

KETTLES

Pots AND Kettles

Does the Ontario Securities Commission live up to its own governance recommendations?

BY JOEL FRIED

GOOD governance has become a mantra for securities markets due to the recent corporate scandals in the United States, and the collapse of the technology bubble. In the U.S., the apparent breakdown of corporate governance has led the Securities and Exchange Commission, Congress and some states to initiate new regulations and procedures for corporations listed on U.S. exchanges to follow. Despite the lack of any strong evidence that Canadian corporations or financial institutions have been materially remiss in governance practices, Canadian regulators also appear ready to introduce new regulations and laws enforcing their own vision of good governance on publicly traded firms in Canada.

Most of the major scandals occurred in the U.S., and it has since been argued that investor confidence needs to be restored through tighter regulation. However, the situation in Canada is more problematic: we have been relatively free of governance scandals. Publicly traded Canadian firms may, in fact, have such sufficiently good governance practices that new regulations simply impose greater costs on the private sector while conferring little, if any, benefit. If that is the case, then it may be useful to reconsider the regulators' own "governance structure" to determine whether or not they are providing leadership through their own governance procedures. In particular, this paper will apply some basic concepts of corpo-

rate governance to the primary regulatory body of security markets in Canada, the Ontario Securities Commission (OSC).¹

OSC Governance Practices

Prior to 1997, the OSC was a part of the Ministry of Finance of Ontario. In that year they became a Crown corporation. The corporation is composed of nine commissioners plus the staff. The commissioners are the ones that set policy and adjudicate cases brought before them by the OSC staff. The board of directors is also composed solely of the commissioners themselves. As such, they constitute the full membership of both the audit and the compensation committees.

The nature of board membership of the OSC is in sharp contrast to recent requirements imposed on the private sector in both the U.S. and Canada.² It has been argued that independent directors at public firms will better represent shareholders and keep management under control. Sarbanes-Oxley (SOX) requires a majority of directors be "independent." In Canada, the OSC has pushed strongly for independent audit committees, arguing that it would increase the economic value added of those companies by anywhere from \$1 billion to \$9 billion.³ The argument is that, by having independent audit committees, boards would be less likely to put a better face on the results of the corporation. As a result,

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recent regulations require that all firms listed on the Toronto Stock Exchange require a majority of independent directors on the audit and compensation committees. Other publicly traded corporations that have not met the independence requirements are required to report why they have not met the “voluntary regulations” on board membership.

Because all commissioners are involved in both administrative and adjudication activities within the OSC, there is, at least in the context of the current debate, some question as to the quality of the leadership role the OSC is playing in attempting to increase independent board membership for private corporations. Indeed, similar arguments could also be levied against the OSC. Because all audit committee members are intimately involved in the operations of the commission, from planning to adjudicating, they have every incentive to place a favourable spin on the operation of their corporation.

Oversight

Prior to incorporation, the OSC budget was determined by the legislature rather than from internally generated registration fees and fines. The 1997 enabling legislation freed them from this financial control of the legislature and they were free to set fee schedules as they saw fit. Any revenue generated that is over and above the cost of running the Commission is to be remitted to the general accounts of the provincial government. This financial freedom significantly reduced the ability of the government to exercise oversight.

What formal oversight remains is in the domain of the Minister of Finance. The OSC must report to the minister at least once a year, indicating past undertakings and future priorities. The minister can require the Commission to address specific issues, reorder priorities, and the like. Nonetheless, relative to other countries, there are surprisingly few venues where critical assessments of the securities regulator can be undertaken. In the U.S. the SEC must report to legislative committees where there are members of both political

parties. Australia and the U.K. both have strong oversight mechanisms. Even some smaller provinces have legislative committees composed of members of all parties that oversee crown corporations, including the securities regulator. Compared to those, the OSC board can initiate a committee to assess the actions of the commission itself, but this committee reports directly to the Board and was last active in 1988.

Accounting

Given the absence of any significant degree of oversight by the provincial government there are at least two means of compensating for it on the part of the electorate. The first is to trust the good offices of those in control of the Commission and hope they behave honourably. While this may well be adequate, it is hardly the response that the regulator itself would demand of a private sector corporation. Rather the financial regulator would require that there be sufficient information—prospectus, quarterly reports, auditor’s reports, etc.—made available to allow the shareholders to make informed decisions backed up by the force of law. In effect, the firm is required to have a degree of transparency and be vulnerable to lawsuit if information is misleading and/or incorrect. Providing a similar level of transparency to the regulatory process is thus a second means of providing an adequate degree of oversight and, further, would be consistent with the OSC mandate in regulating private firms.

The most essential element in providing the necessary transparency and reducing the costs of monitoring any institution is that there be some well-defined set of rules with which to assess its performance, i.e., a method of accounting. The OSC uses generally accepted accounting principles (GAAP) in assessing the financial flows through the organization, as well as providing an annual audit of the books. The problem for government agencies is that these accounts serve the private sector well but are seriously deficient for the purpose of evaluating government programs.

For a government bureau or ministry, it is net benefits from mandated programs rather than profits that are the objective. While cost-benefit analysis is certainly not a panacea—benefits and costs may well be ambiguous and/or poorly measured—it does provide some method with which to assess programs and has therefore played an increasing role in the conduct and evaluation of policy. Both the elected representatives and members of the public can then use these estimates to assess the programs and their agents—both the members of the legislature and civil servants—and can respond in their own best interest.

For a regular government bureau, the specialists who assess and initiate the cost-benefit analysis of a program are elected representatives who have an incentive—re-election—to do things correctly. For a regulatory agency such as the OSC, the costs and benefits are evaluated by non-elected officials and the incentives to do the right thing are less powerful. Indeed, it can be argued that it is not in the regulator's interest to provide transparent accounts of costs and benefits.

For instance, in the absence of accounts, it is a fairly simple matter for the agent to take credit for any positive outcomes and avoid blame for negative ones. Also, without transparency there is a tendency to formulate ambiguous regulations since such obfuscation limits the ability of outsiders to properly evaluate the regulator. In the case of the OSC, this absence of transparency is suggested by the charge of “acting against the public interest,” which is only defined ex post if at all.

Given the asymmetric information in conducting policies, what monitoring there is will be ineffectual without some accounting mechanism. Indeed, a major theme for financial regulation that the Crawford Commission identifies is that:

“Regulation should support clearly identified public policy objectives and be proportionate to the objective. The benefits of regulation (and changes to regulation) must outweigh the costs imposed by it.”⁴

The OSC has, in fact, been required to provide such an analysis under current legislation but the Crawford Commission notes that what the OSC has done has basically been “boilerplate.” For instance, statements on costs and benefits often end with such generalities as “based on experience to date, the

[Ontario Securities] Commission believes that the benefits of the proposed rule justify the costs.” This is qualitatively the same as the firm’s management telling its shareholders that everything it did was profitable—costs were less than revenue in every endeavour—but they didn’t keep any books to confirm that assertion. Such a firm simply could not be publicly traded in Ontario.

It is not that securities regulators are without the means to carry out such cost-benefit analysis. The Crawford Commission speaks favourably of the SEC’s use of cost-benefit analysis, and in soliciting others to assist it in identifying additional costs and/or benefits. One could go further. If the OSC is to lead by example, then, at a minimum, it should seriously face accounting rules that have both relevance and some public acceptance. By this I mean that it have economists, either in-house or under contract, that will undertake cost-benefit analyses on any new regulation, and that they systematically re-examine past regulations to see if they have remained profitable, with benefits outweighing costs.

One of the most important aspects of transparency is that shareholders have access to the accounts of the firm. In the case of the OSC, the equivalent would, at a minimum, involve making public those cost-benefit analyses that are done and, as the Crawford Commission points out, also provide an explanation if they are not. Just as with the firm, this added level of potential monitoring should make the OSC more careful in undertaking new initiatives.

Auditing

Without a meaningful accounting system the issue of auditing—the use of an external supplier to assess the activities of the agent—is moot. Nonetheless, suppose that, following the Crawford Commission recommendation, the OSC does make an attempt to conduct cost-benefit analyses for any new policy initiative. Then an external audit would be as necessary here as it is in the private sector or with the Auditor General’s report for the traditional branches of the government. Certainly, the OSC would not tolerate a publicly traded firm that used only internal accountants to measure its profits and/or losses. Rather, it would require both an external audit and that some

member of management be held to account if the books were found to be materially incorrect. The public should require no less of its regulatory agents.

Compliance

There appears to be a fundamental difference between how private firms and regulatory agencies deal with compliance to ensure that regulations affecting third parties are not violated by members of the firm. For the firm, the compliance officer can go outside—to the regulator or the courts—to ensure that her decisions are enforced. For the OSC, the “compliance officer” reports to the head of the agency itself. At a very minimum, this can lead to the appearance of conflicts of interest. Because the OSC insists that appearance is virtually as important as actions, such an issue

would need to be addressed if the OSC is to lead by example. Providing such an external channel should lead to greater compliance in appearance as well as in fact.

The Crawford Commission has also focused on a second area of compliance. This is the breaching of the presumed Chinese wall between staff and commission. This focus is fairly recent, appearing in the 2003 final report but not the draft report issued the year before. Hopefully, implementing the Crawford Commission suggestion, later reinforced by the Osborne Commission, for the separation of the prosecutorial and judicial branches can restore some confidence in the decisions made by the OSC.

Management Incentives

In the absence of more vigorous oversight by the Ontario Minister of Finance, what alternatives are there for improved performance by financial regulators? One way to reduce the cost of monitoring in the private sector is to try to structure the incentives to management so that they correspond to the interests of shareholders. This is an especially thorny issue and no completely satisfactory solution appears to be available. It is similar in the public sector as well. Thus there continues to be a major role for external monitoring in both private and

public sectors. Nonetheless, we do know some incentive structures are worse than others, and the objective is to avoid the more egregious of these.

To put this in context, what the incentive structure should do is decrease the incentive for agents to loot what is due to the principals. Government bureaus have had great difficulty in providing performance-linked financial bonuses to employees, and this carries over to agencies and crown corporations such as the OSC. First of all, without a meaningful accounting system the issue is moot. With no measure of the costs and benefits of various programs, the bureau

IN THE ABSENCE OF MORE VIGOROUS OVERSIGHT BY THE ONTARIO MINISTER OF FINANCE, WHAT ALTERNATIVES ARE THERE FOR IMPROVED PERFORMANCE BY FINANCIAL REGULATORS?

ANNOUNCEMENT



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itself can fabricate whatever self-serving values it chooses. Furthermore, because of the difficulty—or unwillingness—to measure outputs, the measures usually settled on generally boil down to being correlated with inputs rather than

outputs. But this tends to mean that the greater the extent of regulation, the greater the value the bureaucracy attributes to itself.

Nonetheless, measured or not, the OSC does have potential “profits” that can be identified with the net benefits of the various initiatives it undertakes. To the extent that the agency undertakes activities where the costs exceed the benefits, then citizens—shareholders—are, on balance, harmed. This occurs when the agency over-regulates. Furthermore, with over-regulation (and bonuses tied to inputs) the agents gain in the form of controlling a larger staff, greater compensation, and/or an increase in “empire and/or prestige.” Without an accounting scheme to measure the costs, it is fairly simple for the agent to convince both himself and the principals that his contribution to the shareholders is much greater than it actually is.

For both institutions and individuals, one obvious fact reins in the appetite to expand, namely a budget constraint. Under the previous enabling legislation for the OSC, they too faced a constraint on how much they could expand. In particular, any revenue from fees, fines, and/or settlements above and beyond the costs of operation and designated under terms of settlement for allocation to or for the benefit of third parties was to be remitted to the Consolidated Revenue Fund. These terms were added to the legislation to remove the perception that the OSC “encouraged settlements, not because they were in the public interest, but rather to generate additional revenue.”⁵ In its absence the additional revenue could then be used to expand the agency’s reach and power.

Unfortunately, in the case of the OSC, one should not make too much of this constraint. It turns out that, in addition to revenue from fines and fees, they have a third revenue source that can be regarded as “forced contributions.” These are de facto fines where

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the enabling legislation does not, in the Commission’s view, permit the levying of sufficiently large fines and/or sanctions. This revenue often arises when the very general regulation, “acting against the public interest,” is invoked. A case in point is the three million dollar “contribution” paid by Royal Bank in the RT Capital high close case. The proceeds from that “contribution” were used to fund an investor education program then outside the scope of the OSC.

Competition

It has been argued that regulatory competition can lead to better regulation. Because Canadian firms find it fairly easy to list on U.S. stock exchanges, one could argue that the OSC does face significant competition in regulating firms. Nonetheless, this competition is fairly limited. For instance, investors resident in the U.S. cannot use Canadian brokers to make their trades and, in retaliation, the OSC does not permit Ontario residents to use U.S. brokers, so the “competition” de facto takes the form of collusion against the principals who “own” the regulatory machinery.

Similarly, the regulatory competition among the 13 provincial and territorial security commissions has led to two unfortunate developments. First of all, each regional commission insists that firms operating in their area be subject to their specific regulations, and corporations operating across the country have to conform to the regulations of all commissions. Second, there has been consolidation of the Canadian exchanges over the last decade, placing virtually all equity transactions under the explicit regulation of the OSC. This later development effectively reduced the competition among regulators and gave the OSC greater control.

The inefficiencies that result from the first development led to momentum to have a single federal regulator and the suppression of the provincial regulators.

Among the security commissions this “solution” is only fully supported by the OSC no doubt in the belief that Ontario will have the greatest impact on the federal commission and most of the OSC staff will migrate to it. The possibility of this federal solution is small because, for constitutional reasons, each province can veto federal control in their own province, and a number of provinces are zealous in resisting federal intrusions into areas of provincial jurisdiction. In any case, there is no reason why a federal commission would be either more or less venal than the existing provincial commissions.

Conclusion

In Ontario, the OSC has been quite active in imposing new standards of governance for publicly traded corporations. The question is, how can we determine what the best governance practices are? There are at least two (admittedly extreme) hypotheses that could help determine the answer. One hypothesis is that the regulations imposed by financial market regulators define at least the minimum necessary conditions for good governance practices. The second hypothesis is that the governance practices of the regulator must be the best practices for governance. This assumes they would want to provide an example of best practices and, in any case, would be inclined to use best practices in order to operate most efficiently.

I have used the OSC as a case study of the differences in policies set for the private sector and used by the regulator itself. It can be hoped that the Crawford Commission’s strong recommendation favouring serious cost-benefit analysis is taken to heart, but to date the work produced in-house can best be described as aggressive accounting—data mining—rather than serious economic analysis. This absence of proper accounting is likely the major reason we have no good handle on what best governance practices might be. Certainly it cannot be more lax than the governance procedures used by the OSC itself. Nor could it be as restrictive as current regulations require since, in the absence of cost-benefit analysis, there is every incentive for a regulatory commission to expand its empire and over-regulate. In the absence of fundamental changes in governance procedures at the OSC, and most especially a serious effort to have meaningful

accounting and oversight procedures, there is a real question of the legitimacy of such an organization. Institutions that behave contrary to what they insist others should do can hardly command respect from the community they are supposed to serve. ■

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Endnotes

1. See Chant J. F. and Mohindra N. (2001), “Commissions Unbound: The Changed Status of Securities Regulators in Canada,” Fraser Institute Critical Issues Bulletin. Also Mohindra, N., (2002), “The Governance of the Ontario Securities Commission: Lessons from International Comparisons,” Fraser Institute Occasional Paper no. G1.
2. Ontario Securities Commission (2004), “Multilateral Instrument 58-101: Disclosure of Corporate Governance Practices.”
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5. OSC (2003b), p. 219.