

ONTARIO EXPERT COMMISSION ON PENSIONS

Research Mandate #5: Comparative Models of Risk-based Financial Services

**Mary Condon
Osgoode Hall Law School
York University**

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EXECUTIVE SUMMARY

1. This paper is intended to provide an overview of the academic literature concerning two recent innovations in philosophies of regulation (i) principles-based regulation and (ii) risk-based regulation. The paper also canvasses the implementation of these regulatory philosophies by a number of financial and pension regulators, both within and outside Canada.

2. Principles-based regulation (PBR) is usually considered to have the following features:

- promulgation of high-level standards that are drafted at a broad level of generality
- a focus on an outcomes-based approach
- a commitment to enhanced stakeholder participation in the design of principles
- increased responsibility of regulated entities' senior management for the implementation of principles within firms
- reliance on constant improvement of industry best practices and guidance with respect to best practices rather than prescriptive rule-making

3. Case studies of principles-based regulation

In this section of the paper, material is presented dealing with the U.K. Financial Services Authority, the British Columbia Securities Commission, as well as a number of DB pension regulators. The U.K. Financial Services Authority (FSA) has adopted 11 “principles for business” which are expressed in terms of outcomes and behaviours, rather than process. The FSA intends that its principles-based approach permeate all aspects of its regulatory efforts; key areas where it has concentrated implementation of the approach include its “treating customers fairly” initiative and new “conduct of business” requirements, along with simplified reporting requirements. Firms that implement appropriate internal management systems so as to achieve the designated outcomes can expect lower levels of regulatory scrutiny; on the other hand, the FSA is prepared to take enforcement action based on failure to achieve principles-based outcomes.

Meanwhile, the BC Securities Commission is the Canadian securities regulator that has most enthusiastically endorsed a principles-based approach, while acknowledging that prescriptive rules may still be necessary where a rule could not achieve the desired result through outcomes-based requirements. In the DB pension regulation context, there is some evidence of a move to a principles-based approach by the new Pension Regulator in the U.K. This is currently less obvious in Canada and in the U.S., despite supportive commentary from the Chair of the Federal Reserve.

4. Controversies that are discussed in the academic literature with respect to the adoption of PBR include the following;

- lack of certainty for regulated participants, as compared to prescriptive rule-based approaches

- will modes of collaboration in the design of principles systematically favour those regulated participants who are already powerful?
- will existing methods of legal or political accountability for the introduction and implementation of rules (such as notice and comment requirements) require an overhaul to accommodate the more fluid and outcome-oriented approach of PBR?
- what are the conditions under which breach of general, outcome-oriented principles could be the subject of enforcement action by a regulator or indeed, a civil suit?
- specifically in the pension context, could the achievement of the desired outcomes established by a PBR approach actually be effectively monitored by the regulator, given the time horizons involved?
- are all regulated participants equally well-placed to rise to the challenge of incorporating broadly-based principles into the design and monitoring of internal compliance systems?

5. Based on the above material, issues for consideration with respect to shifting to PBR in the Ontario DB pension context include;

- would PBR enhance the willingness of employer sponsors to maintain a commitment to DB pension provision, given evidence of an increasing shift to DC forms of pension as an alternative?
- can the collaborative design of principles be structured so that beneficiary groups and other third-party stakeholders have a consequential role in the process?
- should the broad, outcome-based principles adopted deal with core substantive issues such as arrangements for plan funding, or the investment of assets, or should they be limited to the reduction of compliance costs with respect to more peripheral regulatory requirements?
- in so far as the introduction of a principles-based approach relies more heavily on upgrading internal management and reporting systems within sponsor firms and less on reactive enforcement activity by the regulator, would this be a positive development?

6. Risk-based regimes of regulation have the following common features;

- they emphasize the need for regulation to be proactive and preventive, rather than reactive and enforcement-oriented
- they validate the enterprise of being selective about the regulatory problems that are targeted for attention, thereby acknowledging the possibility that there may be some regulatory failure
- they employ specific risk assessment techniques which tend to be quantitative and probability-based, which often rely on the collection of large amounts of data as well as mobilizing the knowledge of experts both in the design of risk assessment tools and the interpretation of the data thereby gathered
- they rely to an important extent on the development and operation of internal control systems within regulated organizations to manage the risks identified by the regulator

7. Case studies of risk-based regulation

In this section, material is presented dealing with the U.K. FSA, the OSC, the U.K. Pension Regulator and FSCO. The U.K. FSA has developed a highly quantitative instrument for scoring the risk levels of regulated firms. The relevant risks are those that cause harm to the achievement of the FSA's statutory objectives, such as firm financial failure, misselling, or market abuse. The FSA considers risk to reside in the combination of the impact and the probability of an event. For firms assessed as "low impact" (the overwhelming majority of the firms regulated by the FSA), firm-specific risk assessment is rarely carried out.

The Ontario Securities Commission developed a risk-based approach to its regulatory tasks in 2002. Across the span of substantive regulation engaged in by the OSC (continuous disclosure review, registrant compliance etc), various criteria are identified in order to evaluate which activities and participants might be considered "high risk". These enumerated criteria are in general fairly loosely defined, with the most detailed set of criteria to be found in the registrant compliance area.

The U.K. Pension Regulator takes a risk-based approach to regulating its universe of DB plans. The legislative framework under which it operates introduced a "scheme specific" funding framework in 2006 rather than a generalized minimum funding requirement. The Pension Regulator focuses intensively on a small subset of the population of funds, that is, those with more than 1,000 members. It uses a filter mechanism based on two separate triggers to identify schemes whose plans for funding seem to be based on imprudent assumptions. In addition, the PR pays attention to the strength of the "employer's covenant" in specific schemes, thus including a more qualitative dimension to its risk assessment processes.

Finally, information is provided concerning FSCO's current implementation of a risk-based regulatory strategy, in the areas of (i) review of funding arrangements and (ii) plan investments. The data gathered by FSCO as a result of its industry-wide risk-based review of funding suggests that plans have more difficulty with full funding on a solvency basis than on a going concern basis. Some convergence with respect to actuarial practices is evident from the data, particularly with respect to the interest rate assumptions used to value going concern liabilities and the mortality tables used.

8. Controversies discussed in the academic literature concerning risk-based regulation include the following;

-is the process for choosing risk priorities well-founded and transparent? In particular, is there a mismatch between the risk perceptions and risk acceptance of "citizens" and those of the experts designing and implementing risk identification and assessment techniques? If there is such a mismatch, what weight should regulators give to the risk perceptions and tolerance of the public or, in the pension context, of beneficiaries?

-as with PBR above, are all regulated participants equally well-placed to invest in the internal risk management systems that substitute for robust levels of regulator-led reactive enforcement?

-to what extent can risk-based approaches to regulation measure up to traditional indicators of “good regulation”, such as fair and consistent treatment of all regulated participants, or due process protections from the exercise of regulatory discretion?

1. INTRODUCTION

The research mandate pursued in this study is to provide an analysis of two contemporary philosophies about the appropriate way to formulate regulatory schemes. These are (i) a principles-based approach to regulation and (ii) a risk-based approach to regulation. Both of these orientations to the design and implementation of regulatory schemes will be defined below. The analysis of these novel approaches to regulation will proceed on two levels. First the study will canvass the information available about the application of both of these approaches in related locations of financial regulation in Canada and elsewhere, as well as their application in pension regulatory schemes other than Ontario. Thus, a variety of case studies of the adoption of these approaches in various sites of financial regulation will be selected. In addition, comparative pension regulation examples will be presented where relevant. The second level of analysis will provide an overview of the academic literature discussing both of these approaches, and specifically will attempt to identify the most cogent issues that are likely to be relevant to a consideration of principles-based and risk-based approaches in the context of Ontario pension regulation.

2. PRINCIPLES-BASED REGULATION (PBR)

A. What is meant by principles-based regulation?

PBR is usually defined by comparing it to what it is not, that is, rules-based regulation. At the most general level, the debate is about what is the optimal level of detail to provide in a regulatory standard directed at regulated participants. The debate in the regulatory context mirrors a much longer standing one with respect to legislated or

judge-made law. As Cunningham expresses it, “Debate over classification and relative desirability of articulating law as rules or principles engages a long and jurisprudential history¹”. Thus for example equitable principles have historically been available “to mediate application of rules whose literal enforcement would work hardship²”. Ford distinguishes between rules and principles as follows: “..a rule generally entails an advance determination of what conduct is permissible, leaving only factual issues to be determined by the frontline regulator...A principle may entail leaving both specification of what conduct is permissible and factual issues for the frontline regulator³”. It may immediately be seen that a major feature of PBR is to repose additional discretion in the hands of the regulatory decision-maker.

Scholars and regulators who advocate the adoption of a principles-based approach to regulation usually identify the shortcomings of rule-based regulation that PBR responds to in the following terms⁴. Rules are merely a “best guess” as to the future and their application may have unanticipated consequences. They may be over or under inclusive and may also fail to provide templates to deal with new situations. Nor can the act of promulgating a rule, by itself, guarantee that it will be abided by, as much will depend on the organizational environment in which regulated participants interpret it⁵.

¹ L Cunningham “Principles and Rules in Public and Professional Securities Law Enforcement: A Comparative U.S.-Canada Inquiry” Research Study for the Task Force to Modernize Securities Legislation in Canada, May 31, 2006 at 263, online: [http://www.tfmsl.ca/docs/V6\(5A\)%20Cunningham.pdf](http://www.tfmsl.ca/docs/V6(5A)%20Cunningham.pdf)

² Ibid.

³ Christie L. Ford, “New Governance, Compliance, and Principles-Based Securities Regulation” (Forthcoming) American Business Law Journal, online: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=970130

⁴ The following material is drawn from Julia Black and Herbert Smith LLP “Principles-based regulation. In principle and in practice” Unpublished paper, February 2007, online: <http://www.lse.ac.uk/collections/law/projects/5924%20PBR%20Flyer%20D2.pdf> ; Cunningham, *Supra* note 1; and Ford *Supra* note 3.

⁵ Black *et al.*, *ibid.*

Several scholars like Cunningham and Ford worry that rules offer the opportunity for strategic avoidance and loophole game-playing. As Cunningham puts it, “Rules can be mere blueprints for evading their underlying purposes. Bright-lines and exceptions to exceptions facilitate strategic evasion, meaning artful dodging of a rule’s spirit by literal compliance with its technical letter. The result is gestures of adherence, not acts of fulfillment⁶”. In that sense, according to Ford, rules may take on the characteristic of being a “moral hazard”. In contrast, she argues, “[p]rinciples-based regulation forces firms to actively take responsibility for their own compliance with underlying principles, rather than “facial compliance with detailed rules”, thus making them “agents rather than subjects of regulation⁷”. This theme of active and collaborative participation in the design and implementation of principles by regulated participants is a major feature of the advantages offered by PBR.

It may be worth dwelling for a moment on the issue of why the debate about the respective merits of principles-based as opposed to rule-based regulation is occurring at the present time in regulatory scholarship and policy. Some commentators see it as consistent with a general orientation to deregulation that has been a feature of government policy in many countries for the last several decades. While much empirical examination of deregulatory initiatives across the spectrum of governmental activities has concluded that deregulation operates more as a rhetorical strategy than an actual result of policy change, there is more consensus that the “new regulatory state⁸” downloads much of the detail of regulatory processes to regulated participants or non-governmental

⁶ Cunningham, *supra* note 1 at 265-266

⁷ Ford, *supra* note 3, at 27

⁸ John Braithwaite “The new regulatory state and the transformation of criminology” (2000) 40 *British Journal of Criminology* 222; Orly Lobel “The Renew Deal: The Fall of Regulation and the rise of governance in contemporary legal thought” 89 *Minn. L.R.* 342

organizations, in the interests of achieving efficiencies, more flexibility and less bureaucratization. In the sphere of financial regulation specifically, it is claimed that reducing levels of “command and control” style regulation may foster innovation and competition among capital market participants⁹. From a political economy perspective, there is also some suggestion that the flexibility and open-endedness enabled by PBR is being pushed forward by the trend to globalization, in that less detailed prescription enables organizations to better adopt internal management and compliance systems that will work in a number of jurisdictions¹⁰.

B. What are the major features of principles-based regulation?

1. As implied by the discussion above of the distinction drawn by proponents of this approach between principles and rules, PBR involves the promulgation of **high-level standards that are drafted at a broad level of generality**. Some examples of such principles (discussed in greater detail below) include exhortations like “A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading” or “A firm must arrange adequate protection for clients’ assets when it is responsible for them”¹¹. As implied by these

⁹ For example, a connection has been made between the economic success of London capital markets and the FSA’s advocacy and practice of PBR. See Ford, *ibid* at note 3. See also the U.K. Economic Secretary, Speech to Life and Pensions Conference on 14 Dec 2005, viz “...principles rather than rule-based requirements are far more likely to support innovation in financial markets”. See also the principles for good regulation enumerated in the U.K. Financial Services and Markets Act 2000, Part 1, s.2 which include the desirability of maintaining the competitive position of the UK and the need to minimize any adverse effects on competition.

¹⁰ Sara Hansard “Regulation Round Table: Principles-Based Regulation May Become the Norm in the U.S.” *Investment News*. (19 March 2007), online:

<http://investmentnews.com/apps/pbcs.dll/article?AID=/20070319/FREE/70319003/-1/INIssueAlert04>

¹¹ These are principles 7 and 10 respectively of the U.K Financial Services Authority’s (FSA) eleven principles for business. See FSA, *Principles-based regulation: Focusing on the Outcomes that Matter* (London: FSA 2007), online: <http://www.fsa.gov.uk/pubs/other/principles.pdf>

examples, principles tend to focus on the essence of what regulated participants are expected to achieve in their activities, that is, on their general behaviour rather than on particular processes that they are required to follow¹².

While the implications of a principles-based approach for enforcement by regulators will be discussed below, it is worth noting that some of the literature in this field discusses the merits and demerits of a principles-based approach to the activity of enforcement itself¹³. That is to say, a principles-based approach can operate both at the level of front-end standard setting and at the level of back-end enforcement of rules or principles. In securities regulation for example, it is possible for regulators to sanction market participants for behaviour that is deemed to be contrary to the “public interest”, whether or not that behaviour contravenes a substantive rule of securities regulation¹⁴.

2. Relatedly, principles-based regulation is universally described as involving an **outcomes-based approach**. This orientation is often characterized as sharply distinct from a process-based approach¹⁵. The idea is that regulators define the outcomes to be achieved by regulated participants, with the implication being that the regulated are provided with more flexibility to decide how to achieve the relevant outcome. An example of an outcome defined by the FSA is that “products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and

¹² Black, *et al. Supra* note 4.

¹³ James J. Park “The Competing Paradigms of Securities Regulation” 57 Duke L.J. (Forthcoming 2007). Online: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=999474

¹⁴ *Ontario Securities Act*, R.S.O. 1990, c. S.5, s.127; *Canadian Tire* decision, online: http://www.osc.gov.on.ca/Regulation/Orders/2005/ord_20051216_2110_canadiantire.jsp; Condon, Anand, & Sarra, “Securities Law in Canada: Cases and Commentary” (Toronto: Emond Montgomery Publications, 2005); Cunningham, *Supra* note 1, at 275-282.

¹⁵ Ford, *Supra* note 3, at 39.

are targeted accordingly¹⁶”. In the context of the FSA’s adoption of an outcomes-based approach, Black et al argue that its “(f)ocus on outcomes.. resembles a form of performance-based regulation... The outcome or performance standard may be tightly defined...or more loosely defined¹⁷”.

Although presumably it would be possible for a regulator to come up with its desired outcomes independently, much of the scholarly literature on outcomes-based regulation advocates that “industry involvement in developing the content of rules to which industry will be subject is integral to outcome-oriented regulation¹⁸”. Meanwhile, if the regulatory stance under this approach is all about outcomes, those who are regulated are delegated the responsibility to come up with the processes that will achieve regulator-defined outcomes. However they may embark on the task of developing the appropriate internal processes to achieve the desired outcomes without the “fear of falling offside detailed (and potentially anachronistic and less effective) regulatory requirements¹⁹”. A system where regulated participants are able to customize their own processes to achieve defined outcomes may also be advantageous with respect to costs, both those of the regulator and the regulated. In this way, a principles-based approach may mitigate the complaints of a particular regulated community that pervasive, proactive and detailed compliance requirements impose significant costs, in the absence of persuasive evidence of a need for the requirements²⁰.

¹⁶ Black, *et al*, *Supra* note 4, at 6.

¹⁷ Black, *et al*, *Supra* note 4, at 5.

¹⁸ Ford, *Supra* note 3, at 19.

¹⁹ Ford, *Supra* note 3, at 23.

²⁰ M. Condon and P. Puri, “The Role of Compliance in Securities Regulatory Enforcement” Research Study Commissioned by the Task Force to Modernize Securities Legislation in Canada, 2006). Online: [http://www.tfmsl.ca/docs/V6\(1\)%20CondonPuri.pdf](http://www.tfmsl.ca/docs/V6(1)%20CondonPuri.pdf)

Some scholars position an outcome-oriented approach as distinct from both high levels of regulatory discretion or systems of self-regulation. Thus Ford maintains, “Relative to these options, New Governance-style principles-based and outcome-oriented regulation spans the so-called “public/private divide”, incorporating industry experience and perspectives into a still-resilient regulatory capacity²¹”. As Parker argues, state coercion is still necessary in regulating self-regulation²².

It may also be noted that an outcome-oriented approach likewise be reflexively applied to the regulator itself. That is to say, recent discourses of regulation have advocated that “a more results-oriented approach to public administration” be taken, based on the application of regulatory performance metrics²³. Thus, for example, the U.K. Pension Regulator outlines three key “performance indicators” to be achieved during a three-year time frame²⁴. On the other hand, critics of this development suggest that this requires government regulators to mimic the market, and that the criteria for evaluating the “success” of regulators are insufficiently sensitive to a range of possible regulatory goals other than efficiency²⁵.

Advocates of outcomes-based approaches do not purport to clarify the potential *content* of the outcomes that are settled upon, since this will vary in substantive regulatory contexts. What is generally advocated is an orientation towards flexibility and

²¹ Ford, *Supra* note 3, at 34

²² Christine Parker “Regulating Self-Regulation: The ACCC, ASIC, Competition Policy and Corporate Regulation” in S.Bell (ed) *Institutional Dynamics of Australian Economic Governance* OUP, 2002

²³ Ford, *Supra* note 3, at 19. See N Douglas Lewis *Law and Governance: the old meets the new* Cavendish, 2001 and cf. Patrick Dunleavy et al “New Public Management is Dead – Long Live Digital Era Governance” (2006) 16:3 *JPART* 467-494.

²⁴ The Pensions Regulator “Medium term strategy” April 2006, at p.3-4, online: <http://www.thepensionsregulator.gov.uk/pdf/mediumTermStrategy.pdf>. These performance indicators address (i) scheme funding (ii) governance of pension schemes (iii) risks to DC members.

²⁵ Janine Brodie “The Politics of Social Policy in the 21st Century” in David Broad (ed) *Citizenship and Social Policy: Neo-liberalism and Beyond* Halifax: Fernwood Press, 1999

a focus on problem-solving²⁶, which may, for example, involve treating industry participants differently based on their “risk profile” or abandoning rules that have become redundant because they no longer achieve desired outcomes. The relationship between principles-based regulation and risk-based regulation will be discussed further below, but it appears that some regulators and scholars regard a focus on risk identification and management as a practical example of a principles-based approach²⁷.

3. An implication that flows from the discussion of outcome-based approaches above is a commitment to **enhanced stakeholder participation** in a principles-based approach. Again, Ford identifies “ongoing deliberation” as a key aspect of new governance approaches. She argues that that deliberation is “accomplished by decentralized, broadly participatory stakeholder groups that can access local knowledge and context-specific understandings of a situation²⁸”. She further advocates the need for “robust ongoing communication mechanisms (rather than an information-hoarding, adversarial relationship) between industry and regulator²⁹”. Regulators need to commit to the possibility that they can learn from industry members they are regulating.

In the context of the FSA’s adoption of a principles-based approach, Black et al suggest that

²⁶ Sparrow, Malcolm K., *The Regulatory Craft: Controlling Risks, Solving Problems, and Managing Compliance* (Brookings Institution Press, 2000).

²⁷ See for example the speech of the U.K. Economic Secretary (December 14, 2005) to the effect that “The focus on the quality of risk management naturally leads to a principle-based approach to regulation. This also encourages management to develop their own assessment of business risks, rather than restrict them through sets of rules”. See Ford, *Supra* note 3.

²⁸ Ford, *Supra* note 3, at 25-26.

²⁹ *Ibid*

“Principles-based regulation will work only if there is on-going dialogue between the FSA and regulated firms which develops shared understandings of what conduct is required by the Principles. It is only through extensive regulatory conversations as to the objectives of the regulatory regime, to the respective roles and responsibilities of regulators and regulated firms in achieving those objectives, and to the interpretation and application of the regulatory requirements that any regulatory regime can operate, particularly one which is Principles-based...³⁰”

4. Related to the idea that regulated participants are to be delegated the responsibility to figure out how to achieve the outcomes established by the regulator is that this task involves **increased responsibility for the senior management of firms**. This view has been recently expressed by the FSA. A commitment to “management-based regulation” would ideally involve a recognition by management of the ways in which internal incentive structures and “firm cultures” support or do not support the achievement of regulatory outcomes³¹. An example of this is the way the FSA deals with so-called “market abuse”, such as insider trading or market manipulation. According to the Director of the Markets Division of the FSA, the regulator’s “high level expectations of firms” focus on the need for senior management to “properly manage conflicts of interest and the need for self-reporting by firms if senior management suspect that their own staff have engaged in misconduct”³². In return, the FSA’s commitment to firm senior managements is that “if you can demonstrate your firm has good systems and controls and is complying with them... we won’t pursue the firm in an enforcement action, just the individual”. More generally, the FSA now attempts, in its on-going supervisory

³⁰ Black, *et al.*, *Supra* note 5, at 21.

³¹ Condon and Puri, *Supra* note 20.

³² Sally Dewar, “Market Abuse Policy and Enforcement in the U.K.” Speech to the BBA and ABI Market Abuse Seminar, 22 May 2007, online: http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2007/0522_sd.shtml

processes, to evaluate the extent to which the “firm culture” of financial services providers pose a risk to the outcome of “treating customers fairly³³”.

5. The literature on PBR emphasizes the role of policies and best practices rather than static rule-making. Ford³⁴, for example, proposes the merits of “rolling best practices rulemaking” which involves benchmarking and the establishment of “best practices” by a government regulator, which an industry has to match or exceed. She notes that, “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”. The reason why firms will want to engage in this process is because they have other risks to mitigate, such as reputation risks, liability risks and so on³⁵. The assumption embedded here is that regulation is not the only source of discipline imposed on regulated firms. It is clear that industry councils or trade associations are still intended to play a central role in articulating these often-enhanced best practices standards. But almost by definition, this has to appear in guidance (policy papers; interpretive statements and the like) rather than rigid rules. Black et al argue that with respect to both financial services and tax regulation, “there is a growing consensus that the most appropriate response is to combine Principles with elaboration in the form of guidance rather than more detailed rules³⁶”.

³³ See FSA/PN/088/2007 and FSA, *Treating customers fairly – culture*, (London: FSA 2007), online: http://www.fsa.gov.uk/pubs/other/tcf_culture.pdf

³⁴ Ford, *Supra* note 3, at 36ff.

³⁵ This is why the investment firms appearing in Ford’s example had developed their own proprietary systems for sweeping for “questionable activity in client accounts”

³⁶ Black, *et al.*, *Supra* note 5, at 13.

The FSA in particular has given extensive consideration to the role of industry guidance, and in particular, the circumstances under which it is prepared to endorse it. This is discussed in more detail in the FSA case study, below. The U.K. Pension Regulator has also provided a range of forms of guidance about how it will implement its new legislative mandate³⁷. These include; a code of practice explaining what trustees and others need to do to comply with the new legislation and a free e-learning resource for trustees, which includes a model on funding DB schemes. Canadian examples of current reliance by regulators on industry guidance include the role of the Canadian Institute of Actuaries (CIA) in setting standards for funding valuations (interest assumptions, mortality assumptions etc) and guidelines for asset valuations in pension funds, or the reliance of provincial securities regulators on the Canadian Institute of Chartered Accountants (CICA) to articulate standards for the compilation of issuer financial statements.

C. What sort of legal architecture is required to implement a principles-based approach?

As indicated above, by definition a principles-based approach operates initially at a high level of generality. Thus the principles chosen could be incorporated into governing legislation, though this would make them difficult to change if the regulatory environment changed. The experience with principles-based regulation to date, discussed in more detail below, suggests that it is more common for principles to be promulgated at the level of the regulatory agency itself.

³⁷ John Ashcroft “Role of the Regulator: Fighting the good fight” *Pensions Management* London: Dec 1, 2006, p.1

The question of whether a rule-making power is required in order to establish principles is complicated. On the one hand, principles are to be distinguished from detailed, process-oriented rules. On the other hand, if breach of the outcome-oriented principles can become the basis for regulatory enforcement action, it is likely that they must be considered “binding” on market participants under current administrative law norms³⁸.

Meanwhile, interpretation of the principles is likely to occur by way of various kinds of non-binding guidance documents, emanating either from the regulator or industry-based groups. In a context in which regulatory guidance is partly being provided by the pronouncements of industry groups, there will be a need to think more creatively about ways of rendering such actors accountable for regulatory norm creation. Thus, for example, in the DB pension context, it is clear that pension regulators typically rely significantly on the standards set by associations of actuaries with respect to how valuations of pension funds are conducted, and how projections of future contribution needs are set. While it is beyond the scope of the present study to address in detail how those standards are presently devised by actuary associations, considerations of transparency and accountability likely require the significant role of actuary associations in standard setting to be addressed in any move to implement a more principles-based approach to pension regulation in Ontario. Here it may be noted that the CIA established an Actuarial Standards Oversight Council in January 2007, which is intended to monitor the work of the Actuarial Standards Board and appoint its members.

³⁸ *Ainsley Financial Corp. v. Ontario Securities Commission* (1993), 14 O.R. (3d) 280, 106 D.L.R. (4th) 507, 1 C.C.L.S. 1, (Gen. Div.), aff’d (1994), 21 O.R. (3d), 104 121 D.L.R. (4th) 79, 77 O.A.C. 155, 6 C.C.L.S. 241 (C.A.); M. Condon, “Power Without Responsibility or Responsibility Without Power?” (1995), 10:2 *Banking & Finance Law Review* 221.

Similarly, it is necessary to consider the issue of what bodies would be responsible for interpreting the principles in specific instances of assessing whether regulated participants adhered to them. For example, Black is critical of the possibility that the Financial Services and Markets Tribunal in the U.K, a decision-making body which is at arms-length from the FSA itself, would be accorded the task of giving determinations on the meaning of FSA principles. This is because the “Tribunal is isolated from the FSA and is not party to the regular debate which the FSA enjoys with the industry about the issues which it faces and how they might be dealt with. Nor does the Tribunal system provide the sense of practitioners judging their peers that might be regarded as an important feature of other systems of professional self-regulation based on broad standards of ethical conduct³⁹”. On the other hand, it is precisely the quality of arms-length impartiality that is regarded as necessary to maintain the credibility of an administrative justice system⁴⁰. What appears to be at issue is the extent of reliance on adjudication as a vehicle for implementing a principles-based approach. As discussed below, reactive enforcement strategies tend to be de-emphasized in a principles-based approach, in favour of collaborative, responsive standard-setting.

D. Illustrative case studies of principles-based regulation

1. U.K. Financial Services Authority

³⁹ Black, *et al.*, *Supra* note 5, at 14.

⁴⁰ Coulter A. Osborne, David J. Mullan & Bryan Finlay, “Report of the Fairness Committee to David A. Brown, Q.C. Chair of the Ontario Securities Commission” (2004), online: The Ontario Securities Commission http://www.osc.gov.on.ca/Regulation/FiveYearReview/fyr_20040818_fairnesscommittee.pdf at 13.

In the April 2007 document signaling its commitment to the expansion of a principles-based approach to regulation, the FSA indicates that its rationale for doing so proceeds from the perceived failure of a rules-based approach either to prevent misconduct such as misselling of financial products or to promote innovation⁴¹. The FSA's 11 Principles for Business, which are themselves rules, are expressed "in terms of outcomes and behaviours rather than processes or procedures"⁴². The principles are:

1. A firm must conduct its business with integrity
2. A firm must conduct its business with due skill, care and diligence
3. A firm must take reasonable care to organize and control its affairs responsibly and effectively, with adequate risk management systems
4. A firm must maintain adequate financial resources
5. A firm must observe proper standards of market conduct
6. A firm must pay due regard to the interests of its customers and treat them fairly
7. A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading
8. A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client
9. A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment
10. A firm must arrange adequate protection for clients' assets when it is responsible for them

⁴¹ FSA, *Supra* note 11, at 6.

⁴² *Ibid* at 8

11. A firm must deal with its regulators in an open co-operative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice

While the FSA has the power to draft rules and codes of conduct relating to the conduct expected of Authorized Persons, Approved Persons and other market participants⁴³, it claims that its overall objective is to “help firms make decisions themselves about what business processes and controls they should have in order to meet our requirements⁴⁴”.

The regulator intends its principles-based approach to permeate all aspects of its regulation; however it acknowledges that detailed rules may still be necessary. Insofar as possible, the rules should focus on the end points to be achieved rather than the process for achieving them. Key examples of regulatory areas where the FSA has implemented its principles-based approach include; its “treating customers fairly” (TCF) initiative, anti-money laundering initiatives⁴⁵, a new Conduct of Business sourcebook, simplified reporting requirements, and the removal of requirements for small firms to have external auditors.

With respect to the “treating customers fairly” initiative in the retail sector, for example, it is hoped that this may have an improved effect on persistent problems related to giving poor quality advice or providing unclear product information. The initiative, which derives from the FSA’s Principle 6, has been the focus of close attention for a number of years, with a variety of documents and progress reports having been published

⁴³ See *Financial Services and Markets Act 2000* (U.K.), s. 2(2), 3-6 [FSMA] s.64; s.138; s.119.

⁴⁴ FSA, *Supra* note 11, at 6.

⁴⁵ Where the FSA has apparently replaced “57 pages of rules with two pages of principles, supported by useful industry guidance”. FSA, *ibid* at 23.

by the regulator since 2004. Six specific TCF outcomes are identified as relevant by the FSA⁴⁶. The initiative involves an assessment of the “firm’s culture” with respect to how it treats its customers. However, if the FSA is satisfied that the firm has appropriate internal controls in place, it will “significantly reduce the level of testing carried out on the firm’s culture regarding TCF”. Meanwhile, according to Black et al⁴⁷, an important component of TCF relates to the “processes by which firms design financial products. This is a radical change of focus...The FSA proceeds not by making new rules but through a combination of exhortation...supervisory work and the threat of possible enforcement action”.

In July 2006 the FSA set a deadline whereby all firms were expected to be at least implementing TCF in a “substantial part of their business” by end of March 2007. On assessing performance against this deadline, the FSA noted “for the vast majority of firms, we believe further progress is needed to reach the embedding phase and ensure the consistent delivery of fair consumer outcomes⁴⁸”. Despite this, the FSA remained upbeat, asserting that the results show “that many firms – particularly larger and medium-sized firms – have made good progress with their TCF work⁴⁹”.

⁴⁶ These are that; (i) consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture (ii) products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly (iii) consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale (iv) where consumers receive advice, the advice is suitable and takes account of their circumstances (v) consumers are provided with products that perform as firms have led them to expect, and the associated service is both of an acceptable standard and as they have been led to expect (vi) consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint

⁴⁷ Black, *et al.*, *Supra* note 5, at 5.

⁴⁸ FSA “Treating Customers Fairly initiative: progress report” (London: FSA 2007), online: http://www.fsa.gov.uk/pubs/other/tcf_implementation.pdf

⁴⁹ *Ibid* at 3.

The progress report alerts market participants that the focus and intensity of supervision will increase for those firms that missed the deadline, such that “our follow-up work is likely to have significant cost implications for these firms⁵⁰”. It is adamant that where firms have missed the deadline, “this points to a failure by, or lack of commitment from, senior management⁵¹”. It also notes ominously that if the FSA were to become aware of “significant actual or potential consumer detriment in a firm of any size that failed to meet the deadline”, it would expect to refer the matter to enforcement. In addition, “given the importance we attach to senior management this may include considering referrals on the ground of senior management failings”.

On the other hand, the payoff for regulated firms is that the FSA expects to give “greater recognition” to firms’ own management and controls. Thus, “Well controlled and managed firms that engage positively and openly with us should expect to experience real benefits from our more principles-based approach in the form of a regulatory dividend, for example relatively lower levels of regulatory capital, less frequent risk assessments, greater reliance on firms’ senior management or a less intensive risk mitigation programme⁵²”.

Even more recently, the reform of the “Conduct of Business” rules is described as “a flagship project for the FSA in the move towards principles-based regulation and away from detailed prescriptive rules⁵³”. These rules, which have been in operation since December 2001, include things like “financial promotions, how firms provide

⁵⁰ *Ibid* at 5.

⁵¹ *Ibid* at 5.

⁵² FSA, *Supra* note 6, at 12.

⁵³ FSA/PN/068/2007 “New investment business rules mark significant move to principles-based regulation”, *Press Release*, (London: FSA 2007), online: <http://www.fsa.gov.uk/pages/Library/Communication/PR/2007/068.shtml>

information and advice to clients, non-advised services, and dealing in and managing investments⁵⁴”.

While the FSA has a range of enforcement powers, in practice its enforcement action is minimal, in part because of its commitment to being proactive and responsive. Its enforcement powers include; powers to limit participation in regulated activities; withdrawal of approval from approved persons; disqualification of auditors; fines and public censure. It may also seek injunctive relief, asset freezing or restitution, either from a court or from the FSA itself in some cases. It reserves the right to bring enforcement action based on principles alone⁵⁵. As the CEO of the FSA has noted “Principles are rules and we intend increasingly to take enforcement action on the basis of those Principles alone⁵⁶”.

An important innovation of the FSA’s approach to regulation is the relatively high-profile role that is accorded to its consumer panel⁵⁷. First established as an advisory committee in 1998, it was given statutory recognition in the *Financial Services and Markets Act, 2000*⁵⁸. Its terms of reference provide that the Panel is to be an independent body representing the interests of consumers and providing advice to the FSA⁵⁹. The FSA is required to consider its representations, and give a written statement of reasons for disagreeing with a position taken by the Panel. The Panel has a defined budget, which

⁵⁴ *Ibid* at ‘note 3’.

⁵⁵ See speech by the Director of Enforcement, Margaret Cole (April 2006)

⁵⁶ FSA Chief Executive John Tiner, *Keynote Address: FSA Enforcement Conference*, 16 June 2006, online: http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0616_jt.shtml

⁵⁷ Other U.K. regulators also involve the presence of consumer panels, such as Ofcom, energywatch and Postwatch

⁵⁸ See FSMA ss.8-10

⁵⁹ Julia Black “Involving Consumers in Securities Regulation” Research Study for the Task Force to Modernize Securities Legislation in Canada, June 23, 2006

includes an allocation for research, and members of the Panel are paid depending on the time commitment spent on Panel-related matters⁶⁰.

Finally, the FSA accords a key role to industry-provided guidance in the restructuring of its regulatory approach towards principles and away from rules. Thus, “sector-specific guidance and support provided by industry association, professional bodies or groups of firms⁶¹” is intrinsic to providing assistance to market participants in meeting regulatory expectations while downloading regulatory tasks at the same time⁶². Evidence of following appropriate guidance may also provide a defence for a firm against FSA enforcement action. The FSA is prepared to “confirm” guidance provided by industry associations that elaborates on how to achieve outcome-based principles. It will issue such confirmation if the industry guidance meets certain criteria. These include that; the guidance explains how it relates to the relevant FSA rule or principle; it considers consumer interests and views; it does not affect the rights of third parties; it must remain optional, in the sense that there are multiple ways to comply with rules and principles; it must be publicly available and must not be anti-competitive.

2. B.C. Securities Commission

It has been noted above that important elements of the substance and enforcement of Canadian securities law have traditionally been principles-based. For example, a foundational requirement of securities law is that issuers disclose on a timely basis all information that would be “material”. While materiality is a defined term in securities

⁶⁰ For further discussion of the role played by the consumer panel in FSA regulatory activities, see Black, *ibid* at 622-629. Overall, she concludes that the panel has played a useful role in shaping the FSA’s approach to retail financial regulation

⁶¹ FSA, *supra* note 11, at 11

⁶² The FSA does provide its own internally-generated guidance documents

law, referring to the reasonable likelihood that the information would have “a significant effect on the market price or value of the securities”, it is a well-established axiom of securities law in Canada that whether or not information is material will vary according to the characteristics of the issuer involved. Thus the issuer of the securities is expected to make a judgment about disclosure on the basis of a firm-specific materiality assessment. This may be contrasted with the approach in the United States that is oriented around a checklist of types of transactions and issues that are required to be disclosed by issuers⁶³. Cunningham argues that “a rational system of securities regulation inevitably contains laws bearing attributes of both rules and principles⁶⁴”.

Meanwhile on the enforcement side, a major component of securities regulatory enforcement across Canada is the power of regulators to sanction market participants, following a hearing or settlement procedure, for breaches of the “public interest”⁶⁵. In a 2006 study of the role of principles and rules in securities regulatory enforcement in the U.S. and Canada, Cunningham concluded that “Evidence indicates that the CSA members and the SEC slightly favour rules-based enforcement, but a considerable portion of cases assert principles-based violations”. As between the SEC and the CSA, the SEC exhibits slightly more activity enforcing principles-types laws than CSA members”. However Cunningham also finds that the major self-regulatory organizations in the U.S and Canada (the NASD and IDA respectively) are both “heavily biased to enforcing principles⁶⁶ over rules”.

⁶³ Louis Loss and Joel Seligman *Fundamentals of Securities Regulation* (5th ed) Aspen: 2004 at 512ff.

⁶⁴ Cunningham supra note 1 at 261.

⁶⁵ OSA Supra note 14, at s.127.

⁶⁶ This principles encompass a rule requiring “commercial honour” in the case of the NASD and a by-law proscribing “conduct unbecoming or detrimental to the public interest” in the case of the IDA.

The B.C. Securities Commission (BCSC) is the provincial securities regulator that has most explicitly adopted a principles-based approach. In 2004, the BCSC articulated a new model of regulation that would be principles-based and outcomes-focused. This was expressed in by- now familiar terms as follows:

“Principles-based regulation is an approach to setting regulatory requirements. We aim for high-level requirements that set out desired regulatory outcomes – for example, a registrant must deal fairly, honestly, and in good faith with clients – and rely less on detailed rules to prescribe what market participants must do to achieve those outcomes. To comply with a more principles-based regime, market participants must understand and focus on the required outcomes. This gives them more flexibility to design policies, procedures, and systems that cost-effectively deliver the required outcomes in ways that are appropriate for their particular business”.

The BCSC’s principles-based model was originally instantiated in proposed legislation, a new BC Securities Act (Bill 38) that was introduced into the BC Legislative Assembly in May 2004. While the Act was passed by the legislature, it has since then never been actually proclaimed. The initiative likely foundered on a concern that the provincial approach to securities legislation in BC would become too far out of step with other provinces, given on-going concerns about harmonization across the country. However it is also clear that the BCSC has continued to pursue its principles-based approach at the rule-making and regulatory level of activity.

Thus the BCSC notes “we regulate in a way that requires industry to focus on meeting the standards, not just the prescriptive requirements. Sometimes we can engage industry in designing acceptable solutions without new regulation...The BCSC uses a problem-solving methodology to identify and analyze market risks⁶⁷”. Ford comments that these sentiments require a regulator that is “more pragmatic, more willing to devolve

⁶⁷ BC Securities Commission Service Plan, 2006-2009 at 14.

responsibility to industry, and perhaps humbler about how well-informed and well-equipped it is relative to industry itself⁶⁸”.

In elaborating on its approach to “smart rule-making and guidance”, the BCSC describes its three main building blocks as being “problem definition, tool selection and rule design”. According to the BCSC, if the tool selected to respond to a regulatory problem is a rule, it should state the outcome expected, the outcome should be clear and measurable, the rule itself should be clear and simple and its scope should be limited to “what is necessary to achieve the desired outcome⁶⁹”. The regulator nonetheless comments that “some prescriptive requirements are appropriate where a thorough analysis has shown that the rule could not achieve the desired result through outcomes-based requirements alone⁷⁰”. In a demonstration of its commitment to its approach, the BCSC has defined 13 principles for developing new rules or rule amendments. It also measures its own performance with respect to applying these rule-making principles. Because the number of new rules adopted varies from year to year, the Service Plan indicates that “we will score how rigorously we applied the principles in the last five rules we adopted, and calculate a moving average”⁷¹.

Meanwhile, the perceived alignment of a principles-based approach with a risk-based approach is clearly identified in the 2006-2009 Service Plan. The BCSC identifies the risks that it is most concerned about as being those of unsuitable investments, investment fads, and abusive junior market practices.

⁶⁸ Ford, *Supra* note 3, at 25.

⁶⁹ BCSC, *Supra* note 60, at 33

⁷⁰ *Ibid* at 33. Cost-benefit analyses and regulatory impact analyses are identified as important tools for measuring the need for new rules as opposed to other ways of dealing with regulatory problems.

⁷¹ *Ibid* at 34

Pursuant to the attempt to legislate a principles-based approach to securities regulation in BC, the Securities Commission sponsored a number of studies of the implications to the initiative. One of these concerned the issue of the enforcement of outcomes-based securities legislation⁷². This study concluded, based on an analysis of BCSC enforcement decisions in previous years, that most of the significant enforcement actions that had been taken in the past by the BCSC would “continue to be supported” under the new regime⁷³. More generally, the study asserted that most of the new legislative requirements would be “readily enforceable” because they would require “measurable outcomes, use objective tests that are familiar to adjudicators, or deal with areas where there is a rich understanding of what constitutes acceptable or non-acceptable conduct⁷⁴”. According to Ford, the BCSC has linked its outcome-oriented innovations to “enhanced enforcement and public interest powers, including a legislative prohibition on ‘unfair practices’ [and a] Commission power to order disgorgement⁷⁵”.

3. Use of a principles-based approach in the pension regulatory context

This section addresses the extent to which there is evidence of the adoption of principles-based approaches to regulation of the pension sector specifically. One starting point here might be the **OECD**’s enunciation of six core principles of occupational pension regulation in 2004⁷⁶. The first of these principles relates to “conditions for effective regulation and supervision”. Here an adequate regulatory framework is described as one

⁷² BCSC “Enforcement of Outcomes-Based Securities Legislation” *New Legislation Project*, May 6, 2004, online: [http://www.bsc.bc.ca/uploadedFiles/RIA_Enforcement\(1\).pdf](http://www.bsc.bc.ca/uploadedFiles/RIA_Enforcement(1).pdf)

⁷³ *Ibid* at 4

⁷⁴ *Ibid* at 5

⁷⁵ Ford, *Supra* note 3, at 19.

⁷⁶ OECD Recommendations on Core Principles of Occupational Pension Regulation, 21 July 2004

that is enforced in a “comprehensive, dynamic and flexible way” so as to protect pension plan members and beneficiaries, while not mounting an “excessive burden on pensions markets, institutions or employers”. The text of this principle goes on to exhort the strengthening of the “financial market infrastructure and regulatory framework” and the promotion of a “level playing field between... different operators” by way of regulation. Core principle #6 addresses the need for “effective supervision” of pension funds by bodies which can conduct on and off site supervision, and which are “endowed with appropriate regulatory and supervisory powers... to prevent misselling cases arising from irregularities in the distribution and expenses methods”.

Other principles espoused by the OECD deal with the need for minimum funding rules, for transparency and comparability with respect to asset valuation and liability funding, the regulation of asset management processes by way of “principles related to diversification, dispersion, and maturity and currency matching”. As we will see below, effective risk management strategies are encouraged. Other principles deal with the protection of plan members and beneficiaries with respect to access to schemes, entitlement arrangements, and disclosure of and education about costs and benefits, fees, plan performance and benefits modalities. While these regulatory goals are described as principles, it is not especially evident that they espouse the outcomes-based or collaborative approaches intended as the hallmarks of a principles-based approach to regulation.

Meanwhile, although the new pension regulator in the **U.K.** identifies the reform process⁷⁷ that led to its establishment as supporting a “new kind of regulator” that would be “outcome and customer focused”, we will see below that this objective is interpreted

⁷⁷ See discussion of Pickering report in Pensions Regulator “Medium term strategy” April 2006

primarily as involving a risk-based approach to pension regulation. However some elements of the Pension Regulator’s (PR) approach, as articulated in its “Medium term strategy” document⁷⁸, resonate with the features of a PBR approach described above. In particular the UK PR posits that “the need to work in partnership with trustees, employers and their advisers, and providers (sic) is key to meeting our challenges and delivering our intended outcomes”. To this end, the PR intends to pay attention to the provision of education and information to trustees and provide them with access to codes of practice and guidance. In general, improving the level of pension plan governance is one of three substantive outcomes emphasized by the regulator⁷⁹. This responds to new legislative requirements on trustees that they have “appropriate knowledge and understanding”. The introduction of a “scheme specific framework” for funding as opposed to minimum funding rules is discussed further below⁸⁰.

Despite the express support for PBR by a number of high-level government officials in the **United States**, this approach to regulation does not appear to have penetrated pension regulatory circles there as yet. Indeed a telling criticism of the current ERISA⁸¹ framework for regulating U.S. DB pensions is that it has been “riddled with loopholes that allowed employers to legally underfund their plans⁸²”. ERISA has recently

⁷⁸ *Ibid* at 5, 26

⁷⁹ The others are to strengthen the funding of DB schemes and to reduce the risks to members of DC schemes

⁸⁰ Pension Regulator April 06 document, *Supra* note 24, at 20. Note that a principles-based approach is rather more in evidence when the Pension Regulator discusses its approach to regulating DC plans, where it is indicated that the focus for the immediate future will be on “dissemination of good practice” to employers, trustees, managers, administrators and the development of codes of practice and the provision of guidance, as well as the analysis of “evidence-based material” with respect to specific problems

⁸¹ *Employee Retirement Income Security Act of 1974* (ERISA).

⁸² Susan Stabile “Is it time to admit the failure of an employer-based pension system?” 11 *Lewis and Clark LRev* 2007 305 at note 96. Stabile cites research conducted by Ford, Glickman and Jeszeck who reviewed the funding situation that prevailed in very large US DB plans over a seven year period. Weaknesses in these funding situations were attributed to weak funding rules. Some of these weaknesses included; allowing DB plans that owed “additional funding charges” (AFCs) to still apply FSA (funding standard

been subject to major amendments as a result of the *Pension Protection Act 2006*. One of the most significant aspects of these new provisions has been to considerably augment and prescribe funding requirements for DB pension plans in the U.S., as well as to identify and protect “at risk” plans⁸³. In general, the amendments prescribe higher funding targets for DB pensions, as well as delineating more completely how DB plans are to value their assets and liabilities, with respect to the time horizons used for asset calculations and the interest rate assumptions deployed in connection with liabilities⁸⁴.

In expressing support for a principles-based approach to financial regulation, the Chair of the Federal Reserve in the U.S. includes the fiduciary responsibilities of pension fund managers established by ERISA as an example of a principles-based approach⁸⁵. He also notes that “As in the United Kingdom, a principles-based approach is not inconsistent with the use of rules, which can provide needed clarity or a safe haven from legal and regulatory risks. However, rules should implement principles rather than develop in an ad hoc manner”⁸⁶.

Turning to the pension context in **Canada**, principles-based regulatory approaches have not yet been the subject of widespread debate. However, the area of pension plan governance has involved some efforts to develop voluntary guidelines. Both

account) credits to their funding obligation and therefore not have to satisfy the AFC with cash; allowing the use of “above-market [interest] rates to calculate current liabilities and actuarial measurement of plan assets that differ from market values. See Charles Ford, Mark Glickman, Charles Jeszeck “Weaknesses in Defined Benefit Pension Funding Rules: A Look at the Largest Plans, 1995-2002” (2005-6) 44 *Brandeis L.J.* 351

⁸³ These are plans that are less than 80% funded according to the new funding rules. In connection with such plans the Act requires funding gaps to be closed more quickly and a more rigorous calculation of plan liabilities

⁸⁴ Richard Landsberg “An Overview of the Pension Protection Act of 2006” (2006) 13: 1 *Journal of Deferred Compensation* 13.

⁸⁵ Ben S. Bernanke “Regulation and Financial Innovation” Speech to the Federal Reserve Bank of Atlanta’s 2007 Financial Markets Conference, Sea Island, Georgia, May 15, 2007, online: <http://www.federalreserve.gov/newsevents/speech/bernanke20070515a.htm>

⁸⁶ *Ibid* at 7

OSFI and CAPSA have established principles that are intended to upgrade the level of effectiveness of pension plan governance⁸⁷. Meanwhile the Regie des rentes du Quebec (RRQ) has introduced initiatives with respect to training and information, directed at members of pension committees⁸⁸.

E. Some controversial issues arising from principles-based regulation

1. A major critique of the idea of establishing principles at a high level of generality as an alternative to detailed rules is the lack of certainty that is thereby created for regulated participants. The reality is that high-level principles may require the development of interpretive commentaries to operationalize them for those who need to abide by them. As Black et al note, guidance can be provided in a variety of forms, including; more detailed rules, formal or informal guidance from the regulator (to the industry as a whole or to individual members), guidance from industry associations, or enforcement actions. The possibility of the proliferation of guidance from various entities and in various forms could add a great deal of complexity, inconsistency and inaccessibility to the task of conforming to principles⁸⁹.

A related issue is that of who participates in the formulation and interpretation of principles. The “mutual learning” and collaborative models of deliberation about principles that are extolled by advocates of PBR may not be accessible to all players in

⁸⁷ Ed Tamagno “The Management and Regulation of Occupational Pension Plans in Canada” Caledon Institute of Social Policy, December 2006 at 13-14, online: <http://www.caledoninst.org/Publications/PDF/611ENG.pdf> ; CAPSA “Proposed Regulatory Principles for a Model Pension Law” January 2004, online: [http://www.capsa-acor.org/capsa-newhome.nsf/96aacfd085938dff85256c1a0074ccd4/c3d9a6e25544270a85256e200054c961/\\$FILE/ML-ConsultDoc-Eng.pdf](http://www.capsa-acor.org/capsa-newhome.nsf/96aacfd085938dff85256c1a0074ccd4/c3d9a6e25544270a85256e200054c961/$FILE/ML-ConsultDoc-Eng.pdf)

⁸⁸ The same agency has also proposed to use the principle of equity to “determine the improvements that will be made” to a plan’s benefits in the event that a surplus exists. See Tamagno I at 24

⁸⁹ Black, *Supra* note 4, at 13-14.

the regulated field, especially in regulatory areas where there may be ongoing tension among different types of participant (employees/employers; issuers/investors etc). It is argued by some that the success of a principles-based system depends on the regulators' willingness and ability to learn from the inputs of multiple stakeholders.

A further dimension here is the well-established academic critique of regulatory agency activity that argues that such agencies have a propensity to become "captured" by their dominant constituencies⁹⁰. The possibility of agency capture in the way that PBR is practiced has not yet been carefully addressed by scholars in the field⁹¹. This may be, in part, because a capture analysis assumes a government agency at the top of a hierarchical relationship with the regulated, which then over time becomes inverted. In other words, an approach that sees the government agency as entering into a partnership with private actors in the first place may perhaps consider the possibility of "capture" as irrelevant. But as Lobel argues "...a shift to governance approaches may produce a vicious cycle under certain circumstances – tilting more and more entitlements in favour of those already in power. A central challenge for the governance model is therefore to understand how collaborative environments can be nurtured to produce equitable results, especially

⁹⁰ George Stigler "The Theory of Economic Regulation" (1971) 2 *Bell Journal of Economics and Management Science* 1; Gabriel Kolko *The Triumph of Conservatism: A Reinterpretation of American History 1900-1916* Glencoe, Ill.: Free Press 1963; Dan Carpenter "Protection without Capture: Product Approval by a Politically Responsive, Learning Regulator" (2004) *American Political Science Review* vol 98 (4) 613-631. There is a more recent critique of capture theory that it is too static a description of the ongoing relations between an agency and its stakeholders and that it assumes a rigid public/private divide. There is also the critique that the theory assumes what it purports to demonstrate, in that it concludes that policy outcomes that favour particular interest groups were the subject of active lobbying by those groups. These are indeed shortcomings, but the issues of whether some stakeholders rather than others will dominate the regulatory outcome-choice discussion, or what the constraints on agency room to manoeuvre will be in this process, need to be addressed by the "new governance" approach.

⁹¹ An exception to this is William Bratton "Enron, Sarbanes-Oxley and Accounting: Rules versus Principles versus Rents" (2003) 48 *Villanova Law Review* 1023.

in settings where vast power imbalances exist⁹²”. She also argues that collaborative models of deliberation of the type discussed by PBR advocates are most likely to be successful where there are strong incentives on all sides to cooperate.

There are some models available for structuring the role of a variety of regulatory players so that a diversity of views is represented⁹³. Freeman argues for example, that the kind of negotiated relationships among public and private actors that are increasingly characteristic of regulatory structures in North America work best when there are several strong “repeat player” stakeholders (such as employers and unions) involved in the negotiations⁹⁴. However this raises another issue, which is that, leaving aside the possibility of power imbalances producing inequitable results, the kind of ongoing collaboration about the content of outcomes and “rolling best practices” policy making would take a significant commitment of time and resources for the participants. Thus, Hutter argues that “One feature of trade associations and regimes of enforced self-regulation is that they tend to be dominated by or favour larger businesses. Typically SMEs do not belong to trade associations and neither do they tend to cope well with systems of enforced self-regulation⁹⁵”.

2. Closely related to the questions canvassed above about who will participate in the collaborative enterprise of principles-based regulation, and on what terms, are a set of difficult questions that revolve around the issue of accountability, and whether principles-

⁹² Orly Lobel, “The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought” (2004) 89 *Minnesota Law Review* 342.

⁹³ See Braithwaite and Ayres’ discussion of a potential role for what they call “public interest groups” in *Responsive Regulation: Transcending the Deregulation Debate* Oxford University Press, 1995

⁹⁴ Jody Freeman “The Private Role in Public Governance” (2000) 75 *NYU Law Review* 543.

⁹⁵ Brigid Hutter “The Role of Non-State Actors in Regulation” CARR Discussion Paper #37 April 2006 at 5

based regulation requires the rethinking of traditional administrative law principles⁹⁶. Some commentators suggest that new governance requires the *mutual* accountability of public and private parties to regulatory activity such that the hierarchical position of the government regulator is less obvious⁹⁷. Prosser acknowledges that there may be difficult problems associated with rendering private actors accountable if they are more involved as partners in regulatory activity in a PBR model⁹⁸. William Bratton cites David Tweedie, head of the International Accounting Standards Board, for the proposition that both companies and auditors have to make judgments in the public interest for PBR to work⁹⁹. Specifically in the pension context, Gallery and Gallery argue that there has developed a flawed approach to the disclosure of financial information about superannuation funds in Australia, because “As an outcome of the political process of standard setting, the superannuation fund accounting standard (AAS 25) is a compromise which is conceptually flawed because at the time the standard was developed the standard setters attempted to cater to the demands of the superannuation industry¹⁰⁰”.

Another dimension here is that in North America there are relatively robust systems of accountability built into conventional rulemaking processes, in the form of

⁹⁶ For example, the FSA notes that, under a principles-based approach, firms can rely on “all the material we publish”. It does not matter whether the material is a specific rule, or formal guidance or a case study, or a ‘dear CEO’ letter. See FSA document, April 2007 supra note 11 at 10

⁹⁷ Jody Freeman, *Supra* note 85. See also Freeman, “Private Parties, Public Functions and the New Administrative Law” (2000) 52 Admin LR 813., and Edward Rubin “The Myth of Accountability and the Anti-Administrative Impulse” (2005) 103 Mich LR 2073.

⁹⁸ Tony Prosser “Regulation and Social Solidarity” *Journal of Law and Society* at 378

⁹⁹ Bratton, *Supra* note 91, at 1049

¹⁰⁰ Gerry Gallery and Natalie Gallery “Inadequacies and Inconsistencies in Superannuation Fund Financial Disclosure: The Need for a Principles-Based Approach” 36:1 *The Australian Economic Review*, pp.89-97 at 90 (2003). As is evident from the title of the article, their solution to the inconsistent financial information required from corporate financial reporting generally and superannuation financial reporting is to move to a principles-based approach to the regulation of financial reporting by superannuation funds. They argue that such a principles-based, “conceptually sound” approach is already used in the regulation of corporate financial reporting and it has the potential to “provide a sound basis for ensuring consistent and transparent reporting to fund members” (ibid at 96)

notice and comment requirements. This means that a legitimate question to ask will be whether principles-based regulation would enable the avoidance of these processes, because the informal and dynamic consultation processes that are contemplated may not invite a notice and comment obligation¹⁰¹.

3. A key issue is the extent to which infringement on principles can form the basis for enforcement action. The FSA insists that its principles can be the basis for enforcement. Thus Margaret Cole, the Director of Enforcement at the FSA said, in April 2006, that “where appropriate, we can and do take enforcement action on the basis of principles alone. The key thing to note here is predictability. In order for consequences legitimately to be attached to the breach of a principle it must be possible to predict, at the time of the action concerned, whether or not it would be in breach of a principle¹⁰²”. Ford counsels that regulators may need to be increasingly self-reflexive about the principles underlying enforcement action, so that for example, different enforcement strategies may work for generally compliant as compared to generally non-compliant firms¹⁰³. Black et al warn of the danger of over-compliance, out of fear about where a regulator will find non-compliance with a general principle¹⁰⁴. This raises the general issue of the regulator’s capability to measure the level of compliance with an outcome-based principle.

Meanwhile, turning to the issue of private enforcement of regulatory norms, a number of commentators have raised the issue of whether a principles-based approach

¹⁰¹ Black *et al*, *Supra* note 4, at 14-15.

¹⁰² Margaret Cole “Enforcement: Priorities and issues for 2006” 11 April 2006 at p.5. Cole noted that several recent enforcement actions taken by the FSA had been launched on the basis of breach of a combination of rules and principles or on the basis of breach of a principle alone. For example a penalty was assessed against Deutsche Bank for breaching Principles 2 (failing to conduct business with due skill, care and diligence) and 5 (failing to observe proper standards of market conduct)

¹⁰³ Ford, *Supra* note 3, at 32

¹⁰⁴ Black *et al.*, at 16.

can really work in a context in which there is a vigorous rate of private litigation. That is, can regulated participants who fear the launching of civil suits against them refrain from acting defensively by means of ensuring that they have followed a host of prescriptive rules? In the securities regulation area for example, some argue that it is the less adversarial relationships between disclosing companies and their shareholders in the UK as opposed to the US that explains why PBR has taken hold in the former jurisdiction and not in the latter¹⁰⁵.

4. An intriguing question raised in the academic literature is whether the salience of principles-based regulation may vary depending on the regulatory problem being addressed. Thus for example the FSA admits that rules may be more necessary where the effects of behaviour are not observable for a long period¹⁰⁶. In other words, some outcomes will be harder to monitor than others in terms of whether they are being achieved or not. This is likely to be a significant issue in the pensions context where the ultimate outcome of providing the promised pensions may not be measurable for a significant period, depending on the demographic make-up of the employee group. Thus, for example, it may be that in the pension context a principles-based approach would work better for governance or other specific transaction-oriented issues rather than for the regulation of funding or asset requirements.

Ford argues that “a new governance style, principles-based approach has special relevance to firm compliance functions”, that is those processes in place “to prevent and

¹⁰⁵ Peter J. Wallison “Can Principles-based regulation work in the United States?” American Enterprise Institute for Public Policy Research, June 8, 2007.

¹⁰⁶FSA document April 2007, supra note 11, at p.10;

detect internal wrongdoing and violations of law¹⁰⁷”. Relatedly, some suggest that principles-based regulation should only work at the margins, so that there is a “phalanx of non-negotiable rules governing topics on which there is consensus, such as extreme misconduct and misbehaviour¹⁰⁸”. In this regard, it is worth noting the caveat about principles-based regulation entered by Bratton, analysing the issues arising from the various scandals in U.S. stock markets at the turn of the century. He argues that an advantage of rules is that they enable otherwise disempowered professionals to say “no” to their clients¹⁰⁹. While Bratton was addressing the increasingly threatened position of auditors dealing with their clients on the issue of how to record transactions and financial results on the quarterly and annual financial statements required of reporting issuers by securities regulation, there may well be a parallel here to the relationship between actuaries and their sponsor clients in the pension context.

A related point is that PBR involves a sea-change in the nature of regulatory work itself, which shifts to exercise of judgment rather than checking of compliance with detailed, prescriptive rules¹¹⁰. Regulators will likely need to invest in expertise in order for this approach to work.

It has been observed that PBR downloads responsibility for regulatory compliance to industry participants, especially with respect to designing internal compliance systems. Clearly industry participants will be differentially placed to undertake this task well. Some suggest that there may be a need for regulators to provide incentives to firms that engage in consistently high compliance practices, such as reduced regulatory burdens

¹⁰⁷ *Ibid* at 26

¹⁰⁸ *Ibid* at 42

¹⁰⁹ Bratton, *Supra* note 91, at 1049.

¹¹⁰ FSA, *Supra* note 11, at 12

and, in contrast, more intensive supervision for firms that are high-risk. Relatedly, it may be necessary to provide more specific “safe harbours” for small firms, who may have trouble designing an internal organizational process for meeting specified outcomes¹¹¹.

5. Finally, Cunningham cautions that “Rules and principles are imperfect categories to describe laws. While some laws may fit neatly into such descriptions, most blend aspects of each and rational systems of law invariably partake of hybrids...Ambitions to emphasize one or the other abstractly prevent assessing trade-offs that rules versus principles present, chiefly those of certainty versus context and of norms versus novelty¹¹²”. He adds “It is rarely possible, however, to prevent the principle from morphing into rules¹¹³”.

F. Principles-based regulation in the Ontario pension context

The discussion above seems to indicate that in any specific regulatory context, the salient questions to be asked about a move to more principles-based regulation would be

(i) what type of decision-making process should be used to determine the content of the principles?

(ii) for discussion purposes, what might some salient principles be?

(iii) how would such principles be enforced?

(i) An issue to consider with respect to the first question, in the context of Ontario pension regulation, might be that increasing the opportunities for stakeholder

¹¹¹ Christine Parker, *Reducing the Risk of Policy Failure: Challenges for Regulatory Compliance* (2000) Organization for Economic Cooperation and Development, at 32.

¹¹² Cunningham, *supra* note 1, at 259

¹¹³ *ibid* at 264

collaboration in the design of overarching principles might enhance the willingness of employer sponsors to maintain and strengthen DB pension provision, given that providing such a pension is a voluntary commitment in the first place. On the other hand, there will be difficult issues associated with structuring the participation of the ultimate beneficiaries of a DB pension, which will be necessary to ensure genuine stakeholder collaboration. But since beneficiary groups by definition coalesce around a specific employer or group of employers, there may be a greater possibility of beneficiary collective action than occurs in other areas of financial services regulation. Ultimately, much depends on a realistic assessment of the possibilities for a culture of collaboration among employer and employee groups in the DB pension context in Ontario.

A related practical issue to consider is that genuine stakeholder participation by beneficiaries or groups of beneficiaries will require an upgraded level of expertise and commitment to the process of designing pension principles. An important dimension of this is whether pension beneficiaries (actual or prospective) are routinely provided with sufficient information to enable them to engage productively with the search for plausible outcome-based principles of pension regulation. Here the example of the FSA, which has committed to enhancing investor education and financial capability, may be relevant¹¹⁴.

Finally, other relevant stakeholders, such as actuary groups or pension consultants, should be allowed to contribute to any process for designing DB pension principles.

(ii) The second issue, as to of the content of principles, would require a rigorous examination of the outcomes that are ultimately being sought by the provision of a DB pension system. Some possible principles, for discussion purposes, might be that

¹¹⁴ For a critical view of the FSA's initiatives here see Toni Williams "Empowerment of Whom and for What? Financial Literacy Education and the New Regulation of Consumer Financial Services" (2007) 29(2) *Law and Policy* 226

sponsors should have to keep plans fully funded, if not always then within a reasonable period of time, or that plan investments should carry low risks and should be matched to benefit payments¹¹⁵, or that pension fiduciaries should ensure that plans are adequately funded. Articulating these broad principles might accord significant scope to fiduciaries with respect to exactly how these outcomes might be achieved.

Another area that might be susceptible to a principle-based approach would be clarification of the role of actuaries in the pension context, both at the level of the individual sponsor, or at the level of the CIA as the standard setter for actuarial practices. It is clear that actuarial assessments of future liabilities and valuations of assets have a huge impact on the contribution levels required of sponsors. Again, any move in this direction will likely need to take into account the level of empowerment experienced by actuaries in the sponsor/actuary relationship. A further principle might be that sponsors should disclose to the regulator any material change in the affairs of the pension fund, as an alternative to a more prescriptive, checklist-based approach to reportable transactions.

It would be necessary to accompany this discussion with a clear sense of the legal and non-legal resources necessary to assist the relevant parties in accomplishing these outcomes. To what extent are fiduciaries in the Ontario pension context well placed to assume the fulfillment of broad outcomes, with respect to issues such as pension competence, education, or financial sophistication¹¹⁶? What account needs to be taken of

¹¹⁵ See Charles Ford, Mark Glickman, Charles Jeszeck “Weaknesses in Defined Benefit Pension Funding Rules: A Look at the Largest Plans, 1995-2002” (2005-6) 44 *Brandeis L.J.* 351 at 385 for suggestions along these lines

¹¹⁶ See p.25 above, where it has been noted that the implementation of new UK pension regulatory norms depends heavily on upgrading the quality of pension fiduciaries. See also Andrew Hopkins “Beyond Compliance Monitoring: New Strategies for Safety Regulators” (2007) 29 (2) *Law and Policy*

the reality that the precise measurement of whether such outcomes are being achieved might have to be deferred for a significant period of time?

Yet there is the possibility that a reduction in ongoing regulatory compliance costs might encourage more employers to stay within the DB system or become part of it in the first place. This latter issue would have to be based on a clear specification of where the bulk of compliance costs are being in fact incurred. If major areas of compliance costs did not centre on valuation issues or asset investment issues, but on other process-related aspects of pension regulation, such as transaction notification requirements, it might be possible to generate savings and simplicity from reduction in those reporting requirements.

(iii) Neither PBR, nor risk-based approaches to regulation discussed below, is committed to the role of traditional enforcement sanctioning as a vibrant regulatory tool, but instead focuses on designing strategies for changing organizational cultures, or providing incentives for compliance by way of promising lesser regulatory intervention in the future. Enforcement would be particularly difficult in the absence of some robust consensus about what would constitute acceptable conduct with respect to the achievement of the outcomes articulated. Were such norms of acceptable conduct to develop, then it might be more feasible to operate by way of broadly-based “public interest”-type enforcement standards.

3. RISK-BASED REGULATION

A. What is meant by risk-based regulation?

Sociologists increasingly posit that we live in a “risk society”¹¹⁷, in the sense that individuals and institutions are increasingly oriented towards the identification, analysis and management of a multitude of “risks”, ranging from health to environmental to financial to terrorism risks. Although a good deal of academic literature focuses on the ways in which non-state institutions engage in “risk governance”¹¹⁸, the turn to risk has become a central feature of organizing the activities of government regulators¹¹⁹. While Hood et al caution that it is perilous to generalize about the characteristics of what they call “risk regulation regimes”, some distinctive features of risk regulation are nevertheless identified below, before turning in more detail to the ways in which a variety of financial regulators operationalize their risk regulation approach.

B. Common features of risk-based regimes of regulation

As the essence of an orientation to risk is a focus on the future and its uncertainties, a risk-based approach to regulation emphasizes the need to be **proactive and preventive**, as opposed to reactive and enforcement-oriented. Thus regulatory resources are often shifted away from enforcement activities directed at individual instances of regulatory breach and towards on-going risk monitoring or compliance-related activities, especially on an industry-wide basis. Thus, for example, Lunt et al argue that the U.K.’s FSA has placed more emphasis on improving public information

¹¹⁷ The phrase is generally attributed to Ulrich Beck, who published his book *Risk Society. Toward a New Modernity* in 1992 (Sage Publications)

¹¹⁸ See Ericson et al *Insurance as Governance* (UTP, 2003); Michael Power *The Risk Management of Everything: Rethinking the politics of uncertainty* (Demos, 2004)

¹¹⁹ Hood et al *The Government of Risk* (OUP, 2001); David Moss *When All Else Fails: Government as the Ultimate Risk Manager* (Harvard University Press, 2002)

campaigns that accompany product development as a way of avoiding the need to deal with claims of product mis-selling later on¹²⁰.

Of course, there are still a variety of ways of being a proactive regulator, ranging from outright bans on activities deemed unacceptable, to requiring enhanced disclosure of information or enhanced data collection. On the other hand, some commentators argue that the fact that risk identification, analysis and management has become a common feature of the regulatory scene facilitates the development of “super agencies” that “take a broader, more integrated view of risk management, which co-ordinates across and between sectors and where knowledge is cross fertilised and shared¹²¹”.

In risk-based regulation, there is renewed emphasis on **selectivity** in relation to the potential universe of regulatory problems that are targeted for attention. That is to say, once the focus becomes prioritizing the most serious risks to the regulatory system itself or to the sector being regulated, it is inevitable that other regulatory issues become de-emphasized. It may be countered that regulators have always been selective about the problems they address; what is different about a risk-based framework is that selecting the most serious risks to address is now an important indication of regulatory effectiveness, objectivity and efficiency¹²². Thus for example, the FSA asserts that “our risk-based approach is based on a clear statement of the realistic aims and limits of

¹²⁰ Peter Lunt et al “Approaches to Risk and Consumer Policy in Financial Services Regulation in the UK” <http://eprints.lse.ac.uk/992/01/ApproachestoriskandconsumerTODAY.pdf>

¹²¹ B Hutter “The Attractions of Risk-based Regulation: accounting for the emergence of risk ideas in regulation” Centre for Analysis of Risk and Regulation, London School of Economics, Discussion Paper #33 (March 2005), at 4.

¹²² *Ibid* at 2-3

regulation. In other words, we accept that we can never entirely eliminate risks to the statutory objectives we have been set by Parliament – our non-zero failure approach¹²³”.

A risk-based approach to regulation carries with it the requirement to develop a variety of **risk assessment techniques** that are often quantitative and probability-based. They include methods such as risk scoring techniques, cost-benefit analysis, actuarial analysis, scientific risk assessment, and hazard identification. These techniques often require the collection and filtering of large amounts of data and broadly-based surveillance tools. It should also be obvious that reliance on these techniques involves mobilizing the knowledge of a wide range of experts, such as scientists, epidemiologists, actuaries, and economists among others.

Risk-based approaches rely heavily on the development and operation of **internal control systems** within organizations, from early warning systems to compliance processes to disclosure mechanisms¹²⁴. Thus Power argues that the public control of risk is “achieved indirectly via the inspection of management systems of control¹²⁵”. In that there is a downloading to organizations of responsibility to manage risk, this approach seems compatible with the principle-based approach discussed above.

C. Illustrative examples of risk-based regulation

1. U.K. Financial Services Authority

The FSA’s risk assessment framework, known as ARROW (Advanced, Risk-Responsive Operating FrameWork), is used to assess risks at the level of individual

¹²³ FSA “The FSA’s risk assessment framework” (London: FSA 2006), at p.7, online: http://www.fsa.gov.uk/pubs/policy/bnr_firm-framework.pdf

¹²⁴ As Power expresses it (*Supra* note 118, at 25) “...far from being a private organisational matter, the effectiveness of internal control systems is now an issue for public policy and formal law”

¹²⁵ *Ibid* at 27

firms, the market as a whole, and at the level, internally, of the FSA itself. The relevant risks that are noticed are those that “have the potential to cause harm to one or more of our statutory objectives¹²⁶”. They are firm financial failure, misconduct such as mis-selling, lack of consumer understanding of products, deterioration in market quality, incidents of fraud, market abuse or money laundering¹²⁷. The FSA considers risk to reside in the combination of the impact and the probability of an event. Scoring of impact and probability (as well as their combination) is rated on a four-point scale¹²⁸. With respect to the *impact* of an issue (either at the firm or the market level), the FSA assesses both quantitative information about the scope and severity of the problem as well as qualitative factors about the nature of the harm that will be suffered.

Probability is classified under ten high-level “risk groups”, which are further divided into “risk elements”. “Risk groups” include topics such as environmental risks, risks related to customers, products and markets, prudential risks, control functions¹²⁹, “management, governance and culture”, capital and liquidity. The risk elements enumerated under the environmental risk group, for example, are; economic environment, legislative/political environment, competitive environment and capital market efficiency.

For individual matters, the probability calculation is a “simple rating of the likelihood of the events described by the issue occurring”¹³⁰. When probability is assessed at the level of the firm as a whole, each of the ten risk groups is considered

¹²⁶ FSA, *Supra* note 123, at 8

¹²⁷ *Ibid*, Annex 3 at 58

¹²⁸ That is; low, medium low, medium high or high

¹²⁹ This category includes the elements of compliance, internal audit and “enterprise-wide risk management”

¹³⁰ FSA, *Supra* note 123, at 12

separately, along with any of the issues uncovered during a risk assessment. The ARROW risk model “provides an overview of how inherent business risks, front-line controls and governance arrangements interact within a firm or group, leading to an overall assessment of net risk¹³¹”. In this highly quantitative approach, some risk groups and elements are considered to be more essential than others. Thus, for all firms where risk assessments are undertaken, risk elements comprising “management, governance and culture”, control functions, capital and liquidity are always investigated. In addition, issues relating to customers, products and markets are always examined for firms with significant retail involvement.

However, the FSA makes it clear that for firms that are assessed as “low impact”, firm-specific risk assessment is rarely carried out, though thematic assessment or “remote monitoring” of the firm’s information may result in these low impact firms being reviewed. For firms designated as other than low impact, regular risk assessments are carried out, between one and four years apart. *The overwhelming majority of the 30,000 firms regulated by the FSA are assessed as low impact.*

Firms that are subject to firm-specific risk assessment are assigned to a supervisory team or “relationship manager” and high impact firms are subject to “close and continuing supervision”. The process is undertaken according to a series of stages. After a preliminary probability assessment, additional information may be requested from the firm, an on-site visit may occur, following which a full assessment of probability risk will be made, along with the development of a risk mitigation programme (RMP), that is, a programme of action to be taken by the firm “designed to achieve certain regulatory

¹³¹ *Ibid.*

outcomes¹³²”. Firms will be sent a risk assessment letter along these lines. Thus, through supervision, the FSA seeks to engage firms and promote risk mitigation to prevent adverse incidents before they occur. The regulator will defer to management in crafting solutions if it is confident that management is competent. Once the supervisor gathers information pertaining to risk assessment, the process undertaken is itself subject to validation by senior FSA staff.

With respect to enforcement as opposed to the supervision of compliance discussed above, the FSA is clear that the goal is to choose cases to subject to enforcement action based on the extent to which they support the FSA’s strategic objectives. Thus enforcement action is regarded as only one of a number of tools that could potentially be deployed to achieve the desired outcomes, and the FSA is equally clear that it is not an “enforcement-led” regulator. A variety of sources of intelligence are used to identify the enforcement cases that will be pursued by the regulator, such as “mystery shopping”, complaints from consumers, and data mining from internal sources.

2. Ontario Securities Commission’s approach to risk-based regulation

The Ontario Securities Commission articulated its risk-based approach to regulation in a Staff Notice published in 2002¹³³. This notice indicates that the goal is to “target those activities and market participants where problems are most likely to arise so that limited resources are most effectively employed¹³⁴”. Since identifying risks correctly

¹³² *Ibid* at 26

¹³³ OSC Staff Notice 11-719 “A Risk-based Approach for More Effective Regulation” (2002) 25 OSCB 8410, online: http://www.checkbeforeyouinvest.ca/Regulation/Rulemaking/Current/Part1/sn_20021218_11-719_effective-reg.pdf

¹³⁴ *Ibid*

is a challenge, the notice enumerates criteria designed to evaluate which activities and participants might be considered “high risk”. Each of these criteria then is assigned a weighting or value to reflect its overall importance in determining the risk rating¹³⁵. For example, transgressions affecting many investors are treated differently than those only affecting a few. Deliberate acts are treated differently than inadvertent ones.

The risk analysis applied spans the full extent of the OSC’s regulatory activity. Thus, it is relevant to prospectus review, continuous disclosure review, registrant compliance, and enforcement. Enumerated criteria that will potentially spark close attention from the regulator are in general fairly loosely defined. They are most detailed with respect to the regulation of registered market participants, that is, fund managers and investment counsel/portfolio managers (ICPMs)¹³⁶. Here, market participants are accorded an overall “Investor Risk” rating. This rating is defined as the sum of three types of measured risk (inherent risk¹³⁷, external risk¹³⁸ and internal risk¹³⁹) less measured risk controls. The primary tool for verifying the compliance with regulatory requirements of those selected out as “high risk” is a detailed field review conducted on the premises of the market participant, which may last several weeks. Following this review, a report is issued noting any deficiencies.

¹³⁵ It is also noted however that in some areas of the OSC’s activities, reviews of participant activity may occur on a random basis. This alerts market participants that they may still be subject to regulatory scrutiny even though they may be low risk. It also assists in evaluating the effectiveness of the risk selection criteria.

¹³⁶ Fund managers and ICPMs represent the subset of registrants that are regulated directly by the OSC. Most registered market participants, such as brokers, dealers, investment bankers etc are initially regulated by the Investment Dealers Association, an SRO which is subject to OSC oversight.

¹³⁷ Inherent risk refers to the risk intrinsic to the specific business of the market participant, such as the diversity and complexity of the financial products and services offered, the types of clients serviced and their vulnerability, the size and age of the business, the complexity of the corporate structure, profitability and liquidity

¹³⁸ External risk refers to the ability of the registrant to understand and respond to regulatory requirements

¹³⁹ This type of risk deals with the quality of management, the effectiveness of the firm’s operations, the reliability of its information systems, the adequacy of its marketing and selling strategies, especially with respect to fee disclosure, the appropriateness of its investment policies and its susceptibility to fraud or unethical behaviour.

Risk assessment is also a feature of the selection of matters to pursue in an enforcement action. The kinds of criteria identified as relevant in this selection process include; the nature of the activities at issue, the impact on investors, the urgency of dealing with the matter, and its investigative value. However, as I have argued elsewhere, the criteria are couched in relatively general terms¹⁴⁰. Thus for example, with respect to the nature of the activities, the policy indicates that the regulators will consider relevant whether the market participants involved were registrants or issuers, or their officers and directors. It is not indicated whether regulators would be more likely to pursue an enforcement matter against a registrant or against an issuer. Again, when it is indicated that a further criterion is whether the case involves an issue that the OSC has determined is “high priority”, it is not clear how that determination is made or whether or not it is publicized. As a former Vice-Chair of the OSC has indicated, this risk ranking exercise is “an art – not a science¹⁴¹”.

3. The U.K. Pension Regulator(PR)

In its “Medium Term Strategy” document, the UK Pension Regulator describes a key characteristic of its approach to regulation as that it is risk-based. While also indicating adherence to the goals of being accountable, consistent, transparent and proportionate, the regulator notes that its regulation will be focused on “those schemes posing the most serious risks to our objectives, consistent with meeting all of our statutory objectives”. In pursuing this focus, the PR intends to both work with individual

¹⁴⁰ Mary Condon “Rethinking Enforcement and Litigation in Ontario Securities Regulation” (2006) 32:1 Queens Law Journal 1-44.

¹⁴¹ Susan Wolburgh Jenah “A Work in Progress: Lessons in Risk-based Supervision from the Canadian Marketplace” Brazilian Securities Commission (CVM) International Seminar, Rio de Janeiro, September 5, 2006.

schemes to reduce risk and analyze the risks in the pensions environment more generally. The diagnostic approaches to be used with respect to the first of these endeavours include analysis of scheme returns, whistleblowing, intelligence and “notifiable events”. Resources are not to be devoted unnecessarily to “tick box” supervision. However the PR insists that “it is neither possible, nor indeed desirable, to eliminate all occasions” on which risks materialize.

Like the FSA, the PR operates by targeting a small subset of the population of DB funds. In total the regulator is responsible for 84,600 private sector occupational pension schemes. However less than 2% of these schemes have more than 1,000 members and it is on these 1,600 schemes that the PR trains its attention. Further, it takes the view that two prerequisites for a successful risk-based approach are (i) the need for co-regulation with all those involved in work-based pensions and (ii) accurate information, largely derived from annual scheme returns. Meanwhile, schemes which demonstrate that they are consistently well run and well funded, thus constituting a low level of risk, may achieve “earned autonomy”, that is, a lower level of regulatory interaction¹⁴².

In 2006, the PR noted that its most immediate challenge was to strengthen the funding of DB schemes. Here the 2004 *Pensions Act* had introduced a new funding framework which represented a shift away from a minimum funding requirement and towards a “scheme specific” funding framework. This new approach has the potential to create the risk that individual fund trustees and employers set inadequate funding objectives for their scheme, or make up shortfalls over too long a period. The aim of the PR is to make this framework effective for trustees without formal intervention, by way

¹⁴² This may include; a less detailed or less frequent scheme return; reliance on more reactive information with respect to that scheme; less likelihood of asking for information about recovery plans

of the promotion of better understanding by trustees of their obligations with respect to funding; however the regulator is prepared to intervene formally if necessary.

In particular, the PR uses a “filter mechanism’ based on “triggers” to identify schemes whose funding plans seem more likely to be based on “imprudent or inappropriate assumptions¹⁴³”. Funding-related risks may come to the regulator’s attention from a variety of sources, but especially from the various statutorily-required reports from trustees or actuaries. The triggers relate separately to (i) technical provisions and (ii) recovery plans. All schemes that trigger will be subject to some form of further assessment process.

The technical provisions trigger (the actuarial estimate of the amount needed to pay for benefits as they fall due) involves the regulator assessing the figure identified by the trustees to see if it falls within a range between two other ways of valuing the liabilities. These two values are (a) the figure that represents the funding required to secure the level of benefits provided by the U.K. Pension Protection Fund in the event of employer insolvency¹⁴⁴ and (b) the way the liabilities are calculated and reported on the sponsor’s balance sheet using accounting standards. Where the trustees’ valuation falls below this range, the fund will be selected out for closer scrutiny. However the PR acknowledges that the new legislation governing DB schemes in the U.K. does **not** require ongoing schemes to fund to the solvency level whereby all accrued liabilities could be secured immediately by the purchase of insurance policies.

If there is a shortfall in funding a pension scheme, trustees must prepare a recovery plan. Schemes will be triggered for further assessment on this basis if the

¹⁴³ Medium Term Strategy document, at 36

¹⁴⁴ This fund charges a risk-based levy based on an employer’s level of plan underfunding, its risk of insolvency and the amount of benefits the fund would have to pay

recovery plan is projected over too long a period (longer than 10 years) or is back-end loaded in relation to the level of contributions required (that is, higher levels of contributions towards the end of the period), or if the plan appears to be based on unrealistic investment assumptions.

Even where the calculation of the technical provisions does not lie outside the acceptable ranges, a scheme may still trigger based on the PR's assessment of the nature of the employer. Thus, in applying its risk-based triggers, the PR distinguishes between immature pension schemes with "strong" employers that may not in fact pose any risks, and pension schemes with "weak" employers that will not trigger but do in fact pose risks. While the PR uses externally available information such as information from credit rating agencies, to assess the strength of the "employer's covenant", it is clear that exercises of judgment are still required with respect to scheme specific factors.

It may be worth noting that some pension industry commentators in the U.K. were critical of the 10 year recovery time frame on which the regulator will base its monitoring, and also of the potential for tension between trustees and employers with respect to funding shortfalls¹⁴⁵. On the other hand, adopting scheme-specific funding practices is a less prescriptive approach than the establishment of industry-wide minimum funding requirements.

4. FSCO's approach to risk-based regulation¹⁴⁶

¹⁴⁵ Barbara Cockburn "U.K. pension 'triggers' get cautious welcome" (2005) 39:46 *Business Insurance* 49

¹⁴⁶ It should be noted that both the Regie des Rentes du Quebec and the B.C. Financial Institutions Commission (FICOM) describe themselves as risk-based regulators. In its 2007/8-2009/2010 Service Plan FICOM indicates that it is continuing to develop and implement a risk-based regulatory system for pensions. In October 2006 new annual filing requirements were introduced by FICOM in order to assist the regulator in identifying plans that face increased risk. See www.fic.gov.bc.ca/responsibilities/pension/bulletin5.htm

FSCO currently adopts an explicitly risk-based approach with respect to two aspects of pension regulation (i) funding requirements and (ii) investment of pension assets.

1. Funding review

The Annual Information Summary (AIS), introduced in Ontario in 2000, is used as the gateway to a risk-based approach to funding regulation. The design of the AIS is meant to assist in standardizing the variety of forms of information provided in actuarial valuations, so that funds can be compared one with the other. By entering the information into a database, data from the AIS can be mined to capture plans that present higher risk. A set of risk factors are identified to undergird selection of a plan for more detailed review. These risk criteria may be grouped into (i) regulatory compliance issues and (ii) actuarial concerns.

Regulatory compliance issues relate to matters such as;

- did the employer make the required contributions within the appropriate time frame?
- were any contribution holidays taken that exceeded the amount of surplus indicated in a previous valuation report?

Actuarial concerns involve criteria such as;

- is the solvency ratio acceptable?
- what interest assumptions were used for the going concern valuation?
- what liability discount rates were used?
- what mortality tables were used?
- were the asset valuation methods used reasonable?

-were there undue investment losses since the last valuation report (that is, exceeding 15% of going concern assets)?

-is there an appropriate investment mix?

Plans that are selected out for more intensive scrutiny will undergo a desk review involving a more detailed analysis of issues such as membership data, detailed review of plan documents, and tracking of remittances. If FSCO questions any of the actuarial assumptions used in a valuation, such as, for example, the averaging period used to “smooth” the value of an asset, actuaries are given the opportunity to provide satisfactory information to support the assumptions used. However if FSCO remains unhappy, it refers the matter to the CIA. In rare cases, it may order the sponsor to provide a new funding report. FSCO uses its data base to collect information on the ranges of actuarial assumptions used, allowing it to more easily identify actuarial practices that are outside of industry practice.

A very useful innovation resulting from FSCO’s current approach to data collection about funding issues is its ability to discern trends in DB pension provision. The most recent report issued by FSCO on its risk-based funding supervision provides an overview of data collected between July 2003 and January 2007¹⁴⁷. During this period, approximately 6,400 funding valuation reports were submitted to FSCO. 42% of these reports were selected for further review, and over 22% of these were identified as having material compliance concerns. These concerns were overwhelmingly resolved with plan actuaries and administrators on an informal basis.

¹⁴⁷ FSCO “Funding Defined Benefit Pension Plans: Risk-Based Supervision in Ontario. Overview and Selected Findings 2002-2006” March 2007

Key trends noted by FSCO, based on the data gathered, were that 78% of plans were less than fully funded on a solvency basis, with the median solvency ratio¹⁴⁸ being 86%. In contrast, the median funded ratios on a going concern basis were 98%. There also appears to be a trend towards convergence with respect to interest rate assumptions¹⁴⁹ and the use of the most up-to-date mortality table available¹⁵⁰.

By way of contrast with other pension and financial services regulators, FSCO does not appear to use the size of a pension plan (that is, the number of members) as an explicit trigger for regulatory attention. According to the funding trends report, Ontario's pension sector is dominated by seven very large public sector plans, with a total membership of one million employees or beneficiaries. Nor, unlike the Pension Regulator in the U.K., does it appear to pay specific attention to qualitative information about the financial health of the plan sponsor. This is likely because the specific risk factors identified in the U.K. regime are related to the U.K.'s overall legislative commitment to a "scheme specific" funding regime as opposed to across-the-board minimum funding requirements in Ontario.

2. Investment review

A more recent foray into the arena of risk-based regulation has been FSCO's activities in the area of pension investment monitoring. The approach here replicates the model used with respect to the collection of data about plan funding. Since 2006, pension funds regulated by FSCO have been required to submit an Investment Information Summary (IIS) which provides a standardized set of data about the investment practices

¹⁴⁸ The solvency ratio is the ratio of the market value of the plan's assets to the plan's solvency liabilities

¹⁴⁹ 88% of the plans in the data base used a rate between 6% and 7% to value going concern liabilities

¹⁵⁰ 84% of plans used a 1994 table

of funds, and can be used as a screening mechanism to select funds for further detailed review of their investment practices.

The investment risk criteria that have been devised by FSCO to identify higher risk plans comprise four main components; (i) has the plan complied with the federal investment rules identifying permitted investments for regulated pension funds? (ii) has there been significant investment underperformance as compared to plan benchmarks or relevant indexes? (iii) is there a significant mismatch between the portfolio of assets and the liabilities of the fund? (iv) has there been a significant change in the asset mix of the fund¹⁵¹?

As on the funding side, plans that trigger concern based on these criteria will be selected for a more detailed desk review. This will involve a more detailed assessment of the financial statements and the actuarial report as well as a qualitative assessment of the level of prudence with which investment allocations have been made. Major changes in asset allocation will be probed further. Based on this more detailed review, a letter may be sent by FSCO reminding plan administrators of the factors to be taken into account with respect to pension investment practices.

The risk-based approach to pension investment monitoring in Ontario is sufficiently new that data regarding overall trends is not yet available. However a by-now familiar dilemma that arises is whether pension investment practices should be the subject of more or less prescription in the future. It may be that the kind of quantitative limits established by the federal investment regulations do not easily adapt to a context in which pension plans of widely varying size and sophistication operate. Quantitative limits can be diluted through the use of derivative instruments. Similarly, the limits currently

¹⁵¹ A 20% change in asset allocation will qualify as a significant change

specified may not sufficiently capture novel investment alternatives, such as infrastructure investments or portable alpha instruments. The limits established by the federal regulations also refer to the book value of assets, whereas market values are more typically used to calculate values in the investment context. This inhibits the extent to which risk-based screening can assess whether or not plans are offside the requirements.

An alternative to prescribing quantitative investment limits would be to rely on an overall principle of investment prudence. Obviously the viability of this approach would depend on the extent to which it is supported by a realistic means of enhancing the investment sophistication and knowledge of plan fiduciaries, or their advisors, across the spectrum of the regulated sector.

D. Controversial issues raised in the literature about risk-based regulation

1. Some critiques of risk-based regulation focus on a range of issues having to do with the way risk priorities are chosen. One set of criticisms contrasts the risk perceptions and risk acceptance of “citizens” or the public with those of the “experts” that design the risk identification and assessment techniques and argues that regulators will lose credibility if they ignore the impact of their risk calculations on citizens. Thus, for example, when the FSA only lightly reviews the activities of many firms because their regulatory infractions (if they occurred) would only damage small numbers of people, this is likely to be problematic for those numerically few consumers to whom this might happen and who do not see harm to them as an acceptable risk¹⁵². This problem is exacerbated by the empirical claim made in a variety of contexts that small and medium sized businesses are

¹⁵² Julia Black “Managing Regulatory Risks and Defining the Parameters of Blame: A Focus on the Australian Prudential Regulation Authority” (2006) 28;1 Law and Policy 1, at 24.

less likely to invest in adequate risk management systems, so that such firms might, on some analyses, represent higher risk of repeated negative outcomes for clients.

On the other hand, in the context of debates about whether internal pension fund governance should more broadly represent beneficiaries, Gordon Clark argues that a culture of democracy and representation around the appointment of pension trustees in the U.K. can damage the ability of those funds to make decisions with the appropriate level of sophistication and prudence in order to ultimately secure benefits¹⁵³. In this respect, it is important to note that a major contextual difference between groups of retail clients of a financial services firm and an employee group in a pension fund is the enhanced ability of the latter group to act *as a collective* in interactions with the regulator, since they can more easily communicate with each other, share information and have more potential to adopt a common stance on issues of concern to them.

Another set of related criticisms of risk-based approaches notes that apparently objective calculations, such as risk scoring techniques, contain a subjective element within them, which is rendered less transparent and accountable because of the overlay of objectivity¹⁵⁴. Meanwhile, heavy emphasis in a risk-regulation model is placed on the expertise of technocrats to calibrate the risks correctly. Hutter notes that “uncertainties and points of contestability around the more technical aspects of risk-based regulation can... be exploited by interested parties¹⁵⁵”. Furthermore, the fear of getting the risks wrong in fact might encourage those technocrats to engage in what Power calls “secondary risk management”, where more emphasis is placed by experts on managing

¹⁵³ Gordon Clark “The growing tension between expertise and representation: UK legislation on pension fund governance and US regulation of the mutual fund industry” WPG 06-07 Working Papers in Economic Geography.

¹⁵⁴ Hutter, *Supra* note 95, at 8

¹⁵⁵ *Ibid* at 10

risk to their reputation or liability risk rather than on techniques for dealing effectively with the initial set of risk-related regulatory issues¹⁵⁶.

2. As exemplified by the approach of the FSA, in a risk-based regulatory model, reactive enforcement practices organized around sanctions for offenders are devalued in favour of proactive standard setting and continuous monitoring. Again, to the extent that there is a mismatch between the regulator's view of the role of reactive enforcement and consumers' or beneficiaries' view of this, this may be an ongoing source of tension for the regulator.

3. A final set of issues is the extent to which a risk-based approach will over time measure up to traditional indicators of good regulation. It is noteworthy that the FSA, for example, has crafted its risk-based approach in a context in which the principles for good regulation that are articulated for it in its governing statute place heavy emphasis on avoiding regulatory burdens to the financial services industry and maintaining the competitive position of the U.K. economy. It is harder to validate a risk-based approach from a more traditional legal perspective that would encourage fair and consistent treatment of all market or industry participants, due process protections from the exercise of regulatory discretion and so on. In other words, the popularity of risk-based approaches to regulatory endeavour may signal a sea-change in the way in which we understand regulation to contribute to the well-being of society generally¹⁵⁷.

¹⁵⁶ Power, *Supra* note 118, at 14-15. See also C Hood, "The Risk Game and the Blame Game" (2002) 37:1 *Government and Opposition* 15-37

¹⁵⁷ Note Fisher's comment that "The expertise of the regulator has fundamentally changed and rather than being concerned with the exercise of creative professional judgment it is mainly concerned with the

4. CONCLUSION

Since this research has investigated the use of both principles-based and risk-based approaches to regulation, and considered some of the issues that arise with respect to both approaches, it may be relevant to address the extent to which the two approaches are consistent with each other. At first glance it would appear difficult to align them, since PBR involves high-level principles, and risk regulation involves operationalizing a detailed “risk indicators” analysis. However a number of commentators see PBR as quite compatible with risk management *by industry members*. Thus for example, Hutter describes the concept of “enforced self-regulation” as involving government laying down “broad standards which companies are then expected to meet. This involves companies in developing risk management systems and rules to secure and monitor compliance¹⁵⁸”. Likewise Power argues that “since the mid-1990s considerable effort has been expended on making risk management into a value proposition and in both private and public sectors the concept of risk is being enrolled in a new focus on *outcomes* and *performance*¹⁵⁹”. Thus in both approaches there is a convergence of focus on firms’ internal systems and processes, as a preferred method of risk management in one case, and as providing flexibility in the other. Similarly, both risk-based and principles-based approaches identify the need to invest heavily in enhanced communication to sector participants about broadly cast regulatory expectations.

application of facts to methodologies”. See Elizabeth Fisher “Drowning by Numbers: Standard Setting in Risk Regulation and the Pursuit of Accountable Administration” (2000) 20:1 *Oxford Journal of Legal Studies* 109, at 129.

¹⁵⁸Hutter *Supra* note 95. See also the speech by the U.K. Economic Secretary U.K. (14 December 2005) “The focus on the quality of risk management naturally leads to a principle-based approach to regulation. This also encourages management to develop their own assessment of business risks, rather than restrict them through sets of rules”.

¹⁵⁹ Power, *Supra* note 118, at 13 (emphasis in original)

Certainly the FSA sees the two approaches to regulation as compatible. Thus it declares that

“The shift to a more principles-based approach to regulation complements the risk- and evidence-based models...Risk-based regulation will remain central to determining how we prioritize our resources, as principles-based regulation steers our expectations of firms and the way we deal with them”.

Yet, to the extent that in a risk-based approach, *regulators* do a great deal of data gathering and on-going risk monitoring, it is not so clear that this activity is compatible with the spirit of a PBR approach nor a downloading of regulatory responsibility¹⁶⁰. On the other hand, risk-based regulation involves a light regulatory touch on those organizations identified as low risk. The more general point here is that the specific risk factors emphasized by a risk-based approach should be rationally related to the overall policy goals the regulatory scheme is designed to achieve. If the content of those goals change because of a commitment to a principles-based approach, the risk management exercise by regulators and the regulated may have to change too.

With respect to PBR specifically, a conclusion that can be drawn from this research is that the issue for discussion is less about principles vs. rules than it is about the level of detailed prescription of conduct that is contained in either rules or principles. It is more about the level of flexibility to be accorded to regulated participants to meet broad standards than it is about whether the standard is formulated as a rule or a principle. There will be a need to consider closely the extent to which all interested groups of participants can be involved in designing the standards. There will also be a

¹⁶⁰ Note, however, the FSA’s view (*Supra* note 11, at 9) that “By taking a more overtly risk-based approach to our assessment of whether firms are operating in line with these principles (such as ‘treating customers fairly’) we can create incentives for firms to do the right thing in return for less supervisory intervention”

need to consider precisely what kinds of outcomes and behaviours lend themselves to being described as principles, so as to allow both flexibility in the design of the processes to achieve them, as well as a realistic way of monitoring their achievement. Would all the relevant stakeholders respond positively to a shift to more flexibility in the management of broad outcome-based standards by pension sponsors? Would the concerns of some stakeholders here be mitigated by more substantial accountability standards imposed on third parties such as actuaries? What other mechanisms would be put in place to ensure that the standards were taken seriously and their achievement monitored on an ongoing basis?

Meanwhile, in a risk-based universe, regulators acknowledge that they do not discover all potential regulatory infractions that may ultimately damage those who rely on the regulatory framework in place. This is in part because they are less committed to being reactive and complaint-driven about potential problems and more committed to standard-setting and selective monitoring. Further commitment to a risk-based approach to pension plan monitoring in Ontario requires some clear-sightedness about the possibility that there may be regulatory failures that will go unaddressed, either because the regulators have not yet captured emerging sources of risk in their monitoring processes, or because low impact risks are given low priority. Enhanced communication with beneficiary groups about the implications of risk-based monitoring will be an important component of any expansion of this kind of regime in the future.