issuers and registrants”. The main point of agreement seems to be to defend provincial turf, which is a good illustration of looking at regulation from the standpoint of the supplier rather than the customer.

Regulatory fragmentation is actually increasing across the country in other ways. Quebec is creating a universal regulator for all financial services, a model that is increasingly being implemented around the world. Some provinces are pursuing this model, including Ontario, while others are not. The different structures could make it more difficult to achieve consensus in the securities arena going forward. Ontario has decided to introduce corporate governance reforms that B.C. is challenging the need for. The B.C. Commission is promoting its proposed principled-based securities regime, which departs significantly from the existing rules-based approach – and which forms the basis of the USA project.

The patchwork approach to regulatory reform illustrated above contrasts starkly with the strategic approach being taken in other countries, including Australia, the UK, France and Hong Kong, to name just a few.

Some observers are arguing that Canada cannot afford to impose the same high standards as the U.S., inferring that we can be more competitive with lower standards by keeping costs lower for issuers and the investment industry. But at the same time, many officials rationalize the higher costs inherent in our fragmented regulatory structure and approach as being necessary to deal with regional needs. The result is that Canada has more regulations, greater complexity and higher costs, but lower standards, than competing jurisdictions, particularly the U.S. If a central objective of the regulatory system is to make our capital markets more competitive, and to make it easier for issuers and intermediaries to access the markets and navigate the regulatory system, does this result make sense?

Given all the pressures and initiatives to make the rules and procedures uniform, one must question whether there are any real benefits to having 13 regulators. If the rationale is to be responsive to regional needs, that objective cannot be reconciled with the objective of providing national rules and procedures. It appears that the actual result is a system with all of the additional costs and limitations of a fragmented structure that provides very few of the benefits of a decentralized system. The system preserves only a minor degree of local flexibility that can rarely be used and that users are not demanding. In a sense, we have achieved the worst of both worlds. Quantitative analysis is not required to conclude that the costs exceed the benefits by orders of magnitude. The banking system operates efficiently based on national regulation, so one must question why the securities industry – which is largely integrated with the banking industry – requires provincial regulators.

As noted above, our regulatory system continues to reflect the needs of the governments and agencies that do the work to a greater degree than it responds to the needs of the market – investors, issuers and financial institutions that use the system and pay the considerable costs of regulatory services. The needs of users are straightforward: a clear, efficient and user-friendly system that provides a single point of access to all Canadian markets based on a uniform set of national rules. This means one advisory and complaint service for investors, one registration process for intermediaries and one filing process for issuers. Users should have to deal with only one set of forms and one agency, and pay one fee. Ideally, there should not be any qualifications or conditions that result in cases being moved out of this national system.

RS has concluded that the authorities should reassess both the structure and the approach of the regulatory system based on the needs of the market. We suggest that looking at these issues through the eyes of market participants, it will be easier to identify the gap between their needs and the rules, programs and processes that are in place today. To sum up, the CSA has made a lot of progress, but many issues remain that the Wise Persons’ Committee should address.

## ***The SRO System***

The Committee is examining the regulatory structure at the statutory regulator level. RS is one of the SROs that form an integral part of the overall securities regulation regime. RS believes that the regulatory system should be considered as a whole if the Committee aims to consider the overall effectiveness and efficiency of Canadian securities regulation, and how it can best meet its core objectives. Therefore we have some observations to make on the structure and regulatory approach of the SROs.

In the SRO arena, significant progress has been made in streamlining the system, largely due to the consolidation of member regulation functions at the IDA and the consolidation of Canada's exchanges in 2000. Where we once had five SROs – the IDA, TSE, ME, ASE and VSE -- each with its own rulebooks covering member and market regulation, there is now one national member regulator in the IDA and one national market regulator in RS. The ME continues to regulate certain members in Quebec and its derivatives market.

In spite of this progress, regulatory fragmentation and overlap still exists. The ME duplicates many of the functions of both IDA and RS. The Mutual Fund Dealers Association (MFDA) has been created to regulate mutual fund dealer members, covering most of the same ground as the IDA. Similar administrative, IT and support functions exist at each organization. Duplication, overlaps and also regulatory gaps exist among RS, IDA, MFDA and ME because their mandates have not been rationalized. (See Appendix 2.)

For instance, RS, the ME and the IDA all examine members' trading practices, with RS focussed on Canadian equities, the ME on its derivatives and the IDA on domestic bond markets. Cash securities markets are closely linked to derivatives markets, such as options and futures on underlying equities and bonds. Ideally, surveillance of markets should be integrated, but currently RS and the ME monitor separate markets, relying on limited information-sharing to address cross-market trading issues.

In addition, the Canadian Investor Protection Fund (CIPF) still has oversight responsibility over the SROs that duplicates the CSA's oversight program. CIPF also directly examines member firms, as a back-stop to the IDA's reviews. The CIPF program is a legacy of the need to ensure national minimum standards of regulation among the five SROs that used to participate in the protection fund. The objective is to ensure that all brokerage firms whose clients are protected by the fund are subject to the same standards, because all participants in the system share liability for any claims on the fund. Arguably, that role is obsolete now that the SROs have consolidated and the CSA has ramped up its own oversight program so much.

It would make sense for the SROs to look at further consolidation in order to exploit obvious synergies, reduce overall overheads and, perhaps most importantly in terms of our mandates, to develop an industry-wide perspective on our regulatory priorities. Right now, organizations exist based on the type of product being regulated -- RS for equity markets, the MFDA for mutual fund sales, the IDA for other securities sales and bond markets, the ME for derivatives markets. We have separate rules covering similar ground and separate departments doing similar things but we are all taking a narrow perspective to investor protection and market integrity based on our specific mandates. For example, each SRO has policy, compliance and investigations functions. Each SRO carries out compliance reviews of the firms under its jurisdiction. The IDA, MFDA and ME are all responsible for capital requirements and financial examinations of firms' books. Obviously, this approach is neither as effective nor as efficient as a regulator that looks at the full picture, and is in a better position to control systemic risk.

While the SRO system could itself benefit from a more streamlined structure, as noted in the introduction, a new structure will not automatically produce better regulation. Structure is only an enabler. Just as the statutory regulators should reassess their approach to regulation, the SROs could benefit by reassessing regulatory priorities and the value of current rules and programs

based on our core objective to protect investors and safeguard market integrity. We need to challenge our regulatory approaches to ensure the costs bring commensurate value or reduction of regulatory risk.

As one example that is close to home, RS's market surveillance systems account for about half our budget. Most of the statistical and rule-based alerts generated do not aim at identifying serious problems like manipulative trading, insider trading or frontrunning. The majority of alerts relate to comparatively minor issues such as potential violations of rules on short sales, principal trading, conduct of market makers, and so on. While we need to continue to be vigilant in these areas, the large volume of these alerts requires surveillance officers to spend the majority of their time on them. This leaves little time to analyze and detect more complex manipulations that pose a much more serious threat to investors and market integrity.

Similarly, the SROs' compliance and trade desk reviews of member firms cover a "laundry list" of issues, many of which are minor in nature. The findings that we present to our members when a compliance review is completed frequently set out a number of minor and technical problems to be addressed, but rarely identify serious issues. This may well mean that the system is working as intended and that serious problems are few and far between. The SROs believe this to be the case, but we should be aware that it could also mean we are not concentrating on the right things.

Over the last few years, both IDA and RS have raised the bar in the area of member firms' own compliance systems. For example, on the equity market side, RS introduced new supervision of trading rules that set out detailed instructions for appropriate supervision practices. But we did not make changes to our approach to trade desk reviews of members. Since dealers are now required to perform more detailed internal compliance themselves, it may be appropriate for RS to adjust our review procedures to reduce duplication of firms' internal compliance functions and re-allocate resources to supervising their efforts and looking for different kinds of problems.

The SROs' current approach to regulatory risks also affects our enforcement activities. The investigations and enforcement functions are fed mainly by investor complaints, market surveillance and compliance reviews.<sup>6</sup> If these sources are aimed mainly at dealing with technical problems, then enforcement actions will reflect that. Enforcement is another example of an area where our regulatory approach could benefit from a reassessment.

SRO enforcement actions are sometimes questioned for relevance by the industry. Enforcement should distinguish between honest mistakes and minor transgressions on one hand, and intentional violations and major misconduct on the other. Enforcement actions are a time-consuming, resource-intensive and punitive regulatory tool. Not only does enforcement potentially focus on the wrong areas, actions are always brought after a problem has occurred and, therefore, after the integrity of the market has been harmed and investors hurt. A re-examination of our approach could well lead to a decision to concentrate investigation and enforcement resources on high-risk problems where the threat of significant harm to investors or the market arises. Lesser issues can be dealt with more efficiently (and many argue more fairly) through measures such as directives to fix problems, policy statements, warning letters, guidance from regulators and education programs. These kinds of responses are also better suited to addressing problems while they are current rather than after the fact. A new approach could shift the emphasis from punishing people for transgressions well after the problem occurred (often one to two years later) to addressing problems when they arise, and ideally, taking pre-emptive action before serious harm is done.

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<sup>6</sup> We use the term compliance review to refer to all reviews of member firms by SROs to monitor compliance with rules covering sales, operations, financial and trading requirements.

If regulators can take a more forward-looking view of major risks, the chances of tackling problems before investors are harmed increases. Regulators' credibility with investors and the industry would improve if we could identify and attack high risk problems before the fallout occurs.

These are difficult issues with no easy answers, but they are the kinds of questions regulators should be asking themselves about their current approach. These issues further illustrate the reasons that regulatory leaders should take the opportunity to reassess our overall approach to regulation. Instead of just assessing how to restructure regulators, we should be assessing the effectiveness and value of our rules and programs, with the objective of prioritizing actions to deal with the major risks we are charged with managing and minimizing. It is possible that more improvements in effectiveness and efficiency can be achieved by changing our regulatory approach and targeting achievable changes in structure, rather than by trying to restructure the whole system based on moving to one federal regulator, for example.

***Prescription: Risk-based Regulation***

RS believes that the system would benefit greatly from the use of a disciplined *framework of analysis* that would enable all of the stakeholders involved, including governments and regulators, to assess the strengths and weaknesses of the current system based on its core purpose or mandate. RS suggests that an ideal framework for this purpose is to examine the securities regulation system based on risk management principles. The resulting assessment could be used to chart a course to a more efficient and effective approach to our regulatory programs. The result will also assist the authorities to design a suitable regulatory structure.

The basic purpose of securities regulation is to reduce the risks to investors and other market users. By allowing so many other considerations besides this core mandate to drive our agendas, we not only reduce our focus on dealing with the major risks to investors, we introduce the risk that our ever-expanding regulatory system is becoming so complicated, bureaucratic, expensive and unfocused that it is making our securities markets uncompetitive. In addition to reducing risk, regulators also have a mandate to foster efficient markets. This objective also provides a solid rationale for revisiting our approach.

This Committee is charged with recommending what securities regulatory structure will best serve Canada's capital markets. Given that structure is only a platform on which to build better regulation, RS proposes that the Committee also recommends a review of the approach to regulation using a *framework of analysis* based on risk management principles. Such a review will enable governments, regulators and other stakeholders to assess the strengths and weaknesses of the current system in a dispassionate way. By using the widely-accepted principles of risk analysis as a framework, an examination of the effectiveness and efficiency of regulation could concentrate on achieving results, and help to limit the amount of conflict based on politics, jurisdiction, personalities and turf.

Regulators require financial institutions to implement sound risk management programs, and regulators are increasingly using risk management principles in organizing our own compliance programs. But we need to go further, to look at the main regulatory risks in the market that the regulators are responsible for controlling, and to view them across the whole spectrum of the securities industry.

This approach would involve several steps common to risk analyses:

- 1) Identify the key risks posed to the investing public, market integrity and financial soundness of the investment business;
- 2) Assess the potential impact of these risks;

- 3) Assess how effectively the system is currently controlling these risks and how efficient current programs are;
- 4) Identify potential new programs and tools that could mitigate risks more effectively or efficiently; and
- 5) Prioritize the key risks facing securities markets.

From this analysis, a clear set of priorities and program changes targeted at reducing priority risks will emerge. This risk assessment should encompass the value or cost effectiveness of regulatory programs and tools as well, with a view to allocating regulatory resources efficiently. By looking at these issues across the system, we can also identify duplication and overlap, and highlight any gaps. By examining what we do and how we do it in relation to risk, regulators can develop well-reasoned action plans to employ resources where they are most needed.

In addition to reassessing the approach to regulation, by breaking down activities based on risk management principles, regulators will be in a better position to design a structure for the regulatory system that responds to real needs and best enables us to achieve results efficiently. This approach employs a disciplined analysis of risks and risk controls as a basis for examining structure. The Committee may ask how this exercise would actually work. (For more detailed outline of process we have in mind, see Appendix 3.)

Reviewing regulation based on risk management principles leads to the redesign of regulatory programs. This can in turn lead to improvements in the organizational structure of regulatory bodies because programs organized around risk categories lead regulators to organize their capabilities and allocate their resources differently. Regulators are traditionally organized around functions – compliance, enforcement, disclosure and so on – and, in Canada, by region. Risk-based analysis opens up new options to organize based on risk profile – for instance, setting up a group to cover high risk firms or to ferret out high risk market conduct.

For example, when the UK launched the Financial Services Authority, the FSA initiated a risk-based regulation framework to overcome the cultural differences and “turf wars” among the nine predecessor regulators that were folded into the FSA. The new approach to regulation was based on implementing the best structure, controls and tools to manage the major risks the FSA is responsible for. In addition, the FSA set up a Risk Assessment Division to apply and update the risk framework in response to changes in the markets.

In Canada, any revision to regulatory structure and approach needs to respond to local needs. A risk-based approach can take regional needs into account. Regional differences mean we need to understand how the risk equation may differ by region. For instance, if a region requires a different trade-off between the risk of investments being misrepresented to investors on one hand, and the need to facilitate access to capital on the other, it means that the tolerance level is higher for the risks related to facilitating easier access to capital. Policymakers may also feel that the threat of misleading sales practices is lower, because it is less likely to occur. In this case, regulators may choose to apply less stringent controls – such as different rules or disclosure requirements – to reflect the lower risk or the greater need to provide access to capital. Different risks need different solutions, but this approach lifts the debate into an analysis of the proper regulatory response, as opposed to what jurisdictional boundary or organizational structure must be maintained.

In contrast, when separate jurisdictions are used to deal with local needs, they apply to every facet of regulation. Is it not possible to devise a system that is capable of responding to regional needs without 13 sets of laws, rules and regulatory bodies? This might be done by developing systems to obtain direct input from provincial governments and local market participants. The publication of annual statements of priorities for comment, regular meetings with provincial officials and maintaining strong local offices to deal with local users are examples of the kinds of systems that could be employed.

Another way that a risk-based approach can deal with regional needs is by taking advantage of regional specialization. For instance, we have specialized expertise in junior markets in the West, and in derivatives in Quebec, based on the products of local exchanges. Where a region experiences more of one type of risk, or has better expertise and tools to control that risk, a strong argument exists to concentrate the relevant regulatory programs in those regions. To some degree, this is already happening, based on assignment of primary oversight responsibility over the ME to CVMQ and the Venture Exchange to the BCSC and ASC. By building specialized regional capabilities, the system can ensure that a strong regional presence and staffs are maintained, without requiring 13 separate Commissions. In other words, risk analysis supports a move from an approach where all Commissions try to cover all the bases to one where regional offices specialize and responsibilities are assigned accordingly.

A risk-based approach can also help the authorities to decide who should do what. When measuring how effective a set of controls and tools are in reducing a particular risk, regulators should determine what body is best positioned to deploy a particular type of control. For instance, are insider trading investigations, market surveillance or financial examinations of firms best performed by an SRO, a Commission or the police? The answer should depend on a rational assessment of which body is in the best position to do the job – that has the jurisdiction, powers, skills and experience, regulatory tools, resources and access to information that are needed. In addition, processes can be examined from start to finish, rather than looking only at the part of a process that a particular regulator is responsible for.

After a risk framework for the industry is completed, a firm foundation will have been created on which to design an appropriate regulatory structure to deliver the right regulatory responses in the most effective manner. This analysis will not only improve the effectiveness of regulators by assigning responsibilities based on capabilities rather than geography, it will help to streamline the system by closing gaps and reducing overlap.

## **Conclusion**

In spite of all the issues that led to the establishment of the Wise Persons' Committee, it is important to acknowledge that Canadian securities regulators have made much progress in the last decade. We have a better-funded system, more people with more expertise and experience, more uniform rules and better co-operation than we had 10 years ago. Enforcement has more teeth, supervision of firms and markets is stronger, regulatory procedures and tools are more sophisticated and securities firms' compliance programs are much better. The SROs have consolidated and upgraded their programs.

It is equally important to acknowledge that Canada cannot sit on its laurels, because other markets are far from sitting still. While we tend to focus on developments in the U.S., enormous strides towards regulatory harmonization and market consolidation are being made around the world. The European Union (EU) aims to create a single market across Europe with harmonized regulatory systems across the entire Union. Regional integration is leading to regulatory co-operation in other regions, too. Emerging markets have made dramatic improvements in their regulatory systems, borrowing best practices from around the world.

Because regionalization and globalization of markets keeps growing, many countries are much more strategic about what it takes to succeed in this new world. They are more driven to build competitive financial markets than Canada has been, partly because financial market policy is set at the national level. Everyone clearly recognizes that regulatory efficiency and effectiveness are central to being competitive.

Smaller countries that aim to attract foreign investment and foreign market participants have set a clear goal: to make their regulatory systems look and feel like the systems their target customers

are familiar with. This approach has twin objectives: First, to attract new players, a market must be credible. Sound regulation based on familiar principles, rules and procedures instills confidence. The second objective is to be user-friendly – to employ approaches that investors, issuers and intermediaries are familiar and comfortable with, and which they do not need to investigate extensively in order to understand. Needless to say, in presenting 13 different securities regulators at the provincial level and additional federal regulators to cover other financial sectors, the Canadian system does not look or feel familiar or user-friendly to new entrants.

Consequently, sitting still means Canada is losing ground. As a small capital market in a rapidly integrating financial world, Canada cannot afford to be deflected by minor domestic disputes. We must be equally determined to improve the competitiveness of our securities regulation system and capital markets as others are.

Although we have made progress, the picture must be seen in an international context. Canada still has one of the most complicated regulatory systems in the world. And complicated is expensive in both direct and indirect terms. RS sincerely hopes that the Committee's Report will provide the impetus for significant reform - not just to the structure of our regulatory system, but to our approach to regulation. We are suggesting that taking a new perspective on old issues may help the Committee to challenge some of the "sacred cows" in the system and lead to real progress in changing our approach. We believe reassessing the regulatory approach based on risk may well be the key to successfully dealing with Canada's regulatory structure.

Tom Atkinson  
President and CEO  
Market Regulation Services Inc.

***Appendix 1***

***Comparison of Regulatory Costs and Effort in Specified Jurisdictions***

**APPENDIX 1**

**COMPARISON OF REGULATORY COSTS AND EFFORT  
IN SPECIFIED JURISDICTIONS**

<b>Regulatory Responsibility</b>	<b>Canada</b>	<b>United States</b>	<b>United Kingdom</b>	<b>France</b>	<b>Germany</b>	<b>Hong Kong</b>	<b>Australia</b>	<b>Singapore</b>
<b>Lending Institutions</b>	Office of Superintendent of Financial Institutions (“OSFI”); 143 staff; \$17.8m / Inspector General des Institutions Financières (“IGIF”); 40 staff; \$3.4m / Canadian Deposit Insurance Corporation (“CDIC”); 23 staff; \$3.4m / British Columbia Financial Institutions Commission (“BCFIC”); 81 staff; \$7.2m / Financial Consumer Agency of Canada (“FCAC”); 30 staff; \$5.6m	Office of the Comptroller of Currency (“OCC”); 2,881 staff; \$662.4m / Office of Thrift Supervision (“OTS”); 912 staff; \$229.5m / Federal Deposit Insurance Corporation (“FDIC”); 4,409 staff; \$1,268.3m / Federal Reserve (“FR”); 373 staff; \$135.6m / Reserve Banks 2,604 staff; \$632.4m	Financial Services Authority (“FSA”); \$117.5m	Commission Bancaire (“CB”) and Banque de France; 675.5 staff; \$101.4m	Federal Financial Supervisory Authority (“BaFin”); 346 staff; \$30.5m / Deutsche Bundesbank	Hong Kong Monetary Authority; 231 staff; \$39.3m	Australian Prudential Regulation Authority (“APRA”); 129 staff; \$17.6m	Monetary Authority of Singapore (“MAS”); 158 staff; \$33.0m
<b>Securities Firms and Fund Management Firms</b>	Bureau des Services Financiers (“BSF”); 150 staff; \$9.3m / Commission des Valeurs Mobilières du Québec (“CVMQ”); 200 staff; \$22.4m /	Securities and Exchange Commission (“SEC”); 3,875 staff; \$1,034.0m / Commodity Futures Trading Commission (“CFTC”); 514 staff; \$109.3m / National	FSA; \$40.7m	Commission des Opérations de Bourse (“COB”); 275 staff; \$45.9m	BaFin; 325 staff; \$28.5m	Securities and Futures Commission (“SFC”); 125 staff; \$20.6m	Australian Stock Exchange (“ASX”); 135 staff; \$30.5m / Australian Securities and Investment Commission (“ASIC”); 1,284 staff; \$136.2m	MAS; 99 staff; \$14.0m / The Singapore Exchange (“SGX”); 121 staff; \$8.8m

	<p>Ontario Securities Commission ("OSC"); 350 staff; \$48.8m / Alberta Securities Commission ("ASC"); 106 staff; \$14.7m / British Columbia Securities Commission ("BCSC"); 208 staff; \$26.0m / Manitoba Securities Commission ("MSC"); 34 staff; \$2.9m / Saskatchewan Securities Commission ("SSC"); 17 staff; \$1.1m; Investment Dealers Association of Canada; 215 staff; \$30.5m</p>	<p>Association of Securities Dealers ("NASD"); 2,087 staff; \$711.7m / FR; costs included above</p>						
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<b>Regulatory Responsibility</b>	<b>Canada</b>	<b>United States</b>	<b>United Kingdom</b>	<b>France</b>	<b>Germany</b>	<b>Hong Kong</b>	<b>Australia</b>	<b>Singapore</b>
<b>Insurance Companies (prudential only)</b>	OSFI; 142 staff; \$16.6m / IGIF; 60 staff; \$5.2m / BCFIC; costs included above	State commissioners; 10,847 staff; \$1,426.3	FSA; \$47.4m	Commission de Contrôle des Assurances; \$15.4m (est.)	BaFin; 230 staff; \$20.1m	Office of the Commissioner of Insurance; 231 staff; \$20.6m	APRA; 240 staff; \$32.1m	MAS; 57 staff; \$8.4m
<b>Supervision of and Standards for Exchanges / Clearing and Settlement Systems / Market Service Providers</b>	Securities Commissions (costs included above) / Canadian Depository for Securities*	SEC / CFTC / OCC / FR (costs included above)	FSA; \$9.0m	Conseil des Marchés Financiers ("CMF"); 45 staff; \$15.6m / COB (costs included above)	BaFin (costs included above)	SFC; 106 staff; \$21.9m	ASIC (costs included above)	MAS (costs included above) / SGX (costs included above)
<b>Supervision of and standards for conduct of Capital Markets</b>	Security Commissions (costs included above) / IDA (costs included above) / Market Regulation Services; 80 staff; \$21.0m; Montreal Exchange; 30 staff (est.)**	New York Stock Exchange ("NYSE"); 560 staff; \$290.5m / National Futures Association ("NFA") 145 staff; \$46.1m / SEC and CFTC (costs included above)	FSA; \$9.0m	CMF (costs included above)	BaFin (costs included above)	SFC; 36 staff; \$9.7m	ASIC (costs included above)	MAS (costs included above) / SGX (costs included above)
<b>Regulation of Listed Securities</b>	Toronto Stock Exchange ("TSX"); 32 staff; \$3.1m / TSX Venture Exchange ("TSXVN") 40 staff (est)** / IGIF and Securities Commissions (costs included above); Montreal Exchange	NYSE; 50 staff; \$16.3m / NASD, SEC and CFTC (costs included above)	FSA; \$24.9m	COB (costs included above)	BaFin (costs included above)	HK Exchange Clearing; 174 staff; \$33.9m	ASX (costs included above)	SGX; \$2.3m

<b>Regulatory Responsibility</b>	<b>Canada</b>	<b>United States</b>	<b>United Kingdom</b>	<b>France</b>	<b>Germany</b>	<b>Hong Kong</b>	<b>Australia</b>	<b>Singapore</b>
<b>Regulation of Collective Investment Schemes / Funds</b>	Securities Commissions (costs included above) / Mutual Fund Dealers Association; 60 staff; \$12.6m	SEC / CFTC / NFA (costs included above)	FSA; \$49.7m	COB (costs included above)	BaFin (costs included above)	SFC (costs included as cost of regulation of Management Firms above)	ASIC (costs included above)	MAS (costs included as cost of regulation of Management Firms above)
<b>Regulation of Provision of Financial Advice</b>	Securities Commissions (costs included above)	SEC / CFTC / NFA (costs included above)	FSA; \$158.1m / Financial Ombudsman Services; \$76.8m / Financial Services Compensation Scheme \$27.1m	CMF and COB (costs included above)	BaFin (costs included above)	SFC (costs included as cost of regulation of Management Firms above)	ASIC (costs included above)	MAS (costs included as cost of regulation of Management Firms above)
<b>Regulation of Credit Unions</b>	OSFI; 4 staff, \$0.2m; Credit Union Deposit Guarantee Corporation (Alberta); 36 staff; \$3.2m / IGIF (costs included above)	National Credit Union Administration; 958 staff; 194.5m	FSA; \$2.3m	CB (costs included above)	BaFin (costs included above)	N/A	APRA (costs included in Lending Institutions above) / ASIC (costs included above)	N/A
<b>Regulation of the Provision of Mortgages</b>	FCAC (costs included above)	OTS (costs included above)	FAS (costs included above)	CB (costs included above)	BaFin (costs included above)	N/A	ASIC (costs included above)	N/A
<b>Total Staff</b>	2,011+	30,215	2,971	887.5	901	761	1,788	435
<b>Total Cost</b>	\$255.0m+	\$6,797.6m	\$562.5m	\$174.2m	\$79.1m	\$145.9m	\$216.4m	\$66.4m

#### **NOTES TO TABLE**

- Much of the data within this table was derived from United Kingdom's Financial Services Authority's Annual Report 2002/03.
  - All figures within this report are state in million of dollars. All figures are stated in Canadian Dollars.
  - All costs and staffing estimates within this table are approximated.
  - Because of the nature of financial regulation there is regulatory overlap in relation to regulation in all jurisdictions. The data within this table is not exhaustive and therefore contains some inaccuracy. This table is intended to allow comparison of costs and effort of financial regulation in the referenced jurisdictions.
- \* Staffing levels and the costs of providing regulation services are not available.

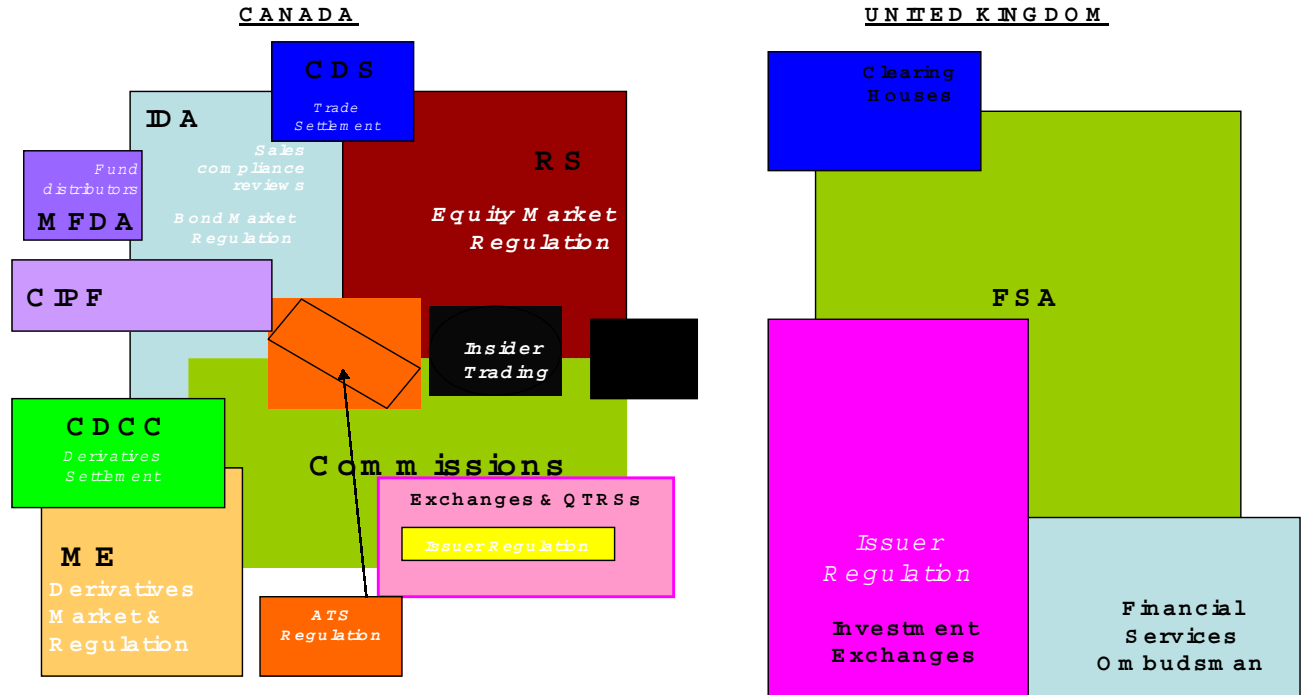
\*\* Costs of providing regulation services are not available. Staffing levels have been estimated.

***Appendix 2***

***Securities Regulation: Canadian Model vs. U.K. Model***

**APPENDIX 2**

*Securities Regulation: Canadian Models vs. United Kingdom Model*



***Appendix 3***

***Outline of Review of Regulatory Approach  
Based on Risk Management Principles***

### **APPENDIX 3**

#### **Outline of Review of Regulatory Approach Based on Risk Management Principles**

This appendix outlines a basic process to assess the current approach to securities regulation based on risk management principles. The primary objective of such a review would be to develop a clear set of priorities and to reassess the value, effectiveness and efficiency of regulatory programs and tools. As outlined in the submission, RS believes a review of this nature would be an extremely beneficial complement to the Committee's review of the regulatory structure. In addition, we believe a review of the current approach to regulation would help to inform a suitable structure for regulation.

It is not necessary that the review of the approach precede a consideration of structure because any recommendation for a new structure must necessarily be based on additional considerations besides the achievement of the core objectives of securities regulation, including regional and political considerations. Therefore, it would be appropriate for the two exercises to proceed in parallel. The results of the review of approach would be employed to flesh out the details of the recommended structure, and to form the basis for setting priorities, allocating resources and designing regulatory programs.

As mentioned in the submission, the UK Financial Services Authority (FSA) employed a framework based on risk management principles in the development of the regulatory approach, programs and organization of the new regulator, which as a new universal financial regulator was created from nine predecessor organizations. The framework was seen as a means to address the varying cultures and regulatory philosophies employed by the former regulators, and to develop a new approach that would be consistent across the organization. The FSA found this approach to be a very effective tool to organize its structure and programs and to unify the divergent cultures of the predecessor organizations. In addition, the application of the model to the design and implementation of regulatory programs has led to desired changes in market behaviour.

The FSA describes its regulatory approach as follows<sup>7</sup>:

The main aim of our strategy is to identify, prioritize and address risks to our four statutory objectives under the FSMA. These are to maintain market confidence, promote public understanding of the financial system, secure appropriate consumer protection and reduce financial crime. Risk in this rather specialized sense is not to be confused with the ordinary and natural commercial risks undertaken by finance firms and within financial markets as part of day-to-day business. For us the basic questions are: what developments, events or issues pose significant risk to our objectives? And how should we use our resources to focus on the risks that matter most? In tackling these questions the Act also requires us to observe certain 'principles of good regulation'. These include economy and efficiency in the use of our resources, the position of the UK as an international financial centre and the need to be proportionate in our regulatory responses. Our approach is designed to ensure that we apply our limited resources to deliver the most effective regulatory action within these parameters.

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<sup>7</sup> Regulatory approach, [www.fsa.gov.uk/approach/](http://www.fsa.gov.uk/approach/)

The FSA's approach is based on its overall statutory objectives and regulatory principles that it has developed. Risk identification and assessment is used to establish a risk framework, which prioritizes the key risks that the FSA is responsible for managing. Risk priorities are then used in determining the FSA's program priorities and resource allocation. In each area, the effectiveness of regulatory tools is assessed in order to ensure that risks are being controlled both effectively and in a cost-efficient manner.<sup>8</sup>

The risk assessment process is an ongoing process. It is not a one-off activity, although the greatest effort is involved in designing the initial framework. The framework is reviewed annually to take account of market developments and to reassess the value and effectiveness of programs as experience is gained with them. The results become an input to the FSA's annual plan and budget.

As an example, the FSA's overall risk framework identifies several major risk groups:

- Financial failure of firms
- Misconduct
- Market quality
- Market abuse
- Fraud and dishonesty
- Consumer understanding
- Money laundering

The specific risks involved in each of these areas are then identified and scoped. The number of specific risks to be analyzed is extensive, but note that the process is designed to examine the main risks, not every potential risk or issue. Examples of specific risks include insider trading, market manipulation, misleading financial disclosure, violation of duty to act in clients' best interests and so on.

Given the number of organizations involved in the CSA, the FSA's use of the framework to organize a new institution and bring together a large number of regulators with different approaches is noteworthy. The risk framework is used not only to identify clear priorities, it is also used on an ongoing basis to assess the effectiveness and value of regulatory programs and specific tools used to mitigate risks and address problems. Canadian regulators might well choose different risk categories, but it is the approach and the results that we believe are important.

The benefits of employing this type of framework to assess the existing approach to regulation are extensive. They include:

- Enables regulators to map their mandates and objectives to key risks;
- Facilitates identification of a clear and focused set of priorities;
- Requires regulators to assess the effectiveness of existing programs and tools, including current rules and compliance tools;
- Includes an assessment of the efficiency or cost – benefit of programs and tools;

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<sup>8</sup> For additional information on the FSA's risk management approach and framework, please see the information on "Building the new regulator" at [www.fsa.gov.uk/approach/1\\_bnr.html](http://www.fsa.gov.uk/approach/1_bnr.html)

- Assists regulators in identifying overlaps and gaps in regulatory programs and resources that can be saved or re-allocated to new priorities;
- Leads to identification of a new approach to regulation organized around management of key risks, and design and prioritization of regulatory programs accordingly;
- Includes identification of ways to measure performance or the success of regulatory programs;
- Provides a platform to redesign the organizational structure of regulators based on effective delivery of these programs.

### Sample Process

The following outlines, at a high level, the process that could be followed in reviewing the current approach to securities regulation in Canada based on risk management principles. Of course, any process of this nature would have to be carefully negotiated among the participants. The primary participants would be members of the CSA. Since SROs are also a significant part of the regulatory regime and delivery of effective regulation requires SROs' priorities and programs to tie into the overall priorities established by the CSA, we suggest that including SROs in the process would be beneficial.

A basic roadmap for the process could be:

1. Identify the project's objectives, institutional participants, scope and deliverables.
2. Establish a steering committee comprised of executives from the project participants.
3. Identify the process to be followed and the schedule.
4. Identify the resources for the project – budget, people assigned to project teams and facilitators.
5. Establish the project teams to analyze the risks in the primary fields of regulation, as well as the regulatory programs and tools used to control these risks.
6. Develop the risk categories applicable to each field of regulation, and the specific risks to be assessed.
7. Assess the actual level of each of the major risks.
8. Assess the effectiveness and efficiency of the programs and tools currently used to control these risks.
9. Identify any overlap, duplication or gaps in the current approach.
10. Identify opportunities to reduce costs, rationalize or reduce activities, and re-allocate resources to priority risks.
11. Identify new programs and tools that would control these risks more cost effectively.
12. Develop an overall risk framework for securities regulation based on the above analysis.
13. Decide on new regulatory priorities and high level changes to programs and tools.
14. Determine the resources and capabilities required to implement the new approach.
15. Identify the options to restructure the regulatory system based on the risk framework and changes to priorities and programs.

RS would be pleased to discuss with the Committee and its staff how a project of this nature might be organized and implemented.