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The debate between the OSC and the BCSC highlights the need to go beyond the nature of the regulator to the philosophy used to regulate.

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ncurities law reform is not the result of daily media stories. However, the proverbial fur has been flying lately, as exemplified by the Ontario Securities Commission’s stern response on Wednesday to the recent proposals by the British Columbia Securities Commission. Yet, we now see regular reports of politicians and regulators openly discussing the urgent need to fix what is widely considered to be broken.

In this debate, much attention has been paid to arguments about the need for a single securities regulator in Canada. No doubt there is, at the very least, an urgent need for reform in the way we structure our regulators. There is, however, another debate worth having in this context. We believe it is important to focus not just on the nature of the regulator, but also on the philosophy used to regulate—a point of significant difference between the OSC and BCSC.

Regulation can be divided into two broad types: input and output. Input-oriented regulations control the details of how products and services are manufactured or sold. Output regulation focuses on results and lets businesses figure out the best way to deliver the specified results.

Input regulation in the securities sector is exemplified by the prospectus disclosure rule for mutual funds. The existing rule sets out, in 51 pages of excruciating detail, exactly how mutual funds must provide prospectus information to investors, including mandatory word-for-word headings and subheadings, precisely stipulated declarations, exact date formats, mandatory rules on tables of contents and other very particular requirements.

A good recent example of output regulation can be found in the Sarbanes-Oxley Act in the United States. One of its most intensely debated elements is a simple requirement in Section 302 that the senior executives of public companies personally certify their financial statements. With this provision, the message from Congress to executives is: "You need to ensure that your company’s public disclosure is complete and correct. We don’t care how you do it. Just do it. And if you don’t do it, personally, will go to jail.”

Input regulation is the dominant form of regulation, but it often produces terrible slips between the cup of prescribed inputs and the lip of desired outcomes. For example, content regulation in Canadian television was intended to result in Canadian watching lots of high-quality Canadian television dramas. It indeed produced lots of Canadian television drama, but of such low

principle: A mutual fund must disclose all information relating to its business, operations or affairs that a reasonable investor would consider important in making a decision about buying or selling the fund, and the fund must keep its books so that the fund’s financial information is always true and up-to-date. The rule could scarcely be simpler. With the basic “output” defined, the BCSC was able to leave 56-plus pages of existing regulations on the cutting room floor. Though dramatically shorter, it is, frankly, hard to imagine anything important that would slip through B.C.’s simple princi- ples, yet was caught by the existing 51-page version of the rule.

The B.C. model reflects the reality that most investors don’t really care about the detailed “inputs” that go into securities. They want to know if the products are sufficiently safe, are being well managed, or have a reasonable chance of success.

Under output regulation, regulators must focus on structure, manage and market their products however they think best, provided they deliver the right sorts of bottom line results. Of course, there also needs to be meaningful penalties for any failure to achieve the mandated outcomes. But the basic approach is straightforward:

The regulator simply specifies what is to be achieved and leaves it to the creativity of industry firms to determine how best to meet those objectives, while satisfying the demands of their customers.

We believe output regulation will work in the securities arena. B.C.’s new model reflects the likelihood of firms having the flexibility to determine the best way to struc- ture itself to meet the general standards mandated. This kind of approach is very similar to the output regulation sucessful used with the U.S. CAFE standards and, more recently, the Sarbanes-Oxley Section 302 certification requirement.

The OSC sees things differently, arguing strenuously in its response to the BCSC for continued domination of input regulation. We understand the OSC’s keen interest in getting the right answer for securities regulation, but we believe output regulation for securities markets is not only a viable alternative, but a preferable one. It will require a significant restructuring of the existing reg- ulatory landscape, but it seems the envi- ronment may be receptive to such changes. Canadian investors deserve a more effective system.

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