



Rules v. Principles as Approaches to Financial Market Regulation

Responding to John H. Walsh, *Institution-Based Financial Regulation: A Third Paradigm*, 49 HARV. INT'L L.J. 381 (2008).

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As the global economic recession deepens, the structure of financial institutions and the legal principles that they apply are of primary concern to investors. One aspect of the legal debate has focused on whether financial market regulation should be based on principles or rules. Generally, principles-based regulation refers to a broad set of standards that gesture in the direction of certain desired outcomes. These standards may be accompanied by guidelines about how to achieve the outcomes. By contrast, rules-based regulation is, as the name implies, based on a set of detailed rules that govern firms' behavior. Such rules enable firms to “tick-the-box” to guarantee compliance with law.

Another possibility—institution-based financial regulation—has recently been proposed by John Walsh as an alternative to rules and principles.¹ This approach appears to have two parts. First, the approach refers to offices that firms are legally mandated to establish. For example, the Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA) require firms to establish certain offices and structures (the “institutions” to which Walsh refers) such as the Chief Compliance Officer, compliance policies and procedures, and annual self-assessments. Second, these firms will by necessity have firm-specific *modus operandi* or ways of functioning. The institutional approach provides them with flexibility in terms of how the required structures evolve and operate within the organization.

¹ John H. Walsh, *Institution-Based Financial Regulation: A Third Paradigm*, 49 HARV. INT'L L.J. 381 (2008). Walsh does not provide an explicit definition of this approach.

In this comment, I challenge the idea that institution-based financial regulation is a third paradigm within the principles-rules debate. Firms by nature utilize their discretion with regards to the way in which either principles or rules are implemented. Under principles-based regimes in particular, firms develop their own mechanisms to comply with the overarching legal regime within which they operate. They seek to adhere to the outcome advocated under the stated principles by utilizing policies and practices that they craft themselves. Thus, institution-based regulation appears to be simply another iteration of principles-based regulation rather than a “third paradigm.”²

To begin, we should recognize that principles versus rules itself is a debate that has a narrow scope and has perhaps been given more emphasis than it warrants. While the choice between principles or rules suggests a unified approach to regulation in either case, the reality is that common law legal regimes are comprised of both principles and rules. Some may say that this general point is not especially relevant to financial market regulation, an area dominated by statute. But in financial markets law, the statutory regimes contain both rules (for example, specifying how long I must hold on to my restricted securities before I resell them³) and principles (for example, in connection with purchases or sales of securities, it is unlawful under the anti-fraud principles for persons “to employ any device, scheme, or artifice to defraud”⁴). Given the prevalence of both rules and principles in the law, the debate seems somewhat unwarranted and certainly undermines the commonly-held notion that U.S. financial regulation is solely rules-based.

In containing both rules and principles, financial market regulation provides varying degrees of information to firms to decide how they wish to ensure compliance. While rules are very specific, principles tend to focus primarily on outcomes and provide firms with less information with regards to how to achieve those outcomes. In the anti-fraud situation, for example, firms may establish insider trading policies with blackout periods and monitoring mechanisms; the law does not mandate such policies or practices, however.⁵ Relatively less information regarding the means of compliance is a central characteristic of principles-based regulation and seems to be a central tenet of the institution-based approach as well.

When one begins to probe the practicalities of the institution-based approach, the line between it and principles-based regulation becomes fuzzier. First, both are based on standards that call for clarification to guide those who seek to comply with them.⁶ Second, both underscore the relevance of “soft law,” i.e., the non-mandatory policies,

² Admittedly, it may also be conceived as an element of the rules-based approach since, although it does not specify particular decision by firms, it does require a certain type of action in which case the institution-based approach is perhaps a hybrid of the two.

³ See 17 C.F.R. § 230.144A (2008).

⁴ 17 C.F.R. § 240.10b-5 (2008).

⁵ Laura Nyantung Beny and Anita I. Anand, *Private Regulation of Insider Trading in the Shadow of Lax Public Enforcement (and a Strong Neighbor): Evidence from Canadian Firms*, U. Michigan Law Sch. Law & Economics Research Paper Series, Olin Working Paper No. 07-019, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1013482.

⁶ See Louis Kaplow, *Rules and Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992).

best practices and interpretive statements that administrative bodies issue to assist firms in complying with the broad principles set out by statutory law. Firms draw on this guidance in crafting their methods of compliance. In the context of Walsh's argument, soft law has been issued with regards to the nature of the COO position and the characteristics of individuals who should fill this position.⁷

Soft law issued by financial market regulators is used to fill gaps that necessarily exist when a principles-based approach is adopted. Importantly, soft law is non-binding and is issued *ex ante* at the regulator's initiative, unlike binding decisions issued *ex post* as a response to requests for relief from strict compliance. When regulators issue guidance and other forms of soft law, they seek to present explanations about how firms can comply with the principles underlying the regulatory regime. They may also be responding to firms' desire for details that are not typically present in principles-based regulation. As a practical matter, the SEC and FINRA as well as the Financial Services Authority in the United Kingdom (a body that has explicitly adopted a principles-based approach) provide voluminous guidance to market participants.

The centrality of soft law in the institution-based approach to financial markets regulation compels us to ask again why and how the institution-based approach is any different from principles-based regulation. Both operate on principles and the prescriptive outcomes that principles seek to achieve. Both rely on the idea that the law *per se* should set out no more than basic legal parameters within which firms will operate and both intend for firms to give effect to these parameters within the context of their businesses and capabilities.⁸

Rather than getting caught up in the formalistic categories of rules versus principles,⁹ we would do well to focus on a key consideration motivating the adoption of either approach: costs and in particular "the relative size of the various costs associated with the formulation and enforcement of legal norms."¹⁰ Rules contain more information for parties and therefore guide their conduct *ex ante* whereas principles require adjudicators or regulators to undertake this effort *ex post*.¹¹ Thus, *ex ante*, legislators bear the costs of identifying the eventualities and circumstances to which a rule applies, whereas *ex post*, in the case of principles, judges and other adjudicators will bear costs in lawsuits that come before them because of lack of certainty.¹²

⁷ See Walsh, *supra* note 1, at 391.

⁸ Along these lines, Walsh's description of institutions-based regulation bears a resemblance to the FSA's principle-based regulation document in terms of their respective foundational concepts. See FINANCIAL SERVICES AUTHORITY, PRINCIPLES-BASED REGULATION: FOCUSING ON THE OUTCOMES THAT MATTER (2007).

⁹ See Daniel Awrey, *Principles, Prescriptions and Polemics: Regulating Conflicts of Interest in the Canadian Investment Fund Industry*, 32 DALHOUSIE L.J. (forthcoming 2009).

¹⁰ Hans-Bernd Schaefer, *Legal Rules and Standards*, in THE ENCYCLOPEDIA OF PUBLIC CHOICE 347, 347 (Charles K. Rowley & Friedrich Schneider eds., 2003).

¹¹ *Id.*

¹² This argument derives from Kaplow, *supra* note 6.

Kaplow refers to costs that arise because of the absence of information in principles as “costs of inquiry.” Such costs are relevant at both the promulgation and enforcement stages, though maybe less in the latter case given that only one specific set of facts needs to be examined.¹³ These costs of inquiry are central to the decision about whether to adopt a rules-based or principles-based approach.

Admittedly, it is not immediately clear at which stage costs are greater. However, it is certain that differing costs arise because of the amount of information contained in rules (i.e. more information) versus principles (i.e. less information). The question that emerges in a review of Walsh’s analysis is: to what extent do the “institutional” requirements to which he refers affect the costs analysis? Walsh does not directly address the cost issue involved in his proposal, but he does imply that regulatory commentary and guidance serve to bridge the information gap *ex ante*.¹⁴ In other words, soft law reduces costs by providing information to the parties about details relating to compliance.

But the information gap is not completely closed as a result of this soft law. Guidelines, policy statements, companion policies and the like do not have the force of law; unlike statutory law, they have not endured the legislative process.¹⁵ The guidance is informative but not legally determinative.¹⁶ Soft law cannot therefore be said to bridge the information gap completely. We must do more thinking about the trade-offs, and particularly the trade-offs relating to costs and information, in a rules vs. principles approach before sanctioning either.

In sum, so-called institution-based regulation does not stand alone as a third alternative in the rules versus principles debate. Rather, it is the principles-based approach recast in the practicalities of a regulatory regime in which guidance and interpretive statements are common elements. When we think of the substance of financial market regulation, the rules versus principles categorization does not take us far. Without further analysis regarding the impact of information deficiencies and costs, choosing one or the other does not necessarily lead to better regulation. What are the costs of providing the information to market participants *ex ante* and *ex post*? Who should bear these costs and at what stage should they be borne? What are those costs of error?

Thus, there is a normative aspect to the discussion. It may be the case that certain aspects of financial market regulation are better dealt with through principles or standards whereas others call out for details *ex ante*. Appropriately resolving this tension will depend to some extent on the severity of the repercussions in case of breach and the prevalence of the activity being addressed. In other words, what type

¹³ *Id.* at 583–84.

¹⁴ Walsh *supra* note 1, at 389–90.

¹⁵ Even Walsh admits that the SEC is careful to indicate as much. *See* Brief of the Securities and Exchange Commission, Respondent at 37–44, *DH2, Inc. v. S.E.C.*, 422 F.3d 591 (7th Cir. Sept 24, 2004) (Nos. 04-2242, 04-2487), *cited in* Walsh, *supra* note 1, at 389. In Canada, this issue was decided in *Ainsley Financial Corp. v. Ontario Securities Commission*, 14 O.R. (3d) 280 [1993] O.J. No. 1830 Action No. 92-CQ-26469 Ontario Court (General Division).

¹⁶ By contrast, advance judgments that respond to a particular request made by an issuer are legally determinative, at least within the factual circumstances of the issuers that receive them.

of message does the regulator seek to send? Detailed prescriptions about prohibited activity may be more effective in curbing the particular conduct at issue.

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