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### **Principles, Prescriptions, and Polemics: Regulating Conflicts of Interest in the Canadian Investment Fund Industry**

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Dan Awrey\*

Principles, Prescriptions, and Polemics:  
Regulating Conflicts of Interest in the  
Canadian Investment Fund Industry

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*Conflicts of interest permeate the Canadian investment fund industry. In response, securities regulators have promulgated National Instrument 81-107 Independent Review Committee for Investment Funds. In the view of securities regulators, NI 81-107 reflects a "principles-based" approach toward the regulation of conflicts of interest. This Article articulates a theoretical conception of principles-based securities regulation, one which transcends the formalism of the traditional "rules" versus "principles" debate to reveal a new regulatory paradigm. Thereafter, the author explores whether and to what extent NI 81-107 truly reflects this principles-based paradigm, manifesting the potential to tap into its inherent wisdom while at the same time minimizing its potential drawbacks. Having reaped the fruits of this exploration, the author concludes with a series of normative proposals respecting how securities regulators should approach both the regulation of conflicts of interest under NI 81-107 and, more broadly, the institutional design and implementation of future principles-based regulatory mechanisms.*

*Lès conflits d'intérêt sont omniprésents dans l'industrie canadienne des fonds de placement. Pour les pallier, les instances réglementaires en matière de valeurs mobilières ont adopté la Norme canadienne 81-107 Examen indépendant des fonds d'investissement. De l'avis des instances réglementaires en matière de valeurs mobilières, la NC 81-107 reflète une approche fondée sur les principes de la réglementation des conflits d'intérêt. L'auteur présente une conception théorique des règlements sur les valeurs mobilières fondés sur les principes, conception qui transcende le formalisme du débat traditionnel qui oppose règlements et principes pour faire ressortir un nouveau paradigme en matière de réglementation. L'auteur tente ensuite de déterminer si la NC 81-107 est l'expression véritable du paradigme fondé sur les principes et, dans l'affirmative, dans quelle mesure offre-t-elle la possibilité de puiser dans la sagesse inhérente de ce paradigme tout en minimisant ses éventuels aspects négatifs? En conclusion, l'auteur formule des propositions normatives sur la façon dont les instances réglementaires en matière de valeurs mobilières devraient aborder tant la réglementation des conflits d'intérêt sous le régime de la NC 81-107 et, de manière plus vaste, la conception et la mise en œuvre institutionnelles des futurs mécanismes de réglementation fondés sur les principes.*

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*Introduction*

- I. *The sources of potential conflicts of interest in the Canadian investment fund industry*
- II. *Regulating conflicts of interest in the Canadian investment fund industry: the structure and salient features of NI 81-107*
- III. *Principles-based securities regulation: its defining attributes, wisdom and potential drawbacks*
  1. *Principles-based securities regulation defined*
  2. *The wisdom and potential drawbacks of principles-based securities regulation*
- IV. *NI 81-107: a principles-based evaluation.*
- V. *Normative proposals*

*Conclusion*

*Introduction*

The past twenty-five years have been a time of metamorphosis in the Canadian investment fund industry. Cutbacks to the Canada Pension Plan and Old Age Security, the shift from defined benefit to defined contribution pension plans and the demographic realities of an aging yet longer-lived population have meant that, more than at any previous moment in history, Canadians find themselves responsible for the investment decisions which determine their financial security.<sup>1</sup> As Canadians have assumed increasing control over these decisions, the primary vehicles through which they have invested their savings have been investment funds such as retail mutual funds, hedge funds, structured products and similar pooled investment vehicles. As of June 2009, members of the Investment Funds Institute of Canada (IFIC) held approximately \$547.1 billion dollars in mutual fund assets under management—up from a mere \$3.6 billion in 1980.<sup>2</sup>

As evidenced by this dramatic growth, Canadians have increasingly placed their trust in the regulated actors—investment fund managers, portfolio managers, investment dealers and advisors—who manufacture,

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1. For a more detailed description of the policy developments and demographic trends underlying the growth of the Canadian investment fund industry, see Glorianne Stromberg, *Regulatory Strategies for the Mid-90's: Recommendations for Regulating Investment Funds in Canada* (Toronto: Ontario Securities Commission, 1995) [Stromberg Report]. Though now somewhat dated, many of the trends identified in the *Stromberg Report* have, if anything, accelerated in the 14 years since its publication.

2. IFIC, *Industry Statistics* (June 2009), online: <[www.ific.ca](http://www.ific.ca)>. This figure does not include other species of investment funds (retail hedge funds, retail structured products or high net worth pooled funds for instance), the aggregate data for which is not readily obtainable.

manage and distribute investment funds. Inevitably, however, the manner in which investment funds are manufactured, managed and sold spawn potential conflicts of interest between these regulated actors and the investors they serve. The effective regulation of these conflicts of interest has been acknowledged by Canadian securities regulators as vital to the objectives of investor protection, fostering fair and efficient capital markets and the promotion of confidence in capital markets.<sup>3</sup> In pursuit of these objectives, provincial securities regulators, under the auspices of the Canadian Securities Administrators (CSA), have in recent years proposed and promulgated a series of regulatory mechanisms, culminating on 1 November 2006 with the adoption of National Instrument 81-107 *Independent Review Committee for Investment Funds*.<sup>4</sup>

The CSA has stated that NI 81-107 reflects a “principles-based” approach toward regulating conflicts of interest in the Canadian investment fund industry.<sup>5</sup> The emergence and rise to prominence of principles-based securities regulation has been dramatic, with both the U.K. Financial Services Authority (FSA) and the Australian Securities and Investment Commission (ASIC) adopting comprehensive principles-based regimes within the past several years. In Canada, the British Columbia Securities Commission (BCSC) oversaw a fundamental overhaul of its *Securities Act* and related regulations in 2004 which, while ultimately not proclaimed into force, would have also marked a pronounced shift toward more principles-based regulation.<sup>6</sup> Calls for more principles-based regulation have even figured prominently in recent proposals for reform in the U.S.<sup>7</sup> Principles-based regulation has also been highly influential in the design of a number of more narrowly targeted securities regulatory mechanisms, including NI 81-107, and in the wider context of tax, accounting and corporate governance regulation. Accordingly, while the current global

3. See Notice and Request for Comment, National Instrument 81-107, *Independent Review Committee for Investment Funds*, (2005) 28:21 O.S.C.B. (Supp. 2) at 4-5 [Proposed NI 81-107].

4. (2006), 29:45 O.S.C.B. 8807 (10 November 2006) [NI 81-107]. While NI 81-107 came into force on 1 November 2006, full compliance was not required until 1 November 2007.

5. See Canadian Securities Administrators, *Concept Proposal 81-402 Striking a New Balance: A Framework for Regulating Mutual Funds and Their Managers*, (2002) 25 O.S.C.B. 1227 (1 March 2002) [Concept Proposal 81-402]; Notice and Request for Comment on Proposed National Instrument 81-107 *Independent Review Committee for Mutual Funds*, (2004) 27 O.S.C.B. 465 (9 January 2004) at 480, 496, and Proposed NI 81-107, *supra* note 3 at 7.

6. See Bill 38-2004, *Securities Act*, 5th Sess., 37th Parl., British Columbia, 2004, s. 203 [Proposed B.C. Act]. Despite this setback, the BCSC has continued to push forward with a number of other principles-based initiatives.

7. See, e.g. Committee on Capital Markets Regulation, *Interim Report of the Committee on Capital Markets* (Washington, D.C.: Committee on Capital Markets, 2006), and New York Office of the Mayor, *Sustaining New York's and the US Global Financial Services Leadership* (New York: Office of the Mayor, 2007).

financial crisis has led many to question the potential efficacy of principles-based regulation, cutting through the reflexive demagoguery it is thus not unreasonable to assert, as does Cristie Ford, that “[t]he significance and wisdom of “principles-based” securities regulation may be among the most pressing questions facing securities regulators internationally today.”<sup>8</sup>

Through this article I hope to make three distinct yet related contributions to the academic and public policy discourse respecting the regulation of conflicts of interest in the investment fund industry and, more broadly, the significance and wisdom of principles-based securities regulation. First, I will articulate a theoretical conception of principles-based securities regulation, one which transcends the engrained formalism of the traditional “rules” versus “principles” debate to reveal a new, coherent and fundamentally different regulatory paradigm. The defining attributes of this principles-based regulatory paradigm include an outcome-oriented focus, a fundamental change in the philosophy of both regulators and regulated actors toward their respective roles in achieving desired regulatory outcomes, and a new relationship between regulators and regulated actors, re-constituted from one of regulated (dis)trust enforced through an adversarial process, to one premised on real trust, a more sophisticated dialogue and shared understandings. As I will illustrate, these attributes share a symbiotic relationship whereby the absence of even one among them is likely to undermine the potential efficacy of any ostensibly principles-based regulatory mechanism.

Second, I will evaluate the potential efficacy of NI 81-107 through the lens of this emerging regulatory paradigm. More specifically, I will explore whether and to what extent the institutional design and implementation of NI 81-107 truly reflect a principles-based approach toward regulating conflicts of interest, manifesting the potential to tap into the inherent wisdom of principles-based securities regulation while at the same time minimizing the impact of its potential drawbacks. I will argue that NI 81-107 reflects a narrow, formalistic view of principles-based securities regulation which lacks many of the defining attributes necessary to maximize its potential efficacy. In this respect, the purpose of this evaluation is not simply to examine the desirability of principles-based securities regulation from a societal perspective—indeed, this endeavour would arguably be premature at this early juncture. Rather, the purpose of this evaluation is to illustrate that unlocking this inherent wisdom, and minimizing the impact of the potential drawbacks, first requires us to formulate a theoretical conception

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8. Cristie Ford, “New Governance, Compliance, and Principles-based Securities Regulation” (2008) 45 *Am. Bus. L.J.* 1 at 1.

of principles-based securities regulation that transcends the myopia of the rules versus principles debate and then to rigorously apply this conception to the institutional design and implementation of principles-based regulatory mechanisms.

Finally, having reaped the fruits of this principles-based evaluation, I will advance a series of normative proposals respecting how Canadian securities regulators should approach both the regulation of conflicts of interest under NI 81-107 and, more broadly, the institutional design and implementation of future principles-based regulatory mechanisms. These proposals include the clearer and more transparent articulation by regulators of the substantive content animating principles-based regulatory mechanisms, the explicit carving out by regulators of a good faith sphere in which regulated actors are free to innovate, and a sustained investment on the part of regulators, in term of both capital and philosophical buy-in, with a view to building a more dialogic relationship with regulated actors and other industry participants.

This article will proceed as follows. I will commence in Part I with a brief overview of the Canadian investment fund industry with a view to identifying and understanding the sources of the potential conflicts of interest which NI 81-107 has been designed and implemented to address. Against this factual backdrop, I will then describe in Part II the structure and salient features of NI 81-107. In Part III of this Article I will articulate a theoretical conception of principles-based securities regulation based on the defining attributes identified above and discussed in greater detail below. At the same time, I will examine the wisdom and potential drawbacks of this emerging regulatory paradigm. In Part IV I will then examine NI 81-107 through the lens of this regulatory paradigm with a view to evaluating both its credentials as a principles-based regulatory mechanism and its potential efficacy. I will conclude this article in Part V with my normative proposals respecting how Canadian securities regulators should approach both the regulation of conflicts of interest under NI 81-107 and, more broadly, the institutional design and implementation of future principles-based regulatory mechanisms.

I. *The sources of potential conflicts of interest in the Canadian investment fund industry*

As observed by Stephen Erlichman, the Canadian investment fund industry is, “by its very nature, rife with actual and potential conflicts of interest.”<sup>9</sup> These conflicts of interest flow from a number of sources which are, in many respects, unique to the products, structure and practices of the investment fund industry. As described in greater detail below, these sources include: the “false dichotomy” between an investment fund and its manager, the multiplicity of functional relationships between an investment fund and its manager, the manner in which managers are often compensated for their services, the fact that managers serve multiple clients, and the structure of the distribution channels through which investment fund securities are sold.

The concept of an investment fund is deceptively simple. Distilled to its essence, an investment fund is a vehicle designed to pool capital from a number of investors into a single investment portfolio under the common management of a professional money manager. In exchange for their capital, investors receive securities in the investment fund which, in turn, enters into a management agreement with the manager for its services. Subject to applicable laws, the investment fund’s constating documents and management agreement, the investment portfolio may be comprised of stocks, bonds and/or other securities, financial instruments or assets. Within these constraints, the manager is vested with the discretion to, *inter alia*, purchase and sell portfolio assets as it deems prudent and appropriate in accordance with the fund’s investment objectives.

An investment fund is typically brought into existence by its manager. In Canada, the vast majority of investment fund managers are regulated actors, registered under provincial securities legislation as, *inter alia*, investment counsel/portfolio managers (or their equivalent) in the jurisdictions in which they carry on business. The majority of investment funds are structured either as trusts or limited partnerships (primarily owing to the flow-through tax status of these vehicles); with the manager generally also acting, either directly or through an affiliate, as the trustee or general partner. Importantly, these vehicles also endow the manager with the maximum degree of flexibility and freedom from statutory constraints with respect to the design of the economic, portfolio management and

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9. Stephen Erlichman, *Making It Mutual: Aligning the Interests of Investors and Managers – Recommendations for a Mutual Fund Governance Regime for Canada* (Toronto: Ontario Securities Commission, 2000) at 71. While Erlichman’s analysis pertained to the structure of the Canadian mutual fund industry, his observation applies with equal force to the broader investment fund industry.

governance terms of the investment fund. These terms are typically contained within a management agreement entered into between, on the one hand, the manager *in its capacity as trustee or general partner* of the investment fund and, on the other, the manager *in its capacity as manager*.

It is at this point that one encounters the first source of potential conflicts of interest between an investment fund and its manager. While the terms of the management agreement (along with the fund's constating and offering documents) are ostensibly negotiated and agreed as between the investment fund and the manager as distinct legal entities, in reality the manager sits on both sides of the negotiating table. Indeed, neither the interests of the investment fund nor its eventual securityholders are independently represented at this all-important formative stage in the life of an investment fund. As a result of this "false dichotomy,"<sup>10</sup> the manager thus finds itself in the dubious position of being able to dictate—to a large extent<sup>11</sup>—the terms of the commercial bargain not only between itself and the investment fund but also, though the investment fund's constating and offering documents, between the investment fund and its securityholders. This false dichotomy thus results in a unique and stark agency problem, one which manifests the omnipresent opportunity for, and corresponding threat of, self-dealing on the part of the manager.<sup>12</sup> This false dichotomy also sets the table for many of the other potential conflicts of interest described in greater detail below.

The multiplicity of functional relationships between a manager and the investment funds it manages manifest several other potential conflicts of interest. The management agreement typically confers upon the manager full purview over all aspects of the management and operations of the

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10. Giuseppe Scaliarini, "The Fiduciary Duty of the Mutual Fund Investment Adviser and Portfolio Manager in the United States" (1995) 10:2 J.I.B.L. 42 at 43. Indeed, this false dichotomy was acknowledged as far back as 1969 by the Canadian Committee on Mutual Funds and Investment Contracts, which observed: "[A]s a practical matter, and regardless of the legal form used, mutual funds rarely, if ever, function as entities separate from their management companies." See *Report of the Canadian Committee on Mutual Funds and Investment Contracts – Provincial and Federal Study, 1969* (Ottawa: Queen's Printer, 1969) at s. 6.04 [*Mutual Fund Report*].

11. Managers are obviously constrained in this respect by applicable securities laws (as discussed in greater detail below) and, arguably, the prevailing market conditions for their products.

12. A historical survey of the investment fund industry reveals that it is indeed ripe with instances in which the latent threat of self-dealing on the part of managers has translated into allegations of real-world misconduct; see, e.g., *Re Mersch* (1998), 21 O.S.C.B. 3805, *Re Hirsch* (1997), 20 O.S.C.B. 5708, and *Re Singh* (1999), 22 O.S.C.B. 462. See also the recent scandals in both Canada and the U.S. stemming from allegations of late-trading and market timing by several managers. While all of these matters were ultimately settled, these enforcement actions serve to underscore the omnipresent threat of self-dealing created by the false dichotomy between a manager and the investment funds it manages.



investment fund. The management agreement also typically provides the manager with the discretion to contractually delegate various management sub-functions to third party service providers such as registrars, transfer agents, custodians and administrators. Indeed, the manager often retains the discretion to delegate some or all of the portfolio management functions to third party portfolio managers.<sup>13</sup> In this respect, an investment fund may be viewed as little more than a web of contractual relationships or, in the blunt characterization of some jurists, a “mere shell.”<sup>14</sup> The potential delegation of these functions creates at least two species of potential conflicts of interest. First, to the extent that the manager or its affiliates are capable of performing these functions, the manager possesses an economic incentive to perform them itself (or delegate them to its affiliates), irrespective of whether this is in fact in the best interests of the investment fund or its securityholders.<sup>15</sup> Second, where expenses related to the provision of such delegated functions are borne by the investment fund (and, ultimately, securityholders) and not payable out of the compensation of the manager, there exists a legitimate concern that the manager is not fully incentivized to procure the most cost-effective services.<sup>16</sup> A frequently cited example of both species of potential conflict arises in the context of obtaining so-called “best execution”<sup>17</sup> of portfolio transactions.

One relationship which managers do not generally have with the investment funds they manage is that of securityholder. Rather, the compensation of the manager is typically derived from a management fee calculated on the basis of one, or a combination, of assets under management (AUM) and/or fund performance. Where the compensation of the manager is based, in whole or in part, on a metric (such as AUM) which is not perfectly correlated with fund performance, this attenuated

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13. In certain circumstances, investment funds may actually be required to delegate certain management functions such as the custodianship of portfolio assets to qualified third parties; see National Instrument 81-102 *Mutual Funds* (NI 81-102), Part 6.

14. See *Tannenbaum v. Zeller*, 552 F.2d 402 at 405 (2d Cir. 1977), cited in *Burks v. Lasker*, 441 U.S. 471 at 480-481 (1979) and in *Zell v. InterCapital Income Sec. Inc.*, 675 F.2d 1041 at 1046 (9th Cir. 1982).

15. Marc Kruithof, “Conflicts of Interest in Institutional Asset Management: Is the EU Regulatory Approach Adequate?” in Luc Thevenoz & Rashid Bahar, eds., *Conflicts of Interest: Corporate Governance and Financial Markets* (Frederick: Aspen Publishers, 2007) at 293 [Kruithof].

16. Indeed, there exists a related concern that managers are thus incentivized to allocate as many expenses as possible to the investment funds they manage.

17. While numerous characterizations of the best execution obligation have been articulated, the obligation is, in essence, that of an agent (such as an investment fund manager) trading securities on behalf of a principal (such as an investment fund) to seek, on a reasonable basis, to execute the trade (1) at the lowest available price, (2) at the lowest possible commission, and (3) in a timely fashion, (4) all without exposing the principal to an unreasonable level of settlement risk.

connection will represent a further source of potential conflicts of interest.<sup>18</sup> For example, managers compensated on the basis of AUM<sup>19</sup> are, from an economic perspective, indifferent as to whether increases in AUM are attributable to fund performance or new investment. In this respect, in the absence of legal constraints, managers may rationally decide to allocate scarce resources to marketing activities—which do not benefit existing securityholders—with a view to attracting new investment, as opposed to portfolio management activities.<sup>20</sup> Similarly, calculating the manager's compensation on the basis of AUM arguably creates a potential incentive for managers to manipulate the value of portfolio assets in order to artificially inflate AUM. The opportunity for manipulation will be particularly acute with respect to illiquid or other assets (such as over-the-counter derivatives) for which there is often no timely and/or reliable source of market pricing data. Finally, in respect of the vast majority of investment funds, there likely exists a critical mass in terms of AUM beyond which all new investment is likely to translate into a drag on performance.<sup>21</sup> Where this critical mass is achieved, the interests of the manager compensated on the basis of AUM will be diametrically opposed to those of securityholders with each additional dollar of new investment.<sup>22</sup>

Potential conflicts of interest also arise from the fact that managers typically provide services on behalf of more than one client, including other investment funds. Indeed, given the economies of scale associated with investment fund management, such conflicts of interest are arguably unavoidable.<sup>23</sup> The resources of managers in terms of the time and effort of their personnel are clearly finite. Accordingly, “[t]he total amount of effort the asset manager can spend is limited and might fall short of the cumulative optimal effort applied to managing all the customers’ portfolios, so that principals in effect compete over the agent’s time and effort.”<sup>24</sup> The investment opportunities available to managers are similarly limited, requiring managers to make decisions respecting how to, *inter*

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18. See *Mutual Fund Report*, *supra* note 10 at s. 9.05.

19. Which would include, for instance, the majority of mutual fund managers.

20. Indeed, even assuming the presence of legal constraints respecting the allocation of such resources, this potential conflict simply re-emerges within the context of the manager’s expense allocation decisions.

21. See Joseph Chen *et al.*, “Does Fund Size Erode Performance? The Role of Liquidity and Organization” (2004) 94 *Am. Econ. Rev.* 1276; Stan Beckers & Greg Vaughan, “Small is Beautiful” (2001) 27:4 *Journal of Portfolio Management* 9, and Jon Christopherson, Zhuanxin Ding & Paul Greenwood, “The Perils of Success” (2002) 28 *Journal of Portfolio Management* 41.

22. This problem is particularly acute for open-ended, continuous offering funds such as mutual funds which, absent a self-imposed cap, theoretically have no upper limit in terms of AUM.

23. Kruithof, *supra* note 15 at 290-91.

24. *Ibid.*

*alia*, prioritize trades, apportion “hot new issues” and allocate expenses amongst their clients. To the extent that managers may possess incentives to favour one client over another—whether by virtue of differing fee structures, personal or professional affiliations or the varying abilities of clients to effectively monitor the actions of the manager—these decisions manifest inherent conflicts of interest.

Finally, the structure of the distribution channels through which investment fund securities are sold represents an important source of potential conflicts of interest. In Canada, investment funds are distributed through investment dealers, advisors and financial planners registered as members of the Investment Industry Regulatory Organization of Canada and/or the Mutual Fund Dealers Association. These distributors are intermediaries, recommending to their clients the purchase and sale of securities, including various investment fund products. While many managers are affiliated with one or more of these distributors, other so-called “independent” managers possess no such affiliations. In either case, managers understandably seek to secure “self space” for their investment fund products with as many distributors as possible.

As observed by Glorianne Stromberg in her influential 1995 report respecting the Canadian mutual fund industry: “virtually all aspects of the investment fund industry are being driven today by distribution and the competition for distribution.”<sup>25</sup> As a result of continued growth and industry consolidation (in particular the vertical consolidation of managers and distributors), this competition has intensified in recent years. Given this intense competition for shelf-space, managers find themselves under constant pressure to provide distributors with incentives to recommend the purchase and continued holding of their investment funds over those of their competitors. As a result of these pressures, a myriad of questionable incentive structures have, over time, emerged. These incentives have included trailer fees, reciprocal commissions, marketing incentive programs, cooperative advertising, commission rebates, bonus commissions, cross-selling arrangements and the subsidization of capital and other costs of distributors—all designed to incentivize distributors to recommend their investment fund products.<sup>26</sup>

To the extent these incentives may cause distributors to recommend investments on a basis other than the best interests of their clients, there clearly exists a potential conflict of interest. Furthermore, the dual business imperatives of maintaining a critical mass in terms of AUM and securing

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25. *Stromberg Report*, *supra* note 1 at s. 3.01.

26. For a detailed survey of these practices, see *ibid.* at s. 9.01.

shelf-space exert pressure on managers to chase short-term performance which, once again, may not be in the best interests of securityholders. These incentives have also proven a fertile environment for the development and proliferation of dubious sales practices on the part of distributors. One example of such practices is “churning,” the sale and subsequent repurchase of the same securities within a client account in an effort to capture higher commissions. While many of these questionable incentives and practices are now either prohibited or restricted under applicable securities laws,<sup>27</sup> others—such as trailer fees—are not. Even more importantly for the present purposes, given the intense pressure on managers to secure both assets and shelf-space, it is reasonable to expect that new species of incentives and practices manifesting potential conflicts of interest will continue to emerge.

Exacerbating the pervasiveness and deleterious impact of the potential conflicts of interest described above is the relationship which typically exists between managers and distributors, on the one hand, and securityholders, on the other. The average retail investor arguably finds himself at a distinct disadvantage vis-à-vis managers and distributors in terms of both market and product-specific information and, more broadly, financial acumen. What is more, even where retail investors possess sufficient acumen, it is arguably unrealistic to expect them to actively monitor the decisions of managers and distributors. Accordingly, as observed by Gerard McCormack:

The beneficiary relies on the investment manager to safeguard his economic interests. The relationship may be said to be one of power dependency and there is clearly an informational imbalance. The trust beneficiary is dependent on information and advice. While it may be an exaggeration to say that the beneficiary is at the mercy of the investment manager there is the potential for abuse of the relationship leading to the personal enrichment of the investment manager.<sup>28</sup>

It is this relationship of trust and dependency—combined with the agency problems and resulting conflicts of interest described above—which has historically prompted courts to recognize the existence of a fiduciary relationship between a manager and its clients.<sup>29</sup> It is this same relationship

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27. For a slightly more robust description of these laws, see the discussion respecting NI 81-102 and NI 81-105 in Part II of this article.

28. Gerard McCormack, “Conflicts of Interest in the Investment Management Function” (1999) 20:1 *The Company Lawyer* 2 at 2.

29. The decision in *Harvard College v. Amory*, 26 Mass. 446 (1830) is frequently cited as the first in a long line of decisions acknowledging the existence of such a fiduciary relationship.

which has made regulatory intervention into this aspect of Canadian capital markets such a priority and inspired the promulgation of NI 81-107.<sup>30</sup>

## II. *Regulating conflicts of interest in the Canadian investment fund industry: the structure and salient features of NI 81-107*

As observed in the *Stromberg Report*: “[t]he single most difficult issue of all of the issues that have been raised in the context of investment funds is how to deal with situations involving conflicts of interest.”<sup>31</sup> The *Stromberg Report* spurred a series of regulatory reforms in the late 1990s which represented a valiant first attempt at addressing many of the potential conflicts of interest described in Part I. These reforms included the promulgation of National Instruments 81-102 *Mutual Funds* (NI 81-102)<sup>32</sup> and 81-105 *Mutual Fund Sales Practices* (NI 81-105).<sup>33</sup> These regulatory mechanisms were notable in at least two respects. First, they extended solely to certain specified conduct and practices arising in the context of the mutual fund, as opposed to the broader investment fund, industry. Second, these mechanisms reflected a prescriptive, rules-based approach toward regulating conflicts of interest.

In the view of the CSA, NI 81-107 reflects a more principles-based approach toward regulating conflicts of interest.<sup>34</sup> NI 81-107 imposes a uniform standard of care on managers to act honestly and in good faith and in the best interests of the investment fund, and to exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.<sup>35</sup> With a view to enforcing this standard

30. While Christa Band has asserted that conflicts of interest in the regulatory sense cannot be defined in terms of fiduciary duties, the CSA’s statements in connection with the promulgation of NI 81-107 make it clear that—at least within the context of the regulation of conflicts of interest in the investment fund industry—enhanced regulation flows from the fiduciary duties owed by managers; Christa Band, “Conflicts of Interest in Financial Services and Markets. The Regulatory Aspect: Part 2” (2007) 22:2 J.I.B.L.R. 88 at 98, and Notice of National Instrument 81-107 *Independent Review Committee for Investment Funds*, CSA Notice of Rule, Commentary and Related Amendments, (2006) 29:30 O.S.C.B. (Supp-1) (28 July 2006) at 3-6 [CSA Notice].

31. *Stromberg Report*, *supra* note 1 at 161.

32. NI 81-102 imposes restrictions on, *inter alia*, (1) the investment activities of mutual funds (including concentration, control and asset type restrictions), (2) certain specified circumstances involving conflicts of interest, (3) fundamental changes in a mutual fund, and (4) sales communications and other representations. NI 81-102 also requires the custodianship of mutual fund portfolio assets and imposes a number of other requirements in connection with the financial affairs of mutual funds, the redemption of mutual fund securities and other compliance and administrative matters.

33. NI 81-105 imposes restrictions on (and in some instances prohibits) various mutual fund sales practices including, *inter alia*, internal dealer incentive practices, marketing and educational practices, reciprocal commissions, charitable donations and tied selling.

34. CSA Notice, *supra* note 3 at 5, 37, 41.

35. NI 81-107, *supra* note 4 at s. 2.1.

of care, NI 81-107 requires that every investment fund that is a reporting issuer appoint an independent review committee (IRC) responsible for overseeing potential conflicts of interest between the manager and the investment fund and imposes a standard of care on IRC members which mirrors that imposed on managers.<sup>36</sup> The manager is then required to refer all “conflict of interest matters” to the IRC.<sup>37</sup>

NI 81-107 defines a “conflict of interest matter” as any matter in respect of which “a reasonable person would consider the manager or an entity related to the manager to have an interest that may conflict with the manager’s ability to act in good faith and in the best interests of the investment fund.”<sup>38</sup> The Commentary accompanying NI 81-107 attempts to supplement this anemic definition by stipulating that a conflict of interest matter is intended to capture decisions made on behalf of the investment fund that may affect or influence the manager’s ability to make decisions in good faith and in the best interests of the investment fund including, potentially, portfolio management processes such as the allocation of investments among funds, and trading practices such as soft dollar arrangements.<sup>39</sup> The Commentary further provides that conflicts of interest at the service provider level will not generally fall within the purview of NI 81-107.<sup>40</sup> While NI 81-107 does not contemplate a materiality threshold for potential conflict of interest matters, the Commentary states that it is not intended to apply to “inconsequential matters.”<sup>41</sup>

NI 81-107 requires that managers institute written policies and procedures designed to govern their actions in circumstances manifesting a potential conflict of interest matter.<sup>42</sup> Similarly, NI 81-107 requires that the IRC adopt a written charter setting out its mandate, responsibilities and functions and, ideally, the policies and procedures the IRC must follow when reviewing conflict of interest matters.<sup>43</sup> Where the manager determines pursuant to its policies and procedures that there exists a conflict of interest matter as defined by NI 81-107, it must refer the matter,

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36. *Ibid.* at s. 3.1. Each IRC member must be “independent.” Pursuant to s. 1.4(1) of NI 81-107, a member of the IRC is independent if the member has no material relationship with the manager, the investment fund or an entity related to the manager.

37. *Ibid.* at ss. 3.1, 3.9.

38. *Ibid.* s. 1.2(a). This section further identifies as a conflict of interest matter any matter which falls under certain prescribed conflict of interest and self-dealing provisions under existing securities legislation. These provisions include those relating to inter-fund trades, transactions in securities of related issuers or of securities underwritten by related underwriters.

39. *Ibid.* at s. 1.2 (Commentary).

40. *Ibid.*

41. *Ibid.*

42. *Ibid.* at s. 2.2(1)(a).

43. *Ibid.* at s. 3.6.

along with the manager's proposed course of action to address the conflict, to the IRC for review.<sup>44</sup>

NI 81-107 contemplates two separate standards of IRC review: recommendation and approval. The instrument identifies three species of conflicts requiring IRC approval: inter-fund trades, transactions in securities of related issuers and investments in a class of securities of an issuer underwritten by an entity related to the manager.<sup>45</sup> In such circumstances, an IRC must not approve an action unless it has determined, after reasonable inquiry, that the action (1) is proposed by the manager free from any influence by, or consideration for, an entity related to the manager; (2) represents the business judgment of the manager uninfluenced by considerations other than the best interests of the investment fund; (3) is in compliance with the manager's written policies and procedures; and (4) achieves a fair and reasonable result for the investment fund.<sup>46</sup> All other conflict of interest matters need only be submitted to the IRC for its recommendation as to whether in the IRC's opinion, again after reasonable inquiry, the proposed course of action achieves a fair and reasonable result for the investment fund.<sup>47</sup>

NI 81-107 incorporates a number of disclosure obligations designed to ensure transparency and impose external discipline over both the manager and the IRC. For example, NI 81-107 requires the IRC to prepare an annual report to securityholders describing, *inter alia*, each instance in which the manager acted in a conflict of interest matter where the IRC did not give a positive recommendation or where the manager failed to fulfill a condition attached to the IRC's recommendation.<sup>48</sup> In addition, the IRC must notify relevant securities regulators in certain prescribed circumstances.<sup>49</sup> Finally, where the manager decides to proceed with an action in a conflict of interest matter that, in the opinion of the IRC, does not achieve a fair and reasonable result for the investment fund, the IRC may in its discretion require the manager to notify securityholders of its decision.<sup>50</sup>

It was the expectation of the CSA in promulgating NI 81-107 that the instrument would serve to enhance investor protection by (1) ensuring that the interests of investment funds (and, ultimately, securityholders)

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44. *Ibid.* at s. 5.1.

45. *Ibid.* at s. 5.2(1).

46. *Ibid.* at s. 5.2(2).

47. *Ibid.* at s. 5.3(1).

48. *Ibid.* at s. 4.4.

49. *Ibid.* at s. 4.5.

50. *Ibid.* at s. 5.3(3).

were at the forefront when managers were faced with conflicts of interest; and (2) improving the decision-making processes of managers through an upfront check on how each conflict of interest is resolved.<sup>51</sup> Furthermore, the CSA expected NI 81-107 to contribute to more efficient capital markets by permitting managers to engage in certain types of conflict of interest transactions without prior regulatory approval, thereby endowing managers with greater flexibility to make timely investment decisions in order to take advantage of perceived market opportunities that they believe are in the best interests of the investment fund.<sup>52</sup> The realization of these expectations rests in large measure on the effectiveness of what the CSA views as its principles-based approach toward the regulation of conflicts of interest under NI 81-107.

### III. *Principles-based securities regulation: its defining attributes, wisdom and potential drawbacks*

The emergence of principles-based securities regulation represents one of the most noteworthy legal developments within global capital markets in recent years. While still in its infancy, this emerging regulatory paradigm has already proven highly influential in connection with the design and implementation of an impressive portfolio of regulatory mechanisms in jurisdictions such as the U.K., Australia and Canada—including NI 81-107. But what is principles-based securities regulation? Where do its wisdom and potential drawbacks reside? Framing the debate surrounding these threshold questions represents a necessary precondition to a principles-based evaluation of NI 81-107 and, concomitantly, the articulation of normative proposals respecting how Canadian securities regulators should approach both the regulation of conflicts of interest under NI 81-107 and the institutional design and implementation of future principles-based regulatory mechanisms.

#### 1. *Principles-based securities regulation defined*

Principles-based securities regulation is frequently described as encompassing a move away from reliance on detailed, prescriptive rules toward more high-level principles or norms in establishing the standards by which regulated actors are required to conduct their business activities.<sup>53</sup> Viewed from this perspective, the distinction between the prescriptive, rules-

51. CSA Notice, *supra* note 30 at 5.

52. *Ibid.* at 6.

53. Julia Black, Martyn Hopper & Christa Band, "Making a Success of Principles-based Regulation" (2007) 1 Law and Financial Markets Review 191 at 191 [Black, "Making a Success"]; Financial Services Authority, *Principles-based Regulation: Focusing on Outcomes that Matter* (April 2007) at 6, online: <<http://www.fsa.gov.uk/pubs/other/principles.pdf>> [FSA].



based and principles-based approaches to securities regulation effectively boils down to one of statutory construction and interpretation, with the resulting normative debate revolving primarily around the relative impact of rules versus principles within the enforcement context—in particular with respect to the possibility of so-called “regulation by enforcement.”<sup>54</sup>

This perspective is, on one level, correct. A move toward more principles-based securities regulation would necessarily entail a shift in terms of statutory construction toward the articulation of broader principles.<sup>55</sup> This shift would, in turn, manifest repercussions in terms of both statutory interpretation and enforcement. However, viewed solely from this narrow, formalist perspective, principles-based securities regulation forms part of—but risks ultimately being subsumed within—the broader theoretical debate respecting the relative merits of prescriptive rules versus principles as regulatory mechanisms. Legal scholars have long struggled to differentiate between rules and principles on the basis of, *inter alia*, their locus on a continuum from generality to specificity,<sup>56</sup> their temporal orientation<sup>57</sup> and the degree of discretion which they confer upon regulated actors.<sup>58</sup> The resulting discourse has largely, though not exclusively, emphasized the form of regulatory mechanisms—their statutory construction and interpretation—over the broader philosophical approach of regulators and regulated actors toward the promulgation, monitoring and enforcement of, and compliance with, these mechanisms.

While this broader theoretical debate has undeniably influenced the development of principles-based securities regulation, its defining attributes clearly transcend this debate’s engrained formalism. As described in greater detail below, these attributes include an outcome-oriented focus, a fundamental change in the philosophy of both regulators and regulated actors toward their respective roles in achieving desired

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54. See e.g. James J. Park, “The Competing Paradigms of Securities Regulation” (2007) 57 Duke L.J. 625, and Harvey L. Pitt & Karen L. Shapiro, “Securities Regulation by Enforcement: A Look Ahead at the Next Decade” (1990) 7 Yale J. on Reg. 149.

55. Or, as Julia Black has characterized it, “formal” principles-based regulation; Julia Black, “Forms and Paradoxes of Principles-based Regulation” (2008) 3 Capital Markets L.J. 425 at 435 [Black, “Forms and Paradoxes”].

56. Ford, *supra* note 8 at 8, and Lawrence A. Cunningham, “A Prescription to Retire the Rhetoric of “Principles-based Systems in Corporate Law, Securities Regulation and Accounting” (2007) 60 Vand. L. Rev. 1411 at 1420.

57. Louis Kaplow, “Rules Versus Standards: An Economic Analysis” (1992) 42 Duke L.J. 557.

58. Cunningham, *supra* note 56 at 1422. Observing this struggle, Cunningham has argued in favour of retiring the rules versus principles rhetoric entirely, asserting, *inter alia*, that the classifications are too crude and ambiguous to describe or guide the design of securities legislation and that most regulatory systems cannot meaningfully be characterized as falling within one paradigm or the other; *ibid.* at 1413, 1417, 1426-1433.

regulatory outcomes and a new relationship between regulators and regulated actors, re-constituted from one of regulated (dis)trust enforced through an adversarial process, to one premised on real trust, a more sophisticated dialogue and shared understandings. While some observers have understandably viewed these attributes as each representing distinct (albeit related) approaches to regulation,<sup>59</sup> the symbiotic relationship between these characteristics also provides ample justification – as argued by Cristie Ford, and expanded upon below – for the view that principles-based regulation in many respects represents a single, coherent and fundamentally different *philosophy* of securities regulation.<sup>60</sup>

The first, and perhaps most elemental, attribute of principles-based securities regulation is its outcome-oriented focus. This focus finds expression primarily in the form of regulatory mechanisms which are designed with reference to—and, importantly, articulate—the regulatory outcomes (or desired behaviours) they are designed to achieve (or incentivize), and not simply the policies and procedures with which regulated actors are expected to comply. As explained by the FSA's Managing Director of Retail Markets, its principles-based approach involves “a shift of emphasis... away from looking at the processes carried out by firms, toward the outcomes we seek to achieve for consumers, firms and markets.”<sup>61</sup> This outcome-oriented focus is premised on the view that regulated actors are better situated than regulators to determine—on the basis of their specific business model and risk profile—the scope and procedural content of the policies and procedures necessary to achieve the desired regulatory outcomes flowing from a given principle.<sup>62</sup> As observed by Cristie Ford, it flows logically from this view that “[s]ome version of outcome oriented regulation is a necessary correlative to principles-based regulation, in that it is a responsible way to force accountability into a

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59. See e.g. Black, “Making a Success,” *supra* note 53 at 191. While Black et. al. perceive a “radically different” approach to regulation in some aspects of the FSA's principles-based regime (particularly in the context of the Treat Customers Fairly (TCF) initiative), the authors are nevertheless explicit in their view that these attributes are, ultimately, reflective of *different* approaches to regulation.

60. This view is reflected in Cristie Ford's article examining principles-based securities regulation from a “new governance” perspective; see Ford, *supra* note 8. However, unlike Ford's article, the intent of which is to examine principles-based securities regulation—and in particular the Proposed B.C. Act—as a new governance regime, the focus of Part III of this article is to construct a more abstract theoretical conception of principles-based securities regulation, examine its wisdom and potential drawbacks and, ultimately, employ this conception to evaluate the potential efficacy of NI 81-107.

61. Dan Waters, “Implementing Principles Based Regulation” (Speech at the ABI Conference, London, 7 December 2006), online: <[http://www.fsa.gov.uk/pages/Library/Communications/Speeches/2006/1207\\_dw.shtml](http://www.fsa.gov.uk/pages/Library/Communications/Speeches/2006/1207_dw.shtml)>, cited in Black, “Making a Success,” *supra* note 53 at 192.

62. Black, “Making a Success,” *supra* note 53 at 192.

system that leaves the articulation of the content of those principles to on-the-ground actors.”<sup>63</sup>

It is important at this juncture to distinguish between *substantive* and *procedural* content for the purposes of principles-based securities regulation. The substantive content of a regulatory principle is collectively made up of the underlying legal and/or regulatory principle which animates it, the statutory expression (i.e. construction) of this principle, the interpretive assumptions underpinning this statutory construction and, importantly, the regulatory outcomes which regulators desire to achieve through its promulgation. The procedural content of a regulatory principle, on the other hand, consists of the specific compliance policies and procedures designed and implemented with a view to achieving the desired regulatory outcomes. While the provision of substantive content is the responsibility of regulators, principles-based securities regulation is distinctive in that it contemplates that procedural content will be provided by regulated actors. As explored in greater detail below, the failure by either regulators or regulated actors to fulfill their respective mandates in this respect will serve to undermine the efficacy of any principles-based regulatory mechanism.

The outcome-oriented focus of principles-based securities regulation envisions a fundamental change in the philosophy of securities regulators toward their own role in achieving desired regulatory outcomes.<sup>64</sup> There are several intertwined facets to this change. To the extent that the procedural content of principles is provided by regulated actors, principles-based securities regulation necessarily demands that regulators loosen their grip on the reins of regulation and, in so doing, devolve responsibility to—and leverage the accumulated expertise of—regulated actors in vital areas such as risk management.<sup>65</sup> This in turn demands that a good faith sphere be expressly carved out in which regulated actors are free to design and implement innovative policies and procedures to achieve regulatory outcomes without the omnipresent threat of regulatory intervention.<sup>66</sup> Of particular importance in carving out this sphere is a philosophy of transparency and restraint in the deployment of enforcement resources.<sup>67</sup> In the absence of such a sphere, regulated actors are likely to behave as

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63. Ford, *supra* note 8 at 60.

64. FSA, *supra* note 53 at 2, 6.

65. Ford, *supra* note 8 at 27.

66. Black, “Making a Success, *supra* note 53 at 200.

67. Ford, *supra* note 8 at 34; *ibid.* at 197.

though subject to prescriptive rules,<sup>68</sup> thereby negating many of the potential benefits of principles-based securities regulation described below. In this respect, principles-based securities regulation contemplates a less central role for enforcement, or the threat thereof, as a mechanism for influencing the behaviour of regulated actors. Finally, the outcome-oriented focus of principles-based securities regulation demands that regulators evaluate their own performance with reference to whether, and to what extent, they have been successful in achieving desired regulatory outcomes,<sup>69</sup> and not such potentially misleading metrics as the promulgation of regulatory mechanisms or the number of enforcement actions commenced or successfully prosecuted.

Principles-based securities regulation also envisions a fundamental change in the expected role and responsibilities of regulated actors within the regulatory process. Most importantly, principles-based regulation requires that regulated actors actively and meaningfully engage with principles at the highest level with a view to designing and implementing policies and procedures—providing procedural content—which achieve the desired regulatory outcomes identified by regulators. This in turn contemplates both an intensified reliance on senior management of regulated actors in terms of their oversight and stewardship in respect of compliance matters<sup>70</sup> and, simultaneously, a more strategic business role for compliance personnel.<sup>71</sup> In a similar fashion, principles-based securities regulation contemplates an expanded role for financial services industry trade associations in the provision of guidance respecting regulatory compliance matters. Principles-based securities regulation thus envisions a substantial shift in the overall regulatory burden—especially in terms of designing optimal compliance structures—from securities regulators to regulated actors.<sup>72</sup>

Given this contemplated shift in the regulatory burden, it is perhaps not surprising that principles-based securities regulation also contemplates a fundamental re-constitution of the relationship between regulators and regulated actors. As observed by Cristie Ford, principles-based securities regulation “entails a regulatory structure which spans the so-called public/

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68. Steven L. Schwarcz, “The ‘Principles’ Paradox” (2009) 10 *European Bus. Org. L. Rev.* 175, and Black, “Forms and Paradoxes,” *supra* note 55 at 449. This “chilling effect” is discussed in greater detail in Part III.2 below.

69. FSA, *supra* note 53 at 4, 14.

70. Black, “Making a Success,” *supra* note 53 at 193.

71. *Ibid.* at 200.

72. Although, as described in greater detail below, any move toward more principles-based regulation would likely involve a somewhat more permanent cost increase for regulators relative to more prescriptive, rules-based regulation.

private divide, pulls industry experience into regulatory decision making, and establishes robust ongoing communication mechanisms (rather than an information-hoarding, adversarial relationship) between industry and regulator.”<sup>73</sup> This new relationship must necessarily be built on a foundation of real, not regulated, trust. As explained by Mark Wagstaff:

What is implied is the primacy of real over regulated trust. This is to counter the inadvertent embedding of suspicion in relationships between government and business... If someone is trusted to do the right thing because there are legal sanctions if they do not, then trust does not reside in the person but in the rule. This is regulated trust, a construct which does not necessarily have a view of the capabilities and drivers of the organisation being examined, but predominantly of its capacity to comply with rules. This narrow focus tends to produce the opposite effect of the all-encompassing gaze which regulators are presumed to deploy, by locating regulatory judgment in the fitness of the organisation as a rule-obeying body, rather than what it actually delivers to its customers.<sup>74</sup>

The anticipated product of this real trust is a more honest and sophisticated dialogue between securities regulators and those they regulate, with the former being more transparent about their expectations of regulated actors and the outcomes they desire to achieve<sup>75</sup> and the latter being more forthcoming about the regulatory challenges they face and how these challenges impact their business activities.<sup>76</sup> Through this enhanced dialogic relationship, principles-based securities regulation is intended to promote “congruence”<sup>77</sup>: the creation of a shared self-interest between regulators and regulated actors with respect to the realization of desired regulatory outcomes.

Congruence in turn demands that there exists a body of shared understandings as between regulators and regulated actors with respect to the *meaning* of the regulatory principle(s) upon which a given principles-based regulatory mechanism is constructed. More specifically, all parties concerned must possess shared understandings as to, *inter alia*, the scope and substantive content of the relevant principles—including both the desired regulatory outcomes and the interpretive assumptions underlying

73. Ford, *supra* note 8 at 28.

74. Mark Wagstaff, “Principles-based Regulation: Stability, Risk and Trust”, (Paper presented to the 2nd Annual Cambridge Conference on Regulation, 12 September 2007), online: <[http://www.cbr.can.ac.uk/pdf/Wagstaff\\_Paper.pdf](http://www.cbr.can.ac.uk/pdf/Wagstaff_Paper.pdf)> [Wagstaff].

75. FSA, *supra* note 53 at 8.

76. *Ibid.* at 17.

77. Wagstaff, *supra* note 74 at 18.

these principles' statutory construction.<sup>78</sup> In this sense, principles-based securities regulation requires the creation of an "interpretive community"<sup>79</sup> in which regulators and industry trade associations, in consultation with each other and their respective constituencies, amplify principles through the formulation and dissemination of substantive and procedural guidance.

As described above, the defining characteristics of principles-based securities regulation transcend the formalism of the rules versus principles debate to reveal a new approach toward—indeed a new *philosophy* of—securities regulation. Before leaving the threshold question of what principles-based securities regulation is, however, a few caveats are in order. First, a move toward more principles-based securities regulation does not entail the wholesale abandonment of prescriptive rules. Prescriptive rules are often necessary to amplify principles<sup>80</sup> and may represent the optimal approach to regulation where significant consensus exists between regulators and regulated actors or where required to deter, prosecute and punish extreme misconduct.<sup>81</sup> Accordingly, prescriptive rules can and should remain in the regulatory toolkit. Second, the preceding description is that of an *emerging* regulatory paradigm. The pronounced shift in momentum toward more principles-based securities regulation in jurisdictions such as the U.K., Australia and Canada has arguably been underway for less than a decade and is, at this very moment, being shaped by the political fallout from the current global financial crisis. It is thus likely that we will observe the continued evolution and refinement of principles-based securities regulation as regulators and regulated actors work together to tap into its inherent wisdom and manage its potential drawbacks.

## 2. *The wisdom and potential drawbacks of principles-based securities regulation*

The wisdom of principles-based securities regulation—especially when viewed vis-à-vis the more prescriptive, rules-based paradigm—resides first and foremost in its inherent flexibility. As observed by Cristie Ford:

The advantage of regulatory principles, as opposed to detailed rules, is not that they will remain forever vague, but rather that their content can

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78. See Julia Black, "Using Rules Effectively" in Christopher McCrudden, ed., *Regulation and Deregulation: Policy and Practice in the Utilities and Financial Services Industries* (Oxford Clarendon Press, 1999) 95.

79. Schwarcz, *supra* note 68 at 184.

80. FSA, *supra* note 53 at 9.

81. Ford, *supra* note 8 at 48.

be filled in more dynamically and insightfully by those with the greatest understanding of the relevant situations... The difference is that their content is intended to remain flexible and up to date – that rather than ossifying, the principles' content will continue to evolve, discarding older formulations as newer, more comprehensive or effective ones emerge.<sup>82</sup>

The flexibility of principles-based regulation, where the content of regulation is the product of a dialogic relationship between regulator and regulated, is thus of particular utility within the context of capital markets and the financial services industry, where change and innovation are perhaps the only constants. In such an environment, this flexibility translates into greater responsiveness in addressing industry developments and new regulatory challenges,<sup>83</sup> especially when compared with the bluntness of prescriptive rules. Importantly, the flexibility of principles-based regulation also minimizes the potential opportunities for so-called “creative compliance.” As explained by Lawrence Cunningham: “[r]ules can be blueprints for evading their underlying purposes. Bright lines and exceptions to exceptions facilitate strategic evasion, allowing artful dodging of a rule’s spirit by literal compliance with its technical letter.”<sup>84</sup> Through the articulation of outcome-oriented principles, and the resulting shift in emphasis from technical to substantive compliance, principles-based regulatory mechanisms can become, in an important way, impervious to evasion.

The inherent flexibility of principles also enhances their durability as a source of regulation. The promulgation of prescriptive rules represents a crystallized, and therefore relatively static, response to the prevailing conditions within a market, regulatory and political environment. Thereafter incapable of reflecting changing conditions or new learning, rules ossify quickly and, thus, require constant amendment in order to respond to the rapid pace of change which characterizes capital markets and the financial services industry.<sup>85</sup> For compelling evidence of this, one need not look any further than the chronically overcrowded policymaking

82. *Ibid.* at 36 [emphasis added].

83. Black, “Making a Success,” *supra* note 53 at 193. See also David Wilson, “Momentum for Change: Providing the Regulation Canada Needs” (keynote remarks to the Dialogue with the OSC, Toronto, 10 November 2006), online: <[http://www.osc.gov.on.ca/Media/Speeches/2006/sp\\_20061110\\_dw\\_dwo-momentum.pdf](http://www.osc.gov.on.ca/Media/Speeches/2006/sp_20061110_dw_dwo-momentum.pdf)>.

84. Cunningham, *supra* note 56 at 1423.

85. Ford, *supra* note 8 at 24; Wagstaff, *supra* note 74 at 16.

agenda pursued by the OSC in recent years.<sup>86</sup> In sharp contrast, the flexibility of principles enables them to evolve organically in response to industry developments and new regulatory challenges, often without the need for formal regulatory intervention.<sup>87</sup> Accordingly, as observed by Cunningham, “in rapidly-changing environments, such as securities markets, rules can become obsolete faster than principles do.”<sup>88</sup> In this respect, the durability of principles-based regulation enables regulators to step off the policymaking treadmill and reallocate resources toward building dialogic relationships with regulated actors and monitoring and enforcing substantive compliance with principles-based regulatory mechanisms.

As previously touched upon, through the attainment of congruence, principles-based securities regulation also manifests the potential benefit of better aligning the behaviour of regulated actors with desired regulatory outcomes. Prescriptive rules are by their very nature either over-inclusive (capturing behaviour which should be excluded) or under-inclusive (failing to capture behaviour which should be included).<sup>89</sup> To the extent of this over (under) inclusiveness, prescriptive, rules-based regulatory mechanisms thus promote or deter the behaviour of regulated actors in ways which are incongruent with their underlying objectives. In this way, “prescriptive requirements emphasize the wrong things. That is, they encourage firms to focus on detailed compliance rather than to exercise sound judgment with a view to the best interests of their clients and the markets.”<sup>90</sup> Once again, principles-based securities regulation minimizes this incongruence through the articulation of outcome-oriented principles which provide regulated actors with the flexibility—and motivation<sup>91</sup>—to design and implement policies and procedures which are to the fullest extent possible aligned with the desired regulatory outcomes. Equally as important, the

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86. See Ontario Securities Commission, “Statement of Priorities for Fiscal 2008-09,” online: <[http://www.osc.gov.on.ca/About/WhatWeDo/wwd\\_2008-2009\\_statement-of-priorities.pdf](http://www.osc.gov.on.ca/About/WhatWeDo/wwd_2008-2009_statement-of-priorities.pdf)>; and Ontario Securities Commission, “Report on Statement of Priorities for Fiscal 2007-2008,” online: <[http://www.osc.gov.on.ca/About/WhatWeDo/wwd\\_2007-2008\\_statement-of-priorities-report.pdf](http://www.osc.gov.on.ca/About/WhatWeDo/wwd_2007-2008_statement-of-priorities-report.pdf)>.

87. Ford, *supra* note 8 at 45.

88. Cunningham, *supra* note 56 at 1423, citing Frank Partnoy, “A Revisionist View of Enron and the Sudden Death of “May”” (2003) 48 Vill. L. Rev. 1245 at 1265.

89. Black, “Making a Success,” *supra* note 53 at 194. See also Duncan Kennedy, “Form and Substance in Private Law Adjudication” (1976) 89 Harv. L. Rev. 1685 at 1689.

90. Ford, *supra* note 8 at 19.

91. While the prospect of regulatory sanctions is no doubt the source of some of this motivation, as Christie Ford points out, it is also the case that firms will be motivated to implement compliance policies and procedures in order to mitigate the risk of civil liability and/or reputational damage; *ibid.* at 23.



articulation of these outcomes provides regulated actors with real-world yardsticks against which to assess their substantive compliance.

Finally, a move toward more principles-based securities regulation offers potentially significant administrative benefits through the streamlining of securities legislation.<sup>92</sup> The voluminous and labyrinthine structure of securities legislation in jurisdictions such as the U.S. and Canada is perpetually at risk of devolving into an unintelligible maze of statutes, rules, orders, policy statements and other pronouncements. In navigating this maze, regulated actors may understandably find themselves uncertain at times as to whether they are aware of, let alone in compliance with, all applicable regulation. In this respect, the structure of prescriptive, rules-based securities legislation arguably exists at cross-purposes with its intent, making compliance both more difficult and more costly—particularly for smaller firms which may lack the requisite in-house compliance resources.<sup>93</sup> By de-cluttering the prescriptive rulebook in favour of the articulation of broader principles, principles-based securities regulation makes regulation more transparent and accessible and, in so doing, renders compliance by regulated actors both easier and less costly and, therefore, more likely. While it is true that much of this ‘clutter’ would perhaps re-emerge in the form of internal compliance policies and procedures and via the proliferation of guidance from both regulators and industry,<sup>94</sup> regulated actors—having been actively engaged in the design and implementation of such policies, procedures and guidance—are arguably more likely to be able to identify the universe of applicable regulation, understand the desired regulatory outcomes and achieve substantive compliance.

Principles-based securities regulation also manifests a number of potentially significant drawbacks. These drawbacks flow primarily from a perceived lack of certainty with respect to the interpretation of principles by regulators and, as a result, a lack of predictability with respect to their potential application.<sup>95</sup> Articulated somewhat differently, the inherent flexibility of principles gives rise to the possibility that regulators and regulated actors will arrive at divergent interpretations respecting, *inter alia*, their scope and/or substantive content. The possibility of such divergence places regulated actors in the uncomfortable position of not necessarily knowing whether their attempts to achieve substantive compliance

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92. FSA, *supra* note 53 at 6.

93. *Ibid.* at 6.

94. Thus leading, potentially, to what Julia Black has characterized as the “communicative paradox” of principles-based regulation; Black, “Forms and Paradoxes,” *supra* note 55 at 447, and Black, “Making a Success,” *supra* note 53 at 197.

95. Black, “Making a Success,” *supra* note 53 at 196.

with a given principle will attract regulatory scrutiny. Accordingly, as described in greater detail below, and as will be amply illustrated in the context of my evaluation of NI 81-107, the absence of sufficient certainty and predictability represents a threat to the efficacy of principles-based regulatory mechanisms.

The perceived uncertainty and unpredictability associated with principles-based securities regulation may translate into an unintended “chilling effect.” Understandably, regulated actors generally do not want to operate within a regulatory grey zone—especially where there exist significant costs in connection with the risk of “getting it wrong.”<sup>96</sup> In such an environment, one might intuitively expect some regulated actors to adopt more conservative interpretations of principles as a way of mitigating this legal risk.<sup>97</sup> By inducing regulated actors to err on the side of caution, the absence of sufficient certainty and predictability thus runs against the prevailing current of principles-based securities regulation—stifling regulatory innovation rather than promoting it.<sup>98</sup>

The absence of sufficient certainty and predictability surrounding principles-based securities regulation also raises the prospect of so-called “regulatory creep.” The concept of regulatory creep proceeds from the premise that regulation – like matter in a gaseous state—will inevitably expand into any empty space that it encounters. Viewed in this light, the flexibility of principles introduces the possibility that they may be used (or, depending on your perspective, abused) by regulators to expand the reach of the regulatory hand into the business activities of regulated actors in a discretionary or arbitrary fashion.<sup>99</sup> A similar risk also arises with respect to industry guidance, where a concern exists that industry-developed “recommended,” “good” or “best” practices will be invoked by regulators as an “opaque proxy”<sup>100</sup> for prescriptive rules. While the risk of regulatory creep is omnipresent, it is particularly acute in the context of politically charged environments such as those which have often followed in the wake of corporate scandals.

The possibility of divergence in the interpretation of principles exists not only with respect to regulators vis-à-vis regulated actors, but also *within* and *between* regulators. There is a risk that the philosophy and

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96. *Ibid.* at 195.

97. Julia Black has characterized this as the “compliance paradox” of principles-based regulation; Black, “Forms and Paradoxes,” *supra* note 55 at 449.

98. See Carlos Conceicao & Rosalind Gray, “U.K. Principles – Problems of Uncertainty” (2007) 26:6 *Int. Fin. L. Rev.* 42.

99. Cunningham, *supra* note 56 at 1433; Wagstaff, *supra* note 74 at 18.

100. Wagstaff, *supra* note 74 at 18.

approach of policymakers toward principles-based securities regulation will not be shared by their colleagues responsible for on-the-ground monitoring and enforcement. This risk has already manifested itself within the context of the FSA's move toward more principles-based regulation where, despite its public commitment to move away from prescription and "tick-box" supervision, some regulated actors have reported that FSA supervisors continue to articulate exceedingly specific expectations in terms of compliance with regulatory principles.<sup>101</sup> An analogous issue arises in jurisdictions such as Canada and the European Union where, as a result of their jurisdictionally fractured securities regulatory regimes, there exists a very real and pressing concern that different regulators will adopt divergent interpretations respecting the scope and/or substantive content of principles.<sup>102</sup>

A move toward more principles-based securities regulation also manifests significant cost implications. Louis Kaplow has asserted:

Rules typically are more costly than [principles] to create, whereas [principles] tend to be more costly for individuals to interpret when deciding how to act and for an adjudicator to apply to past conduct. Second, when individuals can determine the application of rules to their contemplated acts more cheaply, conduct is more likely to reflect the content of previously promulgated rules than of [principles] that will be given content only after individuals act.<sup>103</sup>

While this statement is perhaps broadly accurate, it requires some refinement and elaboration for use in the context of a move toward more principles-based securities regulation. From the perspective of regulated actors, the transition to more principles-based regulation would likely entail a short-term increase in compliance costs stemming primarily from the (re)design and implementation of internal policies and procedures to reflect articulated regulatory principles. Over the longer-term, however, one might expect that regulated actors would realize an "innovation dividend" flowing from positive network externalities, congruence, the implementation of more efficient compliance systems and the resulting rationalization of costs. From the perspective of regulators, however, principles-based regulation would likely involve a somewhat more permanent cost increase relative to more prescriptive, rules-based regulation. While the latter approach to

101. Black, "Making a Success," *supra* note 53 at 198.

102. As observed by David Wilson, *supra* note 83 at 8: "Through consensus, the CSA might well be able to come up with a set of common principles for each regulatory issue. But that would still mean 13 different ways of interpreting and administering them. It would be analogous to adopting a single constitution—and leaving its interpretation to 13 separate Supreme Courts."

103. Kaplow, *supra* note 57 at 557.

regulation facilitates quick processing of a large number of matters while ensuring certainty of interpretation and predictability of application,<sup>104</sup> the former requires sustained investment in the infrastructure of principles-based regulation, including, *inter alia*, the additional relationship management personnel, on-going education programs and enhanced call centre capabilities necessary to build dialogic relationships with regulated actors. The FSA, for example, has earmarked up to £50 million to cover non-recurring expenses relating to, *inter alia*, reorganization costs, training and development and improved knowledge management to be incurred in connection with its transition to a more principles-based regime.<sup>105</sup>

The final drawback of principles-based regulation stems from its wholesale reliance upon the establishment and maintenance of trust between regulators and regulated actors. In the view of many observers, the current global financial crisis has served to punctuate the limitations of regulatory paradigms premised on trust. In the wake of the current crisis, it is thus reasonable to question how principles-based regulation can generate the high level of trust required in order to realize its inherent potential. Furthermore, as Julia Black has observed, principles-based regulation manifests a “trust paradox”<sup>106</sup>: while principles-based regulation requires a high level of trust in order to be effective, it must first be effective in order to generate this level of trust.<sup>107</sup> Indeed, this drawback may prove particularly difficult to address in the context of regulating conflicts of interest: where trust problems represent the motivating force behind regulatory intervention. Nevertheless, as explored in greater detail below, it is possible that even this formidable obstacle can be overcome. The key, as we shall see, resides in effective institutional design and implementation.<sup>108</sup>

The drawbacks outlined above are, in many respects, unavoidable by-products of any move toward more principles-based securities regulation.<sup>109</sup> It is the inherent flexibility of principles which introduces perceived uncertainty, the prospect of both a chilling effect and regulatory creep and the potential for divergent interpretations. However, while perhaps unavoidable, these drawbacks are not unmanageable. Indeed, it is in its ability to manage (and ultimately minimize the impact of) these drawbacks that the symbiotic relationship amongst the defining attributes

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104. Black, “Making a Success,” *supra* note 53 at 195.

105. FSA, *supra* note 53 at 18.

106. Black, “Forms and Paradoxes,” *supra* note 55 at 456.

107. *Ibid.*

108. *Ibid.* at 426.

109. FSA, *supra* note 53 at 22. See also Black’s paradoxes of principles-based regulation, *ibid.*

of principles-based securities regulation is most powerful and evident. The certainty of interpretation and predictability of application potentially lost under principles-based securities regulation can in fact be ensured through the clear articulation by regulators of regulatory principles and desired regulatory outcomes, the promotion of industry guidance and, above all, the building of dialogic relationships between regulators and regulated actors. What is more, principles-based regulation contemplates a good faith sphere in which regulated actors are free, indeed *expected*, to design and implement innovative compliance policies and procedures. Principles-based securities regulation thus reveals itself as much more than a simple move away from prescriptive rules—it is, rather, a new philosophy of securities regulation. It is this broader theoretical conception of principles-based securities regulation which provides the grounding for the remainder of this Article.

#### IV. *NI 81-107: a principles-based evaluation*

There exists a compelling argument in favour of principles-based regulation as the appropriate tack to address conflicts of interest in the Canadian investment fund industry.

As described in Part I, the mounting pressure on managers to secure shelf-space and assets is, over time, more likely than not to result in the emergence of new species of incentives and practices manifesting potential conflicts of interest. As discussed in Part III, the inherent flexibility of principles-based regulation is likely to translate into greater responsiveness—in particular relative to more prescriptive, rules-based regulation—in addressing the new regulatory challenges which will be posed by these future developments. Nevertheless, it remains to be explored whether, and to what extent, the institutional design and implementation of NI 81-107 truly reflect a principles-based approach toward regulating conflicts of interest, manifesting the potential to tap into the inherent wisdom of principles-based regulation while at the same time minimizing the impact of its potential drawbacks.

There exists a certain vantage point from which the institutional design and implementation of NI 81-107 may appear to reflect a principles-based regulatory paradigm. The statutory construction of NI 81-107 relies heavily on the articulation of broad principles, particularly with respect to such central concepts as the standard of care imposed on managers and IRC members, the independence of IRC members and the definition of a conflict of interest matter.<sup>110</sup> Through these broad principles and the

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110. See e.g. the CSA's acknowledgement of this in the CSA Notice, *supra* note 30 at 37, 41.

accompanying Commentary, NI 81-107 attempts to provide substantive content while devolving to managers and IRCs the responsibility for providing procedural content in terms of the policies and procedures necessary to address conflict of interest matters. Furthermore, the process by which NI 81-107 was conceptualized and promulgated manifested elements of a fledgling dialogic relationship between regulators and regulated actors. Spanning a five-year period, this process included the publication of a background legal report,<sup>111</sup> concept proposal,<sup>112</sup> cost-benefit analysis<sup>113</sup> and two separate proposed national instruments.<sup>114</sup> The views of regulated actors were solicited throughout this process both formally, through requests for comment, and more informally, through a series of consultations with key industry stakeholders. It is thus possible to argue, on a number of levels, that the institutional design and implementation of NI 81-107 reflects a principles-based approach to regulating conflicts of interest in the Canadian investment fund industry.

On a far more fundamental level, however, NI 81-107 reflects a narrow, formalistic view of principles-based securities regulation which is, ultimately, likely to undermine its potential efficacy. This regulatory myopia is evident in terms of both the institutional design of NI 81-107 and its subsequent implementation. Perhaps most fundamentally, the CSA has not articulated with sufficient clarity or robustness the substantive content of NI 81-107. More specifically, the CSA has failed to provide sufficient guidance respecting either the regulatory principle animating NI 81-107 or the desired regulatory outcomes. Beyond the CSA's high-level statements in its draft proposals respecting enhanced investor protection and market efficiency<sup>115</sup> and the vague litmus test of ensuring "a fair and reasonable result for the investment fund," the instrument provides scant substantive guidance respecting the *real world* outcomes the CSA expects compliance with NI 81-107 to achieve. It is unclear, for example, whether the CSA is seeking through NI 81-107 to deter self-interested behaviour on

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111. See David P. Stevens, "Trust Law Implications of Proposed Regulatory Reform of Mutual Fund Governance Structures" (1 March 2002), online: Ontario Securities Commission <[http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part8/cp\\_20020301\\_81-402\\_legal\\_report.pdf](http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part8/cp_20020301_81-402_legal_report.pdf)>.

112. See Concept Proposal 81-402, *supra* note 5.

113. See Keith A. Martin, "Mutual Fund Governance Cost Benefit Analysis: Final Report" (July 2002), online: Ontario Securities Commission <[http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Other/fg\\_20030714\\_mfg-cba\\_rpt.pdf](http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Other/fg_20030714_mfg-cba_rpt.pdf)>, and Office of the Chief Economist, "A Cost-Benefit Analysis on the Introduction of Independent Review Committees for Mutual Funds" (January 2004), online: Ontario Securities Commission <[http://www.osc.gov.on.ca/Regulation/Rulemaking/current/Part8/rule\\_20040109\\_81-107\\_mutualfundanalysis.pdf](http://www.osc.gov.on.ca/Regulation/Rulemaking/current/Part8/rule_20040109_81-107_mutualfundanalysis.pdf)>.

114. See Proposed National Instrument 81-107 *Independent Review Committee for Mutual Funds*, (2004) 27:02 O.S.C.B. 526 (9 January 2004) and Proposed NI 81-107, *supra* note 3.

115. See discussion respecting the expectations of the CSA in promulgating NI 81-107, above at 18.

the part of managers or, alternatively, prevent actual (or perhaps potential) harm to investment funds and their securityholders. This is an important distinction. If the CSA is seeking to achieve the former regulatory outcome, how does the predominantly commercial character of the relationship among a manager, an investment fund and its securityholders play into this equation? If the latter, why did the CSA not attempt to incorporate into NI 81-107 conflicts of interest at the *distributor* level in order to better protect investors from predatory incentive structures and sales practices? The answers to these questions manifest potentially important ramifications in terms of how of managers and IRCs approach conflicts of interest under NI 81-107. In this respect, the failure of the CSA to provide outcome-oriented substantive guidance has left managers and IRCs with a dearth of sufficiently concrete yardsticks against which to gauge whether their policies, procedures and proposed courses of action in respect of conflict of interest matters are likely to achieve substantive compliance with NI 81-107.

Nowhere is the failure of the CSA to provide sufficient substantive guidance more evident or impactful than with respect to the legal principle animating NI 81-107. While, broadly speaking, this principle relates to the regulation of conflicts of interest between managers, on the one hand, and the funds they manage (and by extension their securityholders), on the other,<sup>116</sup> NI 81-107 does little to put substantive meat on this skeleton.

The law has long been concerned with conflicts of interest arising in the context of relationships which manifested asymmetries of power or dependency.<sup>117</sup> It is here that one encounters an undeniable nexus between conflicts of interest and the law of fiduciary duty. Fiduciaries owe two distinct duties to their beneficiaries: one of *care* and one of *loyalty*.<sup>118</sup> The duty of loyalty is itself comprised of two further duties not to (1) profit at the expense of the beneficiary, or (2) enter into competition with the beneficiary without their consent.<sup>119</sup> The confluence of these duties require that the fiduciary act at all times in the best interests of the beneficiary and

116. See Staff of the Ontario Securities Commission, "The Canadian Mutual Fund Industry: Its Experience With and Attitudes Toward Mutual Fund Regulation" (1 March 2002), online: Ontario Securities Commission <[http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part8/cp\\_20020301\\_81-402\\_research\\_peport.pdf](http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part8/cp_20020301_81-402_research_peport.pdf)>; Concept Proposal 81-402, *supra* note 5 at 7; Proposed NI 81-107, *supra* note 3 at 4-5, and NI 81-107, *supra* note 4 at s. 1.2.

117. Donovan W.M. Waters, *Waters' Law of Trusts in Canada*, 3d ed. (Thomson Carswell: Toronto, 2005) at 38-39 [Waters].

118. Arthur B. Laby, "Resolving Conflicts of Duty In Fiduciary Relationships" (2004) 54 Am. U. L. Rev. 75 at 98.

119. *Ibid.* at 100; McCormack, *supra* note 28 at 5.

avoid situations where this duty conflicts with his or her self-interest.<sup>120</sup> This duty has become embodied in what is known as the “sole interest” rule.

Strictly applied, the sole interest rule stipulates that transactions between a fiduciary and beneficiary are illegal *per se*. Over time, however, this principle has evolved from a blanket prohibition against transactions between a fiduciary and his or her beneficiary into a patchwork of divergent judicial approaches<sup>121</sup> and doctrinal,<sup>122</sup> categorical and statutory exceptions.<sup>123</sup> This patchwork has succeeded in adding a layer of complexity—if not outright ambiguity—to the common law treatment of conflicts of interest in the context of fiduciary relationships.

Further compounding matters, the strict application of the sole interest rule historically abrogated any need to articulate a precise definition of, or theoretical approach toward, what constituted a conflict of interest. The prevailing view within judicial circles has been that the existence of a conflict must be determined in each case with reference to the facts and the scope of the fiduciary duty in question.<sup>124</sup> Even then, the jurisprudence demonstrates that courts—and even members of the same court—often diverge in their opinions as to whether a given set of facts produces an actual or potential conflict of interest.<sup>125</sup> This general reticence to formulate a definition of, or theoretical approach toward, conflicts of interest extends to lawmakers as well. As observed by Christoph Kumpan and Patrick C. Leyens: “[c]apital market regulators, legislative institutions and legal scholars have usually avoided an abstract and general definition of the

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120. Waters, *supra* note 117 at 39, 877.

121. *Ibid.* at 905, 915.

122. Longstanding doctrinal exceptions include beneficiary consent, settlor or principal authorization and advance judicial approval; *ibid.* at 1236-1240, and John H. Langbein, “Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?” (2005) 114 Yale L.J. 929 at 963-964 [Langbein].

123. Indeed, many of the categorical and statutory exceptions tacitly acknowledge the questionable utility of the sole interest rule within the context of modern commercial relationships. Perhaps most notably, it has been acknowledged that the strict application of the sole interest rule should be relaxed in the financial services context, where it would otherwise prohibit the provision of investment advice and other services by financial institutions to clients who also maintain trust accounts. Such exceptions often reflect the development of comprehensive statutory regimes governing conflicts of interest in the areas of corporate law, financial services and trusteeship; Langbein, *ibid.* at 968-969.

124. See comments of the U.S. Supreme Court in *S.E.C. v. Chenery* (1943), 318 U.S. 80 at 85-86. See also Waters, *supra* note 117 at 918.

125. Waters, *supra* note 117 at 918.



term ‘conflict of interest.’”<sup>126</sup> As a result, “a theoretical foundation of what constitutes a conflict of interest has been largely neglected.”<sup>127</sup>

Finally, even where judges, lawmakers, legal scholars and other social scientists have attempted to advance abstract and general definitions of what constitutes a conflict of interest, these definitions have often differed quite substantially. What is more, each of these definitions arguably manifest inherent flaws – particularly in terms of their over or under-inclusiveness – which limit their potential practical application.<sup>128</sup> The differences between these definitions reflect the lack of consensus within both academic and public policy circles respecting what constitutes a conflict of interest. The shortcomings of these definitions, meanwhile, illustrate the difficulties of advancing a definition which is both sufficiently precise and congruent with the purposes for which it is to be applied.

What all this reveals is a legal principle very much in a state of flux. There exists considerable substantive uncertainty respecting both what constitutes a conflict of interest and how they should be treated – especially in the context of complex modern commercial relationships. Given this manifest uncertainty, the need for robust substantive guidance surrounding the regulatory objectives of NI 81-107 and, in particular, the definition a conflict of interest matter, seems readily apparent. Despite this apparent need, however, the definition of a conflict of interest matter articulated in NI 81-107 is decidedly unhelpful, relying as it does on the dizzyingly tautological phrase “an interest that may conflict”<sup>129</sup> as its interpretive lynchpin. Indeed, NI 81-107 in many respects *reflects* the uncertainty associated with its animating principle, rather than representing any meaningful attempt to *resolve* it. The failure of the CSA to provide sufficient substantive guidance respecting this central concept thus leaves managers and IRCs without meaningful guidance respecting the content and scope of their respective obligations under NI 81-107. Ultimately, this substantive uncertainty opens the door to many of the potential drawbacks of principles-based securities regulation identified above: divergent interpretations respecting the scope and substantive content of NI 81-107 and the prospect of both a chilling effect and regulatory creep. This uncertainty is thus inconsistent with a principles-based regulatory

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126. Christoph Kumpan & Peter C. Leyens, “Conflicts of Interest of Financial Intermediaries – Towards a Global Common Core in Conflicts of Interest Regulation” (2008) 5 *European Company and Financial Law Review* 72 at 75.

127. *Ibid.* at 75.

128. *Ibid.* at 77.

129. NI 81-107, *supra* note 4 at s. 1.2(a).

paradigm and, as a result, likely to undermine the potential efficacy of NI 81-107.

Two brief examples may be of assistance in illustrating how the failure of the CSA to sufficiently articulate the substantive content of NI 81-107 may ultimately undermine its potential efficacy. The first example arises in the context of the compensation of portfolio management personnel. The compensation of portfolio management personnel, particularly within the mutual fund industry, is typically tied at least in part to the performance of their funds relative to their peers (i.e. similar funds managed by other managers) and/or relevant investment indices. Personnel compensated on this basis thus possess an economic incentive to manage their funds with a view to keeping pace, or at the very least not lagging behind, these benchmarks. To the extent that such “index chasing” results in investment decisions which deviate from the best interests of these funds and their securityholders, there exists a clear and pressing agency problem and, therefore, a conflict of interest. Yet the silence of NI 81-107 with respect to this seemingly important issue is deafening. Do such compensation practices constitute conflict of interest matters for the purposes of NI 81-107? If so, given, *inter alia*, the substantial monitoring issues associated with determining the internal intentions of portfolio management personnel, how should managers and IRCs approach the management of this conflict? If not, which appears likely to be the case, why not—especially given the seeming importance of this potential conflict? In this respect, NI 81-107 is either hopelessly ambiguous or poorly designed to protect securityholders from the pernicious effects of conflicts of interest. Indeed, it may be both.

The second example arises in the context of a decision on the part of a manager to terminate an agreement with a third-party service provider with the intention of bringing such services “in-house” or, alternatively, delegating them to an affiliate. As previously noted, to the extent that the manager or its affiliate are thereby able to realize a profit from this decision, the manager possesses a clear economic incentive to pursue this course of action. At the same time, however, there exists no shortage of other legitimate reasons why the manager may elect to terminate the agreement including, *inter alia*, poor performance, uncompetitive pricing, or a perceived increase in legal or reputational risk. The key, according to the CSA, is ensuring that the decision of the manager is in the best interests of the investment fund uninfluenced by the potential economic pay-off.<sup>130</sup> Does this mean, however, that the manager is prohibited from pursuing

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130. *Ibid.* at s. 1.2 (Commentary).

its economic self-interest in the circumstance where the manager does not expect, on a reasonable basis, that the investment fund or its securityholders will be negatively impacted? In such circumstance, on what basis should the manager and its IRC determine whether a “fair and reasonable result for the investment fund” has been achieved? Is the investment fund entitled to share in the economic pay-off, or is the fact that the manager does not reasonably expect the investment fund or its securityholders to be negatively impacted sufficient to discharge this burden? These are important and complex questions which reside at the crossroads of the fiduciary and commercial aspects of the relationship between a manager, an investment fund and its securityholders. Nevertheless, NI 81-107 remains silent with respect to these questions. In turn, this silence opens the door for divergent and potentially sub-optimal interpretations of NI 81-107 on the part of both managers and IRCs.

The regulatory myopia manifest in the institutional design and implementation of NI 81-107 is also reflected in the fact that, while the instrument arguably contemplates a new role for managers (and certainly for IRCs), the same cannot be said of the securities regulators which collectively make up the CSA. NI 81-107 has not been accompanied by any changes which would suggest that these regulators intend to loosen their grip on the regulation of conflicts of interest in the Canadian investment fund industry. Indeed, NI 81-107 had not even been proclaimed in force when the CSA introduced a proposed national instrument articulating a series of prescriptive rules regulating conflicts of interest in the context of so-called “soft dollar” arrangements.<sup>131</sup> This move was particularly perplexing given that soft dollar arrangements are specifically referenced within NI 81-107 as a species of potential conflict which the instrument is designed to address.<sup>132</sup> Similarly, there appears to have been no public acknowledgement on the part of CSA members that they intend to carve out a good faith sphere or adopt a more patient attitude toward enforcement in order to promote innovation in the design and implementation of conflict-related policies and procedures.<sup>133</sup> As we have already seen, in the absence of such a sphere, managers are likely to behave as though subject

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131. See Notice of Proposed National Instrument 23-102 *Use of Client Brokerage Commissions as Payment for Order Execution Services or Research (“Soft Dollar” Arrangements)*, (2006) 29:29 O.S.C.B. 5923 (21 July 2006) and, subsequently, Proposed National Instrument 23-102, *Use of Client Brokerage Commissions as Payment for Order Execution Services or Research Services* and Companion Policy 23-102CP, (2008) 31:2 O.S.C.B. 489.

132. NI 81-107, *supra* note 4 at s. 1.2 (Commentary).

133. While the argument can be made to take a “wait and see” approach to this issue, it is the comfort provided by the *acknowledgement* of this protective sphere which promotes the innovation principles-based regulation seeks to achieve.

to prescriptive rules, thereby negating many of the potential benefits of principles-based regulation.

Finally, CSA members have thus far taken few, if any, meaningful steps to institutionalize the fledgling dialogue which characterized the consultative process leading up to the promulgation of NI 81-107. Unlike the FSA, for example, which restructured its internal organization, considerably increased its phalanx of relationship management (including call centre) personnel, and re-designed its education programs after moving toward a more principles-based regime,<sup>134</sup> Canadian securities regulators do not appear to have undertaken any meaningful organizational, staffing, education or other institutional changes in connection with the implementation of NI 81-107. Along the same vein, while it is difficult to compare the FSA's comprehensive move toward more principles-based regulation with the promulgation of NI 81-107, CSA members do not appear to have earmarked significant capital resources with a view to building the requisite principles-based infrastructure. Furthermore, despite a flood of substantive questions from within the Canadian investment fund industry—many relating to the scope and substance of the definition of a conflict of interest matter—the CSA responded with a largely redundant and highly technical Staff Notice<sup>135</sup> which arguably provides little in the way of new information or substantive guidance. Collectively, these decisions signal that cultivating a more dialogic relationship and building an interpretive community through which to amplify principles, disseminate substantive guidance and ultimately establish shared understandings respecting NI 81-107 are not at present high priorities for the CSA.

Given the apparent reluctance of the CSA to fully embrace the new role contemplated for its members under a principles-based regulatory paradigm, it would seem reasonable to suggest that regulated actors, too, will elect to proceed with the utmost caution. Perhaps nowhere is this caution likely to be more evident than in connection with the development and dissemination of conflict-related industry “good” or “best” practices. The CSA has placed considerable emphasis on the development of such practices as vital to the long-term success of NI 81-107 and publicly expressed confidence that such practices will emerge over time<sup>136</sup> and be disseminated via, *inter alia*, industry trade associations such as IFIC and the IRC's annual report to securityholders. However, observing that CSA

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134. FSA, *supra* note 53 at 18.

135. See CSA Staff Notice 81-307, *Frequently Asked Questions on National Instrument 81-107 Independent Review Committee for Investment Funds*, (2007) 30:13 O.S.C.B. 2807 (30 March 2007).

136. NI 81-107, *supra* note 4 at s. 1.2 (Commentary).

members have not fully bought into a principles-based philosophy, regulated actors may rationally be expected not to invest significant resources in the joint development of such practices nor expose themselves to potential regulatory scrutiny by providing comprehensive public disclosure of these practices.<sup>137</sup> In this and many other respects, the failure of Canadian securities regulators to fully embrace the philosophy of principles-based regulation is likely to result in a downward spiral of apprehension and distrust and, ultimately, undermine the effective regulation of the Canadian investment fund industry.

As illustrated above, the threefold failure of the CSA and its members to articulate sufficient substantive guidance, undertake necessary institutional changes and pursue a more meaningful dialogue with regulated actors suggests that the design and implementation of NI 81-107 is premised on a narrow, formalistic view of principles-based securities regulation. Indeed, to the extent that only one provincial regulator (British Columbia) has even attempted to articulate its vision of what principles-based regulation entails, one might query whether, and to what extent, principles-based considerations factored into the CSA's thought process in connection with the institutional design and implementation of NI 81-107. Whatever the thought process, the narrow, formalistic view of principles-based regulation upon which NI 81-107 is premised ultimately undermines its potential efficacy.

#### V. *Normative proposals*

In light of the forgoing evaluation, the germane normative issues thus become how Canadian securities regulators should approach the regulation of conflicts of interest under NI 81-107 and, more broadly, the institutional design and implementation of future principles-based regulatory mechanisms.

Any attempt to enhance the potential efficacy of NI 81-107 as a principles-based regulatory mechanism must necessarily begin with the provision by the CSA of further substantive guidance. The singular importance of this guidance cannot be underestimated, especially given

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137. The early evidence respecting the validity of this expectation is mixed. While the disclosure provided in the IRC annual report to securityholders in respect of many investment fund complexes might best be described as perfunctory, there appear to be a growing number of managers and IRCs committed to providing more fulsome disclosure. To observe the range of practices in this respect, *See* the IRC annual reports filed in connection with the investment funds managed by RBC Asset Management Inc. (filed 25 March 2009 for the year ended 31 December 2008), CIBC Asset Management Inc. (filed 31 March 2009 for the year ended 31 December 2008), Scotia Securities Inc. (filed 31 March 2009 for the year ended 31 December 2008) and BMO Harris Investment Management Inc. (filed 31 March 2009 for the year ended 31 December 2008), online: <[www.sedar.com](http://www.sedar.com)>.

the substantive uncertainty surrounding the legal principle animating NI 81-107. First and foremost, the CSA must articulate the real-world regulatory outcomes which they desire to achieve. This articulation must extend beyond a mere regurgitation of the purposes for which securities regulation in Canada exists. Rather, these regulatory outcomes must be formulated in a manner that provides sufficient yardsticks against which investment fund managers and IRCs can measure whether their policies, procedures and conduct are in substantive compliance with NI 81-107 *and* against which the performance of regulators can be meaningfully evaluated. Whatever these desired regulatory outcomes may be, unless and until they are clearly articulated by the CSA, regulated actors will be left wandering the desert in search of the substantive guidance necessary to design and implement conflict-related policies and procedures which are compliant with NI 81-107. Accordingly, while the process of identifying and articulating these regulatory outcomes may require some soul searching on the part of Canadian securities regulators, it is nevertheless vital to the efficacy of NI 81-107.

Most importantly, the efficacy of NI 81-107 is clearly tied to the formulation of a more coherent definition of what constitutes a conflict of interest matter. The substance of this definition must be constructed in light of the regulatory outcomes which the CSA desires to achieve. If, for example, the desired regulatory outcome is premised on the elimination of self-interested behaviour on the part of managers, the definition of a conflict of interest matter might be based on the existence of both motive and opportunity for a manager to engage in a course of conduct which manifests the potential to be both beneficial to the manager and detrimental to an investment fund and/or its securityholders. If, on the other hand, the desired regulatory outcome relates to the avoidance of actual (or potential) harm to investment funds and/or their securityholders, this definition might revolve around an examination of the deleterious impact of these courses of action. Ultimately, what is important once again is articulating a coherent definition of a conflict of interest matter—one which reflects the regulatory outcomes the CSA hopes to achieve through the promulgation of NI 81-107. Only then will managers and IRCs find themselves on solid ground in their efforts to achieve substantive compliance.

Finally, realizing the principles-based potential of NI 81-107 requires a philosophical shift on the part of securities regulators. Specifically, regulators must work to build a good faith sphere within which managers and IRCs feel free to develop innovative policies and procedures respecting conflict of interest matters. Regulators must also increase their efforts to span the public/private divide by promoting a more honest and sophisticated

dialogue with regulated actors. Such a dialogue is necessary to create the interpretive community through which regulators and regulated actors can amplify principles, disseminate substantive guidance and ultimately build shared understandings.

The normative proposals to enhance the efficacy of NI 81-107 apply without modification to the design and implementation of future principles-based regulatory mechanisms. First and foremost, regulators must identify and clearly articulate the regulatory outcomes they desire to achieve. The process of identifying and articulating these regulatory outcomes must include an examination of the legal and/or regulatory principles underlying each proposed regulatory mechanism in order to ensure that they are themselves sufficiently certain so as to provide a solid substantive foundation. While the absence of such substantive certainty is by no means fatal, regulators in such circumstances must make a concerted effort to ensure sufficient certainty through the provision of substantive guidance. Second, regulators must carve out a good faith sphere within which regulated actors are free to employ their considerable accumulated expertise toward designing compliance policies and procedures which reflect the underlying principles and achieve substantive compliance with desired regulatory outcomes. Finally, regulators must take meaningful steps to institutionalize a dialogic relationship with regulated actors. Each of these elements is vital to the efficacy of principles-based securities regulation.

The move toward more principles-based regulation also clearly requires a sustained commitment in terms of the allocation of resources and, more broadly, philosophical buy-in. Given the scope and scale of this commitment, any move toward more principles-based regulation is arguably likely to be more successful if implemented at the organizational level, as the FSA and ASIC have done, rather than at the level of narrowly targeted regulatory mechanisms such as NI 81-107. Indeed, it is unrealistic to expect regulators and regulated actors to move fluidly between the prescriptive and principles-based regulatory paradigms depending upon the subject matter of the regulation. Along the same vein, principles-based regulation is arguably less likely to succeed in the context of a fractured securities regulatory regime such as that which, lamentably, still exists in Canada. In such a circumstance, where regulated actors may be required to simultaneously comply with both prescriptive and principles-based rules in different jurisdictions, many if not most of the potential benefits of principles-based regulation will be lost. Accordingly, any further move toward more principles-based regulation should perhaps be tabled

pending the implementation of a national securities regulatory authority in Canada.

There exists one final precondition to the success of any move toward more principles-based securities regulation. Securities regulators must embrace a theoretical conception of principles-based regulation, one which transcends the narrow formalism of the rules versus principles debate. As amply illustrated by the largely empty rhetoric surrounding NI 81-107, the term “principles-based” regulation is often invoked, but seldom defined. The responsibility for this failure rests primarily with Canadian securities regulators (other than British Columbia), who, while increasingly vocal of their support for principles-based regulation, have utterly failed to articulate their vision of this emerging regulatory paradigm. In this article, I have advanced such a theoretical conception and explored its wisdom and potential drawbacks. Furthermore, I have illustrated that, in the absence of such a theoretical grounding, any move toward more principles-based regulation—including NI 81-107—is unlikely to fulfill its inherent promise.

### *Conclusion*

Conflicts of interest permeate the Canadian investment fund industry. The effective regulation of these conflicts of interest is vital to the objectives of investor protection, fostering fair and efficient capital markets and promoting confidence in capital markets. In NI 81-107, the CSA has adopted what it characterizes as a principles-based approach toward regulating these conflicts of interest. Ultimately, I am agnostic as to whether principles-based regulation represents the optimal paradigm—whether in connection with the regulation of conflicts of interest in the investment fund industry or financial markets more broadly. Notwithstanding what its growing chorus of critics—incited by the market and regulatory failures which precipitated the current global financial crisis—may suggest, it is simply too early to tell whether the inherent promise of principles-based regulation can be harnessed. As I have argued, any future success of principles-based securities regulation will be conditional upon its institutional design and implementation: articulating a clear theoretical conception of what principles-based securities regulation is and, thereafter, fully embracing it as a new paradigm—a new philosophical approach toward regulation. To the extent that the CSA and its members have thus far failed to acknowledge the critical importance of these conditions, the prospects for principles-based securities regulation—and for NI 81-107—appear unpromising.