



**Remarks by David Wilson**

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**Enhancing Prosperity: Fair, Efficient and Balanced Regulation**

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**Check against delivery**

Good morning. Before saying anything else, I want to say how pleased I am to be joined today by three of my colleagues from the Canadian Securities Administrators: Jean St-Gelais, the Chair of the CSA and President of the AMF in Quebec; Bill Rice, Chair of the Alberta Securities Commission and Doug Hyndman, Chair of the B.C. Securities Commission.

The OSC along with our CSA colleagues are working very closely towards our shared objective of coordinating and harmonizing the regulation of capital markets in this country. The CSA is doing great work on a number of regulatory fronts, such as the Registration Reform Project.

One of this conference's co-chairs is Linda Hohol, President of the TSX Venture Exchange. Your exchange plays a vital role in providing a capital-raising gateway for growing dynamic new companies to drive Canada's economic future.

Entrepreneurial success helps drive the development of our economy. Our economy needs people to take risks, it needs new ideas and it needs people who have optimism. Our economy also needs people to have trust in the integrity and fairness of our capital markets.

Think for a moment about what distinguishes an advanced economy from an underdeveloped one? I think a fundamental difference is how wide a circle of trust people can count on in conducting their business and commercial activities.

In underdeveloped economies, most people would not trust anyone with their money – outside their own family. In many emerging markets, the circle of trust widens to include friends and those with a close cultural bond.

But in advanced economies, trust is a fundamental cornerstone of prosperity and progress. And that has to include the confidence people need to trust strangers with their capital.

As the renowned Peruvian economist Hernando De Soto notes, the gulf between nations that have successfully cultivated capitalism and those where capitalism has not flourished is measured by trust.

Where there are regulatory and legal institutions designed to ensure the functioning of capital markets, financial institutions and contract law, prosperity is virtually assured. Where business is done with a wink and a nod, prosperity is a dream, not a reality.

Nations where contracts are not binding, where titles to property are not clearly enforceable and where legal rights are not an established fact are much less likely to prosper.

That is why Canada's capital markets have flourished: Issuers, investors and intermediaries have trust in our regulatory system.

The difference is the contrast between a capital market that repels capital – and one that serves as a magnet for it.

The OSC and our counterparts across Canada represent the broad institutionalization of trust in our economy – and it is the duty of regulators to maintain that trust.

As Bank of Canada Governor David Dodge has pointed out: “For our financial markets and institutions to be internationally competitive, our regulatory framework needs to be – and needs to be seen to be – as good as, if not better than that of other countries.”

Today, I want to talk about some of the areas where regulators need to examine to ensure that our regulatory framework continues to meet internationally competitive standards.

In particular, I want to discuss four areas:

1. corporate governance
2. pooled investment vehicles
3. enforcement, and
4. a topic I haven't had a chance to discuss before – the debate between regulation based on broad principles and regulation based on precise and specific rules.

In each of these four areas, the regulatory goal must be to foster fair, efficient and balanced capital markets – pursuing an approach that will position our markets to contribute to economic growth and compete internationally for capital.

## **Corporate Governance**

The first area I want to discuss this morning is corporate governance. There are a few areas here that demand our attention as regulators.

Let's start with SOX 404 – internal controls. My colleague Susan Wolburgh Jenah will be talking about internal controls in the first panel discussion. But I would like to say a few words about our perspective on this topic.

For quite some time, regulators have been contemplating the implications of importing SOX 404 to Canada. The issue went out for comment. Not surprisingly, a great many views were expressed.

Obviously a decision on internal controls will have a major impact on a big chunk of our economy. Implementing SOX 404 in Canada would directly affect Canadian companies having an aggregate market cap of over half-a-trillion dollars.

So we have to get the issue right for these Canadian companies. If we adopt foreign regulations, we must adapt them to suit the distinct needs of the Canadian market.

We also must seek an appropriate approach to executive compensation disclosure for our market. In an executive compensation culture that some feel is not sufficiently tied to corporate performance, where complex compensation arrangements including stock options and top hat pensions are difficult to quantify, our disclosure rules probably need to be tightened up. Regulators have been trying to bring more clarity to this area. Last year the OSC and CSA released a Staff Notice

commenting on executive compensation disclosure in the context of supplemental retirement benefits – top hat pensions. We’re also monitoring recent developments in the U.S. in this area.

Shareholders want to easily and accurately compare and assess what executives are paid – rather than try to juggle several financial tables and footnotes. Shareholders want to be able to answer a simple question: How much are the shareholders paying the CEO? They want a clear number. They also want to know how directors have linked rewards for senior executives to overall corporate performance. As Warren Buffet famously said:

“Executive compensation is the acid test of corporate governance.”

Another area of corporate governance where we must consider the distinct characteristics of the Canadian market concerns closely-controlled companies. In contrast to the U.S., our market is home to a relatively large number of closely-controlled companies. And

we've heard concerns about the CSA governance guidelines' definition of an "independent director" in regards to such companies. The CSA is taking these concerns seriously. When we issued the corporate governance guidelines last April, we committed to reviewing them within a year to assess their impact on closely-controlled companies. By this April, we will be seeking input from interested parties. We will hear all points of view to ensure that we have a policy framework that provides a regulatory approach that is tailored to the characteristics of our market.

### **Pooled Investment Vehicles**

The second area I want to discuss is Pooled Investment Vehicles, such as mutual funds and hedge funds, and the need to update some portions of the regulatory regime in regard to them.

Hedge funds clearly needed to be reviewed, given their sudden growth and evolution. We've seen high-profile problems in this industry, such as Portus.

It wasn't very long ago that hedge funds were the exclusive domain of wealthy "accredited investors," knowledgeable enough to weigh the risks for themselves. Today, hedge funds have extended their reach towards mainstream investors, many of whom do not have the time or the expertise to apply the same degree of due diligence.

In fact, hedge funds have exploded in Canada from representing roughly \$4 billion to over \$30 billion in managed assets.

We at the CSA have pretty much determined that hedge funds *per se* do not require their own separate regulatory regime. But we must ensure that the existing rules that apply to all pooled fund

vehicles are being applied appropriately and effectively to the innovative and rapidly growing hedge fund sector.

For example, it's important to examine referral arrangements, a task which the Mutual Fund Dealers Association has taken on in cooperation with the CSA and the Investment Dealers Association. It's also important to review the appropriateness of the prospectus exemption granted to Principal Protected Notes – PPNs. We need to take a hard look at whether this exemption is suitable for highly complex structured products targeted at the mass market of retail investors. A recent article described PPNs as “raining down upon the market” as an issuance vehicle for structured products in Canada.

We are also continuing to protect the integrity of the mutual fund market. For those who are limited by time, resources and expertise, mutual funds are the window to the world of investing.

Maintaining investor confidence in mutual funds is pivotal to maintaining their confidence in investing.

Mutual fund investors are the ultimate passive investors. Who is to look after their interests when they inevitably come into conflict with the interests of fund managers? This unanswered question has created a regulatory gap.

In 2004, an Ontario Legislative committee called for Ontario regulators to fill the gap by assuring proper oversight of fund managers when faced with potential conflicts of interest.

When entrusted with other people's money, it is essential that someone truly independent of the manager is in the room, representing the interests of passive mutual fund investors.

For that reason, we are working with the CSA on a proposed rule that would impose a minimum, consistent standard of governance for all publicly offered investment funds. It would put in place an Independent Review Committee for investment funds, a sector where Canadians have invested about \$600 billion of their savings – \$25 billion in last year alone.

## **Enforcement**

The third area I want to touch on is the need for fair, vigorous and timely enforcement.

Market abuses are an attack on the trust we are charged with protecting. People will take risks so long as they believe that the market fosters equal opportunity, social mobility and economic fairness. But a market that is perceived to be tainted by abuse and neglected by regulators will fail to attract domestic and foreign

capital flows. It will also fail to attract the potential offered by new ideas and optimism.

People will take a risk, but they won't take a gamble against a stacked deck. We must vigorously signal to these people that the game is fair and that cheaters will be punished.

Quite simply: Failure to prevent, detect and deter abuses such as theft, fraud and insider trading will send the world a very negative message. A message that we accept the preservation of two self-contained, yet dysfunctional markets – one market for outsiders and another for insiders. One market for those who risk their savings and another for those who risk the integrity of the market.

We are sending the message that we do not treat honest investors as second-class citizens. We are sending the message that it is safe to take a risk here because our market is open, transparent and fair.

And we are sending the message to those that would even contemplate violating our regulations – it isn't worth taking the risk.

And we're sending this message by strengthening our enforcement regime.

One of the best ways we are doing that is by building partnerships and relationships with other agencies.

We are attempting to close the historic gap between securities regulation and criminal law enforcement. We're building bridges with enforcement authorities in the RCMP – through the IMETs initiative – and the Ministry of the Attorney General. I'm convinced that by pooling talent and resources and through

enhanced cooperation, we will become more effective in the enforcement area.

We are also fostering alliances with our counterparts in securities regulation. At the OSC, as I mentioned earlier, we work closely with the CSA, and are strengthening ties with the SEC. In an era when fraudulent activities can span provincial and national borders, regulators must be able to work together seamlessly.

### **Principles versus Rules**

The fourth and final area that I would like to mention is the longstanding debate over the place of principles and rules as the basis of securities regulation.

Now is a good time for all of us to take another hard look at that question. It is a time for some further regulatory reflection,

especially in light of the discussion surrounding the evolution of the Passport system, the Crawford Blueprint, and the recent decision by British Columbia to defer legislation relating to regulatory change.

I don't come to this debate with any preconceptions. What I want to do more than anything else is take as many opportunities as possible to discuss the advantages of both rules-based and principles-based regulation with my CSA colleagues and stakeholders in the system.

Detailed regulatory rules and regulations have their advantages and their drawbacks.

Clear rules are relatively easy to interpret and enforce. They tend to command immediate action. And they build confidence in a

public that can understand regulations that are set down in clear, black-and-white language.

On one hand, the volume and complexity of rules could render them an unintelligible maze. Rules offer the advantage of a clear road map; but they could just as easily constitute a map to exits and shortcuts – loopholes that can be exploited to undermine the very spirit of the regulation. And while rules put in place a minimum set of standards – a floor as it were – that often has a tendency to become the ceiling, as market participants meet the minimum requirement and no more.

A regulatory regime based on broad principles, on the other hand, allows itself the flexibility to adapt to the evolving conditions of the market. Principles become evolving standards, which can adjust to different circumstances and changing needs. They could also encourage continuous improvement over time.

But principles can be difficult to enforce. Often, interpretation is needed to compensate for a lack of specificity.

Rules and principles are not mutually exclusive. The reality is that both are needed to achieve the most effective regulation possible.

The balance will, of course, depend upon the context and the goals of a particular regulatory initiative. What works well in some situations may not be the best approach in others. The point regulators must occupy on the rules-versus-principles spectrum might depend on the activity that they are trying to regulate. As regulators, we need to focus on what works – what is most effective in preserving trust in our markets.

And neither approach should be taken as a regulatory license to micro-manage. Rather, what we need to do is set out a clear

framework and then enforce it, not interfere at will with the workings of the markets.

I'm a new regulator, having been Chair of the OSC for only four months now. I have not developed a view on the debate about rules and principles, but I do want to contribute to the dialogue. As I said, I'm encouraging further discussion about the advantages of both rules-based and principles-based regulation.

## **Conclusion**

These are some of the contemporary important issues that are confronting regulators. What balance do we strike between principles and rules in driving our approach to regulation? How to improve corporate governance while taking into consideration the unique needs of our Canadian market? What steps do we take to ensure fairness for all investors in Pooled Investment Vehicles?

And how do we best deliver fair, vigorous and timely enforcement?

We are living in an era of evolving demands, rising expectations and rapidly changing conditions. These changes can present regulators with new challenges to market integrity and the protection of investors.

Our goal is to meet these challenges in a way that fosters fair, efficient and trustworthy capital markets – a balance that contributes to prosperity and growth.

Thank you very much.

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