



## Fad or Reform: Can Principles-Based Regulation Work in the United States?

By Peter J. Wallison

*The idea that accounting and regulation could be “principles-based” rather than “rules-based” began with the Enron debacle and has been fostered by the example of Britain’s Financial Services Authority (FSA), which advertises itself as a principles-based regulator and which has been successful in attracting financial activity to London. While attractive in concept, principles-based regulation and accounting would be difficult to reconcile with many features of the U.S. political and regulatory systems. These issues should be considered before policymakers and others spend more time on the concept. If principles-based regulation does not work in our current financial system, prudential and risk-based regulation—two different concepts frequently confused with principles-based regulation—may be worth pursuing.*

Following the Enron debacle, many commentators argued that the rules-based accounting system in the United States had provided a road map for abuse. A better system, it was said, would be principles-based, allowing auditors to override a rules-based outcome if it seemed to produce an unreasonable result. The ideas underlying principles-based accounting then spread to regulation, especially in light of the success of the FSA—the United Kingdom’s consolidated regulator of banks, securities firms, and insurance companies—in attracting financial activity to London with a regulatory regime that the agency describes as substantially principles-based. According to the FSA, a principles-based regulatory regime specifies desired outcomes and allows financial services companies to chart their own paths to those results. Most recently, Federal Reserve Board chairman Ben S. Bernanke called for more principles-based and risk-focused regulation in the United States,<sup>1</sup> stimulating additional expert commentary on the subject.<sup>2</sup>

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Indeed, the principles-based idea has attracted so much attention among U.S. policymakers that it is sometimes treated as a synonym for other reforms, such as “risk-based” regulation or “prudential” regulation, two concepts that resemble principles-based regulation—and each other—only in the sense that they refer to a change in the way U.S. regulators currently behave. This *Financial Services Outlook* will attempt to define what is meant by principles-based accounting or regulation, and consider whether such systems are likely to be compatible with the U.S. regulatory and political frameworks.

### The Implications of Principles-Based Systems

For all the attention given to principles-based regulation and accounting by policymakers and commentators, there has been little effort to define what it actually means. The concept seems to have two different elements. First, there are principles that govern how the regulator behaves. For example, the FSA has published six principles that essentially outline its regulatory priorities and its approach to regulation. These include promotion

of innovation and competition, respect for management judgment, restrictions in proportion to benefits, and maintenance of a strong financial services market in London. These principles, however, apply to the regulator, not the financial services industry, and give only limited hints about how the FSA expects firms to behave. The U.S. analogue to this aspect of principles-based regulation is the recent statement by the President’s Working Group on Financial Markets, which outlined how the U.S. government and other regulators should address hedge funds, private equity groups, and other “private pools of capital.” Again, the ten principles articulated by the working group are seemingly intended to govern the actions of regulators rather than regulated firms.<sup>3</sup>

Turning to guidance for the regulated, we encounter an approach that is indeed entirely different from the rules-based regime that prevails in the United States. The FSA’s regulatory system is structured around eleven principles (only 194 words, as the agency notes) that focus on results or outcomes for regulated firms. Thus, at an AEI conference in March 2007, Ronald Gould, an FSA adviser, said:

[W]e are much more oriented towards outcomes. . . . If in fact you’re oriented primarily to achieving a desired outcome, you’re actually much less concerned with whether you’ve gotten a big fine out of someone or gotten a big newspaper headline. Instead you much prefer to ensure that your statutory obligations toward the industry and consumers are being effective in the way they’re implemented.<sup>4</sup>

Gould described principles-based regulation this way:

We have a principle that states a firm must manage conflicts of interest, both between itself and its customers and between a customer and another customer. . . . The way we do that in the context of principles is to say to senior management of firms: “Look, no one knows your business better than you do. We have a group of principles here that you need to adhere to but we are not going to give you prescriptive advice as to how to do that. You know your business. Here are the principles.”<sup>5</sup>

The principles that the FSA uses to guide the regulated industries are general and outcome-oriented. Here are four of the eleven:

- 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.<sup>6</sup>

This all sounds reasonable and attractive—and it is certainly the reason that principles-based regulation and accounting have attracted so much interest—but it has some significant implications that may not fit easily with regulatory conditions, enforcement mechanisms, and political attitudes in the United States. These issues are outlined below.

### Who Holds the Power?

When a regulatory agency such as the Financial Accounting Standards Board (FASB) or the Securities and Exchange Commission (SEC) makes a rule, it is exercising regulatory power. If the rule is principles- or outcome-based, the regulatory agency retains the power to interpret the meaning of the rule and to enforce it.

If a regulatory agency makes a detailed rule, however, it transfers a significant portion of its inherent power—the power to interpret the rule’s meaning and scope—to the regulated firm, and the more detailed the rule, the more power is transferred. A simple way to think about the difference between principles-based and rules-based systems is to consider the immensely complicated U.S. income tax system. This is a rules-based system at its most formidable, but let us suppose that the Internal Revenue Service (IRS) were to use a principles-based system in which the rule was simply that everyone should pay a fair percentage of his income. This general principle would leave the IRS in control of how the rule is interpreted and in possession of most of the power associated with the rule. It is the detailed rules of the U.S. tax code that leave taxpayers with the power to interpret the rules most favorably for themselves. Indeed, when we consider it in this light, the rules-based regulatory system takes a great deal of discretion away from government officials, and thus reflects the traditional American suspicion of unfettered government power.

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But it is not only government power that is involved. The Generally Accepted Accounting Principles (GAAP) system, as in force in the United States, appears to have two supporting pillars. First, because it is heavily rules-based, the ultimate power to interpret its meaning is left to the companies and individuals who use it rather than to the accounting professionals who are the first line of enforcement. Financial statements are prepared by management and are only audited by accounting firms. The auditor has the ability to declare when an accounting treatment does not comply with GAAP, but if the client's treatment is reasonable in relation to the GAAP rule, the auditor is essentially powerless. This fact was the source of the complaint about rules-based accounting in the Enron case. It was difficult to find that Enron had actually violated any of the GAAP rules; instead, it had used them as a road map for sham transactions that auditors and analysts could not easily penetrate. Nevertheless, most companies want to present their financial reports in a manner which they believe most accurately reflects their operating results, not as their auditors desire. Again, the rules-based system leaves the power with these ultimate users, as would be appropriate in a society wary of granting excessive power to any one group.

The second pillar supporting GAAP is that the rules specify details about how transactions are to be structured and reported, providing some limited protection for auditors against legal liability. Although this insulation has been eroded by uninformed opinion among the media and members of the political class about the nature of accountants' audit opinions,<sup>7</sup> it retains some value in allowing auditors to claim that they diligently performed the steps that good auditing requires and thus are not responsible for management's misstatements. Under a principles-based accounting system such as that advocated after the Enron scandal, the auditors would be empowered—and perhaps obliged—to intervene and override an application of accounting rules by management that reaches an unreasonable result. In doing so, however, the auditors would be taking ownership of the financial statements and would become ultimately responsible for whether these statements fairly reflect the reporting company's operating results. Such a system may work in a principles-based regulatory system, in which

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the regulator can exercise discretion in charging the auditors with dereliction. But it would be quite troublesome in the context of the current U.S. legal system, in which private class actions—which operate outside any regulatory control—could result in substantial liability for accounting firms that have exercised the authority to modify management's conclusions. An investor who sold because the auditor required a more negative disclosure than the facts warranted could have a cause of action against an accounting firm, just as could an investor who bought securities because of an excessively positive financial report. Thus, it is doubtful that U.S. auditors would want the responsibility associated with a true outcome- or principles-based system as long as the U.S. class action system continues to exist.

Accordingly, the existence of a rules-based accounting system in the United States leaves power with the firms and managements that prepare the financial statements, and withholds it from the regulators and enforcers. Again, this seems to be consistent with the traditional American view about where power should lie.

### **Fairness, Transparency, Consistency**

As noted above, the essence of a principles-based regulatory or accounting system is that the principles take precedence over the rules. No matter what the rules say, the regulator, the regulated firm, and the auditor are supposed to use their reason and judgment in support of the principle rather than invoke a wooden adherence to a rule. Regulatory or accounting decisions based on principles, however, may not always be transparent or consistent with one another, and this can have significant competitive effects. For example, a company that receives a favorable ruling from a regulatory agency about how it can or should conduct its business can have a competitive edge over companies that are not aware of the decision or are otherwise differently treated. The same is true, of course, of an accounting system. A company that receives liberal treatment from its auditor may (at least temporarily) do better in the securities market than a company whose auditor takes a conservative view. Although a general principle may have been published, the regulatory or accounting decision that accepts a particular way of doing business might be informal—

perhaps made by an examiner who observes it but raises no objection—and thus provides one company with an advantage over its competitors.

A rules-based system, on the other hand, is transparent and promotes competition by making market entry easier. Regulatory decisions based on principles can limit market entry. One recent example is Wal-Mart's effort to compete with banks by acquiring a Utah industrial loan company (ILC), a bank-like entity that can take insured deposits. Before it withdrew its application, Wal-Mart's initiative was opposed by the banking industry. Although there was no legal basis for denying Wal-Mart's application, the Federal Deposit Insurance Corporation (FDIC) adopted a one-year moratorium on approving applications for ILCs by "non-financial companies" (whatever *those* are) in order to give Congress time to enact legislation that would keep retailers like Wal-Mart from acquiring ILCs. This, of course, is competitive warfare out in the open, with an industry's regulator taking its part, but it is easy to imagine how it might have been different had the law not explicitly allowed Wal-Mart to acquire an ILC. In that case, the FDIC, under pressure from the banking industry and Congress, might simply have said that for various policy reasons—stated or unstated—it would not be appropriate for a retailer to own a bank. Making up supposed policy reasons to protect favored industries from competition is easy in a principles-based regulatory structure. In a rules-based system, it is usually true that unless a rule forbids it, an action is permitted. Because the industry's opposition was out in the open, the Wal-Mart case is an outlier, but it demonstrates how a principles-based system could be used to limit competition.<sup>8</sup>

Principles-based systems are also extremely difficult to administer consistently over time, leading to differences in treatment that can have competitive effects. Whether a particular way of doing business conforms to the principle involved can be a matter of a particular regulator's opinion, and as regulators and circumstances change, so do interpretations. An activity previously disapproved can become acceptable—and vice versa. The existence of detailed written rules assures that both the regulator and the regulated know what the rules are, despite a change in personnel on either side. In a rules-based system, if changes in technology or the market make it imperative that the rules change, a diligent regulator will change the written language of the rule through "notice and comment" rulemaking. This puts all competitors on an equal footing. In a principles-based system,

however, there may be no need to revisit the principle, even if the interpretation has changed, and some competitors may find themselves at a disadvantage if the new interpretation is not widely known or consistently applied.

## Safe Harbors from Liability and Aggressive Enforcement

The civil liability and regulatory regimes in the United States create significant obstacles to the adoption of principles-based accounting and regulatory systems. In the United States, where companies are subject to liability in private class actions in both federal and state courts, civil rule enforcement by federal and state regulators, and criminal enforcement by both the U.S. Justice Department and state attorneys general, it seems unlikely that principles-based accounting and regulation will ever be adopted. Even if state and federal officials were to act judiciously—seeking, like the FSA, compliance rather than enforcement—firms would still be subject to private class actions, over which there are no formal means of control. It is not hard to imagine a private class action exploiting the opportunities inherent in the FSA's outcome-based principles of firm behavior.

In this context, the most pronounced deficiency of a principles-based system is the extreme legal vulnerability it creates for regulated firms. It is important to recognize that Britain affords a completely different enforcement environment. There is a sole consolidated regulator, the FSA; there is no state or local regulatory enforcement; and there are no private class actions. The FSA follows prudential and risk-based enforcement policies that—at the moment—are unimaginable in the United States. In a prudential enforcement system, the objective of the regulator is not enforcement, but compliance. What is the difference? According to FSA adviser Gould, when the regulator seeks compliance, it is not interested in exacting penalties from regulated firms, but simply in instilling an understanding of their obligations. Imagine the outcry if the SEC adopted such a policy, at least without substantial reform of the securities laws by Congress. When the FSA does engage in enforcement, it follows a risk-based policy. This means that it does not undertake enforcement for minor matters, but only in cases in which it believes a significant principle is at stake or in which the firm or firms involved are taking or have taken risks that threaten the stability of the industry or the market. If a consumer has been mistreated, the FSA may

not pursue an enforcement action if it is not cost-effective. A U.S. enforcement policy of this kind is not likely to withstand pressure from Congress and the media.

As noted on page 3, however, a rule-based system such as GAAP provides at least some protection against liability. If a rule is highly detailed, it begins to assume the characteristics of a “safe harbor” because it confers on the regulated party the power to avoid liability or prosecution by following the road map provided by the rule.

## Convergence of Accounting Standards

For the past several years, the FASB and the International Accounting Standards Board have been working to converge GAAP with International Financial Reporting Standards (IFRS), another financial reporting system used in many developed countries. IFRS is said to be a principles-based system, and there is some concern outside the United States that convergence will push IFRS closer to the U.S. rules-based system. The greater concern, however, should be that the U.S. private class action system, for the reasons already outlined, is inconsistent with principles-based accounting.

As a result, even if companies that report their financial results in IFRS are ultimately able to use IFRS in the United States, they will not want to do so because of the liabilities it will entail for their auditors. It will be a great advance if—as a result of the mutual recognition system currently under consideration—U.S. companies are able to issue their securities in the global capital markets using GAAP, but it appears unlikely that non-U.S. companies will be able to use IFRS in the United States until our liability system is reformed. Whether other countries will grant this access to their markets—if there is no practical access to U.S. securities markets for companies stating their financial reports in IFRS—remains to be seen.

## The Size of the Regulated Market

Finally, although there are many reasons to believe that principles-based regulation would not work in the United States, the number of regulated entities is not one of them. The FSA manages to regulate about 30,000 individual firms in Britain, close to the number of banks, securities firms, investment companies, investment

advisory firms, and insurance companies in the United States. This suggests that even if the United States cannot adopt principles-based regulation, it might be possible to adopt two other concepts that are part of the FSA’s regulatory regime: prudential and risk-based regulation.

In a prudential regulatory system, the regulator does not focus on enforcement, but on compliance. This means that when the regulator finds a rules violation, its first instinct is not prosecution, but rather counseling or guidance—a regime that bears some resemblance to how U.S. bank regulators oversee banks. The objective is to make sure that the regulated firm understands the regulator’s policies, not to make it an example for the rest of the regulated industry. The benefits of a prudential system are that regulated firms are more willing to disclose problems or violations to regulators and institute voluntary fixes

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with the regulator’s guidance. In the more adversarial U.S. system, disclosure of a violation to the regulator may invite an enforcement action and adverse publicity.

Although it seems that a prudential approach would involve higher personnel costs, the FSA pursues this strategy with only about 4,000 employees, compared to 30,000 in the United States (the latter figure includes only those who are involved in the regulation of banks and securities firms). One of the reasons for this vast discrepancy is likely to be the fact that there are *four* different banking regulators at the federal level in the United States. Because of the way the FSA is organized, it is not

possible to break out the securities component of that agency, but the FSA’s total staff for all its regulatory activities in the financial services field is smaller than the combined staffs of the SEC and the National Association of Securities Dealers (NASD), which together have about 7,500 employees for securities regulation alone. Part of the reason for this may be the man-hours that both the SEC and the NASD spend on enforcement activities. The discrepancy in securities enforcement activities between the United States and Britain is quite large. From 1997 to 2001, the SEC and the NASD brought 10,641 enforcement actions, while the FSA brought 758. Adjusting for the different size of the capital markets, the figure for the FSA would have been only 3,319.<sup>9</sup>

In addition to its reliance on prudential regulation, one of the key reasons why UK enforcement levels are lower

may be the FSA's use of risk-based regulation. Thus, because one of the FSA's responsibilities is to protect against systemic risk, the agency spends much of its resources on supervising the largest firms in Britain—the firms in which financial difficulties could have systemic effects. But this approach in “the area of safety and soundness” is manifested in the consumer protection sector by adherence to a cost-effective or cost-benefit standard for enforcement. The agency will not spend its resources on a consumer protection matter if the benefits will not outweigh the costs. As a result, a substantial part of the FSA's activities is devoted to ombudsman-like functions, which take consumer complaints and work out settlements.<sup>10</sup> Thus, while principles-based regulation seems exceedingly unlikely to be adopted by or for U.S. regulators, the adoption of some form of prudential and risk-based regulation—while difficult—may be possible.

## Necessary Reforms

The most important obstacle to the adoption of a principles-based regulatory or accounting system in the United States is the traditional American desire to diversify power and authority. Americans simply feel more comfortable when they can exercise the discretionary judgments that affect their lives and livelihoods. When they must function under regulation, they want to understand the precise scope of that regime.

Even if these attitudes could be overcome, a principles-based system would be precluded by the existence of the private class action litigation system. A principles-based regime depends for its effectiveness on a government regulator that is able to exercise discretion in deciding whether to enforce the rules through litigation or to obtain compliance through less formal means. The characteristic element of a private class action enforcement system, however, is that it operates outside any form of government control or priority-setting except the rules laid down by courts. As detailed in this year's March *Financial Services Outlook*, there is virtually no sound policy reason for retaining the private class action. The enforcement of SEC Rule 10b-5 can be done solely by the SEC itself, as originally intended by Congress when it passed the Securities Exchange Act of 1934.<sup>11</sup> If policymakers continue to look toward the adoption of a principles-based regulatory or accounting regime, the securities class action system will have to be ended.

A thornier question is one of local or state enforcement of securities laws by district attorneys or state attorneys

general. Given the boost such actions can give to political ambitions, they are virtually impossible to stop, and they pose a serious obstacle to a principles-based system. The obvious step to address this problem would be to preempt state or local enforcement of securities laws. This is not as radical an idea as it may seem. Congress has repeatedly called for the SEC to recognize a national securities market in the United States and to foster such a market by regulation, although Congress has never explicitly called for the preemption of state and local securities enforcement. If the United States is to participate in a global capital market in the future, or if a principles-based regulatory regime seems desirable, preemption of state securities law enforcement may be required.<sup>12</sup> The elimination of the private class action system and preemption of state and local enforcement would open the way for a prudential and risk-based regulatory regime at the federal level, and would make U.S. public securities markets far more hospitable to the growing global capital market.

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*AEI research assistant Daniel Geary and editorial assistant Evan Sparks worked with Mr. Wallison to edit and produce this Financial Services Outlook.*

## Notes

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3. President's Working Group on Financial Markets, “Agreement among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital,” February 22, 2007, available at [www.treasury.gov/press/releases/reports/hp272\\_principles.pdf](http://www.treasury.gov/press/releases/reports/hp272_principles.pdf) (accessed June 7, 2007).
4. Ronald Gould, “Financial Regulation—Flattering Misperceptions” (conference presentation, AEI, March 29, 2007), available through [www.aei.org/event1483/](http://www.aei.org/event1483/).
5. *Ibid.*
6. UK Financial Services Authority, “The FSA Publishes Response Paper on Principles for Business,” news release, December 10, 1999, available at [www.fsa.gov.uk/Pages/Library/Communication/PR/1999/099.shtml](http://www.fsa.gov.uk/Pages/Library/Communication/PR/1999/099.shtml) (accessed June 7, 2007).
7. See Peter J. Wallison, “Hostages to Fortune: A Change in the Audit Certification Can Reduce Auditors' Risks,” *Financial Services Outlook* (April 2007), available at [www.aei.org/publication/25915/](http://www.aei.org/publication/25915/).

8. For further discussion of the Wal-Mart case, see Peter J. Wallison, "Is Wal-Mart Leaving the Money Business? Don't Bank on It," American.com, March 19, 2007, available at [www.aei.org/publication25805/](http://www.aei.org/publication25805/); and Peter J. Wallison, "The Wal-Bank Principle," *On the Issues*, May 9, 2006, available at [www.aei.org/publication24350/](http://www.aei.org/publication24350/).

9. Howell E. Jackson, "An American Perspective on the U.K. Financial Services Authority: Politics, Goals & Regulatory Intensity" (discussion paper 522; John M. Olin Center for Law, Economics, and Business; Harvard University; Cambridge, MA; August 2005), available through [www.law.harvard.edu/programs/olin\\_center/papers/522\\_Jackson.php](http://www.law.harvard.edu/programs/olin_center/papers/522_Jackson.php) (accessed June 7, 2007).

10. Howell E. Jackson, "An American Perspective on the FSA: Politics, Goals & Regulatory Intensity" (conference presentation, AEI, March 29, 2007), available through [www.aei.org/event1483/](http://www.aei.org/event1483/).

11. See Peter J. Wallison, "The Sorcerer, the Apprentice and the Broom: What to Do about Private Securities Class Actions," *Financial Services Outlook* (March 2007), available at [www.aei.org/publication25728/](http://www.aei.org/publication25728/).

12. See Hal S. Scott, "Federalism and Financial Regulation," in *Federal Preemption: States' Powers, National Interests*, ed. Richard A. Epstein and Michael S. Greve (Washington, DC: AEI Press, 2007), 148-52, available through [www.aei.org/book885/](http://www.aei.org/book885/).