PUBLIC POLICY SOURCES

Number 61

The Governance of the Ontario Securities Commission:
Lessons from International Comparisons

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A FRASER INSTITUTE OCCASIONAL PAPER

THE FRASER INSTITUTE

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Printed and bound in Canada.
ISSN 1206-6257

Date of issue: August 2002

The Governance of the Ontario Securities Commission: Lessons from International Comparisons

Executive Summary

Securities regulators, including the Ontario Securities Commission (OSC), have been strongly vocal about the need for good corporate governance. But good governance is also important for securities regulators to ensure resources are directed towards socially desirable objectives, and used efficiently.

The focus of this study is a comparison of the OSC's governance structure with that of regulators in other countries responsible for securities regulation. The comparison countries are Australia, the US, the UK, and Hong Kong. The intent of the comparisons is to flush out best practices in governance for a modern securities regulator that could possibly be adopted by the OSC.

There are a number of reasons why it is appropriate to review the OSC's governance structure. In recent years, the OSC has become larger, has absorbed more powers and responsibilities, and has achieved greater independence. It is likely the OSC's powers and responsibilities will continue to grow, including its administrative powers to impose sanctions on market participants. The OSC's growth in powers and responsibilities raises the question of whether existing governance structure is still adequate; its growth in size means it may be possible for the OSC to absorb the costs of some governance measures more efficiently.

By striving towards best practices in public governance, the OSC can lead by example in its efforts to promote the need for good corporate governance. Pursuing best practices would also improve Ontario's competitiveness in global capital markets as it provides assurance to market participants that regulatory powers will be used responsibly and regulatory resources will be used efficiently.

The comparisons reveal there is a lot of similarity in governance between the OSC and regulators in other countries. Some examples are: requirements to submit an annual report; judicial processes for appealing administrative decisions; and a process of public comment for regulators that have rule-making powers.

However, there are also a number of significant differences between the OSC and regulators elsewhere. In the US, Congressional Committees play an ongoing role in the oversight of the Securities and Exchange Commission (SEC). The Committees often draw on the resources of the independent government office, the General Accounting Office, to undertake operational reviews of the SEC. In the UK, a Regulatory Decisions Committee that is operationally independent of both staff and the FSA Board exercises the administrative powers of the Financial Services Authority (FSA). When Hong Kong expanded the administrative powers of its securities regulator, a non-statutory panel was established to audit its procedures to ensure fair treatment of those regulated. The Australian Securities and Investment Commission (ASIC) has an audit committee chaired by someone independent of ASIC that reviews the effectiveness and integrity of the ASIC's internal controls.

The international comparisons provide several important lessons for the OSC about how its governance structure could be improved. Some steps the OSC can undertake itself, such as reporting more on its governance practices, how compensation is determined, public complaints against itself, and how its past performance measures up against its past objectives. It could also put more

effort into its cost-benefit analysis that it publishes with proposals for new rules.

Second, the Minister of Finance could take a more active role in the OSC's governance under the existing legislative framework. For example, the minister could take up a 1988 recommendation of the Standing Committee on Government Agencies to ask the Provincial Auditor to undertake an efficiency audit of the OSC.

Third, some measures can form part of the five-year review of Ontario's securities regulation. The OSC could be restructured more along the lines of the UK's FSA so that the non-executive members of its Board are independent of the OSC's quasi-judicial functions. In such a structure, an operationally independent regulatory committee would hold the administrative powers. The independent board members could form a committee to report on the OSC's execution of its responsibilities.

Introduction

Corporate governance has been defined as the process and structure used to direct and manage the business affairs of the corporation with the objective of enhancing shareholder value (Dey, 1994)). Emphasis on corporate governance continues to rise, with securities regulators being among the staunchest champions.

However, governance also has a role in the oversight of public bodies including crown corporations and financial sector regulators. Governance and accountability frameworks are intended to ensure that public entities use resources for publicly desirable objectives—and do so efficiently. In the case of a regulatory agency, accountability takes on more importance when these agencies have powers of enforcement and administrative sanction.

For commercial corporations, boards oversee management to ensure officers are acting in shareholder interests. For public sector entities, the board's role in governance can be somewhat more complex. A government entity is, naturally, owned by a government, which is technically the entity's shareholder. As a single shareholder, a government has the capacity to directly exercise oversight of its entities. Hence, if a board exists, it is only one element of a government entity's governance. The government determines what role it plays directly in governance, and to what extent it relies on a board to exercise this role. Oversight by government can take many forms. It can involve one or more government departments that exercise oversight from a policy or a central agency perspective. It can also involve the government legislature, often in the form of a committee of members.

This study will compare the governance and accountability mechanisms of Canada's largest securities regulator, the Ontario Securities Commission (OSC), with agencies in other countries responsible for securities regulation. This study's objective is not to evaluate the effectiveness of different governance and accountability mechanisms in ensuring that regulatory agencies do a good job in efficiently carrying out the roles expected of them. Rather, it is intended to detail the range of these mechanisms, and explore whether the public authorities in Ontario can draw insights from the OSC's international counterparts on what the OSC's ideal future governance framework should be.

The study begins with a discussion of why governance and accountability is important for a securities regulator. Next, it outlines the OSC's responsibilities, powers, and governance structure, followed by an outline of the governance structure of four other securities regulators. The study then explores whether there is a case for including a comprehensive review of governance as part of the current five-year review of Ontario's securities legislation, and discusses what lessons the government of Ontario and the OSC can draw from the governance structures of their international counterparts.

Governance and Accountability: Why is it Important for a Securities Regulator?

For any public sector entity, it is important to have appropriate governance mechanisms in place. These entities spend money on behalf of others, and governance is essential to minimize unnecessary or inappropriate expenditure. In addition, the policies these entities develop and pursue will inevitably have an impact on some or all of the public because that is why these entities exist.

While bureaucrats are charged with acting in the public interest, it is human nature for them to inevitably take self-interests into consideration, in whole or in part (Downs, 1967). In addition to a desire to serve the public interest, and pride in the proficient performance of work, bureaucrats can be motivated by such self-interested objectives as power, prestige, and financial compensation (Downs, 1967). For instance, bureaucratic growth can lead to more power and prestige for an organization, as well as greater internal promotion opportunities, even if the costs to the public outweigh any benefits. Regulators of industry are often prone to "capture" because the interests of the regulator can become intertwined with the success of existing industry players.

While governance is important for any public entity, for a securities regulator it is critical for an economy's well being. When the capital formation process is disrupted because of inefficient regulation, it distorts the way resources are allocated throughout society generally.[1] A regulator's governance structure serves as a key line of defense against inefficient regulation and supervision.

The International Organization of Securities Commissions (IOSCO) emphasizes both on the need for operational independence and public accountability for securities regulators. IOSCO's paper, *Objectives and Principles of Securities Regulation,* states that, "The regulator should be operationally independent and accountable in the exercise of its functions and powers" (IOSCO, 1998). In an updated version of the paper, IOSCO indicates that operational independence means that a regulator should be free from external political or commercial interference in the exercise of its functions and powers (IOSCO, 2002). If matters of regulatory policy require consultation or approval by another authority, the process should be clear and transparent. Generally, it is not appropriate for a government authority to be involved in decision-making on day-to-day technical matters (IOSCO, 2002).

On accountability, IOSCO's paper notes this term implies operational independence of sectoral interests, a system of public accountability of the regulator, and judicial review of decisions of the regulator (IOSCO, 2002).

The issues of independence and accountability are intertwined. While independence is generally recognized as important for preventing political influence over day-to-day decision-making, unchecked power can result in possibly worse abuses than those that result from political interference. Hence, measures that provide the regulator with insulation must be accompanied with measures that ensure there continues to be adequate accountability.

The OSC

At the heart of governance and public accountability for a regulatory agency is a clearly specified role. In the case of the OSC, its role in regulating securities markets is outlined in the *Ontario Securities Act (OSA).*[2] The purposes of the *OSA* are to (a) provide protection to investors from unfair, improper, or fraudulent practices;

Table 1: Fundamental Principles for which the OSC shall have regard

- Balancing the importance to be given to each of the purposes of this Act may be required in specific cases.
- The primary means for achieving the purposes of this act are
  - i) requirements for timely, accurate, and efficient disclosure of information
  - ii) restrictions on fraudulent and unfair market practices and procedures, and
  - iii) requirements for the maintenance of high standards of fitness and business conduct to ensure honest and responsible conduct by market participants.
- Effective and responsive securities regulation requires timely, open, and efficient administration and enforcement of this act by the commission.
- The commission should, subject to an appropriate system of supervision, use the enforcement capability and regulatory expertise of recognized self-regulatory organizations.
- The integration of capital markets is supported and promoted by the sound and responsible harmonization and co-ordination of securities regulation regimes.
- Business and regulatory costs and other restrictions on the business and investment activities of market participants should be proportionate to the significance of the regulatory objectives sought to be realized.

Source: Ontario Securities Act.

and (b) to foster fair and efficient capital markets and confidence in capital markets. In pursuing these purposes, the act specifies principles that the commission should have regard for as outlined in table 1.

The OSC's organizational structure consists of two main components:[3] the commission itself, which the OSA specifies shall number between 9 and 13 people; and the staff, whom the commission employs to enable it to carry out its duties.

Commission members are appointed by the Lieutenant-Governor of Ontario (in other words, the government of Ontario) for terms of up to a maximum of 5 years. The Ontario legislature has a Standing Committee on Government Agencies, which can review these appointments.

In addition to being responsible for the administration of Ontario securities laws, commission members also serve as the Board of Directors. In this capacity, the commission is responsible for overseeing the management of the financial and other matters of the OSC. The Lieutenant-Governor designates a member of the commission as chair, and either one or two members as vice-chair. The Chair also serves as the chief executive officer.

Under the OSA, two members of the commission constitute a quorum. However, the commission can assign an individual commission member certain decision-making powers.

The OSA spells out the formal decision-making responsibilities of the commission. The commission has authority over investigations and examinations. It can initiate investigations by appointing persons to carry out them out. Similarly, it can initiate examinations of the financial affairs of a market participant. It can also direct market participants to deliver to the commission any of the books, records, and documents that are required to be kept by the market participant under Ontario securities law.

The commission has the ability to review and overturn decisions that the OSC's executive director makes under the OSA, and a range of decision-making powers over self-regulatory organizations such as the Toronto Stock Exchange.

The commission has three avenues for exercising its enforcement powers. It can pursue criminal prosecution of contraventions of Ontario securities law, in which case convictions can result in fines and imprisonment. The commission can also pursue civil prosecution of contraventions.

In civil proceedings, an Ontario court can make a variety of orders such as the rescission of a securities transaction, prohibiting a person from exercising voting rights attached to securities, restitution to an aggrieved person, and relinquishment to the Minister of Finance any funds obtained as a result of non-compliance with Ontario law.

The third enforcement power available to the commission is its administrative powers. The commission can also make a variety of orders if, in its view, the public interest is being served. Some examples include: a reprimand, a suspension or termination of a person or company's registration, the prohibition of an individual on acting as a director or officer of any public company, and cessation of trading of a security. While non-compliance with Ontario securities law can be used as the basis for making an order, the commission can still make an order even if no law, regulation, or rule has been violated as long as its opinion is that the order is in the public interest. Court decisions, such as *Re: Canadian Tire Corp* (1987) have affirmed that the OSC does not need to find a breach of the OSA or its regulations to exercise its public interest jurisdiction. *The Committee for the Equal Treatment of Asbestos Minority Shareholders versus Ontario (Securities Commission)* confirmed the discretionary nature of its public interest powers.

The commission must hold a hearing to make an order, but temporary orders can be made without one. If the commission is satisfied that securities law has not been complied with, or that a person has not acted in the public interest, it can order that person to cover the costs incurred by the commission for the investigation and hearing. Decisions by the commission can be appealed to the courts. When commissioners are involved in initiating examinations and investigations, the OSA restricts them from presiding over hearings.

In practice, it is the commission's chair who authorizes investigations and examinations at the request of staff. Although not a formal policy, in practice the chair does not participate on hearing panels. It is also a practice for a vice-chair to chair hearing panels to ensure the chair is experienced, and to achieve consistency of approach. Part-time commissioners who are lawyers, or have significant litigation experience, may chair panels on occasion.

The commission has the power to make rules. These rules can either take the form of requirements for market participants to comply with, or permit the commission to grant exemptions to market participants from some requirements under the OSA, as well as the regulations promulgated under the act. Rules can be made that amend or revoke any provision of a regulation made by the Lieutenant-Governor-in-Council. The commission also has the power to develop formal policy statements, which outline how it will interpret rules and regulations, principles and standards on how it will exercise its decision-making powers, and the practices followed by the commission and the director in the performance of their duties and responsibilities. Policy-making powers cannot be, as a result of a prohibitive or mandatory character, of a legislative nature.

In addition to the responsibilities of the commission, the OSA also specifies staff responsibilities. In addition to assisting the commission in fulfilling its functions, the OSA makes the executive director responsible for some decisions, such as issuing receipts for prospectuses and approving the registration of companies and individuals as securities dealers and advisors. The OSA also permits the commission to assign its powers and duties to the executive director or another director, except its powers to order examinations and investigations, as well as its duties in reviewing director decisions.

The commission has the power to make by-laws governing the administration and management of itself. Amongst other things, bylaws can be made setting out the powers, functions and duties of the chair, vice-chairs, and officers. By-laws can also be made to delegate powers and duties of the commission to staff, and governing remuneration of commission members. To date, two by-laws have been published. The first relates to the conduct of affairs of the commission, and the second deals with conflict of interest issues.

Prior to its conversion to a Crown corporation in 1997, the OSC's budget was determined through the Ontario government's appropriation process, and the *Public Service Act* governed salaries. Fee revenue was directed to the Consolidated Revenue Fund. Through conversion, the commission was given control over fee revenue, which allows it to set its own budget. Concurrently, the OSC was exempted from the *Public Service Act*, which allows the commission to determine staff salary levels.

The OSA contains a number of mechanisms to ensure the OSC's accountability. On an annual basis, the OSC is required to prepare financial statements and appoint an auditor to audit the statements. The statements must be included in an annual report, which is submitted to the Minister of Finance. The minister is required to table the annual report with the Ontario legislature.

The legislature has a Standing Committee on Government Agencies, which is empowered to report on the operations of all agencies, boards, and commissions to which the Lieutenant-Governor-in-Council makes appointments. The committee reviewed and reported on the OSC during the first session of the 34th Parliament, and tabled its report in June 1988. The report included 7 recommendations to the OSC on how it should operate, which are listed in table 2. The committee requested a follow-up response from the OSC in the second session of the 34th Parliament, which was included in a report tabled in September 1992. In the report, the OSC described steps it had taken in response to the committee recommendations. The committee has not reviewed the OSC since that time.

Table 2: 1988 Recommendations of the Standing Committee on Government Agencies on the OSC

- The OSC should adopt a proactive policy of communicating its regulatory role to the general public
- The OSC should undertake to streamline and prioritize its investigations of alleged breaches of the Securities Act
- The OSC should undertake a comprehensive review and study of its enforcement and audit procedures with a view to creating an "early warning system" for financially troubled securities firms
- The OSC, in cooperation with the TSE, the IDA, and other regulatory agencies, should undertake to review the adequacy of the National Contingency Fund
- The OSC, in cooperation with the TSE and IDA (Ontario), should undertake a comprehensive review of the effectiveness of self-regulatory organizations within the context of the regulatory framework provided by the Securities Act.
- The Ministry of Financial Institutions, in conjunction with the Ontario Securities Commission, should undertake a comprehensive review of the Securities Act and related legislation
- The Ministry of Financial Institutions should ask the Provincial Auditor to undertake an efficiency audit with respect to the OSC.

Source: Report on Agencies, Boards and Commissions (No. 14).

Also on an annual basis, the OSC must deliver to the minister and publish a statement of the OSC's priorities that includes reasons for the adoption of the priorities. Prior to its finalization, the OSC must publish a notice inviting interested parties to comment on what should be identified as priorities.

On a five-year cycle, the commission and the minister will enter a memorandum of understanding (MOU) setting out:

- the respective roles and responsibilities of the minister and the chair;
- the accountability relationship between the commission and the minister;
- the responsibility of the commission to provide to the minister business plans, operational budgets, and plans for proposed significant changes in the operations or activities of the commission; and
- any other matter that the minister may require.

Once an MOU has been entered into, the OSC must publish it. The first MOU is yet to be published. Under the OSA, the minister also has the power to request information about the OSC's operations and financial affairs, and can appoint someone to examine the OSC's financial or accounting procedures, activities or practices.

Another public accountability measure in the OSA is consultation and publication requirements. Prior to the adoption of a new rule or policy statement, the OSC is required to publish a notice for comment.

For rules, in addition to the proposed rule, the notice must include a discussion of alternatives to the rule and a description of the anticipated costs and benefits of the rule. The OSC is also required to publish the final version of rules, policy statements, bylaws, and MOUs between the OSC and other regulatory authorities and self-regulatory organizations (SROs).

Rules and MOUs with other regulatory authorities and SROs require ministerial approval, as does the adoption of by-laws of the commission. The minister can either approve or reject MOUs and bylaws. For rules, the minister can approve, reject, or return to the OSC for further consideration. To date, three rules have been returned.

In addition to the statutory accountability measures under the OSA, the OSC is also subject to measures under other legislation that generally applies to government entities. It is subject to the *Freedom of Information and Protection of Privacy Act*[4] and the *Ombudsman Act*.[5] Many directives of the Ontario Management Board of Cabinet, a central agency, apply to the OSC.

The OSC has enhanced its governance structure through the establishment of three sub-committees, each of which cannot include staff, and each of which is chaired by a part-time commissioner. These include:

The Audit and Finance Committee

The committee assists the Board of Directors in fulfilling its fiduciary responsibility relating to accounting and financial matters, provides the board with assurance that the financial policies and financial condition of the OSC will enable it to achieve its long-term objectives, and develops an investment policy for managing the OSC's reserves. The committee is composed of at least 3 members, excluding any *ex-officio* members.

The Corporate Governance and Nominating Committee

This committee monitors and evaluates the OSC's corporate governance system and proposes improvements. It also recommends candidates for appointment as commissioners. The commission's chair, David Brown, is an *ex-officio* member.

The Compensation Committee

This committee makes recommendations on the compensation of the chair, vice-chairs, commissioners and executive director. In making recommendations, the criteria used by the committee

are personal and corporate performance; and attracting and retaining qualified individuals for these positions. For commission members, compensation is set at, or below, the recommendation of the Committee for Remuneration, which is jointly appointed by the commission chair and the minister.

Securities Regulators Internationally: Structure and Governance

Comparing governance and accountability of any specific securities regulator to international peers is difficult because of the diverse responsibilities held by securities regulators in different countries. Canadian securities regulators focus on securities including commodities and futures, while in the US a separate regulator exists for commodities and futures. Several countries, including the UK with its Financial Services Authority, have adopted a single regulator for all regulated financial activity including securities, banking, insurance, and pensions. Australia has established two separate regulators along functional lines. One regulator handles consumer protection issues, while the other is responsible for prudential regulation.

However, there is much in common between regulators of securities and other financial sector regulators. For example, operational independence is as much an issue for a bank regulator as it is for a securities regulator. Given the degree of commonality of governance issues for all types of financial sector regulators, lessons can still be drawn from a comparison of different regulators despite their diversity of responsibilities.

This section outlines the governance and accountability structures of four different regulatory bodies with responsibilities for securities regulation. There are some similarities across all the regulators discussed, such as the requirement to submit an annual report, judicial processes for appealing administrative decisions, and for regulators that have rule-making powers, public comment processes.

However, there are some significant differences, such as the extent to which government exercises oversight directly. There are also some unique features that have been set up by some of these regulators to enhance their governance.

The four regulators chosen for the comparison are those in the US, Australia, the UK, and Hong Kong. The US is included because it holds the largest capital markets in the world. The other three are regulators that have recently undertaken significant structural or legislative reform.

Securities and Exchange Commission (SEC)

The SEC is the US federal agency responsible for securities regulation. State regulators are also involved in some of the consumer protection aspects of securities regulation. A separate federal agency, the Commodity Futures Trading Commission, is responsible for the regulation of commodities and futures markets.

The SEC has responsibilities under several statutes including the *Securities Act* of 1933, the *Securities and Exchange Act* of 1934, the *Investment Company Act* of 1940 and the *Investment Advisers Act* of 1940. It is under the *Securities and Exchange Act* of 1934 that the SEC's structure and role are defined. The SEC's responsibilities and authority

were recently expanded by the *Sarbanes-Oxley Act* of 2002.

The *Securities and Exchange Act* specifies that the commission be composed of five commissioners appointed by the President and approved by the Senate. Not more than three members of the commission can be from the same political party. The act permits the commission to delegate any of its functions to a division of the SEC, an individual commissioner, an administrative law judge, an employee, or an employee board. For any action taken under delegated authority, the commission retains a discretionary right to review. The vote of one commissioner is sufficient to bring an action before the commission for review.

The President designates one commissioner to be chairman. Under the *Securities and Exchange Act*, the functions of the commission with respect to the assignment of commission staff, and the commissioners themselves to perform delegated functions, is transferred to the chairman.

Under the various statutes that it administers, the commission has the power to make rules. The process for rule-making is governed by the *Administrative Procedure Act*, and includes notice and consultation requirements. According to the SEC website, if a new rule is a major one, it may be subject to congressional review and veto (SEC, 1999).

Under the commission's administrative enforcement process, the commission's powers to take administrative actions have been delegated to the Office of Administrative Judges. The judges conduct hearings on allegations by SEC staff. All parties can appeal decisions to the commission, which has the power to affirm or deny the administrative judges' rulings or remand the case back for additional hearings.

When the commissioners meet for purposes such as interpreting legislation or amending rules, the meetings are open to the public. However, meetings are closed to the public if the discussion pertains to confidential matters, such as whether to launch an enforcement investigation.

In addition to submitting to Congress an annual report, the SEC is also required under a statute called the *Government Performance and Results Act*

Table 3: Oversight Plan for the Committee on Financial Services for the 107th Congress (Securities)

- Securities Market Structure
- Improving Market Interconnection and Competition
- Regulatory Conflicts Arising From Increasing Convergence of Financial Services Firms
- Accessibility of Market Data
- Securities and Exchange Commission (SEC) Reauthorization and Review
- SEC Fees
- Social Security and Investor-Directed Retirement Accounts
- Stock Options
- Investor Access to Initial Public Offerings
- Technology in the Securities Markets
- New Investment Products
- Decimal Trading
- Mutual Fund Disclosure
- Bond Market
- Self-Regulatory Organizations
- SEC Exemptive Authority
- Commodity Futures Modernization Act Implementation
- Accounting Standards: Protection Against Fraud and International Harmonization
- Organized Crime and Securities Markets
- Investment Company Act of 1940 and the Employee Retirement Income Security Act (ERISA)
- Securities Investor Protection Corporation
- Timely Stock Trade Execution

Source: House of Representatives Oversight Plan for the Committee on Financial Services for the 107th Congress. Digital document available at *http://financialservices.house.gov/media/pdf/oplan107.pdf*.

to submit an annual performance plan. It reports on results in comparison with previously planned performance levels. The act requires that variances from performance targets be explained, and the report must include any proposed corrective actions for future years.

Oversight of the SEC is conducted mainly through Congress where both houses have standing committees that play an active role. In the House of Representatives, the Committee on Financial Services exercises this role. Table 3 lists the committee's oversight plan for the 107th Congress on securities issues. It includes SEC fees, the SEC budget request, and a wide range of policy issues. The committee works through a Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises.

In the Senate, the Banking, Housing and Urban Affairs Committee is responsible for securities market oversight. It works through a Subcommittee on Securities and Investment.

In exercising their oversight roles, both house committees extensively rely on the General Accounting Office (GAO). GAO is an independent government agency that studies government programs and expenditures. In 2001 alone, GAO released nine reports (see table 4) largely related to some aspect of the SEC's operations.

The SEC's budget is determined through the appropriations process. It submits an annual budget to the Office of Management and Budget, an executive agency, and subsequently to Congress. Until recently, staff pay rates at the SEC were subject to civil service laws. However, recent legislation was passed that exempts the SEC from federal pay restrictions.

Table 4: 2001 Reports of the General Accounting Office Directly Related to Securities Regulation

- Securities Operations: Update on Actions Taken to Address Day Trading Concerns
- Securities Regulation: Improvements Needed in the Amex Listing Program
- Lost Security Holders: SEC Should Use Data to Evaluate its 1997 Rule
- Securities and Exchange Commission: Human Capital Challenges Require Management Attention
- SEC and CFTC: Most Fines Collected
- Securities and Exchange Commission: Reviews of Accounting Maters Related to Public Findings
- Securities Investor Protection: Steps Needed to Better Disclose SIPC Policies to Investors
- SEC's Report Provides Useful Information On Mutual Fund Fees and Recommends Improved Fee Disclosure
- Securities Pricing: Trading Volumes and NASD System Limitations Led to Decimal-Trading Delay

Source: General Accounting Office web site. Available electronically at *www.gao.gov.*

Australian Securities and Investment Commission (ASIC)

In Australia, ASIC is responsible for consumer protection regulation of investments, insurance, pensions and banking. It also administers and enforces corporate law. A separate regulator, the Australian Prudential Regulatory Authority (APRA) is responsible for prudential regulation. ASIC was established in 1998, replacing the Australian Securities Commission.

The commission itself consists of three full-time members. The Governor-General, who appoints the members, designates one member to act as chair, and can also designate a member as vice-chair. The full-time commissioners are responsible for managing ASIC's operations. The *ASIC Act* allows for the appointment of up to an additional five part-time commissioners, but this has never happened. In addition, regional commissioners are appointed by the commission, in consultation with state ministers, to run enforcement and regulatory operations in each state and

territory. ASIC does not have rule-making powers, but can make blanket orders and grant some exemptions from compliance with certain provisions of the *Corporations Act*.

ASIC's internal governance is enhanced by an audit committee. Chaired by a committee member independent of ASIC, the committee reviews the effectiveness and integrity of internal controls and ASIC's audit process.

ASIC's external oversight is exercised on a statutory basis through both the Treasurer and Parliament. Under the *ASIC Act*, the Treasurer has the power to give ASIC written directions about policies it should pursue, or priorities it should follow, in performing its functions under corporations legislation. In addition, under the *ASIC Act* a statutory body exists called the Corporations and Markets Advisory Committee (CMAC). CMAC advises the Treasurer on corporations legislation, financial products, and financial markets. CMAC is composed of the ASIC chair and members appointed by the Treasurer . The Treasurer designates a member, other than the ASIC Chair to serve as convenor of the committee.

The Treasurer is also involved in ASIC's financial oversight and can give directions over the timing and amount of appropriated funds to be paid to the commission. In addition, the Treasurer's approval is required for ASIC to enter contracts in which payments exceed A$250,000, and for property leases in excess of 10 years.

Under the *ASIC Act*, there is a standing committee in Parliament called the Parliamentary Joint Committee on Corporations and Financial Services. Consisting of 10 members from the Australian Parliament's two chambers, the committee's duties include inquiring into the activities of ASIC and the operation of corporations legislation. It also examines ASIC's annual reports, which ASIC is required to submit by statute.[6]

Australia's Parliament also exercises financial oversight over ASIC. ASIC's budget is determined through the Parliamentary appropriations process.

Financial Services Authority (FSA)

The UK recently restructured its financial sector regulatory system by establishing a single regulator, the FSA, for deposit-taking, insurance and investment business. It operates under the *Financial Services and Market Act 2000 (FSMA)*.

Under the FSA's constitution, it has a board that consists of a chairman and other members appointed by the Treasury. The authority is responsible for ensuring that the majority of its members are non-executive. The Treasury appoints a non-executive member of the board to chair a statutory non-executive committee. The non-executive committee's functions are to:

- review whether the authority is discharging its functions in accordance with the board's decisions, using its resources in the most efficient and economic way;
- review whether the authority's internal financial controls secure the proper conduct of its financial affairs; and
- determine the remuneration of the board's chairman and executive members.

The non-executive committee must prepare a report on the discharge of its functions for inclusion in the FSA's annual report to the Treasury.

Two statutory panels exist under the *FSMA*. The FSA is required to establish a Practitioner Panel to represent the interest of practitioners, and a Consumer Panel to act in the same capacity for consumers. The FSA appoints a member of each panel to be the chair. The Treasury must approve appointments and dismissals of panel chairs.

Representations by either panel must be considered by the FSA. If the FSA disagrees with a proposal or view expressed in a representation submitted by a panel, it must provide the panel with a written statement of its reasons.

As is the case with all the financial regulators discussed in this paper, the FSA prepares an annual report each year. The report is submitted to the Treasury, which tables it with Parliament. The *FSMA* also requires the FSA to hold an annual meeting to allow a general discussion of its annual report, and for those attending the meeting to put forward questions to the FSA on how it is discharging its functions.

The *FSMA* contains a provision that stipulates the FSA must have regard for generally accepted principles of good corporate governance that can be reasonably assumed are applicable.[7] Some principles, such as relations with shareholders, would not be applicable.

A Regulatory Decisions Committee is responsible for the FSA's regulatory decisions including: refusals of applications by firms for registration, cancellation of permission to conduct regulated activities, disciplinary decisions, and decisions which fundamentally change the nature of what a firm is permitted to do. Members of the Committee are appointed by the FSA board on the recommendation of the Regulatory Decision Committee's chair. The committee is currently composed of retired industry practitioners and other individuals. For complaints against the FSA, there is an Independent Complaints Commissioner to conduct investigations.

While the FSA's budget, financed through fee and fine revenue, does not require any form of government approval, the Treasury has the power to appoint an independent person to conduct a review of the economy, efficiency, and effectiveness with which the FSA has used its resources in discharging its functions. The person that conducts the review is required to provide the Treasury with a written report that must be tabled with Parliament and published. The Treasury also has the power to set up independent inquiries into any failures of regulation. While the FSA has specific rule-making powers in the *FSMA*, the Treasury has the power to limit the FSA's rule-making ability in some areas. Some policy decisions are made by the Treasury, such as deciding which markets the provisions in the *FSMA* for market conduct should be applied to. The Treasury Select Committee of the House of Commons reviews the expenditure, administration, and policy of the Treasury.

There is also some oversight by other government offices. The Director-General of the Office of Fair Trading, responsible for consumer credit and competition issues, and the Director of the Competition Commission vet FSA rules.

Securities and Futures Commission (SFC)

In Hong Kong, the SFC regulates capital markets under an act called the *Securities and Futures Ordinance*. Under the SFC's constitution, the chief executive[8] appoints members of the commission. The number of members must but be at least eight, with a majority being non-executive. The chairman of the commission is also its executive director. A statutory advisory committee provides the commission with policy advice. The committee consists of the SFC chairman, not more than two executive directors of the commission, and 8 to 12 other members appointed by the chief executive after consultation with the commission.

The chief executive can, after consultation with the chairman of the commission, give written directions in pursuit of the commission's regulatory objectives or the performance of its regulatory functions. The SFC has rule-making powers, but some types of rules must be made in consultation with the financial secretary.

The SFC's funding is from two sources: the fees generated from its operating activities and grants appropriated from the Legislative Council.[9] The SFC's budget must be approved by the chief executive, and tabled by the financial secretary with the Legislative Council. The financial secretary also tables the annual report submitted by the SFC.

The chief executive determines compensation for the commission members, including the executive directors. The commission determines staff compensation and has established a remuneration committee chaired by a non-executive commission member, which reviews proposals on compensation structure and recommends amendments, reviews reports on pay levels and pay trends, and recommends any necessary adjustments.[10] A number of other committees have been established including regulatory committees, a budget committee and an audit committee.

The role of non-executive directors is strictly oversight. They meet with the SFC chair and the executive directors to set the commission's overall policy. Their oversight responsibilities include ensuring that the commission acts in a fair and equitable manner. They are not involved in the operations of the commission including disciplinary actions and proceedings.

A new Process Review Panel was established as an accountability mechanism in advance of the revised securities legislation coming into force. The panel is a non-statutory independent body established to review the commission's internal practices and audit its actions to ensure that procedures were followed and those regulated were given fair treatment. The panel published its first annual report on its findings in May 2002.

The Need for Review of the OSC's Governance

The first five-year review of Ontario securities legislation is currently in progress. In May 2002, a committee appointed by the Minister of Finance released a draft report (the Crawford Report) for consultation on how the Ontario securities regulatory framework should be revised. The report contained two recommendations related to the OSC's governance structure. Proposals for new rules should include quantitative cost-benefit analysis or an explanation of its absence. The second recommendation was that additional principles should be added to the existing principles laid out in the OSA, which the commission should have regard for in pursuing its statutory objectives. The additional principles are intended to ensure that the OSC's mandate is consistent with those of other foreign securities regulators.

A strong case can be made that governance should be reconsidered more robustly. Over the course of the last decade, the powers and independence of the OSC have both been enhanced. After the *Ainsley* decision in 1993, the OSC was given its rule-making powers, which are outlined earlier in this paper.[11] In 1997, the OSC was given its financial independence.

While both changes were accompanied by measures to address public accountability issues, it is worth reviewing whether these measures have been adequate.

While there are benefits to adding additional accountability measures into a governance structure, these measures also impose costs. For example, there are significant costs to undertaking an external audit of operations. As organiza-

tions grow larger, their capacity to absorb such costs efficiently also grows. Since 1997, when the OSC was converted to a Crown corporation, expenditures have more than doubled and staff levels have expanded from under 180 to 302 by the end of March 2001. According to its most recent Statement of Priorities for the Fiscal Year ended 2001, staff levels are expected to reach 367 by March 2003.

The Crawford Report includes a number of recommendations that, if implemented, would expand the responsibilities and powers of the OSC. If the recommendations are implemented, administrative powers would be expanded to allow the OSC to levy fines of up to $1 million for contraventions of securities laws, and provide the OSC with the power to order the forfeit of profits that result from the contravention of securities laws. The report also includes recommendations that broaden the OSC's existing powers, such as expanding the scope and range of market participants who can be barred from holding certain positions. There are several recommendations to expand the OSC's rule-making powers in specific areas, and the report proposes a "basket" rulemaking authority to make rules respecting any matter the commission believes is necessary or advisable for carrying out the purposes of the OSA. Should Ontario move forward with the recommendations to expand the OSC's responsibilities and powers, the need for a more robust review of governance becomes greater.

The Ontario government has proposed amalgamating the OSC with the Financial Services Commission of Ontario (FSCO). FSCO is responsible for regulating various financial services such as pensions, insurance, and credit unions. Should the amalgamation take place, the new entity would be both significantly larger and much more complex than either of the individual organizations are now.

A number of public figures have called upon the corporate sector to improve governance. For example, David Brown, Chair of the OSC, said in a recent speech, "The importance of a healthy governance culture in promoting strong, viable and competitive corporations cannot be over-emphasized."[12] The OSC has since called on the TSX to review its governance guidelines in response to new rules in the US that emerged after major accounting scandals. A review of the OSC's governance with the intention to move towards best practices for securities regulators would allow the OSC to promote reforms to corporate governance by leading by example.

In its executive summary, the Crawford Report noted, "Canada competes with other jurisdictions around the world for capital and investment opportunities. Our regulatory regime must be part of our competitive advantage. This requires that our regulators be able to operate efficiently and that our regulatory requirements not be more onerous than those existing in other jurisdictions (particularly the United States), except as may be required to satisfy our public policy objectives (Crawford, 2002)." In a similar vein, the quality of the governance of a regulator contributes towards the competitiveness of a jurisdiction's capital markets. It helps assure market participants that regulatory powers will be used in a reasonable manner and regulatory resources will be used efficiently. In addition, it provides market participants with some assurance that regulatory requirements will continue to be consistent with their preferences.

Finally, a thorough review of governance could help address concerns that have been raised in the past on the use of public interest powers, which permit the OSC to make disciplinary orders, even when no rule, regulation, or law has been broken.

Prior to the introduction of rule-making powers, the OSC came under fire for its use of public interest powers to enforce compliance with non-statutory instruments such as policy statements and blanket orders. Policy statements, which added substantive requirements to what was contained in the OSA and regulations, in many cases exceeded the Lieutenant-Governor's power to make regulations, and some even contradicted the OSA or regulations (MacIntosh, 1994-1995). In 1993, a policy statement concerning penny stock dealers was struck down by an Ontario Court, on the basis that that the OSC was acting outside its jurisdiction (MacIntosh, 1994-1995). Subsequent to the decision, the OSA was provided with rule-making powers, and it engaged in a reformulation process to determine which of its policy instruments needed to be reworded, or converted into a rule or regulation.

More recently, a number of commentators have criticized the OSC for the way in which it exercises its public interest powers in conjunction with making settlements. Technically, the commission is responsible for determining whether or not conduct is contrary to the public interest after holding a hearing process on a staff allegation. However, in practice, market participants generally settle to minimize the adverse consequences of the allegation. As a senior litigator noted in a newspaper editorial, "When enforcement staff asks the commission to exercise its public interest jurisdiction in relation to specific violations of securities laws, there is a reasonable degree of certainty and predictability in the proceedings. The same cannot be said of staff proceedings in cases where there are no specific alleged violations of securities laws, on the basis that staff has the view that conduct is contrary to the public interest. Subjects of investigations can end up in the invidious position of having engaged in a common practice or a previously accepted course of conduct, only to find that with the development of new or altered standards, staff now view such conduct as being contrary to the public interest. This is the heart of the problem: the unspecified or undefined aspect of the jurisdiction. Most cases will never get to a hearing, at least in part because the registrant cannot win (Leon, 2002)."

Settlement is to the OSC's advantage not only because it can avoid going through a lengthy hearing process, but it is also an opportunity to extract "a donation" to its Investor Education Fund. If a hearing is carried through to fruition, the OSC cannot order a fine. After being unsuccessful in convincing the Ontario legislature to provide it with the power to order fines, the OSC simply assumed this jurisdiction through the settlement process (MacIntosh, 2001). Individuals and companies facing allegations are amenable to the settlement process to avoid the tribunal process and the accompanying publicity. While policy-makers have generally turned a blind eye to the issues associated with the OSC's use of its public interest powers, market participants will inevitably be discouraged from participating in Ontario's capital markets if it is clear that checks and balances on the use of public interest power are inadequate.

Finally, a review of governance could explore the need for better financial accountability. In addition to rising overall expenditures, salaries have also been increasing significantly. After converting to a Crown corporation, the number of staff with salaries in excess of $100,000 escalated sharply from 2 in 1996 to 64 in 2000 (Chant and Mohindra, 2001). More recent figures indicate that in 2001, the number reached 80. A comparison of the salaries for the chair, vice-chairs, and senior management at the OSC with public positions of similar responsibility suggests OSC salaries are relatively high (Chant and Mohindra, 2001). For example, the OSC chair earns well over double the salary of the SEC's chairman. While salary levels may reflect market conditions, particularly for specialized staff, it is important that adequate checks are in place to ensure this is the case. More generally, it is important to have solid

oversight over all significant expenditures. For most government organizations, politicians serve as an effective check on expenditures because of their responsibility for raising money (through taxation) as well as spending, whereas officials are only responsible for spending (Downs, 1967). For a self-funding agency that relies on neither appropriations nor voluntary contributions for funding, careful consideration needs to be given on how external monitoring can be integrated into financial oversight.

Conclusions

Lessons for the OSC

The international comparison of governance structures for securities regulators in this paper was by no means exhaustive. It covered only four regulators from four jurisdictions. However, it shows that should policy-makers in Ontario choose to review the OSC's governance structure, they can learn important lessons by examining practices in other countries.

First, the OSC can take steps itself. The OSC could include in its annual report a section on governance that would describe its own governance practices, and include reports from committees, such as the Corporate Governance and Nominating Committee, on the discharge of its functions. The Compensation Committee could report on how it evaluates performance and links it with compensation, which is something Canadian securities regulators are placing more emphasis on with public companies. It could follow ASIC's practice on reporting on public complaints against itself. In either its annual report or its Statement of Priorities, the OSC could report on how its past performance has measured up against its past objectives. And it could take its responsibility to assess the costs and benefits of any new regulatory proposals more seriously, as recommended in the Crawford Report. This could include adopting the regulatory impact assessment techniques commonly used in the UK.

Second, within the existing government framework, the Ontario government could be more active in overseeing the OSC. The minister could take up the Standing Committee on Government Agency's recommendation to ask the provincial auditor to undertake an efficiency examination of the OSC. In making this recommendation, the standing committee noted in its report that while in some cases the committee's resources have been adequate to undertake comprehensive reviews, there are instances where an agency is large and complex with respect to its assigned public responsibilities, in which case the committee should be able to draw on the resources of the provincial auditor. Given the length of time since the last review, and the fact that the OSC is much larger and now operates under financial independence, the case for initiating an efficiency audit is strong.[13]

There are also a number of more fundamental reforms that could be undertaken through the five-year legislative review that would significantly improve the OSC's governance. A more accountable structure could be established along the lines of the SFC in Hong Kong. The part-time members would have no executive or quasi-judicial responsibilities and thus would strictly function as independent board members. These members could form a sub-committee, similar to that which exists within the Financial Services Authority, charged with reporting on the OSC's execution of its responsibilities. In such a struc-

ture, administrative powers would be placed in the hands of a regulatory committee that would be operationally independent of both commission and staff.

In this structure, it would be possible to ensure that hearing panels would consist entirely of individuals with appropriate legal backgrounds and litigation experience. Should the amalgamation of the OSC with FSCO proceed, this structure would make even more sense given that the new entity would be larger, more complex, and would need to deal with a wider range of regulatory decisions.

The statutory Financial Disclosure Advisory Board currently reports to the commission at the commission's request. From a governance context, it is difficult to see the usefulness of a statutory board with this role given that the OSC has the ability to set up its own advisory committees. Consideration should be given to abolishing the committee. Alternatively, it could be structured so that a committee member independent of the OSC could be chosen to serve as the convener.

Lessons for other Canadian regulators

To keep this study succinct, only the largest of Canada's 13 securities regulators was included. The other Canadian regulators differ in structure, powers, responsibilities, and size. Nevertheless, policy-makers from all jurisdictions should look into what insights can be drawn from governance practices in other countries, particularly in jurisdictions where there are currently proposals to expand the regulators' administrative powers. As the provincial and territorial securities regulators vary in size and responsibilities, the costs and benefits of any specific reform to governance will vary.

Notes

[1]Macey, Johnathan (1995), p. 549, citing A. Dale Tussing, "The Case for Bank Failure," *Journal of Law and Economics* 10, 129 (1967).

[2]The OSC also has responsibilities under other Ontario legislation, such as the *Commodity Futures Act*.

[3]Under the *Act* there is also a Financial Disclosure Advisory Board to advise the commission, at the commission's request, on the financial disclosure requirements of Ontario securities law.

[4]Despite the *Freedom of Information and Protection of Privacy Act*, the OSA allows the OSC to exchange information with other regulators, law enforcement bodies, and self-regulatory organizations. Any information received is exempt from disclosure if the commission determines the information should remain in confidence.

[5]Under this act, unresolved public complaints against OSC staff can be investigated by the Ontario Ombudsman Office. According to the 2000/2001 Ontario Ombudsman annual report, 3 complaints against the OSC were dealt with by the office.

[6]In response to a Senate Committee recommendation, the commission now includes in its annual report the number of complaints received against staff members, and the outcome of internal inquires in response to those complaints. Complainants that are not satisfied with the outcome of ASIC's internal investigation can take their complaints to an ombuds office called the Commonwealth Ombudsman.

[7]The generally accepted principles are in the Combined Code of the Committee on Corporate Governance published in 1998, which have been appended to, but do not form part of, the UK listing rules for public companies.

[8]The chief executive is the title of the head of Hong Kong's local government.

[9]The commission has not requested a grant for the past ten years.

[10]The Hong Kong Administration has commissioned a review of the pay structure of statutory bodies including the SFC.

[11]While rules are subject to ministerial approval, it would be very difficult in practice for the minister to reject or return for further consideration a rule that has been agreed upon by all thirteen members of the CSA. Harmonization is a defined objective of the CSA, and such as action would place Ontario out of step with a harmonized rule across the rest of the country.

[12]David Brown (March 7 2002). "Preventing Enron North: Improving Financial Reporting and Corporate Governance in Canada" Digital document available at *http://www.osc.gov.on.ca/en/About/News/Speeches/spch_20020307_conf-board-enron.htm*

[13]The BCSC currently engages an independent auditor to examine risk management and ongoing administrative simplification.

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Acknowledgments

The author wishes to thank A. Michael Andrews and Roy Wares for their comments and suggestions. The author wishes to express appreciation to Susan Wolburgh Jenah and Helen Graham for providing some clarifications of the OSC's governance. The author also wishes to express appreciation to the Committees Branch of the Legislative Assembly of Ontario, the Hong Kong Securities and Futures Commission, and the Australian Securities and Investment Commission for providing helpful responses to information requests. The author, of course, takes full responsibility for any errors and omissions.