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columns CORPORATE GOVERNANCE

A Matter of Principles

By David B. Bayless

Since the Enron implosion, along with other financial and accounting fraud cases that have emerged in the last few years, many commentators have argued that the United States' rules-based regulatory system contributed to the abuses by permitting public companies to comply with the letter of Generally Accepted Accounting Principles and Generally Accepted Auditing Standards but not their underlying principles.

Federal Reserve Board Chairman Ben Bernanke, for example, has recently called for more principles-based regulation in the United States. Interestingly, securities firms here also have affirmed their desire to shift from rules-based to principles-based regulation in part because it gives them flexibility to achieve regulatory objectives in ways that are tailored to their own businesses. Yet in an environment in which a regulator's priority is enforcement, principles-based regulation is a Pandora's box.

The essence of a principles-based regulatory system is that general principles take precedence over specific rules. This kind of regulatory regime sets forth desired outcomes but then permits the regulated financial services companies to exercise their own judgment about how best to achieve those results.

Proponents of principles-based regulation often cite the Financial Services Authority, the consolidated regulator for banks, securities firms and insurance companies in the United Kingdom. The FSA's regulatory system is structured around 11 core principles (which, as the agency repeatedly notes, add up to only 194 words) that govern both firms and individuals. The principles focus on outcomes or results as opposed to a particular manner in which these are achieved. For example, the following four FSA principles are intended to guide how regulated entities should behave:

- A firm must conduct its business with integrity.
- A firm must maintain adequate financial resources.
- A firm must observe proper standards of market conduct.
- A firm must pay due regard to the interests of its customers and treat them fairly.

All of this sounds reasonable, which is certainly one reason that principles-based regulation has attracted so much interest. But the reality is that a pure principles-based regulatory regime is not practical and, in fact, is wholly unrealistic. Even the FSA, known as a "principles-based regulator," has handed down 8,500 pages of rules and guidance aimed at interpreting those 194 words' worth of principles. In fact, the FSA admits that it "has and will always have a mixture of general principles and particular rules." And while the U.S. regulatory regime also uses a mixture of the two, the difference is that the FSA places greater reliance on general principles while U.S. regulators place more emphasis on the rules.

So why not shift to a principles-based regulatory regime in the United States? The problem lies in how a principles-based approach would operate here in the area of securities regulation. Given the structure and priorities of U.S. securities regulation, principles-based regulation would likely hurt securities firms and public companies as well as investors.

As an initial matter, the issuance of a regulation is the exercise of legal authority. If a regulation is based on principles, the regulatory agency retains the power to interpret the meaning of the regulation after the fact. The agency can then also enforce that regulation pursuant to its subsequent interpretation of the regulation. Thus, a principles-based regulatory regime is not transparent

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in terms of addressing what is or is not permitted. This makes it difficult to administer consistently over time, often leading to differences in treatment when personnel changes take place within regulatory agencies.

In contrast, if a regulation is a specific rule, the power to interpret the rule's meaning is limited. Specific rules assure that both the regulator and the regulated know what the rules permit and prohibit. As a result, despite changes in personnel in the regulator, a greater consistency of interpretation can be expected.

Further, unlike the British regulatory system that calls for simply an "appropriate degree" of investor protection, the No. 1 goal of U.S. securities regulation is investor protection. Indeed, investor protection is the most prominent justification for financial regulation in the United States. Toward that end, U.S. regulators invest substantially in their enforcement programs. The SEC's proposed fiscal year 2008 budget was approximately $905 million, with over a third of that amount, $321 million, allocated to the agency's enforcement program. In contrast, the FSA's proposed budget for the same year was $612 million, with only $76 million allocated to its enforcement program.

In a regulatory environment in which enforcement is the top priority, having clear and consistent rules, as opposed to general principles, has its benefits. Imagine that the IRS, a quintessentially rules-based regime, decided to issue a principles-based regulation that said, "All persons should pay a just and fair amount of their gross income as tax to the federal government." The IRS would control how that regulation is interpreted — what is a "just and fair" amount — and would bring enforcement actions after the fact based on its interpretation of what constitutes "just and fair." In reality, of course, the IRS issues detailed rules that are set forth in the tax code. And, while the complexity of the U.S. tax code is a real concern, the fact remains that the specific rules set forth in that code leave taxpayers with relatively clear guidance while placing limits on the IRS' enforcement authority.

Compare this to the current federal securities regulation in the United States. The Financial Industry Regulatory Authority, the non-governmental body that governs securities firms, has issued Rule 2110, which states, in its entirety, that "A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade." This is a paradigm example of a principles-based regulation and is similar to the imagined IRS regulation mentioned above. Arguably, the consensus among FINRA member firms — and certainly among the defense counsel that represent them – is that Rule 2110 has become a tool of abuse by FINRA's enforcement staff. No one knows what this rule requires firms to do or not to do. When FINRA examiners and enforcement attorneys observe conduct that they simply don't like — but which does not fit into specific prohibitions set forth in other rules — Rule 2110 becomes a catch-all enforcement hook.

In addition, principles-based regulation does not advance the goal of minimizing conduct that a regulator wants to prohibit. If FINRA, for example, promulgates a rule that prohibits certain conduct, regulated firms are then put on notice that the conduct is impermissible. The overwhelming majority of securities firms will then put into place policies and procedures to make sure that the prohibited conduct does not happen. But enforcement actions brought under Rule 2110 cannot be dealt with in this manner because such actions only inform firms after the fact that certain conduct was prohibited.

Principles-based regulation in the United States would likely hurt securities firms and public companies as well as investors.

Thus, if the goal is to prevent certain behavior, it is better to have a specific rule that addresses the particular conduct that puts everyone in the industry on notice. This will actually lead to a decrease in the conduct that the regulator is aiming to prevent.

As explained above, a critical difference between securities regulation in the United States and the United Kingdom is the enforcement perspective of each regulatory agency. Domestically, enforcement actions have historically developed as the top priority within the agencies that regulate the securities industry. Within this framework, principles-based regulation would permit a regulator to bring numerous enforcement actions for conduct that is not specifically prohibited, which would pose significant problems for a regulated entity. After all, it doesn't know what conduct or procedures are problematic until long after the fact, when the regulated entity finds itself in the middle of an enforcement investigation, perhaps for conduct that it may not even have known to be prohibited.

In sum, the real issue is not whether regulation is based on principles or rules. The issue instead is the enforcement attitude of the regulator. If the regulator's priority is enforcement (like the SEC and FINRA), then regulated firms are better off with specific rules that set forth what is and is not permitted. A principles-based regulation in the hands of a regulator whose priority is enforcement creates an impossible situation for regulated firms and provides an opportunity for abuse by the regulator. Firms in the United States should be careful about what they wish for in the ongoing debate between principles and rules. ❖