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

Smarter regulation

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Securities law reform is not the usual stuff 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 ails Canada's securities regime.

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 better co-ordination among 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.

Regulations can be divided into two basic types: input and output. Input-oriented regulations control the details of how products and services are manufactured or sold. Output regulation focuses on end 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 disclaimers, exact date formats, mandatory rules on tables of contents and other very particular requirements.

OSC's input regulation often makes terrible slips

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 the U.S. 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, you, 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 Canadians watching lots of high-quality Canadian television drama. It indeed produced lots of Canadian television drama, but of such low quality that Canadians choose not to watch it.

Detailed input regulation of Canadian mutual funds has produced prospectuses that look more and more alike, but which even the regulators now admit investors don't read and which clearly don't meet the basic purposes for which they were intended.

Throughout the securities sector, other input-oriented rules closely control how products can be structured, managed, marketed and sold. Not only are non-standard approaches to disclosure prohibited, but novel products can be difficult or impossible to launch, and well-established investment techniques are restricted or forbidden. The unintended consequence is that innovation is strangled, and true differentiation among competitors is reduced.

This kind of "commoditization" doesn't serve the interests of investors. A one-size-fits-all approach is not appropriate for financial products. Canadian investors are increasingly dissatisfied with the crop of mutual funds available to them and they have shown this through both declining sales and growing cynicism.

In our view, what's called for in the Canadian securities industry is a switch in philosophy from input to output regulation.

Output regulation is powerful and direct. Already, U.S. executives are taking great pains to ensure they can confidently certify their financial statements under Section 302 of Sarbanes-Oxley. Their reviews are leading to an unprecedented wave of specific, candid and insightful disclosure from public companies. We note with regret that other elements of Sarbanes-Oxley, such as the Section 404 requirement regarding internal controls, are totally input-oriented and are giving rise to an orgy of bureaucratic scrutiny from auditors, involving substantial cost that may well prove disproportionate to any ultimate benefit.

Output regulation is far from a new or untested concept. In the early 1970s, the U.S. Congress successfully used output regulation to improve gas mileage in the auto industry. It established Corporate Average Fuel Economy (CAFE) targets that began at 18 miles per gallon and rose to 27.5 mpg over several years. Congress left the "how" to the automakers – through selling smaller cars, making their large cars lighter, making their engines more fuel-efficient – whatever they found most effective. Indeed, the automakers did all of the above and met the requirements – doubling fuel economy in the U.S. fleet. The goal of increasing fuel economy was achieved efficiently, without complicated, bureaucratic regulations.

Happily, in Canada, the British Columbia Securities Commision is promoting just this sort of output-oriented revolution in securities regulation. Its approach starts with a set of broad principles and straightforward guidance, articulated in plain language, rather than the vast and complex web of detailed regulations that currently exists. Its goal is to establish a regime with fewer but better rules, rather than just producing more rules.

For example, the BCSC would replace the existing 51-page stricture on mutual fund prospectuses with a very simple 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 disclosure up to date – period. The rule could scarcely be simpler. With the basic "output" defined, the BCSC was able to leave 50-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 principle, yet be 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. Having precisely mandated forms of prospectuses hasn't resulted in investors being any better informed than before. What really matters to investors is the bottom line: well-structured products that meet their needs, run by honest, competent people, fairly priced, with a view to the client's best interests.

Under output regulation, regulators give businesses the flexibility to 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.

BCSC's output regulation is far from a new concept

We believe output regulation will work in the securities arena. B.C.'s new model would allow each securities firm the flexibility to determine the best way to structure itself to meet the general standards mandated. This kind of approach is very similar to the output regulation successfully used with the U.S. CAFE standards and, more recently, the Sarbanes-Oxley Section 302 certification requirement.

The OSC sees things very 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 regulatory landscape, but it seems the environment may be receptive to such changes. Canadian investors deserve a more effective system.

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