Commentary: The Perils of Principle-Based Regulation

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In recent years, the SEC has been making a move toward more "principles-based" regulation, in which regulatory guidance provides broad compliance principles and leaves regulated firms to figure out how to apply those principles to their own circumstances. This effort had been spurred, at least in part, by convergence, as the SEC has become more familiar with the International Financial Reporting Standards ("IFRS") and with the rule-making of the Financial Services Authority ("FSA") in the United Kingdom, both of which tend to be principles-based. Historically, the SEC's rule-making has been "rules-based," meaning that its regulations have tried to prescribe specific and detailed rules for reporting or other obligations.

Is principles-based regulation better than rules-based regulation? The proponents of principles-based regulation point out that it enables regulators and regulated firms to tailor regulatory obligations to specific situations, which may be unique to particular entities or industries, and which bright-line rules may fail to capture. Rules-based regulations may lead to rote or "boilerplate" responses, which fail to include the detail or specificity that properly reflects a firm's unique characteristics. Regulators cannot conceive of every possible situation that may be important to investors, especially in the context of unique companies, so specific rulemaking runs the risk of leaving out valuable information. In addition, rules-based regulation may lag behind changing circumstances, if financial innovation or market conditions cause firms to adapt quickly and promulgation of rules does not keep up with the pace of change.

However, a look at some of the FSA's enforcement actions suggests that although principles-based regulation may be better for regulators, it's not necessarily a good deal for regulated firms.

The FSA's inside information disclosure rules (the Disclosure and Transparency Rules or "DTR") is the UK's functional equivalent of the SEC's Form 8-K disclosure rules. The DTR require that, unless an exemption applies, issuers notify a regulatory information service of any inside information that directly concerns the issuer without delay. Being principles-based rules, the DTR do not detail specific events that constitute inside information or that expressly require disclosure. Rather, inside information is broadly defined as information that would likely be used by a reasonable investor as part of the basis for the investor's investment decision and, therefore, could have a significant effect on the price of financial instruments. The FSA's only additional guidance is a non-exhaustive list of items

that the FSA believes are "likely to be considered relevant to a reasonable investor's decision." Even that guidance is fairly general and broad, including such items as "information which affects the assets and liabilities of an issuer."

By contrast, the SEC's Form 8-K is much more specific. Issuers must report events specified on Form 8-K within 4 business days (or sooner, depending on the event). Form 8-K divides the reporting events into eight distinct categories, which are further broken down into specific items. For example, the category for events that concern an issuer's business and operations are broken down into specific items, which include entry into or termination of a material definitive agreement; the category for events that concern an issuer's financial information includes the completion of an acquisition and the disposition of a significant amount of assets; and Item 5.02 of Form 8-K requires that an issuer disclose the election or departure of certain specified officers.

It seems that issuers often struggle with the principles-based approach of the DTR. The FSA recently fined Wolfson Microelectronics plc £140,000 for failing to promptly disclose inside information that the FSA believed was required to be disclosed under the DTR. One of Wolfson's customers notified Wolfson that it wanted to terminate its supply contract for two products Wolfson supplied, but at the same time, the customer also informed Wolfson that it intended to increase its order for a different product. Wolfson delayed disclosure for 16 days while it evaluated whether disclosing the terminations was necessary, because Wolfson believed that the customer's increased orders would more than offset the adverse consequences of the terminations. After it eventually disclosed the information, Wolfson's share price dropped significantly. With the benefit of hindsight, it was relatively easy for the FSA to decide that the disclosure was material and, therefore, that it ought to have been made more promptly.

In 2004, the FSA encountered a similar situation where Universal Salvage plc did not report the termination of a major contract. Universal evaluated the financial impact of the termination in light of efforts it intended to take to save costs. The company decided not to report the termination because it believed the overall effect on the company would not be significant. The FSA fined Universal £100,000.

Under the DTR's broad principles-based regulations, Wolfson and Universal Salvage were left to their own judgment to evaluate the impact of important events on the companies' financial prospects and to guess, with little specific guidance, whether that impact would be relevant to investors. However, the FSA had an opportunity to second-guess their judgment, and fines resulted when the FSA decided that the companies guessed wrong (or, in Wolfson's case, that it took too long to deliberate the question). This creates a kind of "gotcha" enforcement, where the regulator can determine, with the luxury of hindsight, whether the

regulated firm properly interpreted and applied the principles to its particular circumstances.

Under the SEC's rules-based regulations, the termination of a supply contract is clearly required to be reported and there would have been no guesswork in determining whether disclosure was required. Moreover, there would have been no question of exactly when that disclosure was required to be made. Wolfson and Universal might have chafed under the burden of a lot of detailed rules, but they would at least have known what disclosure was required and would not have been as vulnerable to the "gotcha" enforcement action.

Thus, we see why principles-based regulation is better for regulators: with rules-based regulation, the burden is on the regulators to identify, in advance, what they want regulated firms to do; but with principles-based regulation, the burden shifts to the regulated firms to figure out what the regulators are likely to want. And with principles-based regulation, the regulators also get the hindsight advantage.

Issuers also are struggling with some of the SEC's new principles-based rules. In the last few years, the SEC has been phasing in a principles-based regulation in its executive compensation disclosure rules. In December of 2007, the SEC reviewed executive compensation disclosure of 350 randomly selected public companies and found that the majority of the companies did not provide adequate disclosure. The SEC published additional guidance regarding the nature of the disclosure it was seeking, but still refrained from prescribing specific disclosure rules. A year later, it did not seem as if disclosure had improved: in October 2008, John White, then the director of the SEC's Division of Corporate Finance said of executive compensation disclosure, "Last year the title of my remarks was 'Where's the Analysis?' and this year, in far too many instances, we're still looking."

Over the years, the FSA and the SEC can be expected to continue to issue more guidance on their principles-based regulations, and a developing history of enforcement actions will provide additional guidance for regulated firms who seek to avoid the problems that have befallen others. The system could develop much like the common law, where guidance is not prescribed through legislated rules, but rather through an accumulated body of precedent. However, that takes time. It's also costly, because lawyers and accountants must be hired to research and evaluate past precedent and to render professional opinions as to its applicability to the particular facts at hand.

In the meanwhile, without clear rules, if a principles-based regulator is so inclined, it can swoop in and say "gotcha." We may be treated to the spectacle of regulated firms begging for more—or at least more detailed—regulation.