

# New Governance, Compliance, and Principles-Based Securities Regulation

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## I. INTRODUCTION

The significance and wisdom of “principles-based” securities regulation may be among the most pressing questions facing securities regulators internationally today. The Financial Services Authority (FSA) in the United Kingdom moved to a comprehensive principles-based regime in 2003. The shift attracted a great deal of interest as it came to light that in 2005, for the first time in recent history, the overwhelming majority of the largest international Initial Public Offerings took place in London rather than in New York.<sup>2</sup> A report by consultants McKinsey & Co., commissioned by

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<sup>2</sup>*See, e.g.*, Gary Parkinson, *Record Amount Raised in London This Year as Foreigners Rush to Float*, INDEPENDENT (U.K.), Aug. 9, 2006, at 40. Whether this shift actually represents a reduction in the perceived value of an American listing is less obvious. *See, e.g.*, Craig Doidge et al., *Has New York Become Less Competitive in Global Markets? Evaluating Foreign Listing Choices over Time* (Fisher College of Business Working Paper No. 2007-03-012, July 2007), available at [ssrn.com/abstract=982193](http://ssrn.com/abstract=982193) (arguing that the decline in cross-listings on the New York and London stock exchanges between 1990 and 2005 is explained by changes in firm characteristics rather than by changes in the benefits of cross-listings).

New York City Mayor Michael Bloomberg and New York Senator Charles Schumer, primarily blamed American overregulation for the city's continuing financial sector woes.<sup>3</sup> Hank Paulson, United States Treasury Secretary, has suggested that, to preserve its global competitiveness, the United States should move toward a more flexible, U.K.-style approach to regulating capital markets.<sup>4</sup> For its part the London Stock Exchange has argued that its superior principles-based approach—not lax standards and not simple distaste for Sarbanes-Oxley Act requirements in the United States—was the reason behind the historic shift.<sup>5</sup>

While the shift is surely complex and multifactorial, the role of principles-based regulation is an important part of the puzzle. In fact, principles-based regulation, described more fully below,<sup>6</sup> is not unknown in North America. The U.S. Commodity Futures Trading Commission now uses principles-based regulation with respect to the clearinghouses and exchanges it regulates.<sup>7</sup> Even the U.S. Securities and Exchange Commission (SEC), often characterized internationally as a particularly rule-oriented and prescriptive securities regulator, has made recent moves toward a more principles-based approach.<sup>8</sup> In Canada, where securities

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<sup>3</sup>Jenny Anderson, *U.S. Financial Sector Is Losing Its Edge, Report Says*, N.Y. TIMES, Jan. 22, 2007, at 3. According to the McKinsey study, the United States controlled 16% of the global stock-offering volume in the first ten months of 2006, compared with 57% in 2001. Europe's share increased from 33% in 2001 to 63% in the first ten months of 2006.

<sup>4</sup>Jeremy Grant & Krishna Guha, *Paulson Seeks British-Style Flexibility in Capital Markets*, FINANCIAL TIMES (U.K.), Nov. 21, 2006, at 1.

<sup>5</sup>The chief executive officer of the London Stock Exchange, Clara Furse, argued that “London’s principles-based regime, rather than a more prescriptive rules-based approach, continues to prove itself as a model that facilitates pro-competitive innovation in a tough but sensible regulatory environment. All the important independent corporate governance surveys confirm that the U.K. is number one for corporate governance standards.” Clara Furse, *Comment: Sox is Not to Blame—London is Just Better as a Market*, FINANCIAL TIMES (U.K.), Sept. 18, 2006, at 19.

<sup>6</sup>See *infra* Parts II.A and II.B.

<sup>7</sup>See, e.g., Walter Lukken, Commissioner Commodities Futures Trading Commission, Address at the University of Houston’s Global Energy Management Institute: It’s A Matter of Principles (Jan. 25, 2007), <http://www.cftc.gov/newsroom/speechestimony/opalukken-23.html>.

<sup>8</sup>E.g., 17 C.F.R. pts. 210, 228, 229, 230, 232, 239, 240, 242, 245 & 249 (2005), [http://www.sec.gov/rules/final/33-8518.htm#P758\\_198667](http://www.sec.gov/rules/final/33-8518.htm#P758_198667) (establishing a principles-based definition and disclosure requirements for asset-backed securities).

regulation is a provincial matter, the province of British Columbia is an ambitious champion of principles-based securities regulation and outcome-oriented regulatory practice. In fact, through its advocacy the entire Canadian securities system may be making a momentous shift away from its historic template, the American approach, and toward U.K.-style principles-based regulation.

In 2004, after a series of regulatory impact analyses and public consultations, the B.C. legislature introduced a bill to create an innovative new principles-based Securities Act for the province (Bill 38).<sup>9</sup> Bill 38 and its associated proposed rules and regulations (together, the “B.C. Model”) would have established the most comprehensively principles-based regime in securities regulation in North America.<sup>10</sup> The companion piece to the statutory reforms was so-called “outcome-oriented” regulation at the level of practice.<sup>11</sup> Bill 38 received Royal Assent on May 13, 2004, and was set to come into force by regulation.<sup>12</sup> It has not done so. Continued evolution in Canadian securities regulation—and especially the growing momentum behind a so-called “passport system” between provincial regulators—means that Bill 38 is now unlikely to come into force in its current form.<sup>13</sup> Nevertheless, the province has not resiled from its advocacy of principles-based and outcome-oriented regulation. The B.C. Securities Commission (BCSC) now takes the position that, in any event, “the most important aspect of regulatory reform is a change in how [regulators] *administer* securities legislation.”<sup>14</sup> It has stated that, “although the 2004 act is not

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<sup>9</sup>Bill 38-2004, Securities Act, 5th Sess., 37th Parl., British Columbia, 2004, § 203. Bill 38 and the research studies and other documents associated with it are available on the BCSC Web site at [http://www.leg.bc.ca/37th5th/3rd\\_read/gov38-3.htm](http://www.leg.bc.ca/37th5th/3rd_read/gov38-3.htm) (last visited Sept. 7, 2007).

<sup>10</sup>*See infra* text accompanying notes 67–78.

<sup>11</sup>*See infra* text accompanying notes 79–84.

<sup>12</sup>Bill 38, 5th Sess., 37th Parl., Nos. 72 and 73 (Royal Assent given May 13, 2004), <http://www.leg.bc.ca/37th5th/votes/v040513.htm>.

<sup>13</sup>British Columbia passed a more circumscribed Securities Amendment Act in 2006. Bill 20-2006, *Securities Amendment Act*, 2nd Sess., 38th Parl., British Columbia, 2006. Depending on external political factors and the results of harmonization negotiations with other Canadian jurisdictions, the Securities Amendment Act may be more circumscribed only in the near term. It contains several provisions that mirror those of Bill 38. However, those provisions will only come into force if enacted by separate regulation, at an as yet unspecified date.

<sup>14</sup>BCSC, MOVING AHEAD WITH REGULATORY REFORM IN BRITISH COLUMBIA (Mar. 2005), [http://www.bsc.bc.ca/uploadedFiles/Moving\\_Ahead.pdf](http://www.bsc.bc.ca/uploadedFiles/Moving_Ahead.pdf) (emphasis added).

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.”<sup>15</sup>

Moreover, British Columbia’s principles-based and outcome-oriented approach is now having a clear effect across Canada through British Columbia’s agency and advocacy within the Canadian Securities Administrators (CSA), the Canadian securities regulatory umbrella group. British Columbia’s coherent vision of its principles-based regulatory regime makes it a significant presence at the negotiating table. As a result, important prospectus-related components of the B.C. Model are now in effect across Canada by way of CSA National Instruments.<sup>16</sup> Also, the CSA has issued for comment sweeping new proposed rules designed to put in place a revised, nationally harmonized and streamlined registration regime for firms and individuals.<sup>17</sup> With respect to firm compliance processes in particular, the CSA has indicated that it intends to make principles-based rules.<sup>18</sup> In the last twelve months, two major reports have come out

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<sup>15</sup>BCSC, HISTORY OF THE 2004 BC SECURITIES LEGISLATION, <http://www.bsc.bc.ca/instruments.asp?id=1894> (last visited Sept. 4, 2007).

<sup>16</sup>*See infra* note 68 (discussing the Continuous Market Access approach under Bill 38). Depending on the province, National Instruments are typically incorporated into provincial law through the provincial securities regulators’ rulemaking powers, by regulation, or by blanket ruling or order. British Columbia’s most striking success so far in pushing Canadian regulators in the direction of its vision occurred in late December 2006 with the adoption of National Instrument 44-101 concerning short-form prospectuses. (Concurrent National Instruments made parallel changes to the requirements governing shelf distribution prospectuses and PREP prospectuses.) Section 2.2 of NI 44-101 provides that an issuer with equity securities listed and posted for trading on an eligible exchange, which is up to date in its periodic and timely disclosure filings in all jurisdictions in which it is a reporting issuer, may file a much-streamlined short-form prospectus. NATIONAL INSTRUMENT 44-101 SHORT FORM PROSPECTUS DISTRIBUTIONS (Dec. 29, 2006), [http://www.bsc.bc.ca/uploadedFiles/NI44-101\(1\).pdf](http://www.bsc.bc.ca/uploadedFiles/NI44-101(1).pdf). The new qualification criteria greatly expand the number of Canadian listed issuers that can participate in expedited short-form offerings. As such, NI 44-101 is a step toward the Continuous Market Access model championed in Bill 38, which would have done away with prospectuses entirely for issuers that were already in the public markets and that were keeping their disclosures up to date.

<sup>17</sup>CAN. SEC. ADM’R, PROPOSED NATIONAL INSTRUMENT 31-103, REGISTRATION REQUIREMENTS AND PROPOSED COMPANION POLICY 31-103CP (Feb. 21, 2007), [http://www.bsc.bc.ca/uploadedFiles/NI31-103\\_Proposed.pdf](http://www.bsc.bc.ca/uploadedFiles/NI31-103_Proposed.pdf).

<sup>18</sup>Prema K.R. Thiele et al., *Canadian Securities Regulators Release Comprehensive Registration Rule For Comment* (Feb. 21, 2007), [http://www.mondaq.com/i\\_article.asp\\_Q\\_articleid\\_E\\_46392](http://www.mondaq.com/i_article.asp_Q_articleid_E_46392).

supporting principles-based regulation,<sup>19</sup> and the Chair of the nation's largest provincial securities regulator, the Ontario Securities Commission, is now of the view that "the arguments in favor of principles-based regulation are very compelling."<sup>20</sup>

This article looks at principles-based securities regulation as a New Governance regime—one that uses innovative, pragmatic, information-based, iterative, and dialogic mechanisms to gather, distill, and leverage industry learning in the service of a still-robust but better designed, that is, more effective and less burdensome, public regulatory mandate.<sup>21</sup> Using British Columbia's approach as an example, this article argues that the B.C. Model's outcome-oriented, open-ended, and collaborative features locate it within the ambit of that emerging analytical perspective. As such, the B.C. Model shares the beneficial characteristics of other New Governance regimes, especially relative to the more prescriptive and inflexible mechanisms associated with classical regulation. The New Governance perspective also brings to light some fresh questions about the B.C. Model, going in particular to the kinds of incentives that industry and regulators have and the relationship between them.

This article draws connections between principles-based regulation and New Governance in a way that transcends specific administrative law topics and should be of interest to scholars of regulation generally. In addition, the article seeks to engage with New Governance scholarship itself, by providing a contextual example of a New Governance experiment operating in the particular environment of securities regulation. While one can be confident overall about the value of putting principles-based and New Governance–inflected regulatory strategies to work in this area, securities regulation also presents its own particular challenges.

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<sup>19</sup>CRAWFORD PANEL ON A SINGLE CANADIAN SECURITIES REGULATOR, BLUEPRINT FOR A CANADIAN SECURITIES COMMISSION (2006), [http://www.crawfordpanel.ca/Crawford\\_Panel\\_final\\_paper.pdf](http://www.crawfordpanel.ca/Crawford_Panel_final_paper.pdf), at 7 ("to provide Canadian capital markets with a competitive advantage globally it is desirable to have as much principles-based regulation as is feasible"). TASK FORCE TO MODERNIZE SECURITIES LEGISLATION IN CANADA, CANADA STEPS UP (2006), <http://www.tfmsl.ca/index.htm> (see, for example, Volume 1, Executive Summary, at 2, recommending "that Canadian securities regulation be based on clearly enunciated regulatory principles which do not need a detailed set of interventionist rules for sound implementation").

<sup>20</sup>David Wilson, Chair Ontario Sec. Comm'n, Address at Dialogue with the OSC: Momentum for Change: Providing the Regulation Canada Needs (Nov. 10, 2006), [http://www.osc.gov.on.ca/Media/Speeches/sp\\_20061110\\_dw\\_dwo-momentum.jsp](http://www.osc.gov.on.ca/Media/Speeches/sp_20061110_dw_dwo-momentum.jsp).

<sup>21</sup>See discussion *infra* Part III.A.

Understanding the contextual implications of decentralized, principles-based, outcome-oriented New Governance approaches to securities regulation in particular helps to deepen the conversation about those approaches more generally.

The article proceeds in four parts. Part II defines “principles-based” and “outcome-oriented” regulation, by reference to classical theoretical debates, the debate around the B.C. Model, and recent trends in public administration. It provides an example of how regulation of a particular compliance requirement, broker firm supervision of client accounts, might be different under principles-based and outcome-oriented regulation. Part III sets out the relationship between principles-based securities regulation and New Governance theory, with specific attention to implications for firm compliance processes and the relationship between “rolling best practices rulemaking” and “light touch regulation.” It examines the relationship between regulator and industry especially in terms of the defensibility of potentially imposing on industry actors the costs of articulating, *ex post*, the specific content of principles-based regulatory requirements in the compliance context. Part IV identifies two particular challenges presented by the securities regulatory context, from the perspective of New Governance: firms’ uneven incentives to innovate in new product development versus compliance and problems of small firm capacity to operationalize principles. The article considers hybrid rules-and-principles regulatory structures, arguing for incorporating relevant third parties into the regulatory structure. Tripartism can be an effective mechanism for responding to regulatory failure, and it may be especially useful in responding to the particular challenges posed by the many small enterprises and “junior cap” issuers operating in the province of British Columbia. Part V offers some concluding thoughts.

## II. WHAT IS PRINCIPLES-BASED SECURITIES REGULATION?

### *A. The Theoretical Debate*

The classic example of the difference between rules and principles or “standards” (to use another term) involves speed limits: a rule will say, “Do not drive faster than 55 mph,” whereas a principle will say, “Do not drive faster than is reasonable and prudent in all circumstances.” Put another way, a rule generally entails an advance determination of what conduct is

permissible, leaving only factual issues to be determined by the frontline regulator or decision maker. A principle may entail leaving both specification of what conduct is permissible and factual issues to the frontline regulator.<sup>22</sup>

A number of scholars have used the relatively straightforward rules–principles dichotomy as a vehicle for evaluating the structural and analytical choices that go into lawmaking.<sup>23</sup> Many of the major arguments relate to the relative certainty of rules and flexibility of principles and the costs of these regulatory choices for regulation promulgators, enforcers, and followers.<sup>24</sup> These broad themes echo in the debate in British Columbia respecting Bill 38, discussed below; its proponents argued that a

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<sup>22</sup>See Louis Kaplow, *Rules versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 559–60 (1992). Ronald Dworkin’s rules–principles distinction, in which principles are reasons that a judge takes into consideration in deciding which all-or-nothing rule should apply, uses the terms in a different fashion than is intended here. RONALD DWORIN, *TAKING RIGHTS SERIOUSLY* 22–28, 71–80 (1977).

<sup>23</sup>See, e.g., Kaplow, *supra* note 22; Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685 (1976); Carol M. Rose, *Crystals and Mud in Property Law*, 40 STAN. L. REV. 577 (1988); Antonin Scalia, *The Rule of Law as a Law of Rules*, 56 U. CHI. L. REV. 1175 (1989); Frederick Schauer, *The Tyranny of Choice and the Rulification of Standards*, 14 J. CONTEMP. LEGAL ISSUES 803 (2005); Pierre Schlag, *Rules and Standards*, 33 UCLA L. REV. 379 (1985); Kathleen M. Sullivan, *The Supreme Court 1991 Term: Foreword: The Justices of Rules and Standards*, 106 HARV. L. REV. 22 (1992); Cass R. Sunstein, *Problems with Rules*, 83 CAL. L. REV. 953 (1995).

<sup>24</sup>For example, on the one hand, scholars usually argue that rules promote precision, formal equality, predictability, certainty, uniformity, and judicial restraint; produce greater net social welfare gains than principles; foster democracy and consistency; facilitate efficient allocation of goods; provide fixed consequences for action; minimize the costs of reaching decisions in particular cases; discourage rent-seeking behavior; and reduce the likelihood of bias, arbitrariness, and abuse of power by decision makers. Rules are, however, not without their disadvantages. Rules can be inflexible, reactive, and costly to promulgate; they require constant amendment to meet changing circumstances; they may be simultaneously over- and under-inclusive. Rules permit different treatment of cases that are substantially alike, mask bias, allow people to engage in socially unproductive behavior to the extent of prohibition (to the “limits of the law”), restrict communication and may thwart understanding, restrict the exercise of discretion, and can be procedurally unfair.

Principles provide advantages that are the flip side of rules’ disadvantages. They provide decision makers with the ability to make their own choices, promote substantive equality and justice, reduce arbitrariness, are flexible and can adapt to changing circumstances over time, favor distributive motives, promote accountability on the part of decision makers, are less costly to promulgate, and allow decision makers to tailor their treatment to the facts of particular cases. Principles can also be disadvantageous in that they can be unpredictable, uncertain, costly for individuals to interpret and for decision makers to enforce, may prevent risk-averse people from engaging in lawful conduct, and they can be manipulated.

principles-based and outcome-oriented approach would discourage “loop-hole” behavior and “checklist” style approaches to law and would promote a more effective and flexible regulatory approach. Opponents of the B.C. Model worried about the uncertainty it could produce and the cost of that uncertainty to market actors. Of course, the conversation is much enriched by the predictable fact that there is no unanimity regarding the basis for analyzing the advantages and disadvantages of each: scholars have evaluated rules and principles in economic terms,<sup>25</sup> abstract normative ones,<sup>26</sup> in terms of regulatory design<sup>27</sup> and behavioral analysis,<sup>28</sup> and on the basis of particular values such as freedom/autonomy,<sup>29</sup> democracy,<sup>30</sup> community,<sup>31</sup> or perceived legitimacy.<sup>32</sup>

Scholars expressing a near-unequivocal preference for either rules or principles are relatively rare,<sup>33</sup> although most lean one way or the other. Many note that rules and principles are more points on a continuum than discrete concepts and that there is a good deal of overlap and convergence between them.<sup>34</sup> Others have resisted the stark dichotomy between rules

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<sup>25</sup>See, e.g., Kaplow, *supra* note 22.

<sup>26</sup>MARK KELMAN, A GUIDE TO CRITICAL LEGAL STUDIES (1987); Kennedy, *supra* note 23.

<sup>27</sup>See, e.g., IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE (1992); James W. Colliton, *Standards, Rules and the Decline of the Court in the Law of Taxation*, 99 DICK. L. REV. 265 (1995); Colin S. Diver, *The Optimal Precision of Administrative Rules*, 93 YALE L.J. 65, 98 (1983).

<sup>28</sup>Russell B. Korobkin, *Behavioral Analysis and Legal Form: Rules vs. Principles Revisited*, 79 OR. L. REV. 23 (2000); Schauer, *supra* note 23.

<sup>29</sup>P.S. Atiyah, *From Principles to Pragmatism in the Function of the Judicial Process and the Law*, 65 IOWA L. REV. 1249, 1272 (1980); Eric A. Posner, *Standards, Rules, and Social Norms*, 21 HARV. J.L. & PUB. POL'Y 101, 116–17 (1997).

<sup>30</sup>Scalia, *supra* note 23.

<sup>31</sup>Rose, *supra* note 23 (arguing that both rules and principles are metaphors for lapses of community).

<sup>32</sup>D.A. Rollie Thompson, *Rules and Rulelessness in Family Law: Recent Developments, Judicial and Legislative*, 18 CAN. FAM. L.Q. 25 (2000–1).

<sup>33</sup>But see Scalia, *supra* note 23.

<sup>34</sup>See, e.g., Russell B. Korobkin, *Behavioral Analysis and Legal Form: Rules vs. Standards Revisited*, 79 OR. L. REV. 23, 30 (2000); Neil MacCormick, *Reconstruction After Deconstruction: A Response to GLS*, 10 OXFORD J. LEGAL STUD. 539, 545 (1990); Frederick Schauer, *The Convergence of Rules and Standards*, 2003 N.Z. L. REV. 303, 305 (2003).

and principles<sup>35</sup> and have pointed out that, historically, the decision-making pendulum has swung between them.<sup>36</sup> Some warn that the rules-versus-principles debate should avoid setting up an artificial separation between law promulgators and law followers that fails to reflect the true iterative quality of the legislative process.<sup>37</sup> More fundamentally challenging arguments also have been made to the effect that it has become an “arrested dialectic”<sup>38</sup> or that the rules-versus-principles debate is really a stand-in for other, deeper disagreements about the proper ordering of society and the proper substantive content of legal rules.<sup>39</sup>

There can be no question that a stark, bipolar understanding of the rules–principles dichotomy risks overdrawing the distinction, making it less useful in practical terms. No statutory scheme is a pure type—as, in fact, the FSA’s description of its groundbreaking principles-based approach as simply “*more* principles-based regulation” acknowledges.<sup>40</sup> Rules still admit of considerable discretion and interpretation. Principles, in the fullness of context, may congeal around a particular meaning. Moreover, calling the B.C. and FSA Models principles-based implies that the main run of securities regulation is comparatively rule based. This is not entirely the case, either constructing securities laws in objective terms, to the extent possible, or certainly by reference to other administrative law schemes. The U.S. Securities Act of 1933 and Securities and Exchange Act of 1934, for example, display real economy in conception and drafting and exhibit nothing like the detailed, rule-bound, command-and-control approach so often now associated with bureaucratic sclerosis and ineffectiveness in other regulatory arenas.

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<sup>35</sup>Ian Ayres, *Preliminary Thoughts on Optimal Tailoring of Contractual Rules*, 3 S. CAL. INTERDISC. L.J. 1, 18 (1993) (arguing that “in many circumstances the dichotomous choice between rules or standards may be a false one, because lawmakers may prefer to enact a complementary set of rules and principles”); MacCormick, *supra* note 34 (arguing that there is no necessary opposition between rules and principles).

<sup>36</sup>Atiyah, *supra* note 29; Rose, *supra* note 23.

<sup>37</sup>JULIA BLACK, RULES AND REGULATORS (1997). See also Margaret Jane Radin, *Reconsidering the Rule of Law*, 69 B.U. L. REV. 781, 814 (1989) (discussing the problems of the rule maker/rule follower paradigm, although not in the context of the rules–principles debate).

<sup>38</sup>Schlag, *supra* note 23, at 383.

<sup>39</sup>Kennedy, *supra* note 23. But see Sullivan, *supra* note 23 (denying that superficial liberal/conservative political allegiances adequately explain judicial preferences for either rules or principles).

<sup>40</sup>See *infra* text accompanying notes 55–66.

Canadian securities law statutes are not appreciably more rule based than U.S. ones.<sup>41</sup> Even if we assume that it is possible to distinguish meaningfully on a large scale between rules and principles, rules as implemented may look more like principles if decision makers use their discretion to temper the harsh effect of a rule that is imperfectly tailored to a specific situation. At the same time, principles may slide into rules over time because people and systems may desire more certainty than they find principles provide.<sup>42</sup>

Nonetheless, taken as a whole, securities regulatory *regimes* can be comparatively principles or rules based.<sup>43</sup> A regime can choose to regulate

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<sup>41</sup>Canadian provincial securities statutes are generally very similar to the American 1933 Act and 1934 Acts. See also LAWRENCE A. CUNNINGHAM, PRINCIPLES AND RULES IN PUBLIC AND PROFESSIONAL SECURITIES LAW ENFORCEMENT: A COMPARATIVE U.S.–CANADA INQUIRY (2006), [http://www.tfmsl.ca/docs/V6\(5A\)%20Cunningham.pdf](http://www.tfmsl.ca/docs/V6(5A)%20Cunningham.pdf) (arguing that the U.S. SEC and the Canadian CSA show strong similarities in enforcement approach, that the SEC/CSA approach is principles based relative to the rule-based models at the U.S. National Association of Securities Dealers and the Canadian Investment Dealers Association (see *infra* note 72), and arguing against broadly principles-based securities regulation).

<sup>42</sup>Schauer, *supra* note 23 (arguing that individuals “resist excess choice as much as they resist excessively constrained choice,” so law implementers and enforcers tend to “round[ ] off the crisp corners of rules” as well as systematically “sharpen the soft edges of principles”). See also BARRY SCHWARTZ, THE PARADOX OF CHOICE: WHY MORE IS LESS (2004) (arguing that from a psychological perspective there is a cost to having an overload of choice). The pressure toward certainty is even more pronounced when the possibility of sanctions exists, and this makes sense for due process reasons. However, this is not to say that principles-based regimes inherently violate the rule of law. The trick is that the regime must not be arbitrary in its exercise of power, and it should be transparent. That it is capable of handling inevitable vagueness in human relations should not invalidate it. TIMOTHY ENDICOTT, VAGUENESS IN LAW (2000); Keith C. Culver, *Varieties of Vagueness*, 54 UNIV. TORONTO L.J. 109 (2004).

<sup>43</sup>Although our analyses are compatible in many respects, at this conclusory level this article parts ways with Lawrence A. Cunningham’s thought-provoking recent article, *A Prescription to Retire the Rhetoric of “Principles-Based Systems” in Corporate Law, Securities Regulation and Accounting* (Mar. 13, 2007), (Boston College Law School Research Paper No. 127), available at <http://ssrn.com/abstract=970646>. Cunningham exposes the various ways in which the labels of “principles-based” or “rules-based” systems can be misleading. He argues that, while individual provisions may be classifiable as either rule or principle when stated as a legal norm, this does not account for how those provisions are interpreted, enforced, and applied. Moreover, he argues that “vague concepts such as materiality and fairness unaccompanied by some specific content create risks of both managerial decision-making and arbitrary enforcement.” *Id.* at 19. Professor Cunningham and I agree on these points, and we agree that rules and principles exist on a spectrum rather than as pure types. Where this article parts ways with Professor Cunningham is with regard to the implications. Cunningham says that problems of classification and implementation are foundational and make the rules–principles dichotomy deeply suspect when used to describe systems. In his view, the most likely explanation for the “flourishing” rhetoric extolling principles-based systems is political: regulatory jurisdictions

internal compliance processes, for example, by way of detailed checklists or by way of sweeping administrative guidelines. Each kind of regime will necessarily include both rule-based and principles-based elements. And, when applied to particular contexts by human regulators, there may be even more bleed-over than drafters intend. Still, one can make meaningful conceptual distinctions between regimes functioning primarily around principles and those operating mainly by way of rules. Moreover, the language of principles is useful for understanding the regulator's necessarily modified role under a New Governance regime, within which the regulator establishes broad goals and outcome requirements but leaves it up to the regulated industry itself to develop effective means for achieving those requirements.

### *B. The Securities Regulatory Context*

In describing the B.C. Model as principles based, drafters and proponents also were participating in a larger transnational debate, which took place following the many scandals of this millennium's early years, about the proper structure of securities regulation and accounting rules. The initial concern was national accounting rules. The primary U.S. accounting standard setter, the Financial Accounting Standards Board (FASB), was criticized in the wake of the Enron debacle for relying too much on detailed rules to determine appropriate accounting treatment with respect to accounting standards.<sup>44</sup> Thereafter, considerable work went into drafting more principles-based Generally Accepted Accounting Principles

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operating in a competitive market for regulatory services use the term, misleadingly, for product differentiation purposes. *Id.* at 54–62. This article is comparatively less gloomy about the scalability of rules and principles to the systems level and, while it recognizes the (positive and negative) impacts of transnational regulatory competition, it is less cynical about regulators' motives in advocating principles-based regulation. This article's response to the problems of classification and implementation recognized here is rather that, in order to be meaningful and effective, principles-based regulation requires a correlative shift in approach among the frontline regulators who interpret, enforce, and apply those principles. Part II of this article, *supra*, argues for a New Governance-style approach as a means of developing a systematic, coherent, conceptually compatible approach to the crucial implementation aspect of principles-based regulation.

<sup>44</sup>Frederick Gill, *Principles-Based Accounting Standards*, 28 N.C. J. INT'L L. & COM. REG. 967 (2003) (describing the criticism and the FASB response and comparing U.S. GAAP to British GAAP). *But see* William W. Bratton, *Enron, Sarbanes-Oxley and Accounting: Rules Versus Principles Versus Rents*, 48 VILL. L. REV. 1023 (2003) (arguing that auditor failure, rather than the existence of a rules-based GAAP regime, was to blame for the Enron crisis).

(GAAP).<sup>45</sup> In Canada and the United Kingdom, the most common view has been that those countries' respective national GAAP are (and are appropriately) more principles based than U.S. GAAP.<sup>46</sup> Europe, generally speaking, has come out broadly in favor of a more principles-based approach to accounting guidelines.<sup>47</sup> Naturally, in practice as in theory, the site of the distinction between rules-based and principles-based approaches is contested ground.<sup>48</sup>

In short order, the rules-versus-principles terminology moved beyond accounting and into securities regulation and corporate governance

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<sup>45</sup>In the United States post-Enron, principles-based GAAP have received the imprimatur of FASB and the SEC. FASB, PROPOSAL: PRINCIPLES-BASED APPROACH TO U.S. STANDARD SETTING (2002), [http://www.fasb.org/proposals/principles-based\\_approach.pdf](http://www.fasb.org/proposals/principles-based_approach.pdf). U.S. SEC, SEC Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System (2003), available at <http://www.sec.gov/news/studies/principlesbasedstand.htm>.

<sup>46</sup>In Canada, Daniel Thornton and Erin Webster have argued that Canadian GAAP principles are more principles-based than American GAAP. Their analysis is based, inter alia, on an examination of the CICA Assurance Handbook and the CICA Accounting Handbook, which they claim are much less prescriptive than American Institute of Certified Public Accountants assurance guidance and FASB accounting guidance. Daniel B. Thornton & Erin Webster, *Earnings Quality Under Rules- vs. Principles-Based Accounting Standards: A Test of the Skinner Hypothesis* (June 2004), available at <http://ssrn.com/abstract=557983>. According to Robert Kershaw, the common—though mistaken—view in the United Kingdom is that it avoided Enron-style scandal in the early years of this millennium because its approach to accounting regulation is principles based rather than rules based. I dispute the claim that U.K. GAAP really are more principles based than American GAAP, however, and argue that the lack of an Enron-style scandal in the United Kingdom may be attributed to good fortune, a more robust professional culture, and/or plain ignorance of the extent of professional failure in the absence of a high-profile scandal. David Kershaw, *Evading Enron: Taking Principles Too Seriously in Accounting Regulation*, 68 MOD. L. REV. 594 (2005). The fight has gone out of this conversation somewhat, given recent transnational convergence of accounting principles around International Financial Reporting Standards. See, e.g., News Release, FASB, *FASB and IASB Reaffirm Commitment to Enhance Consistency, Comparability and Efficiency in Global Capital Markets* (Feb. 27, 2006), <http://www.fasb.org/news/nr022706.shtml>.

<sup>47</sup>See EUROPEAN UNION, REGULATION (EC) No 1606/2002 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL ON THE APPLICATION OF INTERNATIONAL ACCOUNTING STANDARDS, [http://www.cesr-eu.org/index.php?page=contenu\\_groups&id=13&docmore=1](http://www.cesr-eu.org/index.php?page=contenu_groups&id=13&docmore=1) (last visited Mar. 6, 2007); Peter Jeffrey, *International Harmonization of Accounting Standards, and the Question of Off-Balance Sheet Treatment*, 12 DUKE J. COMP. & INT'L L. 341 (2002) (comparing the American, British, and European approaches). But see *More Rules; Auditing Reform*, THE ECONOMIST (London), Mar. 20, 2004, at 34 (observing that European principles-based accounting regulation is under pressure as a result of European scandals and the more prescriptive and detailed Sarbanes-Oxley Act).

<sup>48</sup>See, e.g., Gill, *supra* note 44 (disputing the common wisdom that American GAAP principles are more rule based than British ones); Kershaw, *supra* note 46 (same).

generally. In the United States, there has been a good deal of discussion about the distinction between rules and principles,<sup>49</sup> although legislative outcomes have been more mixed. To take the most obvious example, observers have identified principles-based tendencies in some Sarbanes-Oxley provisions,<sup>50</sup> although the statute also imposed numerous new, detailed rules.<sup>51</sup> Among the Commonwealth countries as well, the scandals at Enron, WorldCom, Canada's Nortel, Australia's HIH, and elsewhere stimulated considerable soul searching about securities regulation and a renewed debate about the virtues<sup>52</sup> and vices<sup>53</sup> of principles-based as opposed to rules-based regulation and the significance of the distinction.<sup>54</sup>

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<sup>49</sup>See, e.g., Cary Coglianese et al., *The Role of Government in Corporate Governance*, (Regulatory Policy Program Report RPP-08 Nov. 2004), available at <http://ssrn.com/abstract=613421> (summarizing the results of deliberations at a conference on corporate governance).

<sup>50</sup>See, e.g., John C. Coffee Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 342–44 (2004) (arguing that Sections 302 and 906 of the Sarbanes-Oxley Act, which require CEOs and CFOs to certify that information contained in periodic reports “fairly presents” the financial condition and results of operations of the issuer, represent a shift to a principles-based system for financial disclosure).

<sup>51</sup>Practitioners, in particular, have criticized aspects of Sarbanes-Oxley for its detailed, prescriptive quality. See, e.g., David S. Ruder et al., *The SEC at 70: The Securities and Exchange Commission's Pre-and Post-Enron Responses to Corporate Financial Fraud: An Analysis and Evaluation*, 80 NOTRE DAME L. REV. 1103 (2005).

<sup>52</sup>Championing principles-based securities regulation in Canada, see, for example, Michael Kane, *Investor Protection at Top of Agenda for Chairman*, SUDBURY STAR, July 30, 2005, at E2 (see *infra* note 72, discussing Ross Sherwood, new chair of the Investment Dealers Association, and his preference for principles-based regulation); Ben Maiden, *Canadian Lawyers Take New Look At Due Diligence*, 24 INT'L. FIN. L. REV. 37 (2005) (discussing Canadian regulators' initiatives post-Sarbanes-Oxley and the desire to remain more principles based than rule based). In Australia: Gerry Gallery & Natalie Gallery, *Inadequacies and Inconsistencies in Superannuation Fund Financial Disclosure: The Need for a Principles-Based Approach*, 36 AUST. ECON. REV. 89 (2003) (arguing that Australia's Superannuation Fund structure should move from a rules-based structure to the structure with corporate reporting, which the authors contend show that a principles-based approach applied to corporate reporting).

<sup>53</sup>Editorial, *Silence No More*, CANADIAN BUSINESS, Summer 2004, at 208 (criticizing Canadian principle-based regulation as soft on enforcement); John Farrar, *Toothless Tiger—All Roar and No Bite*, N.Z. MGMT. (Auckland), Aug. 2005, at 72 (criticizing New Zealand's principles-based approach to corporate law as overly lax).

<sup>54</sup>Neil Baker, *Global Debate Over Controls*, INTERNAL AUDITOR, June 2005, at 50 (discussing the impact of the Sarbanes-Oxley Act in Europe and Britain's attempt to defend their principles-based approach from incursion by post-Sarbanes European regulations); Press Release, Price WaterhouseCoopers, *Financial Firms Face High Reputational Costs from Poor Compliance Risk Management* (June 27, 2005), available at <http://www.pwc.com/Extweb/ncpressrelease.nsf/>

From an early stage, the U.K. FSA has been a thoughtful leader on principles-based financial services regulation. Its approach warrants a brief sketch. What the FSA has in mind, in speaking of principles-based securities regulation, is a comprehensive philosophy about regulation that affects not only its approach to regulating industry, but also its own processes. The FSA's move toward principles-based regulation in the securities area crystallized in 2001, not long after its own creation, with the promulgation of eleven overarching Principles of Business within its Handbook.<sup>55</sup> In the intervening years the FSA has replaced huge swaths of its detailed Handbook rules with short, high-level requirements, often accompanied by regulatory guidance.<sup>56</sup> Between 2002 and 2005, for example, the FSA simplified and restructured its rules relating to listed companies, reducing the length of the rules by 40% and adding six listing principles plus guidance.<sup>57</sup> In 2006, the FSA began consulting on simplifying its rules relating to dealings with retail customers, and it began to replace the detailed obligations established by its existing money-laundering requirements with more streamlined provisions focusing on ensuring that firms have effective risk management and systems and

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docid/9F9DA465D3B9996F8025702D004D8763 (summarizing study findings that “organizations [sic] are not rising to the challenges posed by the shift from rules-based to principles-based regulation or supervision by taking a more holistic approach that moves beyond statutory expectations to strategic and tactical decision-making”); *Lawyers to Lobby on Principle Regulation*, MONEY MARKETING (London), Aug. 11, 2005, at 3 (reporting on a group of lawyers questioning the constitutionality of principles-based regulation at the FSA).

<sup>55</sup>Jonathan Edwards & Simon Wolfe, *Compliance: A Review*, 13 J. FIN. REG. & COMPLIANCE 48, 49–50 (2005). The Principles are posted on the FSA Web site, <http://fsahandbook.info/FSA/html/handbook/PRIN/2/1> (last visited Sept. 4, 2007).

<sup>56</sup>General guidance is contained in the FSA Handbook. For example, guidance on appropriate responses to whistleblowing appears in FSA, HANDBOOK MODULE SYSC (SENIOR MANAGEMENT ARRANGEMENTS, SYSTEMS AND CONTROLS) 18.2: PRACTICAL MEASURES, <http://fsahandbook.info/FSA/html/handbook/SYSC/18/2> (last visited Sept. 4, 2007). From time to time, where a matter is urgent or likely to be temporary, the FSA will publish a “Guidance Note.” See, e.g., FSA, GUIDANCE NOTE NO. 8 (2003), <http://www.fsa.gov.uk/pubs/guidance/guidance8.pdf> (covering Credit Union Common Bonds).

<sup>57</sup>FSA, BETTER REGULATION ACTION PLAN: WHAT WE HAVE DONE AND WHAT WE ARE DOING (2005), [http://www.fsa.gov.uk/pubs/other/better\\_regulation.pdf](http://www.fsa.gov.uk/pubs/other/better_regulation.pdf), at 7.

controls and that firms' senior management take responsibility for managing money-laundering risk.<sup>58</sup>

In some circumstances, relevant FSA guidance has been formulated in concert with industry itself. For example, in 2004 a group of four trade associations published industry guidance on their understanding of the FSA's rules with respect to trading ahead of investment research. The FSA publicly confirmed that the guidance was consistent with the regulator's intent.<sup>59</sup> The FSA has even moved away from prescribing the specific examinations that individuals engaged in particular financial-sector activities must pass. Now, firms choose from a list of examinations based on what they believe is appropriate to their circumstances.<sup>60</sup> In terms of its own processes, the FSA has moved to a risk-based regulatory approach (assisted by the "Arrow" methodology),<sup>61</sup> and it emphasizes consultation with the public and industry. The FSA consults on many aspects of its operations, and it even began consulting on streamlining its own Enforcement and Decision-Making manuals in early 2007.<sup>62</sup> Also, it has shifted some of the innovative burden from itself to industry—for example, in challenging industry to propose a credible solution to conflict-of-interest issues arising from soft commission and bundled brokerage arrangements.<sup>63</sup> The FSA considers its work unfinished; its Business Plan for 2007/8, which sets out its priorities for the coming year, focuses on the organization's ongoing drive toward "more principles-based regulation."<sup>64</sup>

Significantly, the FSA's move toward a principles-based approach is something other than deregulation, outsourcing, or reduced regulation. John Tiner, the FSA's Chief Executive, recently described his organization's principles-based approach to include "[t]he heightened significance of

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<sup>58</sup>FSA, BETTER REGULATION ACTION PLAN PROGRESS REPORT (2006), [http://www.fsa.gov.uk/pubs/other/2660\\_Action\\_plan.pdf](http://www.fsa.gov.uk/pubs/other/2660_Action_plan.pdf), at 8.

<sup>59</sup>FSA, *supra* note 57, at 8.

<sup>60</sup>*Id.* at 10.

<sup>61</sup>*See, e.g.*, FSA, THE FSA'S RISK-ASSESSMENT FRAMEWORK (2006), [http://www.fsa.gov.uk/pubs/policy/bnr\\_firm-framework.pdf](http://www.fsa.gov.uk/pubs/policy/bnr_firm-framework.pdf).

<sup>62</sup>FSA, REVIEW OF THE ENFORCEMENT AND DECISION MAKING MANUALS (2007), [http://www.fsa.gov.uk/pubs/cp/cp07\\_02.pdf](http://www.fsa.gov.uk/pubs/cp/cp07_02.pdf).

<sup>63</sup>FSA, *supra* note 57, at 7.

<sup>64</sup>FSA, FSA BUSINESS PLAN 2007/08 (2007), *available at* <http://www.fsa.gov.uk/pages/Library/Corporate/Plan/bp2007.shtml>.

communication in a principle-based system. Our efforts to rationalise and focus the FSA Handbook. Our enhanced Risk-Based approach. And, managing down regulatory costs.”<sup>65</sup> He argued that principles-based regulation produced simply “better” regulation, meaning simultaneously “(1) a stronger probability that statutory outcomes are secured; (2) lower cost; and (3) more stimulus to competition and innovation.”<sup>66</sup> Like proponents of the FSA approach, proponents of the B.C. Model argued that its principles-based regime could produce both more effective and less costly regulation.

### *C. The B.C. Model as Principles Based and Outcome Oriented*

Bill 38 is principles based relative to other North American securities law regimes.<sup>67</sup> In terms of requirements for regulated issuers, for example, the most striking proposal in Bill 38 would have replaced existing prospectus-disclosure rules, short-form prospectus provisions, the entire exempt-market transaction structure, and existing continuous disclosure obligations with an overarching “Continuing Market Access” structure. Continuous Market Access simply would require all companies accessing

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<sup>65</sup>John Tiner, Remarks at the SII Annual Conference: Better Regulation: Objective or Oxymoron (May 9, 2006), available at [http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0509\\_jt.shtml](http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0509_jt.shtml). See also Clive Briault, Speech at ABI 2007 Conference: Principles-Based Regulation—Moving from Theory to Practice (May 10, 2007), available at [http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2007/0510\\_cb.shtml](http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2007/0510_cb.shtml).

<sup>66</sup>Tiner, *supra* note 65.

<sup>67</sup>Relative to other securities law statutes, the language of Bill 38, *supra* note 9, is also considerably streamlined. The statute is drafted in plain language and the statutory architecture is comparatively stripped down. Compare, for example, §§ 57 and 57.1 of the existing British Columbia Securities Act, [RSBC 1996] c. 418, with § 27 of Bill 38. Both deal with the prohibition on fraud and market manipulation. The two sections in the old Act run to 222 words, and separately address “direct or indirect” engagement or participation in prohibited transactions relating to trading in British Columbia (further subdivided into frauds perpetrated on persons in British Columbia, and frauds perpetrated on “any person anywhere” in connection with B.C. securities) and prohibited transactions by persons in British Columbia. By contrast, the provisions of Bill 38, *supra* note 9, read, in full:

A person must not engage in or participate in conduct relating to securities if the person knows, or reasonably should know, that the conduct

- (a) results in or contributes to a misleading appearance of trading activity in, or an artificial price for, a security, or
- (b) perpetuates a fraud on any person.

the B.C. capital markets to disclose all “material information” (here, replacing “material fact” and “material change”) on a real-time basis.<sup>68</sup> The BCSC argued that the complex rules characteristic of the existing prospectus regime did not help gullible investors or stop fraudulent actors, and it proposed that more effective tools for this purpose were investor education, compliance reviews, and enforcement action.<sup>69</sup> As noted above, Canadian securities regulators have since taken a collective step in this direction through the use of National Instruments.<sup>70</sup> Another sweeping principles-oriented move in the B.C. Model, relevant to this article’s concern with regulatory oversight of compliance processes and procedures, was the establishment of a Code of Conduct for dealers and advisors.<sup>71</sup>

The B.C. Model replaced detailed rules of conduct for dealers and advisors with an overarching Code of Conduct consisting of twenty-eight

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<sup>68</sup>See Part 5 of Bill 38, *supra* note 9. Canadian securities regimes do not require an equivalent document to the Form S-1 Registration Statement in the United States, so prospectuses must include all information that in the U.S. would be provided by way of Registration Statement. Under the Continuous Market Access approach, public companies would still have to file a detailed prospectus the first time they accessed the public capital markets, much as American issuers file a Form S-1. Bill 38 §1 defines material information as “information relating to the business, operations or securities of an issuer that would reasonably be expected to significantly affect the value or market price of the issuer or a security of the issuer.” For a critical perspective on the impact of the move to a material-information standard, see MINISTRY OF FINANCE (ONTARIO), FIVE YEAR REVIEW COMMITTEE FINAL REPORT—REVIEWING THE SECURITIES ACT (ONTARIO) (2003), <http://www.fin.gov.on.ca/english/publications/2003/5yrsecuritiesreview.pdf>. The Committee’s most compelling criticism is that material-information disclosure seems to impose a heavy burden on an issuer to be aware of information external to that issuer.

<sup>69</sup>BCSC, NEW CONCEPTS FOR SECURITIES REGULATION: A NEW WAY TO REGULATE (2002), [http://www.bsc.bc.ca/uploadedFiles/2002\\_New\\_Concepts.pdf](http://www.bsc.bc.ca/uploadedFiles/2002_New_Concepts.pdf).

<sup>70</sup>See *supra* note 16.

<sup>71</sup>Other innovations included firm-only registration (which was abandoned before the project as a whole was abandoned), secondary market liability (which may be resurrected, accompanied by similar provisions in Ontario), enhanced enforcement powers, and replacing existing prospectus and continuous disclosure rules with a “Continuous Market Access” approach. See BCSC, INVESTOR REMEDIES IN SECURITIES LEGISLATION—A REGULATORY IMPACT ANALYSIS (2004), [http://www.bsc.bc.ca/uploadedFiles/RIA\\_Investor\\_Remedies\(1\).pdf](http://www.bsc.bc.ca/uploadedFiles/RIA_Investor_Remedies(1).pdf); BCSC, ENFORCEMENT OF OUTCOMES-BASED SECURITIES LEGISLATION (2004), [http://www.bsc.bc.ca/uploadedFiles/RIA\\_Enforcement\(1\).pdf](http://www.bsc.bc.ca/uploadedFiles/RIA_Enforcement(1).pdf) [hereinafter BCSC, ENFORCEMENT]; CHRISTINA WOLF, BCSC, BETTER DISCLOSURE, LOWER COSTS—A COST-BENEFIT ANALYSIS OF THE CONTINUOUS MARKET ACCESS SYSTEM (2002), [http://www.bsc.bc.ca/uploadedFiles/CBA\\_Report.pdf](http://www.bsc.bc.ca/uploadedFiles/CBA_Report.pdf); CHRISTINA WOLF, BCSC, COST SAVINGS UNDER A FIRM-ONLY REGISTRATION SYSTEM (2004), [http://www.bsc.bc.ca/uploadedFiles/RIA\\_Firm-Only\\_Registration\(1\).pdf](http://www.bsc.bc.ca/uploadedFiles/RIA_Firm-Only_Registration(1).pdf).

rules arranged under eight broad “standards.”<sup>72</sup> According to the BCSC, the B.C. Model requires those subject to securities regulation in British Columbia to use their own or industry experience to develop strategies, uniquely tailored to their business, for abiding by the regulatory requirements. The Code of Conduct provisions dealing with compliance systems are of particular interest here, and they impart a sense of the Code’s generality and its high-level (almost ethics-level) abstraction.<sup>73</sup> As at the FSA, each provision is accompanied by nonbinding regulatory guidelines.<sup>74</sup> The first two of the seven compliance-related provisions, which

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<sup>72</sup>Because the BCSC delegates frontline regulatory authority over most dealers and advisors to two self-regulatory organizations, the Investment Dealers Association (IDA) and the Mutual Fund Dealers Association, the practical impact of the Code is blunted. In addition to the existing Securities Act and Rules, most dealers and advisors (but not, for example, portfolio managers) are also subject to rules promulgated by those self-regulatory organizations (SROs). Participants in Commission-sponsored public consultations have argued that coordination with the SROs is required so that those organizations’ approaches do not subvert the Commission’s. BCSC, DEREGULATION PROJECT—COMMENTS FROM TOWN HALL AND FOCUS GROUP MEETINGS (2002), [http://www.bcsc.bc.ca/uploadedFiles/2002\\_ConsultationOverview\\_Feb.pdf](http://www.bcsc.bc.ca/uploadedFiles/2002_ConsultationOverview_Feb.pdf). The IDA, in particular, also has been moving toward a principles-based approach. See PAUL C. BOURQUE, ADDRESS AT THE IDA RED TAPE CONFERENCE: NEW APPROACHES TO REGULATING THE FINANCIAL SERVICES SECTOR (Sept. 25, 2002), [http://www.ida.ca/Files/Media/RecSpeech/2002\\_RedTapeConference\\_en.pdf](http://www.ida.ca/Files/Media/RecSpeech/2002_RedTapeConference_en.pdf); see also Kane, *supra* note 52.

<sup>73</sup>The compliance systems provisions are not more broadly cast than most other provisions of the Code of Conduct. For example, the principal Code requirement with respect to conflicts of interest states, “Resolve all significant conflicts of interest in favour of the client. Use fair, objective, and transparent criteria. If there are conflicts of interest between or among clients, use fair, objective, and transparent criteria to manage those conflicts. Apply the criteria consistently in all cases.” BCSC, SECURITIES REGULATION IN BRITISH COLUMBIA: GUIDE FOR DEALERS AND ADVISORS (2004), [http://www.bcsc.bc.ca/uploadedFiles/Guide\\_Dealers\\_Advisers.pdf](http://www.bcsc.bc.ca/uploadedFiles/Guide_Dealers_Advisers.pdf), at 25. This statement is one of four that, along with general interpretive “Guidelines” provided by the Commission, constitute the new regime’s approach to conflicts of interest. This can be contrasted with the thirteen separate provisions of the B.C. *Securities Rules* that previously addressed conflicts of interest. B.C. *Securities Rules*, 194/97 B.C. Reg. §§ 16, 53, 54, 75–85.

<sup>74</sup>In Canada, as in the United States and the United Kingdom, administrative guidance is nonbinding. Its promulgation does not require that the administrative agency in question engage in notice-and-comment rulemaking. For a thoughtful discussion of the distinction between guidance and rules in the United States, see Peter L. Strauss, *Publication Rules in the Rulemaking Spectrum: Assuring Proper Respect for an Essential Element*, 53 ADMIN. L. REV. 803 (2001). Administrative guidance has not been the subject of widespread litigation in Canada. The notable exception is the *Ainsley* case, in which the Ontario Securities Commission was held to have issued *binding* policy statements governing the operation of penny stock dealers without regard to its notice-and-comment obligations. *Ainsley Financial Corporation et al. v. Ontario Securities Commission et al.*, 14 O.R. (3d) 280 (Ont. Ct. (Gen. Div.) 1993).

will be discussed later in an example involving dealer-firm account supervision,<sup>75</sup> state:

19. *Maintain an effective system to ensure compliance* with this Code, all applicable regulatory and other legal requirements, and your own internal policies and procedures. (Associated guidelines begin, “You must develop, implement, and monitor a written compliance system that satisfies the requirements of the Code. . . .”)

20. *Maintain an effective system to manage the risks associated with your business.* (The Guidelines begin, “You must think about the risks associated with your business that are additional to regulatory risks and design your compliance system to account for those additional risks. . . .”)<sup>76</sup>

In support of its approach, the BCSC argues that prescriptive requirements emphasize the wrong things. That is, they encourage firms to focus on detailed compliance rather than to exercise sound judgment with a view to the best interests of their clients and the markets. Detailed and top-down requirements also calcify the regulatory system to reflect one-size-fits-all industry practice in a particular point in time. By contrast, the BCSC argues, general obligations subject to industry-driven reflection and amendment ensure sustainability, in that industry can evolve unhindered by overregulation. They also ensure flexibility, in that emerging issues that should be regulated are addressed in the general course, because market participants need to consider the purpose of the rules in the context of the objectives of securities regulation when making compliance decisions.<sup>77</sup> The BCSC also argues that compliance will increase if rules are fewer, easily understood, and adequately communicated.<sup>78</sup>

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<sup>75</sup>See *infra* Part II.D.

<sup>76</sup>BCSC, *supra* note 73 (emphasis added).

<sup>77</sup>BCSC, NEW PROPOSALS FOR SECURITIES REGULATION: A NEW WAY TO REGULATE (2002), [http://www.bcsc.bc.ca/uploadedFiles/2002\\_New\\_Proposals.pdf](http://www.bcsc.bc.ca/uploadedFiles/2002_New_Proposals.pdf) [hereinafter NEW PROPOSALS].

<sup>78</sup>BCSC, *supra* note 69. Another factor that makes British Columbia’s view on principles-based regulation controversial is the province’s history in securities regulation. The signaling effect of the new regime is different because British Columbia was once home to the now-defunct Vancouver Stock Exchange, notorious in the 1980s and 1990s as the “scam capital of the world.” Joe Queenan, *Scam Capital of the World*, FORBES, May 29, 1989, at 132 (describing the Vancouver Stock Exchange as “the longest-standing joke in North America” and “[r]umored to be a laundering vehicle for mobsters and undesirables”). The regulatory environment in British Columbia has changed profoundly since those years. See, e.g., Greg Potter, *Digging in the Dirt*, B.C. BUSINESS, Aug. 1, 2005, at 30 (describing the contemporary Vancouver-based mining industry as credible, scrupulous, and closely regulated). By contrast, when speaking of the SEC, the notion of principles-based regulation sometimes conjures up the opposite image

The second essential component of the B.C. Model—implicit in its operation but not found on the face of Bill 38—is an outcome-oriented approach and the attendant rolling-in of some new learning about compliance and enforcement best practices.<sup>79</sup> Industry involvement in developing the content of rules to which industry will be subject is integral to outcome-oriented regulation. The roots of outcome-oriented regulation are with the insights of the “reinventing government” or “new public management” movements in public service provision.<sup>80</sup> In broad strokes, those approaches advocated a more results-oriented approach to public administration, including substantial devolution to industry, risk-based management, and transparency and accountability through continual re-evaluation of government performance based on performance metrics.<sup>81</sup>

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—that of regulatory overreaching. *See, e.g.*, Letter from KPMG to Jonathan G. Katz, Secretary, SEC, re Proposed Revision of the Commission’s Auditor Independence Requirements (Sept. 25, 2000) (on file with the SEC under File No. S7-13-00), available at <http://www.sec.gov/rules/proposed/s71300/kpmg2.htm> (arguing that the proposed guidelines on auditor independence constitute substantive regulation that exceeds the SEC’s authority and that proposed principles would create arbitrary and vague criteria for independence). This is partly a function of the American historical worry about the overreaching administrative/regulatory state, which does not have firm foundations in American constitutional law. *See, e.g.*, Roberta S. Karmel, *Realizing the Dream of William O. Douglas—The Securities and Exchange Commission Takes Over Corporate Governance*, 30 DEL. J. CORP L. 79 (2005) (identifying historic worries about SEC overreaching, although not identifying the SEC’s foray into corporate governance as principles based).

<sup>79</sup>The B.C. Model buttressed these innovations with enhanced enforcement and public interest powers, including a legislative prohibition on “unfair practices,” the Commission power to order disgorgement, and provisions allowing any “interested person [who] believes that another person has contravened” Bill 38 or the associated regulations to apply to the Commission to hold a hearing. Bill 38, *supra* note 9, §§ 29, 61 & 64. Proposed provisions that would have given the Commission the power to prohibit a professional from practicing before the Commission, if the professional had intentionally contravened the securities legislation, did not survive to the final version of Bill 38. *See* NEW PROPOSALS, *supra* note 77, at 99–100.

<sup>80</sup>The “New Public Management” reforms are commonly associated with the Westminster-style governments, while the term “Reinventing Government” refers to the reform movement in the United States. Corresponding public-sector innovations were known as “National Performance Review” in the United States under the Clinton Administration and “Program Review” in Canada under Prime Minister Jean Chrétien. *See generally* PETER AUCOIN, *THE NEW PUBLIC MANAGEMENT: CANADA IN COMPARATIVE PERSPECTIVE* (1995); DONALD F. KETTL, *THE GLOBAL PUBLIC MANAGEMENT REVOLUTION* (2d ed. 2005); DAVID OSBORNE & TED GAEBLER, *REINVENTING GOVERNMENT: HOW THE ENTREPRENEURIAL SPIRIT IS TRANSFORMING THE PUBLIC SECTOR* (1992). There are, of course, important differences between the national movements. They are beyond the scope of this article.

<sup>81</sup>Recently, Patrick Dunleavy and his colleagues have identified three overarching themes around which they suggest another diverse set of second-tier New Public Management—

One scholar who emerged in response to the Reinventing Government movement in the United States had a direct impact on the B.C. Model. Malcolm Sparrow's contribution was to incorporate the new learning processes, *mutatis mutandis*, into regulatory functions.<sup>82</sup> His approach illustrates the application of outcome-oriented principles to the regulatory (as opposed to public-service provision) task. Sparrow described how the most effective modern regulatory techniques use sophisticated problem-solving methods and self-reflective analysis to do the difficult work of "pick[ing] important problems and solv[ing] them." He found that certain common elements characterized the best innovations in regulation: (1) a clear focus on *results* and effectiveness, based on an expanded and more specific set of indicators *including* "big picture" high-level impacts, behavioral outcomes (compliance rates, agency activities), and resource efficiency; (2) adoption of a disciplined *problem-solving* approach; and (3) an investment in collaborative partnerships where feasible.<sup>83</sup> Sparrow was an explicit muse for the BCSC in devising the B.C. Model.<sup>84</sup>

#### *D. Examples: Investment Dealers' Account Supervision and Cartaway*

In November 2003 the BCSC published a useful regulatory impact analysis that compared account supervision systems mandated by the current, rule-based approach with those of the proposed B.C. Model (the "Account Supervision Case").<sup>85</sup> The BCSC's report analyzed the impact of the B.C.

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inspired approaches have been introduced: (1) disaggregation—splitting up public-sector hierarchies into wider and flatter hierarchies; (2) competition—separating purchaser and provision to create more competition and diversity among potential providers; and (3) incentivization—rewarding performance, particularly with pecuniary incentives. Patrick Dunleavy et al., *New Public Management is Dead—Long Live Digital Era Governance*, 16 J. PUBLIC ADM. RES. & THEORY 467 (2006).

<sup>82</sup>MALCOLM SPARROW, *THE REGULATORY CRAFT: CONTROLLING RISKS, SOLVING PROBLEMS, AND MANAGING COMPLIANCE* (2000).

<sup>83</sup>*Id.* at 99–122 & 155–70.

<sup>84</sup>In a speech to the Task Force to Modernize Securities Legislation in Canada, the BCSC Vice Chair Brent Aitken stated that the BCSC had been "following Sparrow's methodology since 2001." BRENT W. AITKEN, BCSC, *ANOTHER WAY FORWARD FOR SECURITIES REFORM* (Oct. 14, 2005), [http://www.bcsc.bc.ca/uploadedFiles/Aitken\\_Presentation\\_IDA\\_Oct2005.pdf](http://www.bcsc.bc.ca/uploadedFiles/Aitken_Presentation_IDA_Oct2005.pdf), at 6.

<sup>85</sup>CHRISTINA WOLF, BCSC, *STRONG AND EFFICIENT INVESTOR PROTECTION: DEALERS AND ADVISERS UNDER THE B.C. MODEL—A REGULATORY IMPACT ANALYSIS* (2003), [http://www.bcsc.bc.ca/uploadedFiles/Regulatory\\_Impact\\_Analysis.pdf](http://www.bcsc.bc.ca/uploadedFiles/Regulatory_Impact_Analysis.pdf).

Model on four firms that were members of the IDA, the self-regulatory organization to which the various Canadian provincial securities commissions delegate frontline regulatory oversight of investment dealers.<sup>86</sup> As such, the four firms were subject to the IDA's rules governing account supervision. Each of the four firms studied had distinct operational characteristics: two were national dealers (one Toronto based and bank owned and one large but local and independent), and two were regional dealers (one medium sized and the other small).<sup>87</sup> While account supervision was regulated both under the existing system and the B.C. Model, the firms believed they would change their practices significantly under the B.C. Model.<sup>88</sup>

According to the BCSC's analysis, existing IDA account supervision rules are much more detailed than the B.C. Model's requirements. The IDA requires daily and monthly reviews of accounts for trading violations, suitability, and business risk factors. The IDA-mandated reviews are transactional in nature. Moreover, IDA policy requires the daily reviews to assess each trade against nineteen criteria (and more if the trade is in futures or options). The policy contains many thresholds that define which trades need to be reviewed. For example, every account with over \$1,500 of commissions in a given month must be reviewed. The IDA enforced its specific procedures by auditing firms tightly for compliance.<sup>89</sup>

The firms, however, did not find the transaction-based daily and monthly reviews useful in detecting abuses characterized by patterns of behavior, which is where they thought the biggest risks arose. Front running and stock manipulation, for example, may be ascertainable only by way of a review of trading patterns, which are not readily visible with the transactional focus mandated by the IDA's daily and monthly reviews. The firms also felt that the daily and monthly reviews were duplicative and that the policy-derived thresholds governing the daily reviews were both too low and too rigid. For example, the \$1,500 threshold caught thousands of

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<sup>86</sup>Because SRO rules are the dominant factor for such firms, *see supra* note 72, to be effective the B.C. Model would have to involve corresponding principles-based changes to those rules as well.

<sup>87</sup>WOLF, *supra* note 85, at 6.

<sup>88</sup>*Id.* at 7.

<sup>89</sup>*Id.* at 13.

self-directed trades, trades in blue chip stocks, and other sales transactions that did not carry large risks. Yet, the threshold failed to catch mutual fund trades, which do not generate commissions, even though very active trading in mutual funds could raise a red flag with respect to an account's treatment. According to one firm, up to 85% of transactions caught by the daily reviews did not warrant scrutiny. Out of ninety mandated criteria for daily transaction-based reviews, the firms would have eliminated twenty-three entirely and would have modified most of the rest. In particular, the firms felt that a supervision regime using risk-based sampling would be significantly more efficient. According to the BCSC's analysis, the firms were unanimous in their view that the IDA-mandated system contributed significantly to their regulatory burden without providing meaningful investor protection. The burden was aggravated by the need to maintain extensive documentation of compliance (including maintaining separate paper records, even where electronic records were generated) for IDA audit purposes.<sup>90</sup>

The inefficiency of the mandated reviews was a concern for the firms, but the transaction-based reviews' failure to detect key forms of high-risk behavior was even more troubling. As a result of the perceived limitations in the mandated reviews, each of the firms already had developed its own parallel supervisory system, which it thought better managed compliance risks. One of the large dealers stated that it detected 90% of potential compliance problems through its proprietary system, which it ran first, and that daily reviews caught the remaining 10% of potential problems. Yet, each process took the same amount of time. The need to conduct the mandated reviews drained resources away from the more effective internal system. Regardless of the efficacy of their internal systems, dealers were still required to comply with procedures mandated under the IDA rules. Significantly, the dealers involved pointed out that they felt they needed to ensure their accounts were adequately supervised regardless of regulatory requirements, for civil liability reasons, for reputational ones, and because they considered it to be good business practice.<sup>91</sup>

Certainly some of the problems with the IDA's mandated reviews could be ameliorated by modifying the rules themselves; for example, the IDA could eliminate its requirement for paper records where suitable and

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<sup>90</sup>*Id.* at 13–15 & 17.

<sup>91</sup>*Id.* at 14–17.

secure electronic records existed. Perhaps following industry consultation, it could reconsider some of its ninety mandated criteria for daily reviews. However, this kind of tinkering does not solve the larger problem: that the regulator, based on its own incomplete knowledge base, had issued detailed and static requirements when the firm's own experience and incentives would have produced more efficient and effective ones. The IDA requirements also treated each firm the same, even though each one worked in a different environment and carried a substantially different risk profile. For example, while each firm thought there was some continued utility to transactional reviews, the firms cited several different reasons for thinking so.<sup>92</sup> Moreover, each firm suggested a different alternative to the existing policy-based thresholds for winnowing out those daily transactions that warranted a closer look. While each of the firms would still use some form of analytical threshold, they would have modified the thresholds in different ways based on their own compliance experiences and their understanding of their own businesses.<sup>93</sup> What is required, then, is more than retooling the rules. Static and detailed rules are blunt instruments, and they will necessarily be ill fitting in some situations. They are also incapable of reflecting new learning, including from the firms' own proprietary risk-management systems. In that context, the BCSC's regulatory impact analysis argued that the perceived consistency benefit of the existing system was at best outweighed by its cost and was at worst illusory.<sup>94</sup>

In contrast, the principles-based and outcome-oriented B.C. Model would require adequate account supervision not by way of detailed rules, but through the Code of Conduct provisions dealing with compliance systems. The relevant provisions are the ones set out above: that a firm must "maintain an effective system to ensure compliance with the Code, other legal requirements, and its own internal policies and procedures," and it must "maintain an effective system to manage the risks associated with its business."<sup>95</sup> The key advantages of the B.C. Model over the existing one, as the Account Supervision Case demonstrates, redound both to efficiency and effectiveness. Because the B.C. Model is outcome oriented rather than

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<sup>92</sup>*Id.* at 13.

<sup>93</sup>*Id.* at 16.

<sup>94</sup>*Id.* at 18.

<sup>95</sup>See BCSC, *supra* note 73.

process oriented, each firm would be in a position to develop the “effective systems to ensure compliance” that best suited its own risk profile. As the firms’ own proprietary systems demonstrate, the firms are already using outcome-oriented mechanisms.<sup>96</sup> The principles-based model permits firm innovation in compliance processes, allowing firms to sharpen their compliance practices and procedures without fear of violating detailed (and potentially anachronistic and less effective) regulatory requirements.<sup>97</sup> The BCSC’s regulatory impact analysis did not acknowledge another consideration, though it is equally valid: that an outcome-based regulatory requirement relieves the regulator itself of the need to be possessed of perfect information about how to ensure compliance. Buttressed, always, by credible enforcement to deal with intransigents, outcome-oriented regulation resituates the informational burden onto the parties generally best equipped and most motivated to bear it—the firms themselves.

Interestingly enough, the BCSC’s regulatory impact analysis and a follow-up report issued in May 2004 also point out that in certain circumstances the principles-based approach would actually provide more clarity and certainty than the existing statutory regime.<sup>98</sup> Alongside its specific requirements, the existing regime accords the BCSC broad powers to act “in the public interest” in responding to misfeasance not covered by existing statute and rules.<sup>99</sup> *Re Cartaway*,<sup>100</sup> a notorious B.C. case, illustrates the problem. In brief, the respondents were among a group of eight individual brokers employed by a registered dealer. Without adequate disclosure, they personally invested in a small publicly listed company they intended to use as a shell, and they funneled some mining claims into it through a shelf company. They entered into a private placement, which

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<sup>96</sup>WOLF, *supra* note 85, at 19.

<sup>97</sup>*Id.*

<sup>98</sup>*Id.* at 43–45; BCSC, ENFORCEMENT, *supra* note 71, at 10–13.

<sup>99</sup>B.C. Securities Act §§ 161 & 162. Other Canadian provinces’ statutes have similar or equivalent provisions. *See, e.g.*, Ontario Securities Act, R.S.O. 1990, c. S.5, §127.

<sup>100</sup>2000 BCSECCOM 88 (Oct. 2, 2000), *available at* <http://www.bccsc.bc.ca/enforcement.asp> (search Decisions and Orders). The Commission found that it was in the public interest to impose the maximum administrative penalty available under the B.C. Securities Act on two of the brokers. Its enforcement decision was appealed to the Supreme Court of Canada on the questions of what factors the Commission could consider in exercising its public interest powers and the standard of review for judicial review of the exercise of the Commission’s public interest powers. *See Cartaway Resources Corp. (Re)*, [2004] 1 S.C.R. 672.

they split among friends, without disclosing to investors the material change in Cartaway's business from a company in the business of licensing residential garbage containers in the small city of Kelowna, British Columbia, to a mining exploration firm with claims in Voisey's Bay, Labrador, then the site of a major staking rush. A few months later they entered into another private placement, with the brokers' registered dealer as agent. Cartaway (through its principals, the respondents) disclosed the acquisition of the Voisey's Bay claims during this second offering but did not disclose the respondents' roles in acquiring the claims, the brokers' controlling shareholdings in Cartaway, or any of the related conflicts of interest. The offering was oversubscribed by a factor of four to one, and all of that offering was placed with the dealer's clients.<sup>101</sup>

The BCSC found that the respondent brokers had contravened various specific sections of the British Columbia Securities Act and Rules, including disclosure requirements, but that some of the brokers' most egregious behavior did not contravene any specific provisions. The BCSC therefore relied on its public interest powers to sanction the brokers for acting contrary to the public interest, by putting themselves in a position of conflict of interest with their clients' best interests, by acting in their own interests rather than their clients', by failing in their duties as "gatekeepers," and by deceiving and intentionally misleading their dealer, its clients, the relevant exchange, and the public.<sup>102</sup>

In support of the B.C. Model, the BCSC points out that the facts in *Cartaway* would have implicated directly several specific principles in the proposed Code of Conduct for Dealers and Advisors, including prohibitions on deceptive and misleading conduct, conflicts of interests, and conduct damaging to the reputation of securities markets.<sup>103</sup> The *Cartaway* case emphasizes that the B.C. Model should be analyzed not by comparison to a perfect rule-based system, but to the existing system, which is characterized by sometimes ill-fitting rules, necessarily accompanied by a sweeping residual public interest power.<sup>104</sup>

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<sup>101</sup>2000 BCSECCOM 88.

<sup>102</sup>BCSC, ENFORCEMENT, *supra* note 71, at 11–12.

<sup>103</sup>*Id.* at 12–13.

<sup>104</sup>This observation is also relevant to charges that principles-based enforcement raises concerns about procedural fairness or due process. Notably, the Canadian Supreme Court has been willing to accept that broadly worded regulatory requirements do not necessarily violate

### III. IMPLICATIONS FOR FIRM COMPLIANCE

#### *A. New Governance and the New Regulator*

As the above example demonstrates, the B.C. Model imagines a substantially different relationship between regulator and industry—one that acknowledges the value of the specific, contextual knowledge that industry actors themselves have in establishing effective and appropriate regulatory standards. Correlatively, the B.C. Model also requires a somewhat reimagined regulator that is more pragmatic, more willing to devolve responsibility to industry, and perhaps humbler about how well informed and well equipped it is relative to industry itself. Rather than seeing the regulator as the central articulator of non-negotiable, specific requirements, the B.C. Model requires the regulator to define broad themes, to articulate them on a flexible and dynamic basis, to accept input from the ground level of regulated entities, and to effectively manage varied incoming information from industry actors.

New Governance imagines a similar role for the regulator. The term New Governance has emerged as an overarching moniker to refer to a new approach in legal scholarship that emphasizes not legal doctrine or formal jurisprudence, but rather how change actually happens within complex real-life social systems.<sup>105</sup> New Governance identifies ongoing deliberation

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constitutional protections. See *Ontario v. Canadian Pacific Ltd.*, [1995] 2 S.C.R. 1031 (holding that a prohibition in the Environmental Protection Act on polluting the natural environment “for any use that can be made of it” did not violate section 7 of the Canadian Charter of Rights and Freedoms on the basis of vagueness or overbreadth); *Canadian Foundation for Children, Youth and the Law v. Canada (Attorney General)*, [2004] 1 S.C.R. 76 (holding that a Criminal Code provision allowing parents and others to use force toward a child, “if the force does not exceed what is reasonable under the circumstances,” did not violate section 7 of the Charter on the basis of vagueness or overbreadth).

<sup>105</sup>Other terms include “democratic experimentalism,” “reflexive law,” “responsive regulation,” and “network governance.” A very limited list of key New Governance works would include Michael C. Dorf & Charles F. Sabel, *A Constitution of Democratic Experimentalism*, 98 COLUM. L. REV. 267, 345–56 (1998); James S. Liebman & Charles F. Sabel, *A Public Laboratory Dewey Barely Imagined: the Emerging Model of School Governance and Legal Reform*, 28 N.Y.U. REV. L. & SOC. CHANGE 183 (2003); Charles F. Sabel & William H. Simon, *Destabilization Rights: How Public Law Litigation Succeeds*, 117 HARV. L. REV. 1015 (2004); Susan P. Sturm, *A Normative Theory of Public Law Remedies*, 79 GEO. L.J. 1357, 1365–76 (1991); Susan Sturm, *Second Generation Employment Discrimination: A Structural Approach*, 101 COLUM. L. REV. 458, 555 (2001). On the similarities and differences between various New Governance perspectives, including the ones above, see Bradley C. Karkkainen, “New Governance” in *Legal Thought and In the World: Some Splitting as Antidote to Overzealous Lumping*, 89 MINN. L. REV. 471 (2004); Orly Lobel, *The Renew Deal: The*

as the most legitimate and most effective mechanism for making decisions in complex organizational structures. Deliberation is accomplished by decentralized, broadly participatory stakeholder groups that can access local knowledge and context-specific understandings of a situation. New Governance securities regulation, then, entails a regulatory structure that spans the so-called public/private divide, pulls industry experience into regulatory decision making, and establishes robust ongoing communication mechanisms (rather than an information-hoarding, adversarial relationship) between industry and regulator. The regulator establishes broad policy guidelines and regulatory goals for industry action. It cooperates with industry where possible in determining means to achieve those goals. However, on the basis that industry generally has access to superior contextual information, it refrains from describing the specific content of those principles, including the precise means by which industry ought to achieve the articulated regulatory goals. Individual firms thus are able to use their own superior knowledge of their particular firm needs and vulnerabilities to innovate, while remaining accountable for their performance. At the same time, the regulator collects and analyzes firms' diffuse contextual knowledge to produce a system that is more adept at learning from its own experience.

A New Governance-style, principles-based approach has special relevance to firm compliance functions—meaning those policies, processes, and systems that firms themselves must have in place to prevent and detect internal wrongdoing and violations of law. In the compliance context, New Governance permits a dynamic and continually reevaluated internal understanding of compliance. Most firms will try to abide by most credibly enforced and reasonable regulatory requirements, in part for pragmatic business reasons. The enforcement of law, like law itself, serves an expressive purpose. Regulatory approval (or at least the absence of regulatory condemnation) confers legitimacy on firm operations, and it has currency with clients, suppliers, creditors, and industry peers.<sup>106</sup> However,

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*Fall of Regulation and the Rise of Governance in Contemporary Legal Thought*, 89 MINN. L. REV. 342 (2004).

<sup>106</sup>See Avitai Aviram, *Regulation by Networks*, 2003 BYU L. REV. 1179 (2003) (describing “network effects” as a mechanism for private ordering and self-regulation); Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253 (1999) (arguing that corporate actors are motivated less by the desire to avoid liability than by the joint effect of social norms and the correlative prospect of financial gain in the market); Edward B. Rock, *Saints and Sinners: How Does Delaware*

a regulatory regime based on overly detailed and prescriptive rules sends the message, even to generally law-abiding firms, that observing the strict letter of the law is what matters and that responsible actors may take advantage of loopholes, perhaps even with a clear conscience. If adherence to externally defined, checklist-style compliance indicators confers the legitimacy that firms seek, then the firms have an incentive to adhere to those checklist-style compliance indicators and nothing more. Worse yet, firms may purchase compliance programs modeled on the prescriptive rules, regardless of their perceived efficacy, as insurance against enforcement action. In this way, compliance-related regulatory requirements might actually generate moral hazards that undermine corporate governance objectives.<sup>107</sup> Moreover, for that minority of industry actors that is inclined actively to seek out loopholes and to avoid regulatory requirements, a rules-based system will do nothing to address that inclination. Creating ever-longer lists of prohibited behavior or checklists of compliance-related best practices will not be effective if the basic culture of the firm does not foster law-abiding behavior.<sup>108</sup>

By contrast, a principles-based regime sets out requirements governing, for example, “reasonable and effective” compliance programs and requires industry actors to take the responsibility for determining how to meet those outcomes in the particular context of their businesses. At a minimum, such an approach forces firms to turn their minds to their

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*Corporate Law Work?*, 44 UCLA L. REV. 1009 (1997) (arguing that that Delaware corporate law, as interpreted by courts, is best understood as attempts to create social norms for senior managers, directors, and the lawyers who advise them); Mark C. Suchman, *Managing Legitimacy: Strategic and Institutional Approaches*, 20 ACAD. MGMT. REV. 571 (1995) (arguing that law shapes organizational conduct not only because of law’s cultural weight, but also because organizational legitimacy is pragmatically linked to benefits and penalties); Cass Sunstein, *Social Norms and Social Roles*, 96 COLUM. L. REV. 903 (1996).

<sup>107</sup>See Kimberley D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U. L.Q. 487 (2001) (arguing that placing excessive importance on compliance structures raises dangers of underenforcement and social waste); William S. Laufer, *Corporate Liability, Risk Shifting, and the Paradox of Compliance*, 52 VAND. L. REV. 1343 (1999) (arguing that the moral hazard will persist until prosecutors and firms share a consistent understanding of what an “effective” compliance system entails, as well as a workable metric for evaluating compliance systems). As is evident from the discussion above, this article disagrees with Laufer’s and Krawiec’s to the extent that they argue for more specification and more certainty as a response to problems of facial compliance.

<sup>108</sup>For example, Enron’s Code of Ethics, with its Vision and Values platform encompassing its RICE (Respect, Integrity, Communication, and Excellence) values statement, was once cited as a model corporate code of ethics. BETHANY McLEAN & PETER ELKIND, *THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON* (2003).

compliance processes and those processes' relationships to their particular business risks. This attention forcing should reduce noncompliance associated with managerial distraction. Principles-based regulation also sends the important message that firms should orient themselves toward underlying principles of responsible business practice, rather than toward facial compliance with detailed rules. Principles-based systems, buttressed by meaningful regulatory oversight, make "cosmetic compliance" harder. Requiring firms to fill in the content of those principles themselves makes firms *agents* rather than subjects of regulation. It has the potential to dissipate firm resistance to externally imposed regulatory rules, which (according to some firms) fail to appreciate the particular nuances of their business and needs.<sup>109</sup> Endogenous, engaged experience is more likely to produce real learning and a more genuine compliance culture within the firm.<sup>110</sup>

Equally important is the regulatory system's ability to learn. Learning systems start from agreed premises of existing law, but they are pragmatic and open to promising new approaches. Effective regulatory learning entails, first, the ability to gather and analyze, in an open-minded way, experience from actual practice and input from industry actors and other stakeholders, including, of course, regulators' own experiences. Systems, including regulatory systems, also learn better and faster where they include some sort of mechanism for amplifying "local" learning, for example, by way of parallel experiments moderated and overseen by a clearinghouse-style regulator. With New Governance, the regulator serves as a centralized information-gathering body that aggregates experience and permits comparative learning between industry actors.<sup>111</sup> New

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<sup>109</sup>See, e.g., EUGENE BARDACH & ROBERT A. KAGAN, *GOING BY THE BOOK: THE PROBLEM OF REGULATORY UNREASONABLENESS* (1982) (describing causes of, and site-level frustration with, legalistic enforcement efforts); Robert B. Cialdini, *Social Influence and the Triple Tumor Structure of Organizational Dishonesty*, in *CODES OF CONDUCT: BEHAVIORAL RESEARCH INTO BUSINESS ETHICS* 44 (David M. Messick & Ann E. Tenbrunsel eds. 1996) (suggesting that overmonitoring can decrease employees' independent motivation to comply with law).

<sup>110</sup>See Cristie L. Ford, *Toward a New Model for Securities Law Enforcement*, 57 *ADMIN. L. REV.* 757, 791–92 & 806–10 (2005). See also Edward L. Rubin, *Images of Organizations and Consequences of Regulation*, 6 *THEORETICAL INQ. L.* 347, 376–77 (2005) (attributing to a "systems theory" approach the notion that "legal regulation of the corporation cannot rely on the imposition of specific stimuli; rather, it will be effective only if it can induce an internal process that integrates the corporation with other social systems").

<sup>111</sup>See, e.g., Dorf & Sabel, *supra* note 105, at 287–89 & 354–56 (describing innovative regulatory strategies that combine local experimentation with a centralized standard-setting and

Governance envisions a “learning by doing” structure, meaning that industry and regulator continually revise both ends and their own process through their participation in it. Transparency and accountability, including accountability for adhering to non-negotiable participatory norms, are reinforced by the centralized comparative data analysis function.<sup>112</sup>

In the Account Supervision Case above, each firm in question was running its own live experiment with supervision processes, considerably disciplined by real fears of civil liability and adverse reputational effects in the event of failure. The regulator collected their experience and analyzed the ways in which different actors reached different solutions to the problem of supervision, simultaneously learning about effective means for achieving regulatory goals. Generally, this demonstrates the need for firms

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information-processing clearinghouse, which coordinates the local experiment and generates “rolling” performance principles); Brandon L. Garrett & James S. Liebman, *Experimentalist Equal Protection*, 22 YALE L. & POL’Y REV. 261, 291–92 (2004) (describing the continuous information flow between local units and a central regulator). At least one scholar has argued that experimentalism effectively eliminates the dialectic between rules and principles. See William H. Simon, *Toyota Jurisprudence: Legal Theory and Rolling Rule Regimes*, in LAW AND NEW GOVERNANCE IN THE EU AND THE US 37 (Gráinne de Búrca & Joanne Scott eds. 2006) (arguing that what Simon calls the Toyota Production System combines a commitment to tightly articulated, formalized norms—that is, detailed rules—with a commitment to continually adjusting, revising, and re-writing those rules as they come into tension with unanticipated circumstances). Simon’s perspective is not inconsistent with my own, although it is more ambitious. We would both probably agree that principles-based regulation, when buttressed by outcome-oriented regulatory practice, responds to the classic vagueness concerns about the use of principles alone and to the concerns about literalism associated with traditional rules. Because he is dealing with a different context, however, Simon emphasizes the detailed and democratized decision-making implementation stage, and he backgrounds the centralized articulation of principles that is a primary concern here. He also deemphasizes the distinction between the principle articulator (that is, the securities regulator in this case) and the implementer (primarily industry, but also frontline regulators). In the context of the immediate rules-versus-principles debate in securities regulation, this article is reluctant to blur that distinction. It argues that New Governance-style regulation is best understood as a coherent and rational way of filling in the content of principles, rather than a third way altogether.

<sup>112</sup>Similarly, Jody Freeman describes “collaborative governance” in administrative rulemaking as a process characterized by: (1) a problem-solving orientation; (2) participation by interested and affected parties in all stages of the decision-making process; (3) provisional, revisable solutions subject to continuous monitoring and evaluation; (4) accountability that transcends traditional public and private roles in governance, in that parties are interdependent and accountable to each other; and (5) a flexible, engaged regulator that facilitates multistakeholder negotiations, provides appropriate incentives, acts as capacity builder, and takes its ultimate decisions recognizing that regulatory success involves industry collaboration (although it is not ultimately limited by industry consensus). Jody Freeman, *Collaborative Governance in the Administrative State*, 45 UCLA L. REV. 1, 21–22 (1997).

to disclose information about their methods and experience. More particularly, where one or another actor encountered difficulty in developing a workable supervision system, the regulator would be able to draw on others' successful examples to help the struggling actor or pressure it to achieve better results. The regulator could also better identify and then query firms that seemed to be relying on pro forma and potentially sub-optimal compliance responses that appeared imperfect relative to the particular environment and capacities of that firm.

Importantly, as the Account Supervision Case demonstrates, regulation is not the only force pushing firms toward compliance. On the contrary, the shift toward outcome-oriented and principles-based regulation reflects the reality that rules are fashioned in an iterative way, through a polycentric process, in which regulation is only one part.<sup>113</sup> In other words, regulatory requirements are only one component going into what scholars Neil Gunningham, Robert Kagan, and Dorothy Thornton have called an organization's "license to operate."<sup>114</sup> In the Account Supervision Case, reputational effects, network effects, and concerns about civil liability had already driven the firms in question to establish independent supervisory systems to address the failings of the mandated checks.

That said, 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. New Governance theory is to be distinguished from industry self-regulation and also from so-called "soft law" options.<sup>115</sup> In fact, meaningful and effective enforcement capacity is a precondition to New Governance regulation.<sup>116</sup> An

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<sup>113</sup>See, e.g., Christine E. Parker, *Reinventing Regulation Within the Corporation: Compliance-Oriented Regulatory Innovation*, 32 ADMIN. & SOC'Y 529, 531–33 (2000) (describing "compliance-oriented regulation" as taking seriously "the interaction of public regulation with preexisting regulatory space," within which the state must compete with other regulatory offerings); Christine E. Parker, *Meta-regulation: Legal Accountability for Corporate Social Responsibility*, in THE NEW CORPORATE ACCOUNTABILITY: CORPORATE SOCIAL RESPONSIBILITY AND THE LAW (Doreen McBarnet et al. eds., forthcoming), available at <http://ssrn.com/abstract=942157>.

<sup>114</sup>NEIL GUNNINGHAM ET AL., *SHADES OF GREEN: BUSINESS, REGULATION AND ENVIRONMENT* 41–75 (2003) (describing interrelated social, economic, and regulatory standards that businesses comply with in order to meet the expectations of multiple stakeholders).

<sup>115</sup>New Governance models should not be confused with "soft law," unreinforced by sanctions. See, e.g., Karkkainen, *supra* note 105, at 485–89.

<sup>116</sup>Bradley C. Karkkainen, *Adaptive Ecosystem Management and Regulatory Penalty Defaults: Toward a Bounded Pragmatism*, 87 MINN. L. REV. 943 (2003) (describing the "penalty default"). See

important component of credible enforcement is the regulator's own ability to specify, measure, and monitor its outcomes, interrogate and tinker with its own processes, and learn from and adapt to challenges. The regulator should operate along the same outcome-oriented, problem-solving, self-reflexive lines that it requires from industry. Outcome-oriented practice, in its best form, must mean something substantially different from unbridled regulatory discretion to interpret principles in any way the frontline regulator sees fit. The outcome-oriented approach, then, responds directly to worries that principles-based regulation could be arbitrary, inscrutable, or amount to regulatory overreaching. The continued investigatory mindset is also the principle-minded regulator's defense against regulatory ossification over time.

Malcolm Sparrow's model of problem-solving regulation is instructive both externally, in terms of the regulator's relationship to industry, and internally, in terms of the regulator's relationship to its own practices.<sup>117</sup> Another promising analytical framework, described as "root cause analysis," operates within the Toyota Production System as a problem-solving technique. It involves asking a series of nested "why" questions about a particular failure, each of which is meant to deepen the response to the last.<sup>118</sup> It has clear application to organizational contexts such as securities law—for example, when the superficial reason for a regulatory failure is that a particular process was not in place. By asking subsequent "why" questions, one can access underlying causes. For example, a firm's compliance processes did not operate effectively to prevent wrongdoing because the firm had not turned its mind to the scenario that occurred; it had not turned its mind to that scenario because its compliance department did not understand enough about its business processes; its compliance department did not understand enough because it was institutionally isolated; it was institutionally isolated because it was seen as a cost center and a "meddler"; it was seen this way because of a firm culture that reinforced "making the numbers at any cost." Root cause analysis on

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also AYRES & BRAITHWAITE, *supra* note 27, at 35–41 (on regulators' need for a "benign big gun," or heavy sanctioning option, to make less intrusive self-regulatory options viable); Parker, *Reinventing Regulation*, *supra* note 113, at 533–35 (identifying credible enforcement as a precondition to what she calls "compliance-oriented regulation").

<sup>117</sup>See SPARROW, *supra* note 82.

<sup>118</sup>Simon, *supra* note 111, at 20–21 & 25–26.

the heels of a compliance failure also illustrates the important role that enforcement learning and other forms of on-the-ground learning play in enhancing overall regulatory capacity.

Returning to the B.C. Model, certain fundamental priorities need to be kept in mind if the BCSC's outcome-oriented approach is to remain credible and respected. These priorities are not new. The first is that regulatory conduct should be as transparent as possible. In addition to being good regulatory policy, transparency fosters credibility and trust. It reinforces the notion that BCSC action will not be arbitrary, which in turn encourages responsible firms to believe that they will be rewarded for their responsibility. Relatedly, the BCSC must resist the temptation to seize the low-hanging fruit of easy, technical violation cases in favor of more important (and often more difficult) cases. In the interest of allocating resources wisely, BCSC staff should cooperate with responsible firms where those firms continue to behave responsibly. The BCSC has multiple remedies available to it, and staff should tailor the nature of their response to the severity of the conduct at issue.<sup>119</sup> They should be creative and pragmatic, within the limits of statutory power, in devising effective remedial or enforcement measures.<sup>120</sup> Such measures may respond to the need for the corporation to internalize learning and reframe "punishment as persuasion."<sup>121</sup>

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<sup>119</sup>The various Canadian provincial Securities Acts provide a range of remedial options, including administrative penalties (cease trade orders, director and officer bars, etc.), fines, the power to order disgorgement, plus quasi-criminal provisions. In addition, the Criminal Code of Canada contains provisions governing insider trading, capital markets fraud, and organizational liability.

<sup>120</sup>For example, a noteworthy innovation being adopted by the BCSC, along with the FSA in the United Kingdom and the New York Stock Exchange in the United States, is the notion of the selective business line shutdown. See, e.g., Kip Betz, *Comprehensive Penalty Review Underway at NYSE Regulation, Official Says*, 36 SEC. REG. & L. REP. (BNA) 2116 (Dec. 6, 2004); Patrick Hosking, *FSA Plans to Get 'Creative' with Wrongdoers*, THE TIMES (U.K.), Feb. 23, 2006, at 48. The U.S. Federal Reserve has also barred Citigroup from engaging in any major acquisitions until the company had "fix[ed its] regulatory problems." Mitchell Pacelle et al., *Fed Ties the Hands of Citigroup*, WALL ST. J., Mar. 18, 2005, at C1. Temporary business line shutdowns represent a new level somewhere near the upper end of the enforcement pyramid described in AYRES & BRAITHWAITE, *supra* note 27, at 35–41. See also *infra* text accompanying notes 180–86 for a discussion of reform undertakings.

<sup>121</sup>Pablo De Greiff, *Deliberative Democracy and Punishment*, 5 BUFF. CRIM. L. REV. 373 (2002) (arguing for a "communicative theory of punishment" under which a primary aim of punishment is to persuade offenders about the wrongfulness of their conduct). De Greiff's insight applies here, even though strictly speaking the Commission cannot punish, but can only deter.

A regulator should hold its greatest fire for the firms against whom deterrent action is necessary, yet it should not hesitate to use that sanctioning power where necessary. Just as importantly, it should be able to tell the difference: the regulator's credibility, and the so-called enforcement pyramid approach, is premised on the regulator's ability to identify problem firms and noncompliance accurately and to distinguish them, respectively, from generally responsible firms that periodically make mistakes, as well as from market failures not associated with law violation.<sup>122</sup> Risk analysis is a central tool here. The use and continual revisiting of appropriate risk factors will also make the BCSC better at identifying "bad actor" firms and at imposing its regulatory pyramid over industry appropriately. Publication of the BCSC's risk factors would further transparency and credibility as well.<sup>123</sup>

A closer relationship between industry and regulator is another part of this equation. In fact, each side has incentives to be trustworthy and open with the other. The regulator needs industry's knowledge to remain credible and apprised of current industry practices. Regulated firms seek the legitimacy that regulatory approval confers, not only for culturally expressive reasons but also because that legitimacy can confer tangible benefits, including currency with clients and other industry actors. Moreover, industry and regulator are in a "repeat player" relationship, which ought to strengthen incentives to behave well toward each other.<sup>124</sup> That said, it remains to be seen whether the BCSC's relationship with its regulated entities reflects these incentives toward cooperation and mutual trust or

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<sup>122</sup>JOHN BRAITHWAITE, *TO PUNISH OR PERSUADE* (1985); AYRES & BRAITHWAITE, *supra* note 27, at 19–53 (advocating for a "minimal sufficiency principle" in the deployment of regulatory action, under which most firms are coaxed or persuaded into compliance and a progressively smaller number of progressively more difficult firms are met with a hierarchical set of increasingly severe sanctions). *But see* SPARROW, *supra* note 82, at 39–42 (cautioning that a pyramid approach should apply primarily in contexts where there is reason to believe that improving compliance is an effective method of decreasing risks, that is, where law violation rather than, for example, market effects, caused the harm in question).

<sup>123</sup>*See* FSA, *THE FSA'S RISK ASSESSMENT FRAMEWORK* (2006), [http://www.fsa.gov.uk/pubs/policy/bnr\\_firm-framework.pdf](http://www.fsa.gov.uk/pubs/policy/bnr_firm-framework.pdf); ONTARIO SEC. COMM'N STAFF NOTICE 11-719, *A RISK-BASED APPROACH FOR MORE EFFECTIVE REGULATION* (2002), [http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part1/sn\\_20021218\\_11-719\\_effective-reg.pdf](http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part1/sn_20021218_11-719_effective-reg.pdf). The U.S. SEC has also created an Office of Risk Assessment under Charles Fishkin, online at <http://www.sec.gov/about/offices/ora.htm>, although public risk assessment guidelines are not currently available.

<sup>124</sup>ROBERT AXELROD, *THE EVOLUTION OF COOPERATION* (1984).

exhibits something more like the cat-and-mouse mentality characteristic of, for example, tax law enforcement.<sup>125</sup>

### B. Costs and Compliance

Some scholars have noted that the theoretical rules-versus-principles dichotomy drains away an important evolutionary, iterative, contingent, law-in-action way in which legal prescriptions evolve and are implemented.<sup>126</sup> While this may be true of a rigid, essentialist understanding of rules and principles, the worry is really only valid at that level. Principles-based regulation actually goes a long way to *permitting* an evolutionary, iterative, polycentric lawmaking process. It takes seriously the role of on-the-ground implementers in setting the content of the law on a rolling basis.

The advantage of regulatory principles, as opposed to detailed rules, is not that they will remain forever vague, but rather that their content can be filled in more dynamically and insightfully by those with the greatest understanding of the relevant situations. Even in principles-based regimes, the content of the principle will be filled in and will accrete with time. The difference is that their content is meant to remain flexible and up to date—that rather than ossifying, the principles' content will continue to evolve, discarding older formulations as newer, more comprehensive or effective ones emerge. Moreover, that content, as precisely articulated in a given context, is generated by direct reference to the operative principles rather than, as with a loophole mentality, in an attempt to avoid the spirit of the law in favor of its letter.<sup>127</sup> What this means, though, is that one cannot

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<sup>125</sup>Sol Picciotto, *Constructing Compliance: Game-Playing, Tax Law and the Regulatory State*, 29 LAW & POLY 11 (2007).

<sup>126</sup>See Radin, *supra* note 37. Obviously, laws are not always applied in keeping with the intent of statutory drafters. For example, Peter May found, in the context of state-level land use and development management mandates in the United States, that it is more difficult to foster conciliatory regulatory approaches among frontline implementation staff than it is to foster more formal, legalistic regulatory approaches. Peter J. May, *Mandate Design and Implementation: Enhancing Implementation Efforts and Shaping Regulatory Styles*, 12 J. POLY ANALYSIS & MGMT. 634, 653 (1993). May's point applies most clearly to cases where mandates are developed by parties removed from those implementing the mandates. This is less the case when discussing the BCSC, a relatively small organization characterized by physical proximity and frequent interaction between commissioners, policy staffers, and enforcement officers.

<sup>127</sup>For more on this topic, see William H. Simon, *After Confidentiality: Rethinking the Professional Responsibilities of the Business Lawyer* (Columbia Public Research Paper 06-119, Aug. 15, 2006), available at [ssrn.com/abstract=924409](http://ssrn.com/abstract=924409), at 14 (distinguishing between formalist and new

evaluate a principles-based regime from the point of view of legitimacy or efficacy without understanding the mechanisms and actors chosen to fill in that content.

An outcome-oriented approach of the kind described here is not the only means for filling in content within a principles-based regulatory approach, but it is the best one. Another possibility would be to fill in the content of principles through regulatory discretion. For example, the BCSC could go the way of American criminal prosecutors: the black box of discretion.<sup>128</sup> This is not a good solution. Relative to outcome-oriented practice, it is nontransparent, nonaccountable, and proceeds on an ad hoc basis without internalizing its own learning in any systematic way. At the other end of the spectrum would be industry self-regulation. In view of its troubled history, British Columbia may be even more keenly aware than other jurisdictions of the need to maintain credible regulatory oversight of its provincial capital markets, for obvious substantive reasons as well as with regard to the “optics.”<sup>129</sup> Of course, there are also compelling, normative, and pragmatic<sup>130</sup> arguments, not specific to British Columbia, in favor of some more substantial degree of ongoing regulation of the securities markets.

Relative to these options, New Governance-style principles-based and outcome-oriented regulation spans the public/private divide, incorporating industry experience and perspectives into a still-resilient

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approaches to legal compliance and professional responsibility, even though both approaches expect regulators and practitioners to describe their practices as explicitly as possible).

<sup>128</sup>Most of the literature on prosecutorial discretion emerged around mandatory minimum sentences and, later, the U.S. sentencing guidelines, which arguably increased prosecutors' power at the expense of judges' power. Prosecutorial discretion has been criticized for its lack of transparency and accountability and for the differentially negative effect of discretion on marginalized groups. See, e.g., Gerald W. Heaney, *The Reality of Guidelines Sentencing: No End to Disparity*, 28 AM. CRIM. L. REV. 161, 192–97 (1991); Cynthia K.Y. Lee, *From Gatekeeper to Concierge: Reigning in the Federal Prosecutor's Expanding Power Over Substantial Assistance Departures*, 50 RUTGERS L. REV. 199, 235–40 (1997). See also Brandon L. Garrett, *Structural Reform Prosecution*, 93 VA. L. REV. 853 (2007) (citing concerns about prosecutorial discretion in forcing corporate structural reforms during settlement).

<sup>129</sup>See *supra* note 78.

<sup>130</sup>See, e.g., Robert A. Prentice, *The Inevitability of a Strong SEC*, 91 CORNELL L. REV. 775 (2006); Rafael La Porta et al., *What Works in Securities Laws?* (Tuck School of Business Working Paper No. 03-22, July 16, 2003), available at <http://ssrn.com/abstract=425880> (arguing, based on analysis of the securities laws of forty-nine countries, that countries with better legal protections for investors have more developed financial markets).

regulatory capacity.<sup>131</sup> What this article envisions is shared implementation of principles-based regulatory mandates within which other actors, such as individual public issuers, broker/dealers, and portfolio managers—as well as, potentially, trade associations, industry councils, shareholders, and other stakeholders—may play a role in facilitating regulation and contributing provisional content to principles. Ultimate enforcement and coercive power remains with the regulator. The regulator uses its enhanced outcome-oriented analytical capacity to interrogate industry action, communicate results, provide ongoing guidance, and spur laggards with a view to effectuating its irreducibly *public* policy goals of safeguarding investors and promoting efficient capital markets.<sup>132</sup>

This kind of approach could potentially impose additional costs on private actors as compared to a prescriptive, detailed, rule-based approach. Indeed, this was a central point made by opponents to Bill 38. Critics like David Brown, former chair of the Ontario Securities Commission, identified that, at least in its initial stages, a principles-based regime moves substantial costs from legislators to industry actors.<sup>133</sup>

In the same vein, Louis Kaplow has posited that rules are costly *ex ante*, as their content must be already filled in when they are promulgated, while principles are costly *ex post* and those costs are imposed on a broader range of individuals.<sup>134</sup> He has argued that the choice between rules and principles in statutory drafting should in part come down to the frequency with which a particular problem arises. Statutory directives

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<sup>131</sup>The literature on this topic is now voluminous and heterogeneous and beyond the scope of this article. *But see, e.g.*, Jody Freeman, *The Private Role in Public Governance*, 75 N.Y.U. L. REV. 543 (2000); Jody Freeman, *Private Parties, Public Functions and the New Administrative Law*, 52 ADMIN. L. REV. 813 (2000); Daniel Guttman, *Public Purpose and Private Service: The Twentieth Century Culture of Contracting Out and the Evolving Law of Diffused Sovereignty*, 52 ADMIN. L. REV. 859 (2000); Gillian Metzger, *Privatization as Delegation*, 103 COLUM. L. REV. 1367 (2003); Michael P. Vandenbergh, *The Private Life of Public Law*, 105 COLUM. L. REV. 2029 (2005); Paul R. Verkuil, *Public Law Limitation on Privatization of Government Functions*, 84 N.C. L. REV. 397 (2006).

<sup>132</sup>The accountability issues presented by shared public/private regulation are most fully canvassed in Freeman, *Public Parties*, *supra* note 131.

<sup>133</sup>Letter from David Brown, Chair Ontario Securities Commission, to Doug Hyndman, Chair British Columbia Securities Commission (June 27, 2003), *available at* [http://www.bsc.bc.ca/uploadedFiles/BCN2003-12\\_OSC.pdf](http://www.bsc.bc.ca/uploadedFiles/BCN2003-12_OSC.pdf), at 3 (charging, *inter alia*, that the B.C. Model “is focused on a reduced role for the regulator, but overlooks the increased costs of compliance for market participants . . .”).

<sup>134</sup>Kaplow, *supra* note 22.

governing frequently recurring situations should be drafted as rules, not principles, because economies of scale justify incurring the costs of determining the content of the law *ex ante*.<sup>135</sup> By contrast, exceptional, isolated, or unusual situations should be governed by principles because there would be no point, and it would be a waste of resources, to try to anticipate the content of such laws in advance.

Whether principles-based systems really do impose greater *ex post* costs on private actors is an empirical unknown. An accurate measurement of relative costs would have to acknowledge, for example, that the cost of rules includes not only *ex ante* drafting costs, but also the *ex post* costs of periodically inappropriate, overly broad or overly narrow application of rules to unanticipated circumstances. Even leaving that observation aside, the Kaplow account fails to consider two important points, both of which go not to the frequency but to the content of the conduct in question.

First, it is not sensible to incur the *ex ante* costs of rule specification where the regulator or statutory drafter is operating under a serious information deficit. This may be the case on a relative basis *vis-à-vis* other actors or because events are too fast moving to be able to ascertain the proper content of rules in advance. In other words, the fact that a situation recurs frequently does not necessarily mean that the regulator has sufficient information to deal with it appropriately. In those situations, ascribing content to a legal prohibition or directive should be done by such actors or at such time as the greatest amount of information that can be feasibly gathered is available.<sup>136</sup>

Edward Rubin has said that open-ended, learning systems are preferable to prescriptive, command-oriented regulatory systems where the regulator “knows the result it is trying to achieve but does not know the means for achieving it, when circumstances are likely to change in ways that the [regulator] cannot predict, or when the [regulator] does not even know the precise result that she desires.”<sup>137</sup> It is not an admission of weakness for a regulator to acknowledge that at least the first two of

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<sup>135</sup>*Id.* at 577.

<sup>136</sup>At some point, of course, this statement runs into the general prohibition against retroactivity. The greatest information may only be available with the benefit of hindsight, but effective administration of justice and basic fairness principles require that some informational completeness be sacrificed in the interest of real-time clarity.

<sup>137</sup>Edward Rubin, *The Myth of Accountability and the Anti-Administrative Impulse*, 103 MICH. L. REV. 2073, 2131–34 (2005) (citing organizational theorists).

Rubin's conditions may reasonably exist, particularly in the context of corporate compliance. It does not have to be the business of a regulator to know the precise means for achieving corporate compliance in any given firm. It is the business of the regulator to try to ensure good compliance with law, but the corporations or firms themselves are in a better position, in terms of access to information, to determine appropriate means for reaching that end.

Second, Kaplow's thin, industry cost-oriented approach to the choice between rules and principles must be qualified where the nature of the directive is such that costs must be borne *ex post*, by a broader group of actors, in order to meet regulatory objectives. In those cases, costs should be borne *ex post* by that broader group of actors. In other words, there are times when firm engagement may be the *sine qua non* of regulatory effectiveness. Regulation concerning firm-compliance processes in particular depends on industry buy-in. Regulators in a functional system need not anticipate every form that (right- or) wrongdoing can take, nor create exhaustive and detailed lists of prohibited conduct, because sanction alone is not and could not be what keeps the system functioning.<sup>138</sup> If the most promising way to make a compliance policy work, for example, is for industry actors themselves to define and implement a firm-specific and firm-appropriate strategy for implementing it, then industry actors may well be expected to bear the attendant costs. Our concern should be to adopt the effective system with the lowest *overall social* costs, not the lowest costs to industry alone.<sup>139</sup>

All of these considerations are more important with respect to compliance processes than to any other aspect of business conduct, because compliance processes are so deeply enmeshed with firm culture and the firm's sense of itself and its relationship to its environment and its regulator. Principles-based regulation is not a panacea, and it will not eliminate all problems. However, it brings with it the exciting potential to build the

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<sup>138</sup>See, e.g., TOM R. TYLER, *WHY PEOPLE OBEY THE LAW* (1990) (arguing that people obey the law if they believe it is legitimate, not because they fear punishment).

<sup>139</sup>This does not necessarily preclude a subsequent decision to compensate particular parties for their compliance expenses. One of the assumptions behind having industry pay compliance costs is that, having introduced particular business risks into the world, it should be required to internalize the cost effect of those risks. However, where this approach turns out to impose disproportionate compliance costs on a particular party, regulators or society may still choose to address the iniquity through some form of compensation.

buy-in from the regulated firm that is essential to a compliance program that actually works.

### C. Rolling Best-Practices Rulemaking

One of the key underlying notions of New Governance theory is that regulators can improve industry conduct and stimulate a “race to the top” through “bootstrapping,” or “rolling best-practices rulemaking.”<sup>140</sup> The idea is attractive in part because it describes a concrete mechanism for avoiding the specter—sometimes associated with incorporating industry standards into regulation—of a race to the bottom. Proponents of rolling best-practices rulemaking hope for more than simply avoiding a bad result. The rolling best-practices rulemaking approach suggests a mechanism for harnessing regulation to change the ground rules by which industry operates. In its strongest form, this kind of rulemaking shifts regulatory expectations off a static, industry-standards model toward a model that incorporates the best practices of the highest-performing actors as new industry-wide benchmarks. It is a fluid regulatory structure that forces firms to strive for improvement continually and in contextually appropriate, industry-generated directions. One of the regulator’s primary roles in such a regime is to aggregate and reflect industry actors’ experiences back to them, to establish careful matrices for assessing performance across firms, and to challenge laggards with the experiences of their higher-performing peers.<sup>141</sup>

In securities regulation, the notion of rolling best practices runs into an immediate, but ultimately artificial, conceptual roadblock: the emphasis on light-touch regulation. Light-touch regulation—meaning regulation based on disclosure obligations and a relatively minimalist set of regulatory and registration requirements—is the dominant paradigm in securities

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<sup>140</sup>Dorf & Sabel, *supra* note 105, at 350–54 (explaining that “[s]uch rules require regulated entities to use processes that are at least as effective in achieving the regulatory objective as the best practice identified by the agency at any given time. . . . benchmarking establishes and periodically updates the standard to incorporate improvements . . .”).

<sup>141</sup>*Id.* at 354–56. The regulator’s comparative and aggregative functions, and the provisional basis on which any particular practice is held to meet regulatory outcomes, are important components of New Governance theory. They establish a flexible system for ascribing content to regulatory principles. This means that, contrary to Cunningham’s assertion that the “new governance paradigm” is a trend favoring rules over principles in regulatory design, Cunningham, *supra* note 43, at 48, New Governance is actually more compatible with principles-based and outcome-oriented regulation.

regulation. The U.K. FSA's explicit emphasis on its light-touch approach, in contradistinction to its characterization of the Sarbanes-Oxley-era American approach as costly and burdensome, gives this term contemporary relevance. Yet, even the Sarbanes-Oxley Act does not begin to approximate the interventionist regulatory schemes in some other areas of administrative law.<sup>142</sup> It is an article of faith among both regulators and securities industry players that the capital markets ultimately are a dynamic and positive force and that regulation should limit itself to addressing market failures, such as information asymmetries. Regulation in this area seeks to foster efficient and trustworthy capital markets, not to set goals or direction for those markets.<sup>143</sup> In this context, it is generally presumed that regulators should not be telling business how to do its business. The worry about rolling best-practices rulemaking, then, is that an approach that uses continually increasing best-practices benchmarks to ratchet up industry performance is fundamentally opposed to the prevailing conviction that the regulator's role is to establish only *minimum* standards for industry.

In fact, rolling best-practices standards and light-touch regulation are not mutually incompatible. The regulatory goal of setting only minimum standards reflects a normative position, not a quantitative one, regarding the role of regulation in the securities markets. The light-touch approach need not (in fact, it should not, in its best form) try to describe a permanent, objective, process-based floor that firms must achieve. Similarly, rolling best-practices standards represent a method for identifying and leveraging information about effective means for achieving a regulator-determined goal. One may choose to regulate minimally according to a series of static checklists, or one may choose to regulate minimally by reference to evolving industry learning about the most efficient, fairest, most effective, and least costly means of achieving those minimum standards.

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<sup>142</sup>The most interventionist, command-and-control regulatory methods seem to have been more common in the 1970s and 1980s than they are now, particularly in environmental regulation. See, e.g., ANTHONY I. OGUS, ED., *REGULATION, ECONOMICS AND THE LAW* (2001); Bruce A. Ackerman & Richard B. Stewart, *Comment, Reforming Environmental Law*, 37 *STAN. L. REV.* 1333 (1985); Eric W. Orts, *Reflexive Environmental Law*, 89 *NW. U. L. REV.* 1227 (1995); William H. Simon, *Legality, Bureaucracy, and Class in the Welfare System*, 92 *YALE L.J.* 1998 (1983).

<sup>143</sup>See, e.g., THOMAS K. McCRAW, *PROPHETS OF REGULATION* 172-75 & 185-88 (Harvard University Press 1984).

The Account Supervision Case, above, illustrates this point. Both the detailed IDA rules and the principles-based B.C. Model seek to require firms to meet minimum standards, in terms of establishing appropriate and effective compliance systems to detect questionable activity in client accounts. The IDA approach uses detailed, process-based rules as a means of forcing firms to meet those minimum standards. The B.C. Model uses the Code of Conduct for Dealers and Advisors as elaborated upon by administrative guidance and ultimately industry experience. Recognizing the IDA rules' limited effectiveness in identifying questionable account activity, and mindful of civil liability and reputational risks, firms developed their own proprietary systems to meet their account supervision obligations. However, those supervisory systems were developed as better means for achieving the same perceived minimum level of effective supervision. The B.C. Model's principles-based and outcome-oriented approach would not have demanded increasingly costly or elaborate account supervision systems from the dealers. The B.C. Model would simply have allowed those firms to achieve existing regulatory standards using more effective and context-appropriate methods, as those methods were generated through industry experience itself. It would also have allowed the BCSC to collect and disseminate that industry experience to other industry actors facing similar challenges.<sup>144</sup>

The Account Supervision Case also highlights two other important conceptual relationships: the connection between the regulator and broader

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<sup>144</sup>Different regulators have somewhat differing views on the extent to which regulators should actively disseminate best practices information. For example, the FSA produces a range of supporting materials for industry, including statements of good—and of less good—practices and case studies. Briault, *supra* note 65. The IDA has even incorporated best-practices standards into its regulatory expectations on at least one recent occasion. See, e.g., IDA MEMBER REGULATION NOTICE MR0441—HANDLING CLIENT COMPLAINTS (Dec. 19, 2006), [www.ida.ca](http://www.ida.ca) (follow “Regulatory Policy” hyperlink, then follow “Member Regulation Notice” hyperlink, then search “MR0441”). By contrast, Commissioner Robin Ford of the BCSC is of the view that, unlike consultants or trade associations, it is not the regulator's role to try to ratchet firms up to best-practice standards. In her view, it is the role of the industry bodies and consultants to disseminate best-practices standards. If the regulator thinks standards are not high enough then it should, after consulting, make the rule stricter or issue guidance to say that it will be demanding more of firms under the relevant principle. While the Commission should pass on information about good or best practices where it makes sense to do so, it must remain mindful that it exists to maintain minimum standards and that it should not tell firms what to do. In Commissioner Ford's view, doing so is a disincentive to senior management taking responsibility for compliance and may create a moral hazard. E-mail from Robin Ford, Commissioner of the BCSC, to author (Apr. 3, 2007, 5:39 PM PST) (on file with author).

social or economic factors as determinants of firm behavior and the connection between best practices and outcome-oriented regulation. On the first point, the way the BCSC uses industry learning both connects its regulatory agenda with, and distinguishes its regulatory agenda from, compatible compliance-generating forces beyond regulation. According to Sandy Jakab, Manager of Policy for the Capital Markets Division of the BCSC, the BCSC's goal is to use best or good practices in an instructive rather than mandatory way.<sup>145</sup> In fact, the BCSC prefers the term "good practices" to "best practices," mindful that the latter can be misunderstood in the context of a light-touch regulatory approach. Jakab notes that, in the context of the BCSC's role in setting minimum standards, "good" practices are those methods that work to achieve the minimum standard most consistently, most efficiently, and with minimal risk. Jakab emphasizes that, if implemented literally, such that every improvement in a particular firm's practices automatically translated into a heightened process-based regulatory expectation across the board, a pure best-practices approach would also fall prey to potentially adverse firm-on-firm competitive effects. According to Jakab, the BCSC's view is that one size will not fit all in setting regulatory standards and that regulators must be sensitive to the costs of any new regulatory requirement.<sup>146</sup>

Jakab points out that the more literal meaning of best practices—in other words, the most state-of-the-art and highest, and perhaps the most comprehensive and elaborate, practices being used by industry leaders—is available to be put forward by other stakeholders, such as industry associations and trade councils. According to Jakab, industry councils and trade associations have a central role to play in articulating best-practices standards. But, it is not the place of the regulator to rank practices as "best" or "second best." Rather, it concentrates on sharing information on those practices that have been shown to work in achieving regulatory goals.<sup>147</sup> Significantly, by reconciling light-touch regulation and the desire for effective and improving standards, the notion of "best practices" becomes bifurcated between regulator and other third parties. The BCSC explicitly recognizes the role of other forces—social, reputational,

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<sup>145</sup>Telephone Interview with Sandy Jakab, Manager, Policy, Capital Markets Division, BCSC (Feb. 22, 2007) [hereafter "Jakab Interview"].

<sup>146</sup>*Id.*

<sup>147</sup>*Id.*

economic, and legal—that go into ensuring that firms remain law abiding.<sup>148</sup> While using the tools of industry-based good- or best-practices experience to disseminate learning about effective means for achieving regulatory goals, the BCSC is neither the overseer nor the repository for all industry learning.<sup>149</sup> By tying its approach to industry best practices and establishing an ongoing dialogic relationship between its regulatory requirements and other standard-setting bodies, regulatory action becomes an organic piece of constantly moving, innovating industry action. In keeping with this, the BCSC's industry-derived information on best practices may appear in guidance (policy papers, interpretive statements, and the like) but not in actual rules.

The Account Supervision Case also illustrates the connection between rolling good or best practices and outcome-oriented administrative action. That is, the more basic reason that best practices are not the subject of official notice-and-comment rulemaking is that an outcome-based system would not mandate any particular good or best practice. The B.C. Model's principles-based and outcome-oriented approach seeks, by definition, to avoid prescribing process. Indeed, for this reason an outcome-based regulatory approach is the essential underpinning for making use of good or best practices in principles-based regulation. Outcome-oriented practice presumes that there may be more than one path to an acceptable compliance goal, thereby reconciling its best-practices approach with its light-touch regulatory mandate.

#### IV. CHALLENGES AND OUTSTANDING QUESTIONS

British Columbia has claimed that its principles-based and outcome-oriented approach is more flexible, more capable of learning from experience, and better at safeguarding investor interests, all while still minimizing unnecessary costs to industry. With respect to compliance, for

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<sup>148</sup>See GUNNINGHAM ET AL., *supra* note 114; Parker, *Reinventing Regulation*, *supra* note 113.

<sup>149</sup>In Jakab's view, industry actors also could be more proactive and effective if they understood that guidance does not set out mandatory standards and that they are free to develop their own tailored approaches to achieving regulatory outcomes. Jakab notes that the consulting industry can, unwittingly, be unhelpful when it concentrates on developing more comprehensive and elaborate means of achieving ever-increasing compliance standards, rather than on the most effective and efficient means to achieve minimum standards. Jakab Interview, *supra* note 145.

example, the aim has been to move away from a technical and literal, checklist-style approach to regulatory mandates, toward something more dynamic and geared specifically toward reaching underlying regulatory goals. The idea behind outcome-oriented regulation is that the securities regulator should not be policing technical rule violations, and industry should not be primarily concerned with technical compliance. Both regulator and industry should be focused on achieving good regulatory results on important issues, in the most efficient manner.

Even an optimist would agree, however, that challenges exist. The B.C. Model shares important features with other New Governance approaches to regulation and public service provision. As such, cautionary tales from other New Governance-style experiments, such as the ones emerging from the No Child Left Behind Act in the United States, are relevant.<sup>150</sup> The decentralized, pragmatic, information-based, and participatory structures that New Governance uses to produce continually ratcheting standards of performance are vulnerable to many familiar regulatory failings, including lack of political will, failure of credible enforcement, and a potential misfit between means and ends. In the same way, making principles-based securities regulation in British Columbia work, and enabling it to leverage all the advantages of a New Governance regime, means paying careful attention to context.

The B.C. Model is promising and noteworthy because New Governance-style securities regulation opens the *possibility* of thoroughgoing change for the better, including meaningful reform of corporate compliance and the relationship between regulator and industry. However, making those changes stick requires that catalysts for change be embedded in institutional arrangements. There is more work to be done before one should venture to say whether principles-based and outcome-oriented securities regulation in general, and the B.C. Model in particular, operates on the ground in a way that can move industry compliance forward in measurable and sustainable ways. The purpose of this article is to develop a framework for pursuing those questions as part of a broader research

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<sup>150</sup>The New Governance potential of the No Child Left Behind Act has been explored in, for example, James S. Liebman & Charles F. Sabel, *The Federal No Child Left Behind Act and the Post-Desegregation Civil Rights Agenda*, 81 N.C. L. REV. 1703, 1704–07 (2003); Liebman & Sabel, *supra* note 105, at 184–85, 191–92 & 303–04. These authors also acknowledge the significant problems with that Act, including the weakness of the Act's formal enforcement mechanisms. See Liebman & Sabel, *supra*, at nn. 78–86 and accompanying text.

agenda. The following sections flag two issues in particular that deserve closer attention: first, firm incentives to innovate in compliance practices (as opposed to, for example, product development) and, second, the problem of varied firm capacity to operate effectively under a principles-based regime, with special attention to using a hybrid rules-and-principles approach to help smaller and less-well-resourced firms cope. Provisional responses to these challenges, including a proposal for regulatory tripartism, are developed below.

### *A. Firm Incentives to Innovate*

According to Stephen Bland, Director for Small Firms at the FSA, his agency is approached with some frequency to sign off, under its principles-based approach, on a firm's assessment of the compliance bona fides of new business products. The wholesale market, in particular, is a sector that regularly seeks principles-based regulatory accord (which is something less than approval per se) to issue innovative products and business practices.<sup>151</sup> The banks and private firms that regularly develop new structured finance products for sale into the wholesale market are likely to be among the most sophisticated of market players. They are the market actors most likely to have the capacity to work effectively within a principles-based system, to seek the competitive advantages offered to innovators under a flexible, discursive, regulatory approach, and to advocate on behalf of their products and those products' consonance with regulatory goals. Principles-based regulation will be attractive to wholesale market participants to the extent that it helps them bring creative products to market more quickly and easily.

It is less clear that a market actor's innovative mindset with respect to structured finance products will necessarily translate into innovation in the area of compliance. High-functioning firms will excel in both areas. However, the pressure to innovate and improve may not be uniformly as intense in compliance areas as in new product development. Among more problematic firms, one can even imagine an inverse relationship: the same drive for innovation that pushes a firm to create new products also pushes it to take risks and cut corners in corporate governance and compliance. Among firms that see their internal compliance departments

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<sup>151</sup>Interview with Stephen Bland, Director, Small Firms at the Financial Services Authority, in Vancouver, British Columbia (Sept. 28, 2006).

as cost centers or, worse, obstacles to be circumvented wherever possible, the mere presence of principles-based regulatory opportunities to improve their compliance practices, or to learn from others' best practices, will not generate the internal will to do so.

This distinction between product development and compliance highlights a number of questions about principles-based regulation. Specifically, what makes rules "roll" under a rolling best-practices regime, and what prompts a revision to the content of a regulatory principle? Are revisions likely to be common where firms have obvious, built-in incentives to innovate, such as in creating highly profitable financial instruments for sale, and uncommon when it comes to compliance processes and procedures? How can regulators keep compliance on the agenda? Should compliance even be subject to a rolling deliberative process in this environment, or are prescriptive rules a better solution in terms of protecting investors and fostering fair and efficient capital markets?

Not all compliance rules should be subject to deliberation and argumentation. A participatory, principles-based regulatory regime should still maintain a phalanx of non-negotiable rules governing topics on which there is consensus, such as extreme misconduct and misbehavior. Circumscribing these outer boundaries of permissible conduct actually makes reasonable deliberation possible with respect to topics on which there is not consensus. Of course, this is not a full answer. The Account Supervision Case demonstrates that compliance processes, like other areas of firm conduct, benefit from an outcome-oriented, rolling best- (or good-) practices approach. Some rules may well roll more automatically than others, for perceived self-interest reasons. Therefore, part of the job of the regulator may be to help industry players see that meaningful compliance is in their self-interest.

Regulators can provide short-term incentives and rewards to firms that exhibit consistently good compliance. In particular, regulators encourage compliance when good actors benefit from a reduced regulatory burden and a more hands-off approach. High-risk actors—firms whose compliance systems have been shown to be materially inadequate to address the compliance risks posed by their particular business, whether or not that business is itself high risk—should be subject to increased oversight. They should attract more compliance visits, more scrutiny of their practices between visits, more explicitly defined outcomes emanating from regulators, and eventually even caution letters, potential conditions or restrictions on the firm's license, or a referral to enforcement staff. The

BCSC does this.<sup>152</sup> While somewhat instrumental, differential regulatory treatment based on a firm's compliance history does establish clear incentives for firms to remain on good terms with the regulator.

Looking to more endogenous mechanisms, a firm is more likely to maintain good compliance processes and to exhibit a genuine culture of compliance where it is able to identify a link between its long-term business success and good compliance processes. For example, a firm's compliance staff may be able to demonstrate that preventive compliance processes are less costly in the long run than enforcement and civil liability arising from a compliance failure.<sup>153</sup> In the Account Supervision Case above, the fact that firms had created internal supervisory programs on their own initiative demonstrates that they were convinced of this calculation.

Also, one may hope for deeper points of convergence between compliance and profits. In other spheres of activity, finding the leverage points that establish, in the organization's view, the connection between good internal practices and external success has effected measurable progress on previously intractable problems.<sup>154</sup> Here, Neil Gunningham's notion of the "license to operate" may be language that both compliance and business sides of the firm understand.<sup>155</sup> The "license to operate" encompasses not only regulatory requirements, but also the full range of social, business, and environmental factors that go into a firm's ability to flourish. Where firms are subject to pressures from a broad range of stakeholders to practice good corporate governance, that license to operate becomes thicker and more substantial.<sup>156</sup>

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<sup>152</sup>E-mail from Michael Sorbo, Manager, Examinations, BCSC Capital Markets Regulation Division, to author (Feb. 21, 2007, 13:54 PM PST) (on file with author) [hereafter Sorbo e-mail #1].

<sup>153</sup>Penny Tham, Group Compliance, Head of North Asia, ABN AMRO, Remarks at British Columbia Securities Commission's Capital Ideas Conference in Vancouver, British Columbia (Sept. 28, 2006), transcript at 17, available at <http://www.bsc.bc.ca/uploadedFiles/news/publications/CompleteTranscript-CapitalIdeas2006.pdf> [hereinafter Capital Ideas Conference].

<sup>154</sup>Susan Sturm, *The Architecture of Inclusion: Advancing Workplace Equity in Higher Education*, 29 HARV. J. L. & GENDER 247 (2006).

<sup>155</sup>GUNNINGHAM ET AL., *supra* note 114.

<sup>156</sup>*Id.* at 141. Business representatives participating in the Gunningham study also observed that the social license standards to which they are held may be higher than the regulatory ones. *Id.* at 52–55.

Broker-dealer firms may also be able to integrate the principles set out in the Code of Conduct for Dealers and Advisors, based as they are on a coherent set of ethical standards, with broader (and potentially status-conferring) professional standards.<sup>157</sup> At the internal level, firms may come to see that good compliance processes actually improve the internal environment and make employees more committed and more willing to innovate, confident in the knowledge that the firm's compliance safety net will prevent them from inadvertently engaging in impermissible conduct. Firms that explicitly live by and reinforce ethical principles for their employees may even come to be seen as more rewarding places to work, with associated benefits in the labor market. Locating the precise leverage points for this to happen in the securities regulatory context—including concepts, processes, and structures—is part of the work that remains to be done to understand and enable compliance standards to roll upward.

### *B. Capacity Issues and Hybrid Rules-and-Principles Models*

As the BCSC recognizes, not all firms under its regulatory ambit will be possessed of equivalent capacity.<sup>158</sup> The B.C. securities environment is characterized by a large number of junior-cap companies, small natural resource venture issuers, and small portfolio managers that do not have the means to engage large compliance departments. Neil Gunningham and Darren Sinclair have pointed out that many small and medium sized enterprises (SMEs) operate at the margins of profitability and cannot afford to devote many resources to such non-bottom-line issues as environmental protection, or as suggested here, to state-of-the-art compliance processes.<sup>159</sup> Also, they often lack awareness and expertise; they may not have integrated compliance priorities into their business decisions; and they are likely to be less frequently inspected because as a group they are numerous, but each individual SME presents a quantitatively lower risk to

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<sup>157</sup>Gary Hagland, *A Critical Evaluation of the Compliance Administrative Control System Within Albert E Sharp and its Motivational Impact Upon Those It is Supposed to Control*, 3 J. FINAN. REG. & COMPL. 28, 33 (1994) (early compliance-related case study of stockbrokers firm, noting that compliance controls were reinforced where firm equated corporate quality control with the codification of professional standards).

<sup>158</sup>See Jakab Interview, *supra* note 145.

<sup>159</sup>NEIL GUNNINGHAM & DARREN SINCLAIR, *LEADERS & LAGGARDS: NEXT-GENERATION ENVIRONMENTAL REGULATION* 13–40 (Greenleaf Publishing 2002).

regulatory objectives. SMEs' focus on economic survival means that they may lack the bandwidth to take action on issues like compliance, unless they are facing specific overt threats or pressure through, for example, regulatory action.<sup>160</sup> Moreover, a principles-based regulatory regime may impose additional competitive pressures on smaller firms because larger industry actors with greater capacity to innovate are rewarded in such a system.

One option for responding to smaller firms' more limited capacity is to create a hybrid rules-and-principles system. Conceptually, this could entail either some sort of midpoint between two approaches or a system that gives industry actors a choice between principles-based and rules-based alternatives. The latter would effectively locate principles-based regulation *adjacent to*, rather than in lieu of, existing regulatory rules, such that firms that lack the desire or the capacity to innovate in compliance systems could rely on detailed, preexisting rules. This is the approach adopted by two regimes in Europe: the continental comply-or-explain regime for corporate governance<sup>161</sup> and the U.K. FSA's approach. The U.S. Commodity Futures Trading Commission is also moving along what it calls a hybrid rules-and-principles spectrum, which includes the statutory core principles in the Commodity Futures Modernization Act.<sup>162</sup> Under the FSA model, which is probably the most fully developed, firms have the option of either abiding by the safe harbor of established rules or applying innovative practices that nevertheless meet the FSA's principles-based regulatory guidelines. If a firm chooses to use the principles rather than the rules, it must convince the FSA that its alternative mechanism is likely to achieve the same regulatory goal. If the firm succeeds, the FSA uses its exemptive authority to deactivate the operative rule, while giving effect to the operative principle and the firm's proposed innovation.

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<sup>160</sup>*Id.* at 13–14.

<sup>161</sup>See EUROPEAN CORPORATE GOVERNANCE FORUM, STATEMENT OF THE EUROPEAN CORPORATE GOVERNANCE FORUM ON THE COMPLY-OR-EXPLAIN PRINCIPLE, (Feb. 22, 2006), [http://ec.europa.eu/internal\\_market/company/docs/ecgforum/ecgf-comply-explain\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/ecgforum/ecgf-comply-explain_en.pdf). The European comply-or-explain model emphasizes transparency and disclosure, but leaves the details up to the particular issuer. As it stands, the principle is essentially a straightforward disclosure requirement. It assumes a high level of shareholder sophistication. Firms have the option of simply rejecting the nonbinding regulatory suggestion, which leaves it up to shareholders to discipline the firm. This hands-off approach especially does not make sense in a less transparent and liquid market arena such as British Columbia's, which is characterized by a large volume of exempt transactions and closely held companies.

<sup>162</sup>Lukken, *supra* note 7.

This approach is not unlike the prophylactic-rules approach suggested by some New Governance scholars.<sup>163</sup> In theory, it has the advantage of sharing with the regulators on-the-ground information about potential emerging best practices in real time. Regulators can then disseminate information about those best practices to other industry actors, including smaller or less well-resourced ones, who can benefit from the innovations without having to reinvent the wheel themselves.<sup>164</sup> This approach also conserves each firm's resources, allowing a firm to make incremental modifications to a compliance rule as it learns about what works.<sup>165</sup> A hybrid rules-and-principles system may also allay industry fears about regulatory discretion and overreaching under a purely principles-based regime.<sup>166</sup> As the FSA example demonstrates, the shift to a principles-based system, in

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<sup>163</sup>Dorf & Sabel, *supra* note 105, at 403. The concept also shares some ground with what Ian Ayres and John Braithwaite call "enforced self-regulation," which permits firms to substitute their own privately devised compliance rules for the public ones. One difference, however, is that in the Ayres and Braithwaite model, the default public rules are more onerous, as well as being less tailored, than the privately developed alternative. Additionally, the enforced self-regulation model is useful primarily for large firms with the internal compliance capacity to develop a comprehensive set of compliance rules and to self-monitor for compliance with those rules and for lessons derived from experience with them. AYRES & BRAITHWAITE, *supra* note 27, at 101–32. The hybrid FSA model permits a more piecemeal approach to substituting a particular innovation for a specific rule.

<sup>164</sup>The sociolegal literature illustrates the important role that mimicry, or "isomorphism," plays in disseminating new practices. Paul J. DiMaggio & Walter W. Powell, *The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields*, in *THE NEW INSTITUTIONALISM IN ORGANIZATIONAL ANALYSIS* (Walter W. Powell & Paul J. DiMaggio eds., University of Chicago Press 1991). Depending on context, the phenomenon can be functional as well as dysfunctional.

<sup>165</sup>Contrast this with, for example, the costs imposed by the Sarbanes-Oxley Act § 404, as ultimately implemented. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 404, 116 Stat. 779, 789 (codified as amended in 15 U.S.C. §§ 7201–7266 and scattered sections of 18 U.S.C. (Supp. II 2002)). Professor Langevoort has argued that Sarbanes-Oxley § 404 has been as expensive as it has in part because "accountants, lawyers and consultants captured the meaning of the statutory text early on in ways that . . . have generated large rents for their professional activities." Donald C. Langevoort, *The Social Construction of Sarbanes-Oxley*, 105 MICH. L. REV. 1817, 1828 (2007). Anecdotally this does not seem to have been a problem in the application of British Columbia's principles-based requirements, at least so far, but it is a potential risk in British Columbia as well and one that calls for a more detailed examination than can be undertaken here.

<sup>166</sup>Also relevant to fears about regulatory overreaching is the fact that capital markets internationally are now very much in competition with each other. See also Capital Ideas Conference, *supra* note 153, transcript at 87–89.

practice, is more evolutionary than it is revolutionary. Preexisting rules continue to provide a baseline, and change happens at the margins.

There is, however, one large danger in the use of such a hybrid system: it may be subject to being gamed. Specifically, noncompliant industry actors could choose to rely strategically on existing detailed rules whenever they had a colorable basis for arguing that they were in compliance with the rule, regardless of whether their actions were in keeping with the underlying principle. The firm could selectively look for loopholes in the rules, falling back on principles only if and when the regulator decided to challenge the conduct in question. In this context, the innovations for which principles-based regulatory approval would be sought in advance would be limited to those that were obviously impermissible under existing rules.<sup>167</sup> Firms would avoid the delay, cost, and risk of seeking regulatory approval for innovations that could somehow be shoehorned into existing rules. This in turn would cut the regulator out of the learning loop. In effect, the rules-versus-principles choice would devolve to rules wherever possible.<sup>168</sup> Principles-based regulation would be reduced to the service of last recourses and *ex post* justifications.

The response is as follows: first, while a principles-based regulatory approach may use existing detailed rules as prophylactic rules, it must be clear that industry actors are expected to abide by regulatory principles as well. Rules-based and principles-based regulatory expectations must operate serially, not in parallel. An enforcement response should be swift and unequivocal where a firm appears to be using a loophole in detailed rules to avoid abiding by a regulatory principle. And, enforcement sanction must be available for violation of principles themselves.<sup>169</sup> Second, separate from the enforcement context, the regulator should be conscious of the need to maintain an ongoing dialogue with firms about their practices.

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<sup>167</sup>This is reminiscent of the familiar phrase with respect to Project XL in the environmental arena: “if it ain’t illegal, it ain’t XL.” SPARROW, *supra* note 82, at 23.

<sup>168</sup>Schauer, *supra* note 23.

<sup>169</sup>*See, e.g.*, Stephen Bland, Director, Small Firms, U.K. FSA, Remarks, *in* Capital Ideas Conference, *supra* note 153, transcript at 23–24 (describing the Citigroup case in which that firm was fined £11 million for breaching two FSA principles); David Wilson, Chair, Ontario Securities Commission, Remarks, *in* Capital Ideas Conference, *supra* note 153, transcript at 53–54 (discussing Canadian mutual fund market timing probe, which resulted in mutual fund firms disgorging C\$209 million to investors based on having violated their obligation to treat their clients fairly).

Where a firm has shown an historical propensity to operate close to the line or to abide by the letter rather than the spirit of the law, that firm should be supervised more closely. Firms that have demonstrated bona fides may be granted more leeway.<sup>170</sup> Under this approach, the regulator may seek to enhance struggling firms' capacity by providing examples of others' good practices and refrain from pursuing formal enforcement where firms are engaged in a bona fide effort to abide by regulatory principles.<sup>171</sup> Again, a renewed relationship between regulator and industry, based on trust and information sharing, is an important piece of regulatory effectiveness.<sup>172</sup> And maintenance of an ongoing, regular, and collaborative dialogue between the regulator's compliance (not enforcement) function and industry actors could mitigate any relative delay, cost, and risk associated with seeking principles-based regulatory approval.

### C. A Partial Proposal: Tripartism

The BCSC already recognizes a particular role for third-party industry councils and trade associations, as a way of encouraging firms to learn from each others' best practices while maintaining an explicit light-touch regulatory focus.<sup>173</sup> More ambitiously, Ian Ayres and John Braithwaite have advocated for what they call "tripartism" as a form of responsive regulation.<sup>174</sup> Ayres and Braithwaite describe regulatory tripartism as a regulatory policy that fosters the participation of third-party public interest

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<sup>170</sup>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. Sorbo e-mail #1, *supra* note 152. This is consistent with the so-called "enforcement pyramid." AYRES & BRAITHWAITE, *supra* note 27, at 35–40.

<sup>171</sup>*See, e.g.*, Capital Ideas Conference, *supra* note 153, transcript at 63: "For these small firms, sometimes they don't know what good business practice is, and we're not saying, of course, that we know. But what we do have the ability to do is go to a large number of these small firms, observe what works, what is good, what doesn't work, and then play it back to the community as a whole as a sort of service to them, if you like, to help them improve their standards and run their businesses in good business practice ways."

<sup>172</sup>The BCSC's Capital Markets Regulation Division also works with trusted industry actors to develop principles-based win-win outcomes where possible. E-mail from Michael Sorbo, Manager, Examinations, BCSC Capital Markets Regulation Division, to author (Feb. 21, 2007, 13:19 PM PST) (on file with author).

<sup>173</sup>*See* Jakab Interview, *supra* note 145.

<sup>174</sup>AYRES & BRAITHWAITE, *supra* note 27, at 54–100.

groups in three ways: by giving third parties access to all the information the regulator possesses, by giving them a seat at the negotiating table, and by giving them the same standing to sue or prosecute that the regulator has. Ayres and Braithwaite suggest that a strategy of meaningful tripartite dialogue can facilitate attainment of regulatory goals, prevent corruption, and prevent the kind of agency capture that is harmful to the public good and regulatory goals. At the same time, it encourages helpful capture in which the regulator saves enforcement resources by overlooking minor or technical compliance breaches, and the firm more efficiently spends its resources on meeting the underlying goals of the regulation, including even making extralegal beyond-compliance efforts, rather than meeting the literal rules of the regulation.<sup>175</sup>

The notion of tripartism also has been advanced in the work of Neil Gunningham and Darren Sinclair, with respect to SMEs in the environmental regulatory arena.<sup>176</sup> Gunningham and Sinclair propose that, where government's capacity to regulate SMEs is limited, regulators may harness a credible third party to play a surrogate regulatory role. Regulatory surrogacy through trusted third parties may be particularly important in an environment like British Columbia, which is characterized by many small firms and junior-cap issuers. Third-party intervention is useful in this context as a means of helping SMEs meet regulatory requirements while not overstressing regulatory resources.<sup>177</sup> Third-party regulatory surrogates with commercial power or some other basis of authority relative to SMEs may also help break through SME resistance.

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<sup>175</sup>Ayres and Braithwaite also argue that the more complete "republican regulatory tripartism" they describe fosters democracy, both in terms of citizen empowerment and because the outcome under tripartism is more likely to be closer to the legal standard settled upon through the democratic process. *Id.* at 81–94. Like many scholars working under the New Governance umbrella, broadly defined, Ayres and Braithwaite see in their proposal the possibility of furthering not only better regulation, but better governance at large and, ultimately, a more effective, equitable, engaged, and legitimate democracy. *Id.* at 12–18. *See also* Dorf & Sabel, *supra* note 105; Michael C. Dorf, *After Bureaucracy*, 71 U. CHI. L. REV. 1245 (2004).

<sup>176</sup>GUNNINGHAM & SINCLAIR, *supra* note 159, at 13–40.

<sup>177</sup>The costlier option (and one that is more interventionist than anything existing in securities regulation to date) would be to establish an information arm within the BCSC that is in a position to respond to inquiries and conduct one-on-one compliance audits, completely separate from enforcement. This option is by the U.S. Occupational Safety and Health Administration with respect to SMEs under its regulation. *See* U.S. DEP'T OF LABOR, OCCUPATIONAL SAFETY AND HEALTH ADMINISTRATION, OSHA'S CONSULTATION PROGRAM, <http://www.osha.gov/dcsip/smallbusiness/consult.html> (last visited Sept. 7, 2007).

An appropriate third party might be a trade association or industry council, or it might include professionals like bankers or accountants who have preexisting relationships with the SMEs. Such a third party could provide face-to-face information, ongoing support, and clear practical guidance to SMEs, focusing on the ways in which good compliance practice is also good business practice. The third party could facilitate self-inspection and self-audit by publishing key criteria and communicating information about best and acceptable practices. Given the right incentives, an industry association, for example, could go further—requiring self-reporting; establishing awards for high performers; conducting audits; and supporting a streamlined, simple, inexpensive, and SME-appropriate accreditation process.<sup>178</sup> An additional possibility for increasing the public effect of regulatory approval of a particular best practice would be to institute a reward program for compliance leaders, under which they are permitted to use a revocable certification mark. Certification marks have gained real currency as it has been shown that they have value in the marketplace.<sup>179</sup>

Tripartite relationships may also be useful in the enforcement environment, as the use of what one might call “reform undertakings” at the U.S. SEC suggests. Reform undertakings are more open-ended, discursive problem-solving remedies embedded within traditional enforcement mechanisms. They seem to be a promising avenue.<sup>180</sup> Under a reform undertaking arrangement, the regulator’s enforcement staff and the firm enter into a settlement agreement relating to an action that enforcement has initiated for violation of the securities laws. One term of the settlement agreement is that the firm shall retain, at its own expense, an independent third-party monitor to oversee its compliance processes and procedures for a period of time after the settlement has been concluded. That third

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<sup>178</sup>GUNNINGHAM & SINCLAIR, *supra* note 159, at 16–24.

<sup>179</sup>Consider, for example, the International Principles Organization’s ISO 9000 (management systems), 14001 (environmental), and 26000 (social responsibility) certifications. Certification regimes also have crossed the divide between “technical” matters like management systems or Kosher certification, and more political questions, like those underlying ISO 26000 social responsibility mark. *See also* Ian Ayres & Jennifer Gerarda Brown, *Mark(eting) Nondiscrimination: Privatizing ENDA with a Certification Mark*, 104 MICH. L. REV. 1639 (2006) (proposing a voluntary mark to designate businesses that do not engage in employment discrimination on the basis of sexual orientation).

<sup>180</sup>Ford, *supra* note 110. *See also* Garrett, *supra* note 128 (describing the deferred prosecution phenomenon in criminal prosecutions).

party should have credibility and the right skill set and should be both independent and accountable. The third party's role is to intervene in the firm over a more extended period of time, identifying compliance failures and reasons for the alleged law violation. It then reports back to the regulator on its findings, recommendations, and the steps taken by the firm in response to those recommendations. Reform-undertaking provisions are generally drafted in prospective, principles-based language, giving the firm and third parties substantial scope to interpret what constitutes a reasonable or appropriate remedial recommendation. In an ideal case, a reform-undertaking third party uses best-practices learning in other contexts to ratchet up compliance performance in the subject firm. It operates in a transparent, reasoned, problem-solving manner and engages firm employees and officers in a dialogic process, both as an information-gathering tool and as part of challenging existing assumptions and forcing positive endogenous change.

Returning to the B.C. Model, there is nothing about Canadian jurisprudence that would preclude such creative remedies. To the contrary, similar remedies exist in multiple Canadian regulatory arenas and are consistent with Canadian approaches to public policy.<sup>181</sup> Reform-undertaking-style remedies have already been used by the IDA<sup>182</sup> and Market Regulation Services, Inc. (another SRO),<sup>183</sup> as well as the Ontario Securities Commission.<sup>184</sup> Reform undertakings or something approximating

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<sup>181</sup>See Cristie L. Ford, *In Search of the Qualitative Clear Majority: Democratic Experimentalism and the Quebec Secession Reference*, 39 ALTA. L. REV. 511, nn. 26–33 and accompanying text (2001) (identifying Canadian precedents for New Governance-style regulation).

<sup>182</sup>Settlement Agreement, In the Matter of Union Securities Ltd. and John P. Thompson (Apr. 18, 2006), available at [http://www.ida.ca/Files/Enforcement/SettlementAgreements/SA2006041801\\_en.pdf](http://www.ida.ca/Files/Enforcement/SettlementAgreements/SA2006041801_en.pdf) (retaining Grant Thornton LLP as a Compliance Monitor, tasked with, among other things, “monitoring and evaluating Union’s compliance systems and corporate governance procedures”).

<sup>183</sup>Market Regulation Services Inc., commonly known as RS, is the independent regulation services provider for Canadian equity markets. See Offer of Settlement, In the Matter of UBS Securities Canada Inc. (Oct. 8, 2004), available at <http://docs.rs.ca/ArticleFile.asp?Instance=100&ID=4CDF42F183D6455D903D528E03DF0330> (settlement agreement wherein UBS Securities agreed, inter alia, to retain an independent consultant to review its supervisory and compliance systems to ensure that they comply with Universal Market Integrity Rules).

<sup>184</sup>See Order, In the Matter of Agnico-Eagle Mines Limited (Apr. 28, 2005), available at [http://www.osc.gov.on.ca/Enforcement/Proceedings/RAD/rad\\_20050428\\_agnico-eagle-mines.pdf](http://www.osc.gov.on.ca/Enforcement/Proceedings/RAD/rad_20050428_agnico-eagle-mines.pdf) (settlement agreement wherein Agnico-Eagle Mines agrees to “initiate a review of its disclosure and reporting practices and procedures by an independent third party, acceptable to

the deferred prosecution agreement in the United States also are a clear possibility under the organizational sentencing provisions of the Criminal Code.<sup>185</sup> In their recent treatise on risk management, authors Todd Archibald, Kenneth Jull, and Kent Roach make a case for “embedded auditors” as a component of sentencing. Such sentencing orders would provide, under authority of court order, that regulatory inspectors be placed on site of the convicted corporation to monitor compliance for a period of time.<sup>186</sup> Thus, reform-undertaking-style third-party involvement already has roots in Canadian soil.

Regardless of the specific tripartite mechanism in question, involving a third party in governance increases the scope of perspectives available to the regulator. It also permits broader participation from stakeholders and others that typically do not have a voice in securities regulation, notwithstanding the importance of securities regulation to individuals and broader

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both Agnico-Eagle and Staff, at the expense of Agnico-Eagle” and “implement any recommendations made by the independent third party referred to above that are approved by Staff, within a reasonable period of time, as approved by Staff”); Order, In the Matter of Murray Hoult Pollitt and Pollitt & Co. Inc. (Nov. 17, 2004), *available at* [http://www.osc.gov.on.ca/Enforcement/Proceedings/RAD/rad\\_20041117\\_pollitt.pdf](http://www.osc.gov.on.ca/Enforcement/Proceedings/RAD/rad_20041117_pollitt.pdf) (settlement agreement wherein Pollitt & Co. agrees to “forthwith retain Cassels Brock Regulatory Consulting Inc., at its sole expense, to ensure that its revised practices and procedures have been properly implemented and to ensure that compliance staff and trading officers are properly trained in their obligations, roles and responsibilities”). The brevity of both Orders, and the absence of detailed terms governing the third party’s retainer and obligations, is striking relative to those from the IDA, the RS, and the U.S. SEC. *See* Ford, *supra* note 110, at nn. 140–43 and accompanying text.

<sup>185</sup>Criminal Code of Canada, Part XXIII: Sentencing: Probation. §732.1 (3.1) states, in relevant part,

The court may prescribe, as additional conditions of a probation order made in respect of an organization, that the offender do one or more of the following: . . .

(b) establish policies, principles and procedures to reduce the likelihood of the organization committing a subsequent offence; . . .

(d) report to the court on the implementation of those policies, principles and procedures; . . .

(g) comply with any other reasonable conditions that the court considers desirable to prevent the organization from committing subsequent offences or to remedy the harm caused by the offence.

<sup>186</sup>TODD L. ARCHIBALD ET AL., REGULATORY AND CORPORATE LIABILITY: FROM DUE DILIGENCE TO RISK MANAGEMENT ¶¶ 12:20:10.20, 12:50:60.20 (2005) (describing the statutory basis for, and rehabilitative potential of, placing state compliance auditors in companies convicted of criminal or regulatory offenses).

social interests. The examples above involve third-party expertise actors like compliance consultants and industry associations, but depending on the context this does not necessarily represent the universe of potential third parties. Tripartism plays a role in providing transparency and enhancing accountability, as examples from the larger world of corporate governance and corporate social responsibility activism demonstrate. For example, third-party-certified best or good practices affect consumers, as Forest Practices Certification has shown in the forestry industry.<sup>187</sup> Entire corporate compliance and corporate social responsibility consultancy industries now exist, and ethical investing funds and advocates pressure for triple-bottom-line reporting.<sup>188</sup> Other potential third parties include industry associations like the Canadian Bankers Association, nonprofit corporate social responsibility organizations like the Global Reporting Initiative, or for-profit firms like Innovest or Institutional Shareholder Services, which operates the Investor Responsibility Research Center.<sup>189</sup> Shareholder representatives and major accounting firms could even play a role. One should resist trying to identify the right third parties *ex ante*. One should also resist dismissing any potentially suitable third party out of hand, given the important role these actors could play in broadening the regulatory conversation beyond the dyadic.

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<sup>187</sup>Errol Meidinger, *The New Environmental Law: Forest Certification*, 10 *BUFF. ENVTL. L.J.* 211 (2003) (describing standard setting, certification, accreditation, and labeling for enforcing sustainable forest management standards in the absence of applicable national law); Richard B. Stewart, *A New Generation of Environmental Regulation*, 29 *CAP. U. L. REV.* 21, 34–43 (2001) (describing reflexive law information strategies for disseminating information about an organization's environmental performance, with the goal of giving stakeholders sufficient information to pressure organizations to "behave better").

<sup>188</sup>John M. Conley & Cynthia A. Williams, *Engage, Embed, and Embellish: Theory Versus Practice in the Corporate Social Responsibility Movement* (UNC Legal Studies Research Paper No. 05-16, Mar. 25, 2005), available at <http://ssrn.com/abstract=691521> (discussing, with some skepticism, the corporate compliance industry in London).

<sup>189</sup>Paul Rose, *The Corporate Governance Industry* (Ohio State Public Law Working Paper), available at <http://ssrn.com/abstract=902900> (identifying major for-profit and not-for-profit players in the corporate governance industry).

## V. CONCLUSION

Principles-based regulation and outcome-oriented regulation are responses to a visceral recognition that traditional, rule-oriented legal regimes are limited in their ability to deal with some broader organizational and cultural problems. Resistance toward effective compliance and other forms of corporate cultural dysfunction are not easily dislodged. Principles-based regulation forces agency on firms, making them active participants in defining the compliance processes that will best address their particular business risks and situation. Some version of outcome-oriented regulation is a necessary correlative to principles-based regulation, in that it is a responsible way to force accountability into a system that leaves articulation of the content of those principles to on-the-ground actors. Securities regulators can do quite a bit to advance their vision of modern securities regulation without statutory change. The decision of the BCSC to proceed with a principles-based and outcome-oriented regulatory approach, despite the fact that Bill 38 has not come into force, is a prime example of this option. Securities commissions have substantial discretion and extensive rulemaking powers. The practice of securities regulation can continually improve notwithstanding its statutory architecture in the implementation phase.

Principles-based regulation is important primarily because it identifies that on-the-ground implementation is more important than idealized (principles-based) statutory design. A principles-based and outcome-oriented regulatory approach consistent with New Governance, like the B.C. Model, does not advocate simply removing rules, leaving the capital markets to self-regulation or subject to the whims of a regulator's discretion. Rather, it provides a rational, systematic alternative to an unscripted layering-on of rules on rules to deal with each new situation and their corresponding adverse system effects. The most promising aspect of the B.C. Model is not the opportunity for open-ended and flexible securities regulation, viewed from the stratospheric level of statutory drafting and policy making. Rather, it is the opportunity for dialogic and transparent securities regulation, viewed from the ground occupied by industry, frontline regulators, corporate social responsibility advocates, and shareholders.