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### A Prescription to Retire the Rhetoric of "Principles-Based Systems" in Corporate Law, Securities Regulation and Accounting

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**A PRESCRIPTION TO RETIRE  
THE RHETORIC OF “PRINCIPLES-BASED SYSTEMS” IN  
CORPORATE LAW, SECURITIES REGULATION AND ACCOUNTING**

*Lawrence A. Cunningham*\*

60 VANDERBILT LAW REVIEW \_\_\_\_ (Oct.-Nov. 2007)

Abstract

*This Article corrects widespread misconception about whether complex regulatory systems can be fairly described as either “rules-based” or “principles-based” (also called “standards-based”). Promiscuous use of these labels has proliferated in the years since the implosion of Enron Corp., with users exhibiting an increasing habit of celebrating systems dubbed principles-based and scorning those called rules-based. While the concepts of rules and principles (or standards) are useful to classify individual provisions, they are not scalable to the level of complex regulatory systems. The Article uses examples from corporate law, securities regulation and accounting to illustrate this problematic phenomenon. To describe or design systems as principles-based or rules-based, analysis must account for the application and interaction of all provisions. Once these features are accounted for, the labels become facile. The Article thus concludes that it is neither possible nor desirable to fashion such systems to be “principles-based” or “rules-based” and that such misleading labels should be retired.*

*The Article then explores why the rhetoric extolling “principles-based systems” is flourishing. It considers three hypotheses: (1) a regulatory emphasis on discretionary enforcement to induce cautious compliance, (2) a quest to rejuvenate ethical principles in the practice of corporate law, securities regulation and accounting and (3) a deflective political strategy in jurisdictional competition to signal product differentiation. The first and second hypotheses are credible but suffer from both descriptive and normative weaknesses, including how they can backfire by leading to overzealous enforcement. The third is the strongest descriptively but is most troubling normatively. Political effort to differentiate regulatory products using these labels is a form of misleading advertising. This deflection not only underscores the need to retire these labels, it also reveals a routinely overlooked limitation of jurisdictional competition in corporate law, securities regulation and accounting.*

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*Lawrence A. Cunningham*

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## INTRODUCTION

Many people seem to believe that legal or accounting systems can be either “rules-based” or “principles-based.”<sup>1</sup> The numerous debacles epitomized by Enron Corp. drew worldwide attention to these labels. Many attributed the debacles to weaknesses in the United States accounting system, which they classified as “rules-based.”<sup>2</sup> The Sarbanes-Oxley Act directed the Securities and Exchange Commission (SEC) to study this claim.<sup>3</sup> Within and outside the United States, policymakers seize on these categories to self-classify their legal and accounting systems and use these labels as grounds for promotion, reform or prescription.<sup>4</sup> This Article contends that this regulatory enthusiasm for analysis positioned across the rules/principles axis is misplaced.

These classifications are too crude to describe or guide the design of corporate law, securities regulation or accounting systems. Inquiry concerning the nature of rules and principles demonstrates how these labels invariably require sorting individual legal or accounting provisions onto a continuum rather than precisely fitting them into the categories. Describing a system as principles-based or rules-based would require not only an inventory of all its provisions along that continuum but also account for how they are applied and how they interact. Within large complex regulatory systems, assessment of the application and interaction of individual provisions may result in systemic qualities that differ significantly from one based on an inventory of the individual provisions. Moreover, a conscious effort to design a system to be either principles-based or rules-based would require forcing individual provisions toward the poles. To do so interferes

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<sup>1</sup> The phrase “standards-based system” is also used. *See infra* text accompanying notes \_\_\_\_-\_\_\_\_.

<sup>2</sup> *E.g.*, HARVEY PITT, SEC CHAIRMAN, TESTIMONY BEFORE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS (asserting that US accounting is “based on rules, and not on broad principles”); FIN. ACCT. STANDARDS BD.: PRINCIPLES-BASED APPROACH TO U.S. STANDARD SETTING, NO. 107205 (Oct. 2002); SENATE REPORT NO. 107-205, at 13 (2002); *see* Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 CORNELL L. REV. 394, 421 (2004); William H. Widen, *Enron at the Margin*, 58 BUS. LAW. 961, 965 (2003); John C. Coffee, Jr., *Understanding Enron: “It’s About the Gatekeepers, Stupid,”* 57 BUS. LAW. 1403, 1408-09 (2002); Stephen C. Gara & Craig J. Langstraat, *The Sarbanes-Oxley Act of 2002: A New Ballgame for Accountants*, 34 U. MEM. L. REV. 73, 93-94 (2003); Anthony J. [sic], *Stopping the Enron End-Runs and Other Trick Plays: The Book-Tax Accounting Conformity Defense*, 2003 COLUM. BUS. L. REV. 35, 161-62 (2003).

<sup>3</sup> Sarbanes-Oxley Act, § 108(d), 15 U.S.C. § 7266; *see infra* text accompanying notes \_\_\_\_-\_\_\_\_.

<sup>4</sup> *See, e.g.*, Cathy Quinn, Corporate Governance (Speech) (July 8, 2005) (New Zealand Securities Commissioner advertising the country’s “robust principles-based framework for good corporate governance” instead of a “more prescriptive rules-based approach”); Irish Financial Regulator (Rialtir Airgeadais) (Speech), Institute of European Affairs, Fin. Services Reg. (June 21, 2005) (“We are a principles-based regulator” and oppose “rules-based systems”); Irish Financial Regulator (Rialtoir Airgeadais) Annual Report 9 & 18 (2004) (same); Nicholas Le Pan, *Financial Regulatory Outlook*, 23 CANADIAN NAT’L BANKING L. REV. 52 (Dec. 2004) (describing approach to corporate governance regulation as focused on behaviors addressed through “guidelines” that “are not rules,” including “such as boards making sure they have the information they need in the form they need it”).

with the benefits of the relationship among rules and principles and impairs tailoring the form of articulation to meet desired objectives.

Surveys of US corporate law and securities regulation and of US and international accounting illustrate the necessity and value of combining rules and principles and the difficulty of designing systems warranting classification as rules-based or principles-based. All these systems contain a blend of provisions ranging from the particular to the general, from those providing precise ex ante instruction to those defined after the fact. The provisions serve different ends and, because within large complex systems they are not isolated from one another, they are mutually informative. Thus, corporate fiduciary duty laws bear principles-like attributes but interact with individual statutes and, through repeated applications in non-statutory contexts, they form a doctrinal structure bearing rule-like attributes. Anti-fraud principles in securities regulation and measurement principles in accounting interact with individual rules requiring specific disclosures and classifications to produce a coherent body of legal and accounting provisions.

Yet global rhetoric increasingly speaks of the availability of *systems* denominated as principles-based. As countries develop corporate laws, debate centers on whether they should be formulated as rules-based or principles-based.<sup>5</sup> US federal securities regulation is routinely criticized as rules-based, while the Canadian system is heralded as principles-based.<sup>6</sup> Across the globe, many characterize the US accounting system as rules-based while calling the international accounting system principles-based.<sup>7</sup> Within the US, regulators and compliers alike invoke such language when campaigning for favored provisions<sup>8</sup> or championing state versus federal primacy in regulating public

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<sup>5</sup> See, e.g., South Africa Corporate Governance Code (2002) (“principles-based” not rules-based and “encourages directors to perform in the spirit of the code rather than simply applying the tick box approach”); Thailand Stock Exchange, *The Principles of Good Corporate Governance for Listed Companies* (March 2006) (11-page statement of principles and best practices, none of which is binding). The Task Force to Modernize Securities Legislation in Canada commissioned a study from me which initially asked which is superior, a rules-based or principles-based system of securities regulation, and ultimately involved elucidating some of the main characteristics of securities regulation in the United States and Canada. See Lawrence A. Cunningham, *Principles and Rules in Public and Professional Securities Law Enforcement: A Comparative US-Canada Inquiry* (May 31, 2006).

<sup>6</sup> E.g., Ruth O. Kuras, *Harmonization of Securities Regulation Standards between Canada and the US*, 81 U. DETROIT MERCY L. REV. 465, 472 (2004); Allison Dabbs Garrett, *Themes and Variations: The Convergence of Corporate Governance Practices in Major World Markets*, 32 DENV. J. INT’L L. & POL’Y 137, 161 (2004)

<sup>7</sup> See Frederick Gill, *Principles-Based Accounting Principles*, 28 N. C. J. INT’L L. & COMM. REG. 967 (2003); see also Matthew A. Melone, *US Accounting Standards: Rules or Principles? The Devil Is Not in the Details*, 58 U. MIAMI L. REV. 1161 (2004); Hervé Stolowy, *Nothing Like the Enron Affair Could Happen in France!*, 14 EURO. ACCT. REV. 405 (2005) (reviewing responses to Enron debacle among French accounting scholars, practitioners and policymakers); Kenneth Yong, *Exploring Rules-Based and Principles-Based Accounting*, ACCT. TODAY (Nov. 2004), p. 32 (international accounting is “popularly considered as being principles-based” while US GAAP is “branded with a rules-based reputation”).

<sup>8</sup> See, e.g., Piper Rudnik, Report on SEC Proposal on Executive Compensation (calling it less rules-based and more principles-based, meaning disclosing all material items, whether or not they fit squarely within a box of specific rules); Cynthia A. Glassman, (Speech), Tenth Annual Corporate Counsel Institute: Priorities

corporations.<sup>9</sup> Overwhelmingly, rhetoric vaunts “principles-based systems” and denigrates “rules-based systems.”

Why this enthusiasm for principles-based systems, even though delivering them is improbable? The Article explores three possible hypotheses. One possibility, the regulatory hypothesis, is to provide a counterweight to strong systemic forces that demand and produce provisions bearing rule-like characteristics. This response expands enforcement arsenals and thus can elicit more cautious compliance. While this explanation for the language is credible, four limitations appear—two that question its normative desirability and two its descriptive accuracy.

Normatively, this strategy can induce excessively cautious compliance outlooks that impair the benefits of rules and backfire as unfair or illegitimate if enforcement is biased towards principles without sufficient regulatory guidance in rules. Descriptively, the hypothesis is weak because the demand for rules always is offset by regulatory use of principles to fortify enforcement arsenals and the rhetoric does not speak of a balance of principles and rules but trumpets “principles-based systems” and denigrates “rules-based systems.”

A second possibility, the ethical hypothesis, is that the pro-principles rhetoric reflects desire to promote ethical values rather than expressing concern for the form of articulated legal and accounting provisions. What the Enron-type debacles showed was not so much the dangers of rules but manifest violation of a different set of principles addressed by business and professional ethics. This interpretation suggests that the language is ultimately a call for policymakers to emphasize those ethics, and targeted actors to abide them. While also credible, two qualifications appear, one normative, one descriptive.

Descriptively, such a call to ethical rejuvenation implicitly assumes a decline in ethics during the relevant period, which may or may not be justified. Normatively, this strategy could backfire too. Exhortations to abide the spirit of laws project a moral appeal that may be desirable. But rhetorical stories of principles-based systems could produce belief that rules can be subordinated or eliminated which, ensuing analysis suggests, is neither possible nor wise.

A third possibility, the political hypothesis, views proponents of principles-based systems as attempting to signal product differentiation in jurisdictional competitions designed to maintain or expand authority. This is the most convincing explanation as a descriptive matter. Under this account, Delaware judges promote their state’s corporate law as principles-based to forestall increased federal regulation, which they criticize as

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and Concerns at the SEC (March 9, 2006) (SEC Commissioner reporting her effort in 2003 to make management’s discussion and analysis (MD&A) disclosure less obscure by adopting an SEC “interpretive release that provided principles-based guidance to help get MD&A back on point”).

<sup>9</sup> See, e.g., Sean J. Griffith & Myron T. Steele, *On Corporate Law Federalism: Threatening the Thaumatrope*, 61 BUS. LAW. 1 (2005).

rules-based; British Columbia advances a principles-based system to challenge Ontario's dominance in Canadian securities regulation; countries that say they offer principles-based systems signal that they are mature enough to honor principles without the need for detailed rules; and international accounting promulgators promote their product as principles-based against US GAAP, which they rebuke as rules-based, to gain leadership in establishing the global accounting system.

Although the political hypothesis is descriptively appealing, it is normatively troubling. If it is impossible to devise "principles-based systems," then promoting them is misleading. In addition to how this undermines the hortatory aspirations of the ethical hypothesis, it exposes a negative by-product of the jurisdictional competition that results in such linguistic overstatement. This potential for misleading rhetoric has been overlooked in the literature concerning jurisdictional competition. Explicitly recognizing it not only supports retiring the misleading labels, it identifies a new limitation on the efficacy of jurisdictional competition.

To reach these conclusions, the Article proceeds in three Parts. Part I reviews the literature on rules and principles, showing considerable struggles concerning matters of classification and trade-offs as well as of labeling. Extending this literature from individual provisions to entire systems, discussion justifies skepticism about whether it is feasible to describe or design such system as "principles-based" or "rules-based."

Part II focuses on corporate law, securities regulation and accounting. It first surveys major substantive provisions in these fields to demonstrate the presence of a range of provisions, from rules to principles, whose application and interaction frustrates simplistic characterization of the systems as rules-based or principles-based. It then reviews proposed system designs that illustrate how even conscious efforts to avoid having an interactive mixture of provisions do not succeed.

Part III considers three possible explanations for the fashionable rhetoric extolling principles-based systems in corporate law, securities regulation and accounting. It explores the hypotheses that attribute this phenomenon to promoting regulatory capabilities or ethical values and summarizes their descriptive and normative weaknesses. Analysis of the hypothesis that political factors explain the phenomenon is shown to be the most descriptively accurate but normatively most troubling. In addition to adding a reason to doubt the virtue of jurisdictional competition, this cements the case to retire as misleading the labels "rules-based" and "principles-based" to describe legal or accounting systems.

## I. THE DYNAMICS OF RULES AND PRINCIPLES

Rules and principles are individual forms of articulation constituting components of larger regulatory systems that, in varying degrees, enable regulators to communicate expectations and provide people with guidance about what is required or permitted. Legal scholars continually struggle to delineate the categories of individual rules and principles and assess their relative merits. The difficulties associated with the treatment of individual provisions multiply when attempting to analyze the characteristics of the

larger complex regulatory systems of which the individual provisions are fragments. This Part reviews some of the extensive literature, taking the analysis as evidence that it is impossible and undesirable to design a system fairly characterized as principles-based or rules-based.

#### A. *Treatment of Individual Provisions*

The following sub-sections discuss the literature concerning treatment of individual provisions as rules and principles. Analysis suggests that rules and principles are best conceived as residing along a continuum according to a provisions' relative vagueness and posing subtle trade-offs. The ensuing section shows that the difficulties of treating individual provisions multiply when addressing large complex regulatory systems.

1. Labels — A preliminary difficulty in the literature concerning rules and principles concerns labels which, many scholars observe, are fraught with ambiguity and confusion.<sup>10</sup> Scholars often invoke a simple polarity concerning driving regulations to illustrate two alternative expressions of a legal or accounting provision. One formulation provides specific directives defined *ex ante* (such as a 55 mph speed limit) while another provides general directives whose specific content is defined *ex post* (such as to drive at a reasonable rate of speed). Scholars assign different labels to such illustrations.

The first formulation invariably is called a *rule* and the second often is called a *standard*. Some legal scholars use the term *principle* while others use the word *standard*<sup>11</sup> or use them interchangeably.<sup>12</sup> Some use the term *principle* to denominate the animating purpose of a stated rule. In turn, some scholars use the word *standards* to capture both rules and principles so understood.<sup>13</sup> Others reserve the label *principles* for the different idea of background justifications for laws or other commands (whether rules, standards or something else). Increasingly, analysts use the label *standards* to denote a measure of performance or conduct, often established by non-governmental organizations (as in Internet standards or credit rating standards).<sup>14</sup>

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<sup>10</sup> See, e.g., Kathleen M. Sullivan, *The Supreme Court 1991 Term—Foreword: The Justices of Rules and Standards*, 106 HARV. L. REV. 22, 57-59, n. 231 (1992); Pierre J. Schlag, *Rules and Standards*, 33 UCLA L. REV. 379, at n. 16 (1985); Louis Kaplow, *Rules and Standards: An Economic Analysis*, 42 DUKE L.J. 557, 559 at n. 2 (1992).

<sup>11</sup> See Ronald Dworkin, *The Model of Rules*, 35 U. CHI. L. REV. 14, 22-25 (1967); RONALD DWORKIN, *TAKING RIGHTS SERIOUSLY*, 22-28, 71-80 (1977); John Braithwaite, *Rules and Principles: A Theory of Legal Certainty*, 27 AUSTRALIAN J. LEGAL PHIL. 47, at n. 2 (2002).

<sup>12</sup> See Sullivan, *supra* note \_\_\_, at 58 n. 231 (citing Professors Dworkin, Schauer and Radin); see also Kaplow, *supra* note \_\_\_, at 559 at n. 2 (noting that “Outside the debate over formulation of the law, the terms are often used interchangeably”).

<sup>13</sup> This is the dominant approach in the accounting literature. See Mark W. Nelson, *Behavioral Evidence on the Effects of Principles- and Rules-Based Standards*, 17 ACCT. REV. 91 (2003).

<sup>14</sup> See Symposium, *Owning Standards*, 48 B.C. L. REV. 1 (2007).



The discordant labels also emerge in practice. Corporate law’s “business judgment *rule*” can be seen as a broad principle—a judicial presumption that corporate officials act with due care. In the US, the shorthand reference of “*Rule 10b-5*” is invariably used to designate securities regulation’s most vague and open-ended anti-fraud principles. Accounting terminology offers GAAP (generally accepted accounting *principles*) and GAAS (generally accepted auditing *standards*), both of which contain a mixture of provisions fairly denominated as rules, principles or standards.

The proliferation of contradictory labels may simply suggest that such labels mean little. Indeed, some dismiss the confusion that the stew creates in legal theory as mere nominalism, which does not impair analysis.<sup>15</sup> However, it is possible that the disagreement on labeling reveals something more substantive about these ideas and how useful they are as analytical tools. One possibility is that the categories are inevitably unstable. As discussed below, this instability supports conceiving of the content in the categories (rules, principles, standards) as residing on a continuum across which provisions operate iteratively, meaning that their substantive meaning is mutually informative.

For now, the question of terms in legal and accounting theory requires authors to state vocabulary choices at the outset of any analysis. As a contrast to *rules*, I will use the term *principles*, in part, because that is the commonly used term in contemporary rhetoric and this, in turn, suggests that something more is at stake in labeling than many suppose.<sup>16</sup> I also choose the word principles rather than standards to reflect how the latter term increasingly is used to designate performance or conduct measures, not legal provisions that are contrasted with rules.

2. Classification — A more important difficulty is the problem of classifying given provisions as rules or principles. The common illustration from driving regulations (the rule of 55 mph versus the principle of reasonableness) is easy but incomplete. The following notes three classification methodologies—what I call analytical, conceptual and functional—and concludes by suggesting that these are united by the single quality of a provision’s relative vagueness.

A common analytical approach to classifying laws as rules or principles uses their temporal orientation. It distinguishes *when* content is provided: rules define boundaries *ex ante* while principles define them *ex post*.<sup>17</sup> In securities regulation, brokers know that they are not allowed to make unauthorized trades for clients (a rule) but may not know whether other behavior exhibits commercial honor until it is evaluated after the fact (a principle). Thus rules and principles are sometimes classified according to how much

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<sup>15</sup> Braithwaite, *A Theory of Legal Certainty*, *supra* note \_\_\_\_, at n.2.

<sup>16</sup> See *infra* text accompanying notes \_\_\_\_-\_\_\_\_ (discussing how rhetoric promoting principles-based legal and accounting systems may be related to promoting principles of business ethics).

<sup>17</sup> See Kaplow, *supra* note \_\_\_\_.

guidance they provide to actors *ex ante*—how much certainty is provided. Notably, in this view, both rules and principles can be either complex or simple.

A weakness of the temporal classification is that the expression of any legal provision is always *ex ante* whereas its application is always *ex post*. To that extent, the method only distinguishes articulations according to whether one has been applied or not. Put differently, the temporal classification carries an implicit assumption that an articulated provision can determine its future application, which it cannot.<sup>18</sup> True, the circumstances in which such resulting uncertainty arises may be few or yield only modest uncertainty. Still, the tool does not enable completely classifying all provisions into discrete categories of rule and principle. Instead, provisions offer varying degrees of certainty and thus array across a spectrum from rule-like to principle-like.

A more conceptual classification views rules and principles in terms of designated attributes such as their relative generality versus specificity, abstractness versus concreteness and universality versus particularity. Provisions characterized by generality, abstractness or universality are principles while those being specific, concrete and particular are rules. Provisions bearing a mix of these attributes are more or less principles-like or rules-like. Thus, as examples, a provision that is general and abstract but not universal is principle-like while a provision that is specific and particular but abstract is rule-like. Sub-qualities bearing on these attributes include the extent of a provision's clarification, detail, exceptions or limitations.

In securities regulation, the directive to exhibit “commercial honor” is a principle because it is general, abstract and universal.<sup>19</sup> A broker's duty to warn customers of the hazards of penny stock investment vehicles is a rule because it is specific, concrete and particular.<sup>20</sup> A directive that companies disclose information “on a rapid and current basis” is principle-like because it is general and universal but also concrete.<sup>21</sup> A directive that brokers invest for clients only in high-grade securities is rule-like because it is particular and specific but still abstract.<sup>22</sup>

This conceptual approach thus results in arraying provisions along a continuum from principle to rule, classified according to how many of the various attributes of rule or principle characterize a provision.<sup>23</sup> Although the continuum metaphor has

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<sup>18</sup> Cf. Arthur L. Corbin, *The Parol Evidence Rule*, 53 YALE L.J. 603, 630 (1944) (no writing can prove its own completeness).

<sup>19</sup> NASD Manual, Rule NASD Rule 2110 (“A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade”).

<sup>20</sup> Penny Stock Reform Act of 1990; SEC Rule 15g-1 through 9.

<sup>21</sup> See Sarbanes-Oxley Act, Act, § 501, amending 15 U.S.C. 78o-6.

<sup>22</sup> See *Messer v. E.F. Hutton & Co.*, 847 F.2d 673, 679 (11<sup>th</sup> Cir. 1987).

<sup>23</sup> See, e.g., Margaret Jane Radin, *Presumptive Positivism and Trivial Cases*, 14 HARV. J.L. & PUB. POL'Y 823, 828-32 (1991) (using the continuum metaphor); Sullivan, *The Supreme Court, 1991 Term*, *supra* note \_\_\_, at 57 (same); Carol M. Rose, *Crystals and Mud in Property Law*, 40 STAN. L. REV. 577, 604-610

considerable appeal, a few scholars question how useful or rigorous the imagery is.<sup>24</sup> Indeed, a limitation of this conceptual approach is that there is no logical limit to the number or type of attributes that might be used in the classification process and there is no crisp way to rank their magnitude or importance. At best, the result is a classification scheme bearing a fuzzy logic, in which intuition plays as much a role as hard-headed conceptualization.

Finally, a functional approach to classifying a legal or accounting provision as a rule or a principle considers the scope of discretion reposed in designated actors. The more discretion a provision reposes the more it is principle-like and the less discretion reposed the more it is rule-like. This approach is satisfactory only in those rare circumstances involving limited groups of actors. For example, if a provision relates only to legislatures and judges, this approach can weigh how much discretion the legislature reposes in judges. However, the utility of this classification declines with increasing numbers of actor groups.

Provisions that purport to restrict a given actor's discretion by rule-like precision may increase discretion in other actors. For example, legislatively-established criminal sentencing guidelines limit judicial discretion concerning punishment. But they increase prosecutorial discretion when making charging decisions. In accounting, using a rule or principle to constrain or create managerial discretion simultaneously affects the relative discretion held by auditors engaged to review managerial decisions.<sup>25</sup>

A weakness of all the foregoing classification methods is that they do not necessarily enable classifying all the possible permutations that legal or accounting provisions can assume. A large portion of laws (and many accounting provisions) do not fit either category, however specified, nor do some provisions readily appear to reside between the poles. Consider factor tests.<sup>26</sup> A law against market manipulation, for example, may be tested according to factors such as the timing, frequency and structure of given securities trades.<sup>27</sup> Similarly, corporate laws and securities regulations can use

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(synthesizing the virtues of “crystalline” and “muddy” articulations of legal provisions, akin to the iterative conception).

<sup>24</sup> See James G. Wilson, *Surveying the Forms of Doctrine on the Bright Line–Balancing Test Continuum*, 27 ARIZ. ST. L. J. 773, 776-777 (1995) (conceiving of a rules-principles continuum is an analytical dead-end, a matter of technique rather than bearing normative significance); Scott Brewer, *Exemplary Reasoning, Semantics, Pragmatics, and the Rational Force of Legal Argument by Analogy*, 109 HARV. L. REV. 925, 972 (1996) (dismissing the notion of a continuum on grounds that it conflates distinct phenomena of logic and semantics that must be kept distinct).

<sup>25</sup> See Mark W. Nelson, *Behavioral Evidence on the Effects of Principles- and Rules-Based Standards*, 17 ACCT. REV. 91 (2003).

<sup>26</sup> See Cass R. Sunstein, *Problems with Rules*, 83 CAL. L. REV. 953, 963-964 (1995).

<sup>27</sup> See *infra* text accompanying notes \_\_\_\_ - \_\_\_\_.

presumptions that may be rebutted. These may or may not exhibit principle-like or rule-like qualities.<sup>28</sup>

Any approach to classifying legal or accounting provisions as rules or principles is thus contestable and leaves room for refinement. Yet uniting all the varying classification methods is a kind of super-ordinate attribute: vagueness. Principles are vaguer compared to rules which are less vague. Vagueness is greater when a provision offers less ex ante guidance because much of its definitional content is provided only ex post; vagueness is increased by the features of abstractness, generality, and universality; and provisions are vaguer when they repose greater discretion in actors compared to those that constrain discretion. While admittedly imperfect, in the ensuing discussion and analysis I treat provisions as classifiable along a rules-principles spectrum according to their relative vagueness.

3. Trade-Offs — Perhaps the most difficult problem appearing in the literature on rules and principles concerns trade-offs when choosing which to favor. The literature acknowledges some reasonable approximations of trade-offs and yet scholars challenge their overall validity. To illustrate, consider how the legal obligations of securities brokers should be stated as to whether to recommend a security. One possibility is a rule-like provision that prohibits recommending anything other than AAA-rated bonds. Another is a principle-like directive requiring that the broker evaluate the investment's suitability in relation to a customer's risk tolerance and investment objectives.

The rule appeals for its relative certainty and predictability; the principle appeals for its relative capacity to exploit advantageous circumstances and possibly avoid undesirable ones. On the downside, rules can be blueprints for evading their underlying purposes. Bright lines and exceptions to exceptions facilitate strategic evasion, allowing artful dodging of a rule's spirit by literal compliance with its technical letter. Rules can benefit resourceful and informed parties (such as brokers) yet harm reliant and ignorant ones (such as customers).<sup>29</sup> In rapidly-changing environments, such as securities markets, rules can become obsolete faster than principles do.<sup>30</sup> Principles may promote conservatism among regulated actors, protect other participants and have longer shelf-lives. But they pose problems of uncertainty and ex post surprise, which can impair achieving goals such as, in securities regulation, market efficiency and public perceptions of fairness.

Promulgation and compliance costs vary. In general, rules are more costly than principles to create and principles are more costly than rules to comply with.<sup>31</sup> When

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<sup>28</sup> See Ruth Gavison, *Legal Theory and the Role of Rules*, 14 HARV. J.L. & PUB. POL'Y 727, 750-752 (1991).

<sup>29</sup> See Elaine A. Welle, *Freedom of Contract and the Securities Laws: Opting out of Securities Regulation by Private Agreement*, 56 WASH. & LEE L. REV. 519, 562-563 (1999).

<sup>30</sup> See Frank Partnoy, *A Revisionist View of Enron and the Sudden Death of "May,"* 48 VILL. L. REV. 1245, 1265 (2003).

<sup>31</sup> See Kaplow, *supra* note \_\_\_\_.

rules enable relatively cheap compliance, compliance is more likely; but when principles mean compliance is relatively costly, non-compliance risk rises.<sup>32</sup>

The desirability of a rule or principle may be clearer in some cases than in others. The clarity depends on the possibility of defining the importance of relative objectives. This conventionally involves determining which are more important, predictability and certainty or fairness and context. In general, constraining discretion to promote predictability and certainty dictates adopting rules; emphasizing fairness and contextual sensitivity leads to the formulation of principles.

Yet the precise trade-off between certainty and context is not always clear. A principle can be more certain than a dense weave of rules.<sup>33</sup> For example, a vague articulation can yield a well-understood meaning while a densely specified series of articulations can yield competing understandings. The Sherman Antitrust Act may be vague when using the terms contract, conspiracy and restraint of trade but shared understanding of the meaning of these terms combine to give a more rule-like quality to the statute. While such shared understandings may have more to do with the nature of language and meaning than with the nature of rules and principles, language and meaning cannot be divorced from an evaluation of the trade-offs associated with principles versus rules.

Moreover, rules may promote certainty in a given context but export uncertainty to others; principles may promote flexibility in given contexts but also show “expansionist tendencies” that curtail flexibility in others.<sup>34</sup> Nor are the alternatives always trade-offs. A combination of certainty and contextual sensitivity is possible. To provide certainty, a rule must be flexible; to be open-ended, a principle must be stable.<sup>35</sup> These observations make it difficult to contend that rules always provide more certainty than principles or that principles always provide more contextual sensitivity than rules. Indeed, rules may be more certain for contexts that are simple, stable and involve small stakes but less certain when addressed to complex, dynamic, high-stakes contexts.<sup>36</sup> This is especially so when new rules are adopted and subject to change during implementation and evolution.<sup>37</sup>

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<sup>32</sup> *See id.*

<sup>33</sup> *See* Stephen A. Saltzburg, *The Fourth Amendment: Internal Revenue Code or Body of Principles?*, 74 GEO. WASH. L. REV. 1702, 1703 (2006) (demonstrating, in the context of the Fourth Amendment, how “principled rules provide clearer guidance to law enforcement and citizens than arbitrary ‘bright-line’ rules”).

<sup>34</sup> Schlag, *Rules and Standards*, *supra* note \_\_\_\_, at 411-14

<sup>35</sup> *Id.* at 405-407.

<sup>36</sup> *See* Braithwaite, *A Theory of Legal Certainty*, *supra* note \_\_\_\_; RICHARD A. POSNER, PROBLEMS OF JURISPRUDENCE 48 (1990).

<sup>37</sup> *See* Brett H. McDonnell, *SOX Appeals*, 2004 MICH. ST. L. REV. 505, 529 (making this point in the context of the rules-heavy Sarbanes-Oxley Act).

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To summarize, the literature addressing rules and principles reflects considerable struggle, especially as to classification and trade-offs and even as to labeling. This is due, in part, to how laws (and accounting provisions) address vast territories, pursue varying objectives and assume a wide variety of forms, complexity, notice content and production methods. True, individual provisions can be classified along a rules-principles spectrum according to their relative vagueness and associated trade-offs can be worked out for designing provisions to suit objectives. Yet the foregoing review suggests that these are neither simple nor incontestable matters even at the level of treating individual provisions.

### B. *Treatment of Entire Systems*

The issues discussed in the preceding section become impossibly complex and contestable when one tries to describe entire systems as either “rules-based” or “principles-based.” Descriptions of large complex regulatory systems must assess not only the character of all their individual provisions but also how those provisions are interpreted, enforced and applied as well as how they interact. Accounting for all these factors casts doubt upon the analytical utility of using the binary terminology of “rules-based” versus “principles-based” to describe such systems.

1. **Threshold** — The simplest way to reach a characterization of a system as “rules-based” or “principles-based” would be based on an inventory of the form in which individual provisions are expressed. At this simple level, a principles-based system is one in which all, a majority or the most important articulations are vague and a rules-based system is in one which such provisions are non-vague. In considering whether such systems are possible or desirable as a threshold matter, it would be important to provide a theoretical or philosophical foundation for favoring either.

It is difficult to provide such foundations. Consider two alternative intellectual traditions that address relative preferences for rules versus principles within a system: law and economics and critical theories. While each may support a systemic preference for rules or principles, this support is too limited to defend systemic classifications of rules-based or principles-based.

Law-and-economics scholarship addressing rules and principles guides analysis according to a desire to detail law as efficiently as possible.<sup>38</sup> Theorists seek the optimal precision of law,<sup>39</sup> informed by formal characterization of associated costs.<sup>40</sup> A

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<sup>38</sup> See Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257, 262 (1974).

<sup>39</sup> See, e.g., Colin S. Diver, *The Optimal Precision of Administrative Rules*, 93 YALE L. J. 65 (1983).

decidedly directive stance in this tradition is to promote certainty. This means a general preference for stating posited law in the form of rules, rather than principles.<sup>41</sup> But since principles also can promote certainty, this analysis cannot defend a system fairly characterized as rules-based. Indeed, contemporary economic analysis increasingly favors principles, especially when informed by behavioral theories, which question how much certainty rules provide as compared to principles,<sup>42</sup> or by game theory, which explores how principles may be better than rules to facilitate bargaining and neutralize strategic behavior.<sup>43</sup>

At the other extreme, critical theories may be invoked to support the virtues of principles compared to rules. Important work in this tradition positions the normative forms of argument favoring rules or principles in terms of political consciousness. A leading illustration is how arguments favoring rules can resemble the form of arguments that favor individualism and how arguments favoring principles can resemble the form of arguments that favor altruism.<sup>44</sup> An example of this parallel is how arguments favoring principles include that they can promote contextual sensitivity. To the extent that one prefers the forms of argument favoring altruism one may likewise support favoring a legal system that uses principles whenever possible.

Yet this methodology restates the rules-principles argument in other terms, in this case by analogy to individualism-altruism. The analysis that suggests that rules and principles reside along a continuum could likewise be restated: people are rarely either purely individualistic or purely altruistic but show varying degrees of such attributes in varying contexts. Furthermore, principles do not have a monopoly on promoting contextual sensitivity, a virtue that rules can also promote. Thus, as with economic analysis, this conceptualization does not enable defending the creation or maintenance of systems that rely exclusively or predominantly on principles rather than rules.

2. Applications — Even if one could simply inventory the character of individual provisions within a system to classify them as rules-based or principles-based, and defend

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<sup>40</sup> See, e.g., Kaplow, *Rules and Standards*, *supra* note \_\_; see also Gavison, *Legal Theory and the Role of Rules*, *supra* note \_\_, at \_\_.

<sup>41</sup> See, e.g., Rose, *Crystals and Mud*, *supra* note \_\_, at 590-595 (not necessarily endorsing, but elucidating this position); Clifford Holderness, *A Legal Foundation for Exchange*, 14 J. LEGAL STUD. 321, 322-26 (1985).

<sup>42</sup> See Russell Korobkin, *Behavioral Analysis and Legal Form: Rules vs. Standards Revisited*, 79 OR. L. REV. 23 (2000); Tom Baker, Alon Harel & Tamar Kugler, *The Virtues of Uncertainty in Law: An Experimental Approach*, 89 IOWA L. REV. 443 (2004)

<sup>43</sup> See Ian Ayres & Eric Talley, *Solomonic Bargaining: Dividing a Legal Entitlement to Facilitate Coasean Trade*, 104 YALE L.J. 1027 (1995); Jason Scott Johnston, *Bargaining Under Rules Versus Standards*, 11 J.L. ECON. & ORG. 256 (1995).

<sup>44</sup> Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685 (1976); see also Duncan Kennedy, *The Stages of Decline of the Public/Private Distinction*, 130 U. PA. L. REV. 1349 (1982).

it according to objectives such as certainty or contextual sensitivity, this simple exercise is incomplete. Suppose that an inventory of the individual provisions that comprise US securities regulation or accounting justify the common descriptions of these systems as “rules-based.” To sustain that characterization for the system as a whole would also require accounting for how those provisions are interpreted, enforced and applied.

Individual provisions may be classifiable as either rule or principle when stated as a legal norm but they are subject to a separate set of decision norms that govern their application.<sup>45</sup> For example, a decision norm may guide judges toward either a formalistic or instrumentalist methodology. A provision fairly classified as a rule may retain that character when applied using a formalist (or literalist) methodology but may assume the attributes of a principle when applied using an instrumentalist (or purposive or dynamic) methodology. These two levels of definition thus complicate any claim that a legal system is principles-based or rules-based.

These complexities can be dramatized by comparing descriptions of national legal systems. Consider the following example of alternative conceptions of such systems:<sup>46</sup>

In some legal cultures, it is generally understood that rules should be read literally, that the appliers and interpreters of rules should not be empowered to modify the rules at the point of application, that judges should interpret rules according to their ordinary meaning except in the most egregious cases, and that the virtues of specificity and predictability are more important, especially within the legal system, than the virtues of flexibility in the face of changing or unforeseen circumstances. . . .

In other legal systems, by contrast, the virtues of rule-ness and formality are less apparent, and it is widely accepted that reaching the correct outcome in the individual case is more important than the virtues brought by rigid obedience to specific rules. In these societies, the rule-ameliorating devices, rather than being scorned, are celebrated, and rule-interpreters, rule-enforcers, and rule-appliers who refuse to employ these devices are typically castigated with epithets like “mechanistic” and “formalistic.”

Using prevailing global jargon, at least in terms of the application of laws, the first conception might be called a rules-based system and the second a principles-based system. Which better describes the US legal system? In prevalent global classifications, especially in securities regulation and accounting, the US system is depicted as rules-based while other national systems and international accounting are dubbed principles-based.<sup>47</sup> The foregoing passage continues as follows:

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<sup>45</sup> See Meir Dan-Cohen, *Decision Rules and Conduct Rules: On Acoustic Separation in Criminal Law*, 97 HARV. L. REV. 625 (1984).

<sup>46</sup> Frederick Schauer, *The Convergence of Rules and Standards*, 2003 NEW ZEALAND L. REV. 303, 320-321.

<sup>47</sup> See *supra* notes 1 & 7 (citing sources).



As should be apparent, there is a widespread view, supported by some moderately serious research, that the US is the best example of the latter, and that most other advanced legal systems are at least somewhat closer to the former than is the US.

Interestingly, this conclusion (which seems correct) contradicts prevailing global classification—at least as it concerns securities regulation and accounting. This may simply reflect that the foregoing descriptions concentrate on application rather than initial formulation. It also may simply mean that those subjects are special cases (and that accounting is not law in the US).

More generally, however, this contrast is congruent with the difficulties sampled in the previous section concerning classification of individual provisions as rules or principles and navigation of the trade-offs that individual provisions pose. When positioned in the broader context of entire systems that must also take account of the norms of decision-making, the credible but contradictory descriptions justify more skepticism about whether “rules-based” or “principles-based” can be analytically reliable descriptions of any comprehensive legal system (or accounting system).

3. Interactions — Beyond the crude exercise of inventorying the character of individual provisions and the additional complexity of addressing how those provisions are applied, one must consider the further complexity that arises from how individual provisions interact within a system. Adding this complexity fortifies skepticism about such systemic labeling.

Consider the simple driving regulation illustration appearing in the rules versus principles literature. An individual speed limit can be stated more vaguely (a reasonable speed) or less vaguely (55 mph). Which is superior for a given roadway varies according to numerous factors, such as traffic volume and patterns, safety, serenity and energy conservation. Taking account of these factors, no functional system could establish either as the law for all roads within it.

Indeed, a law designating the speed limit as 55 mph on a given roadway implicitly endorses that as a reasonable speed. A principle directing drivers to cruise at a reasonable speed requires assigning meaning to the word reasonable which would be interpreted, in part, in relation to zones carrying a designated limit. So a *system* of driving regulations invariably contains a mixture of rules and principles. Good examples are laws that prohibit driving faster than a reasonable speed notwithstanding any particular posted limits or driving at a reasonable speed but in no event exceeding 35 mph. Such systems in which rules and principles co-exist and interact are neither rules-based nor principles-based.

The same interaction of rules and principles appears in virtually any complex legal system. Consider two individual provisions contributing to the law of insider

trading within the larger system of US securities regulation. Section 16(b) provides a “short-swing profit” *rule* which penalizes certain kinds of insider trading by officers and directors;<sup>48</sup> Section 10(b) contains broad anti-fraud *principles* that have been interpreted to prohibit insider trading by officers, directors and many other persons.<sup>49</sup> It is possible to conceive of the rule and the principle as substitutes.<sup>50</sup> If a system contained only the rule it could be called rules-based and if it contained only the principle it could be called principles-based. What is the proper characterization when a system uses both, as in the US?

The two provisions interact in complex ways that prevent citing either of them to support characterizing the system as rules-based or principles-based. The rule of 16(b) compels disgorgement of short-swing profits, meaning gains on securities transactions by designated insiders within a stated time period without regard to intent. The principle of 10(b) makes it criminal for unspecified insiders to trade in securities on the basis of material non-public information. The two laws share a similar general purpose, of prohibiting securities market profit-making based on selectively available information, but Section 10(b) advances a fairness objective in relation to external shareholders while Section 16(b) also advances a management regulation objective in relation to business operations.<sup>51</sup>

The rule’s designation of certain corporate insiders and transactions promotes certainty that the principle’s open-endedness otherwise prevents.<sup>52</sup> In some cases, issues arising under one of the provisions can be useful in discerning the appropriate application of the other, as where a problem that the rule does not address is sufficiently handled by

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<sup>48</sup> 15 U.S.C. 78p(b) (designated insiders must disgorge profits from securities transactions occurring within a six-month window).

<sup>49</sup> 15 U.S.C. 78j; Rule 10b-5, 17 C.F.R. 240.10b-5; *United States v. O’Hagan*, 521 U.S. 642 (1997); see *infra* text accompanying notes \_\_\_\_-\_\_\_\_\_.

<sup>50</sup> Schauer, *The Convergence of Rules and Standards*, *supra* note \_\_\_\_, at 321-25 (treating these provisions as substitutes).

<sup>51</sup> See Steve Thel, *The Genius of Section 16: Regulating the Management of Publicly Held Companies*, 42 HASTINGS L.J. 391, 399 (1991) (making the case that the purpose of §16(b) was to prevent insiders from manipulating corporate operations to induce favorable stock price fluctuations); Roberta S. Karmel, *The Relationship between Mandatory Disclosure and Prohibition against Insider Trading: Why a Property Rights Theory of Inside Information is Untenable* (Book Review) 59 BROOKLYN L. REV. 149, n. 51 (1993) (§16(b)’s benefits not achieved by §10(b) are promoting long-term rather than short-term outlook among management and discouraging them from manipulating events over the short term); Merritt B. Fox, *Insider Trading Deterrence versus Managerial Incentives: A Unified Theory of Section 16(b)*, 92 MICH. L. REV. 2088 (1994) (reconciling the overall framework); *but see* Marleen O’Connor, *Toward a More Efficient Deterrence of Insider Trading: The Repeal of Section 16(b)*, 59 FORDHAM L. REV. 309 (1989).

<sup>52</sup> See Steven R. Salbo, *Regulation of Insider Trading in a Global Marketplace: A Uniform Statutory Approach*, 66 TUL. L. REV. 837, 861 (1992) (“Clear and precise regulation of insider trading would eliminate the need for section 16(b)”).

the principle.<sup>53</sup> The presence of both provisions and their interaction shows the difficulty of the simple method of inventorying all provisions within a system to classify it as principles-based or rules-based.

Consider a broader illustration of how individual provisions that make up the larger system of federal securities regulation interact. At stake in contexts governed by Section 10(b) are broad principles of materiality and disclosure. Invocation of those concepts in one context illuminates their meaning in others, including in contexts to which separate rules apply. For example, a fact is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision.<sup>54</sup>

Under that definition, rules that mandate disclosure using mechanical tests can be understood to designate such information as material.<sup>55</sup> Thus Section 13(d) requires owners of 5% or more of the voting power in registered equity securities of any company to disclose specific information about their equity position and intent with respect to corporate control.<sup>56</sup> Such a rule can be justified on the grounds that investors would consider such ownership and plans to be important as the materiality principle defines it. Section 13(d) may be a rule and Section 10(b) a principle but the interaction between them contributes systemic qualities that frustrate tidy categorization of the system as rules-based or principles-based.

4. Benefits — Even if one were to decide that a system’s inventory of expressions is or should be “principles-based” or “rules-based,” that those attributes are sustained through both their applications and interactions, it would remain difficult to contend that a commitment to those systemic qualities is desirable. At a basic level, interactions among individual rules and principles within a larger system can produce numerous benefits. Apart from enabling a closer fit between form and objectives, these benefits include the following.

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<sup>53</sup> See *Foremost-McKesson, Inc. v. Provident Sec. Co.*, 423 U.S. 232, 255 (1976) (while §16(b)’s scope is unaffected by whether other sanctions might inhibit abuse of inside information, §10(b) is available to handle some of those other problems not addressed by §16(b)).

<sup>54</sup> See *TSC Indus., Inc. v. Northway*, 426 U.S. 438, 449 (1976); Joan MacLeod Heminway, *Materiality Guidance in the Context of Insider Trading: A Call for Action*, 51 AM. U. L. REV. 1131, 1137 (2003).

<sup>55</sup> See Victor Brudney, *A Note on Materiality and Soft Information Under the Federal Securities Laws*, 75 VA. L. REV. 723, 727 (1989) (“The particular items of information mandated to be disclosed [under SEC rules] are presumably automatically deemed to be ‘material’.”). Thousands of examples of prescribed items can be cited, including the specific requirements found in (a) Item 11 to Form S-1 concerning the required prospectus for offering securities, (b) Items 1-8 to Form 8-K stating events that require filing a current report and (c) the content of both quarterly reports on Form 10-Q and annual reports on Form 10-K.

<sup>56</sup> Exchange Act, §13(d); 17 C.F.R. 240.13d-1 (2006); see *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49, 58 (1971) (emphasizing purpose of rule to provide shareholders with information about the bidder and incumbent management to provide additional information of its own without any intention to aid management in resisting a bid by tipping the balance of power between bidders and managers).

First, interaction between individual rules and principles within a larger system constrains abuse of power, by both those subject to the provisions and those who enforce them. Risk of power abuse arises from principles without rules or from rules without principles.

Imagine a principles-only system, such as one stating only that public companies must “disclose all material facts” (period) or that their financial statements must “be fairly presented” (period). How do managers determine what to do in a given circumstance? Who decides whether companies have complied with the principles? How will an enforcer make the case that a violation occurred or a manager defend against the charge? Vague concepts such as materiality and fairness unaccompanied by some specific content create risks of both ad hoc managerial decision-making and arbitrary enforcement. Some specificity reflecting rule-like characteristics is necessary to give meaning to such principles. Alone, they are vulnerable to abuse.

Conversely, imagine a rules-only system, such as a specific schedule of required items of disclosure listed from A to Z or triggered by events one through ten. Absent accompanying principles, rule-makers operate by fiat. Managers need not think or exercise judgment, even when following those rules produces absurd results. Some may even exploit the rules as blueprints to achieve such absurd results. Principles are necessary to mediate the rules.

Second, the co-existence of rules and principles within a system helps to assess its coherence. The concept of materiality in securities regulation might be expected to mean the same thing in different contexts; if it does not, an explanation for the difference is required.<sup>57</sup> If variations cannot be convincingly explained, then either the rules are not based on principles or they are based on the wrong principles.<sup>58</sup> For example, Section 13(d), which requires 5% owners to disclose their position and intent concerning control, should bear some logical relation to the concept of materiality. Thus, the rule is coherent if it requires disclosure of information that “reasonable investors would consider important in making an investment decision.”

Third, the interaction among rules and principles reduces anxiety over whether an individual provision should initially be formed as a rule or a principle. The issue is how much the form of articulation controls its application and interaction with other provisions so that outcomes vary in otherwise equivalent circumstances. Perhaps there is some control, but with dynamic interaction, convergence occurs to limit its effect. As an extreme example, with separation of governmental powers, legislatures may create laws residing toward either end of the rules-principles spectrum. When legislatures choose rules, judges often relax and thus transform them into laws exhibiting principles-like features; when legislatures enact principles, judges can tighten them into laws with rule-

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<sup>57</sup> See *TSC Indus., Inc. v. Northway*, 426 U.S. 438 (1976).

<sup>58</sup> See Christopher W. Nobes, *Rules-Based Standards and the Lack of Principles in Accounting*, 19 ACCT. HORIZONS 25 (2005).

like features.<sup>59</sup> This observation does not mean that the initial legislative choice is inconsequential; it may be of considerable significance in given cases. However, it also suggests that the choice is not final so that the form does not *control* the application.

This observation also contributes perspective on any systemic preference for expressing individual provisions as rules or principles. The dynamic interaction of individual rules and principles within larger systems suggests caution about designing a legal or accounting system that presumptively privileges rules or principles. If any presumption were warranted at an abstract level, it would suggest having a combination of rules and principles to maximize the benefits of the interaction among them. But even that presumption risks overlooking important trade-offs associated with formulating individual provisions and ignoring the dynamics of their application and interaction within the larger system.

## II. A SURVEY OF THE SYSTEMS

While the preceding discussion suggests conceptual difficulties in imagining how any legal or accounting system can be either rules-based or principles-based, the following discussion surveys actual and proposed systems of corporate law, securities regulation and accounting. It attempts to provide, for each system, both an inventory of individual provisions and a sense of how the provisions are applied and how they interact. The examination justifies more skepticism that any of these systems may fairly be described using such labels.

### A. Existing Systems

A canvas of the major topics appearing on the syllabus in corporations and securities regulation, and some of the commonly cited topics in accounting, suggests that misconceptions exist about how they may be classified as rules-based or principles-based. At minimum, common conceptions are overstated.

1. Corporate Law — Scholars commonly describe corporate law, especially Delaware corporate law, as principles-based,<sup>60</sup> although some see a more rules-like

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<sup>59</sup> See Schauer, *The Convergence of Rules and Standards*, *supra* note \_\_\_, at 321-325; *infra* text accompanying notes \_\_\_-\_\_\_ (example of the relationship between §102(b)(7) of the Delaware General Corporation Law authorizing director-liability exculpation and the judicial doctrine of good faith that amplifies an exception to that authorization).

<sup>60</sup> See Marcel Kahan & Ehud Kamar, *Price Discrimination in the Market for Corporate Law*, 86 CORNELL L. REV. 1205, 1236 (2001) (“Delaware’s corporate law tends to rely on standard-based tests [meaning] that the relation between a certain set of facts and the outcome of a legal dispute is determined *ex post* rather than *ex ante*”); Curtis Milhaupt, *In the Shadow of Delaware? The Rise of Hostile Takeovers in Japan*, 105 COLUM. L. REV. 2171, 2212 (2005) (“The major features of Delaware corporate law [include] the prevalence of broad standards over detailed rules”); Ehud Kamar, *A Jurisdictional Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1914-1915 (1998) (“Delaware [corporate] law is at one end of this continuum. It relies extensively on broad legal standards”).

quality among the principles.<sup>61</sup> As the following discussion shows, both are credible positions, meaning that neither is clearly correct. Corporate law is a mixture of rules and principles whose application and interaction generates a rich complex tapestry that diminishes the utility of any such tidy classifications.

Before deeply examining corporate law, note first that inquiry concerning rules versus principles in corporate law is distinct from the debate in corporate law scholarship concerning whether the law is or should be more mandatory or enabling.<sup>62</sup> Corporate law doctrines array along a rules-principles continuum whether they are required by law or optional. Take cumulative voting. Most state statutes authorize but do not require using this voting method.<sup>63</sup> Even so, the law of cumulative voting is best located at the rules end of the range, for it denotes a specific mathematical formula for casting and counting votes in director elections. In the minority of states that require cumulative voting, disputes concerning its use may be resolved by applying principles-like tools such as fiduciary duty.<sup>64</sup>

At the rules end of the corporate law spectrum are provisions that establish a hierarchy of sources of legal authority. This hierarchy puts state corporation law statutes at the top, followed by articles of incorporation (the charter), then by-laws and then contracts (with judicial decisions hovering throughout). So statutes may authorize corporations to adopt tailored provisions suiting particular goals, but then require that any tailored provision appear in the charter or in the by-laws.<sup>65</sup> Courts treat as a dead letter

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<sup>61</sup> Troy A. Paredes, *A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law Isn't the Answer*, 45 WM. & MARY L. REV. 1055, 1133-1134 (2004) (“Delaware law of fiduciary duties is itself more rule-like and predictable than many standards, having been fleshed out by an extensive body of case law precedent that reflects a consistent underlying norm of shareholder primacy”); compare Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1071 (“Delaware’s corporate law rules are standards based”) (emphasis added); Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1104 (1997) (criticizing “a persistent tendency to acknowledge that Delaware corporate law largely involves standards, but then to try to reduce it to a set of rules”).

<sup>62</sup> See John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618 (1989) (distinguishing debate over contractual freedom from inquiry into how judges should approach gaps in corporate arrangements); Larry E. Ribstein, *The Mandatory Nature of the ALI Code*, 61 GEO. WASH. L. REV. 985 (1993).

<sup>63</sup> Del. Gen. Corp. L. § 214; Model Act § 7.28.

<sup>64</sup> See, e.g., *Humphrys v. Winous Co.*, 133 N.E.2d 780 (Ohio 1956).

<sup>65</sup> E.g., Model Act §§ 7.27 (action by shareholders); 7.28 (election of directors); 8.24 (action by directors).

provisions placed in the wrong document.<sup>66</sup> When the charter and by-laws contain conflicting provisions, a corporate law rule provides that the charter controls.<sup>67</sup>

Rules delineate the distribution of power in corporate life. The basic rule relating to shareholder power is a simple negative injunction: shareholders have no general power over management of a corporation.<sup>68</sup> Corporation statutes provide that boards have this power. Statutes grant shareholders power in specific situations, usually director elections, charter amendments, certain business combinations and dissolutions.<sup>69</sup> Even in specific cases where shareholders have power, they usually lack authority to initiate action but may only consent to (or withhold consent from) board-made proposals.<sup>70</sup>

Rules require that shareholders elect directors.<sup>71</sup> Rules granting managerial power to boards are accompanied by additional rules regulating board conduct. Directors have no power to act individually, but only to bind the corporation when acting together as a board. Both statutory rules and judicial applications impose stringent formalities for board action. For example, the statutes contain rules requiring notice and quorums and also authorize action by written consent in lieu of meetings but only if unanimous and using teleconference connections but only if specified requirements are met.<sup>72</sup>

Why all these rules? They provide a baseline ordering mechanism necessary to create the formal creature law calls the corporation; they also begin to shape the balance of power among its participants.<sup>73</sup> Principles come into play and mediate these rules, provide rationales, and interact with them to alter the system's overall character. Thus while the hierarchy of corporate law sources contributes apparent rule-like certainty, it is possible to persuade a court to enforce, as a contract, a provision placed in a by-law when

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<sup>66</sup> See *Roach v. Bynum*, 437 So.2d 69 (Ala. 1983) (super-majority shareholder quorum and voting provision required to appear in charter appeared in by-law and so was unenforceable); *Datapoint Corp. v. Plaza Securities Co.*, 496 A.2d 1031 (Del. 1985) (director-approved by-law amendment limiting shareholder action by written consent unenforceable because it conflicted with Delaware Code §228(b) which requires any limitations on this grant of authority to appear in the charter).

<sup>67</sup> See *Paulek v. Isgar*, 551 P.2d 213 (Colo. App. 1976); *Benintendi v. Kenton Hotel, Inc.*, 294 N.Y. 112 (1945).

<sup>68</sup> See Model Act § 8.01; Del. Gen. Corp. L. § 141(a); *Gashwiler v. Willis*, 33 Cal. 11 (1867).

<sup>69</sup> E.g., Model Act §§ 8.03 & 8.05 (election of directors), §§ 10.03 & 10.04 (amendment of articles of incorporation), § 11.03 (statutory mergers) and §§ 14.02 & 14.03 (voluntary dissolution).

<sup>70</sup> See, e.g., Lucian Ayre Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43 (2003).

<sup>71</sup> Del. Gen. Corp. L. § 211(b).

<sup>72</sup> E.g., Del. Gen. Corp. L. § 141(f) & Model Act § 8.21 (action by unanimous written consent in lieu of a meeting); Del. Gen. Corp. L. § 141(i) (board meetings using teleconference connections).

<sup>73</sup> See Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1593 (1989) (noting power allocation function of such mandatory terms in corporate law).

a statute directs it to appear in the charter.<sup>74</sup> Rules granting managerial power to boards and episodic consenting power to shareholders are relaxed considerably into a principles-like framework for closely-held corporations, a context in which many traditional rules of corporate law similarly relax into principles.<sup>75</sup>

Toward the rules end of the corporate law spectrum are provisions governing the forms of business combinations and divestitures. Corporate law offers a menu of alternative forms, including statutory merger, asset sales and stock sales.<sup>76</sup> This enables transaction engineers to structure deals that, while having identical substantive effects, may or may not require a shareholder vote or carry appraisal rights.<sup>77</sup> Courts respect formal rules, invoking such further rules as the doctrine of independent legal significance (in effect, a denial of the so-called de facto merger doctrine).<sup>78</sup> To protect against hostile takeover bids, moreover, statutes offer rule-bound anti-takeover provisions.<sup>79</sup>

Rules also enable designing transactions to achieve identical substantive results using subsidiary corporations that likewise avoid shareholder votes or appraisal rights. Courts similarly defer to these structural maneuvers, projecting a rigid rule-like quality to these laws.<sup>80</sup> They respect statutory distinctions between redemptions and mergers, even when transactional alternatives present identical substantive consequences to shareholders.<sup>81</sup> The same rule-bound results follow in relation to third parties. Transactions structured as mergers mean that all assets and liabilities of the constituent corporations combine “by operation of law” with immutable implications for third-party consents<sup>82</sup> whereas in asset or stock acquisitions they transfer by operation of contract with changeable implications for third-party consents.<sup>83</sup>

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<sup>74</sup> See *Jones v. Wallace*, 628 P.2d 388 (Or. 1981).

<sup>75</sup> See, e.g., *Zion v. Kurtz*, 405 N.E.2d 681 (N.Y. 1980) (enforcing agreement despite noncompliance with statutory provisions); *Triggs v. Triggs*, 385 N.E.2d 1254 (N.Y. 1978) (same); see also Larry E. Ribstein & Burce Kobayashi, *Choice of Form and Network Externalities*, 43 WM. & MARY L. REV. 79, 85 & 89 (2001).

<sup>76</sup> Del. Gen. Corp. L. §§ 241 (redemptions), 251 (mergers), 271 (asset sales); see also Model Act, § 11.03 (share exchange).

<sup>77</sup> See *Heilbrunn v. Sun Chemical*, 150 A.2d 755 (Del. 1959); *Hariton v. Arco Electronics, Inc.*, 188 A.2d 123 (Del. 1963).

<sup>78</sup> See D. Gordon Smith, *Independent Legal Significance, Good Faith, and the Interpretation of Venture Capital Contracts*, 40 WILLAMETTE L. REV. 825 (2004).

<sup>79</sup> E.g., Del. Gen. Corp. L. § 203 (specific rules lay out ex ante instructions using extensive definition, of terms such as interested stockholder, and bright-lines, such as 90-day and 3-year periods and 66.66% voting and 85% ownership thresholds).

<sup>80</sup> See, e.g., *Equity Group Holdings v. DMG*, 576 F. Supp. 1197 (S.D. Fla. 1983) (applying Florida law).

<sup>81</sup> See, e.g., *Rauch v. RCA Corp.*, 861 F.2d 29 (2d Cir. 1988) (applying Delaware law).

<sup>82</sup> See *PPG Indus. v. Guardian Indus.*, 597 F.2d 1090 (6<sup>th</sup> Cir.), cert. denied 444 U.S. 930 (1979).

<sup>83</sup> See *Branmar Theatre v. Branmar, Inc.*, 264 A.2d 526 (Del. Ch. 1970).



Why these rules? As with the rules and principles establishing and mediating the hierarchy of sources in corporate law, these rules prescribe mechanical devices to govern a corporation's life; they also allocate power among participants. How are they mediated? As to respecting forms of corporate combinations, the de facto merger doctrine sometimes prevails for shareholders and more often succeeds when advanced by other constituencies to challenge formal transaction structures. Thus, non-shareholder claimants increasingly succeed in invoking the de facto merger doctrine when asserting claims in tort, labor and environmental law.<sup>84</sup>

The statutory law of appraisal rights is intensely rule-bound, especially in Delaware. There, appraisal provisions are a detailed labyrinth of rules that first grant rights, then deny those rights, and then restore some of those rights, depending on stated formal attributes of a transaction.<sup>85</sup> Yet courts awarding the appraisal remedy face numerous questions whose resolution requires applying vague concepts. These involve such matters as whether the appraisal remedy is exclusive or may be conjoined with other claims,<sup>86</sup> the applicable valuation method,<sup>87</sup> and identification of the business to be valued.<sup>88</sup> Resulting appraisal remedy doctrine can be described as rules-based or principles-based because, in fact, it is a mixture—but neither is a particularly faithful description.

Toward the principles end of the continuum in corporate law are the laws of fiduciary duty, mainly the duties of care and loyalty. It is possible to understand much of Delaware corporate fiduciary duty law as hortatory sermonizing.<sup>89</sup> Many characterize Delaware fiduciary duty law as indeterminate, putting it squarely on the principles (vague) end of any continuum.<sup>90</sup> That location is unsurprising when one considers that Delaware courts conceive of themselves as courts in equity (a designation still formally

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<sup>84</sup> See, e.g., *Ruiz v. Blentech Corp.*, 89 F.3d 320 (7<sup>th</sup> Cir. 1996) (personal injuries); *Fall River Dyeing & Finishing Corp. v. NLRB*, 482 U.S. 27 (1987) (labor); *North Shore Gas Co. v. Salomon, Inc.*, 152 F.3d 642 (7<sup>th</sup> Cir. 1998) (environmental).

<sup>85</sup> Del. Gen. Corp. L. § 262.

<sup>86</sup> See *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983); *Rabkin v. Philip A. Hunt Chemical Corp.*, 498 A.2d 1099 (Del. 1985); *Glassman v. Unocal Exploration Corp.*, 777 A.2d 242 (2001).

<sup>87</sup> *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

<sup>88</sup> *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993) (whether the business to be valued is solely the business as it existed absent the transaction or taking account of value that arises in the first-stage of a two-step acquisition).

<sup>89</sup> See Rock, *Saints and Sinners*, *supra* note \_\_\_\_.

<sup>90</sup> See Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1, 53 n. 221 (2005) (citing and summarizing more than a dozen articles offering competing assessments of the virtues of such indeterminacy in Delaware corporate fiduciary duty law).

retained by its Court of Chancery).<sup>91</sup> Even when statutorily codified, as in the Model Business Corporation Act (the Model Act), the duty of care bears a vague general quality typically associated with principles.<sup>92</sup>

Still, fiduciary duty cases addressing designated doctrinal subjects can be synthesized into recognizable rules.<sup>93</sup> In mundane cases of ordinary business decisions or activity, the business judgment rule presumes that directors met their duty of care. The few cases exposing directors to liability for breaching the duty of care in ordinary contexts address egregious behavior, as when directors are inebriated, ill-informed or commit illegal acts.<sup>94</sup> A rule emerges that directors are liable for breach of the duty of care in ordinary settings only when drunk, ignorant or criminal. Corporations also can opt for a statute-authorized rule against personal director financial liability for breaching the duty of care,<sup>95</sup> a license created immediately after the Delaware Supreme Court held ill-informed directors liable for breaching the duty.<sup>96</sup>

That license assumes the form of a rule: it concretely and prospectively authorizes exculpation. The rule has a limit. Exculpation does not extend to liability arising from “acts or omissions not in good faith.”<sup>97</sup> The vast majority of Delaware corporations took advantage of the rule. That, in turn, contributed to increasing judicial invocation of a principle of good faith.<sup>98</sup> Resulting judicial opinions are complex and so difficult to reconcile that they provide little advance direction.<sup>99</sup> The result is a vagueness

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<sup>91</sup> See Lawrence A. Cunningham & Charles M. Yablon, *Delaware Fiduciary Duty Law after QVC and Technicolor: A Unified Standard (and the End of Revlon Duties?)*, 49 BUS. LAW. 1593 (1994); Lyman P.Q. Johnson & Mark A. Sides, *The Sarbanes-Oxley Act and Fiduciary Duties*, 30 WM. MITCHELL L. REV. 1149, 1193-94 (2004).

<sup>92</sup> See Model Act § 8.30; D. Gordon Smith, *A Proposal to Eliminate Director Standards from the Model Business Corporation Act*, 68 CIN. L. REV. 1201 (1999).

<sup>93</sup> See Paredes, *A Systems Approach*, *supra* note \_\_\_, at 1133-34; see also Rock, *Saints and Sinners*, *supra* note \_\_\_, at 1104 (noting and criticizing tendency of scholars to pursue this route).

<sup>94</sup> See *Francis v. United Jersey Bank*, 432 A.2d 814 (N.J. 1981); *Smith v. Van Gorkum*, 488 A.2d 858 (Del. 1985); *Miller v. AT&T*, 507 F.2d 759, 762 (3d Cir. 1974) (applying New York law); see also *In re Caremark Int'l Inc.*, 698 A.2d 959 (Del. Ch. 1996) (opinion approving settlement elaborating, in dicta, on duty of care's bearing on maintaining a system of internal control).

<sup>95</sup> Del. Gen. Corp. L. § 102(b)(7).

<sup>96</sup> *Smith v. Van Gorkum*, 488 A.2d 858 (Del. 1985); see also Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STAN. L. REV. 1055 (2006).

<sup>97</sup> Del. Gen. Corp. L. § 102(b)(7). The limitation also excludes liability arising from breaches of the duty of loyalty, unlawful distributions, intentional misconduct, knowing violations of law and deriving improper personal benefits. *Id.*

<sup>98</sup> See Hillary Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456 (2004); Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 DEL. J. CORP. L. 1 (2006).

<sup>99</sup> See Matthew R. Berry, *Does Delaware's Section 102(b)(7) Protect Reckless Directors From Personal Liability? Only if Delaware Courts Act in Good Faith*, 79 WASH. L. REV. 1125 (2004); John L. Reed &

characteristic of principles. This development illustrates not only how rules and principles interact but also how a relatively tight statutory rule enables its judicial transformation into a much more open-ended principle.<sup>100</sup>

The ultimate principle in corporate law is the duty of loyalty.<sup>101</sup> This forbids corporate officers and directors to act contrary to the interests of their beneficiary, traditionally meaning the corporation and its shareholders. When personal and corporate interests conflict, the official must subordinate her interests to those of the corporation and its shareholders. These abstract principles are mediated in many states by statutory safe-harbor rules delineating processes that officials can follow to protect their decisions from judicial rebuke in such “self-interested” transactions—usually approval by a majority of disinterested and fully-informed directors or shareholders.<sup>102</sup>

Although written as rules, the linguistic character of such statutes requires interpretation that judges perform to mediate between the principle of loyalty and the rules of process that the statutes articulate. From the interaction, cases produce results with varying degrees of vagueness (blending attributes of rules and principles). Thus, even though the duty of loyalty is equity-like, it still carries hints of rule-ness. This quality manifests in the tests that Delaware courts use to evaluate breaches of the duty in contexts in addition to self-interested transactions, especially the entire fairness test in cash-out mergers and the heightened scrutiny applied in takeover contexts.<sup>103</sup>

In cash-out mergers, judges endorse using an independent committee to mimic an arms’-length transaction measured by fair value.<sup>104</sup> In takeovers, courts particularize abstract fiduciary duty to require boards to auction a company to the highest bidder if a sale is to be effected;<sup>105</sup> if a transaction does not amount to a sale, then associated

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Matt Neiderman, *Good Faith and the Ability of Directors to Assert §102(b)(7) of the Delaware Corporation Law as a Defense to Claims Alleging Abdication, Lack of Oversight, and Similar Breaches of Fiduciary Duty*, 29 DEL. J. CORP. L. 111 (2004); David Rosenberg, *Making Sense of Good Faith in Delaware Corporate Fiduciary Law: A Contractarian Approach*, 29 DEL. J. CORP. L. 491 (2004).

<sup>100</sup> See *supra* text accompanying notes \_\_\_\_-\_\_\_\_.

<sup>101</sup> E.g., *Schnell v. Christ-Craft Indus., Inc.*, 285 A.2d 437, 439 (Del. 1971) (“inequitable action does not become permissible simply because it is legally possible”).

<sup>102</sup> See, e.g., Del. Gen. Corp. L. § 144; Model Act §§ 8.60-8.63.

<sup>103</sup> See Marcel Kahan, *Paramount or Paradox: The Delaware Supreme Court’s Takeover Jurisprudence*, 19 J. CORP. L. 583 (1994) (offering coherent account of Delaware takeover cases despite much criticism of them as incoherent); Troy A. Paredes, *The Firm and the Nature of Control: Toward a Theory of Takeover Law*, 29 J. CORP. L. 103 (2003) (offering coherent account of the cases using the theory of the firm).

<sup>104</sup> *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983); *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988); see Lawrence E. Mitchell, *Fairness and Trust in Corporate Law*, 43 DUKE L.J. 425, 434-36 (1993) (discussing process-oriented concept of fairness in corporate law).

<sup>105</sup> See *Arnold v. Society for Savings Bancorp*, 678 A.2d 533 (Del. 1996); *Paramount Comm., Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1994); *Revlon v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986); *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261 (1989).

defensive tactics must survive a reasonableness test.<sup>106</sup> In both contexts, courts review whether directors were independent and followed a sufficient process to benefit shareholders, blending rules and principles.<sup>107</sup>

If corporate law contains both rules and principles that are applied and interact in these classification-defying ways, does it matter whether an articulation originates as a rule or as a principle? Two examples suggest that it matters little. First, laws governing shareholder distributions can be stated either way. Traditional statutes, such as Delaware's, are detailed rules that apply concepts of par value and legal capital;<sup>108</sup> modern statutes, like the Model Act, use general principles, forbidding distributions if making them would prevent the corporation from paying its debts when due or reduce its assets below liabilities (measured using any methods that are reasonable in the circumstances).<sup>109</sup> Courts apply the traditional statutes liberally, allowing boards to measure statutory terms (such as assets and liabilities) according to reasonable valuations they choose.<sup>110</sup> Perhaps it matters whether one or the other is the starting point, but this evidence suggests that it matters only slightly.<sup>111</sup>

Second, a similar lawmaking option characterizes corporate law governing asset sales. Traditional statutes require shareholder consent when a corporation's board proposes to sell "all or substantially all" the corporation's assets.<sup>112</sup> Innovative statutes attempt greater specification by requiring a shareholder vote only if the transaction leaves the corporation "without a significant continuing business activity."<sup>113</sup> Comparing the provisions, the traditional one is relatively more principles-like and the innovative one slightly more rule-like (a pure rule formulation would define the threshold numerically,

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<sup>106</sup> See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989).

<sup>107</sup> Emphasis on the process-oriented rules produces concern that directors and advisors use mindless checklists to meet the expected requirements. See Stephen J. Lubben & Alana Darnell, *Delaware's Duty of Care*, 31 DEL. J. CORP. L. 589, 589 (2006) ("tracing the waning of the duty of care: a rule that now requires little more of a director than a ritualistic consideration of relevant data"); *infra* Part III.A.

<sup>108</sup> Del. Gen. Corp. L. §§ 154, 160, 170, 171, 173, 244.

<sup>109</sup> Model Act, §§ 6.21 & 6.40.

<sup>110</sup> See *Klang v. Smith's Food & Drug Centers, Inc.*, 702 A.2d 150 (Del. 1997); *Randall v. Bailey*, 23 N.Y.S.2d 173 (Sup. Ct. N.Y. 1940); *Pereira v. Cogan*, 294 B.R. 449 (S.D.N.Y. 2003) (applying New York law).

<sup>111</sup> See BAYLESS MANNING & JAMES J. HANKS, JR., *LEGAL CAPITAL* (3d ed. 1990); Craig A. Peterson & Norman W. Hawker, *Does Corporate Law Matter? Legal Capital Restrictions on Stock Distributions*, 31 AKRON L. REV. 175 (1997) (empirical study showing that the forms may matter some for purposes of signaling information to shareholders in the market even if they do not matter much in respect of creditor protection).

<sup>112</sup> *E.g.*, Del. Gen. Corp. L. § 271.

<sup>113</sup> See Model Act § 12.02(a).

and no US corporate law statute does so). Yet the alternative statutes lead to the same result.<sup>114</sup>

This survey spans much of the corporate law syllabus. A full examination would confirm that rules and principles dot the landscape in blended measure, with applications and interactions that influence and reshape systemic characteristics. Rule-like provisions address corporate formation, preemptive rights, director removal and shareholder oppression and deadlock; principle-like provisions mediate each of these. Principles-like provisions also appear in the corporate opportunity doctrine, where case law also enables synthesized statements bearing rule-like character;<sup>115</sup> limited liability is a rule subject to exceptions based on public regarding principles;<sup>116</sup> and corporate dispute administration is replete with yet another set of principles and rules, addressing matters such as indemnification, special litigation committees and statutes of limitation.<sup>117</sup> But these illustrations should suffice to question the possibility of tidy classification of corporate law as rules-based or principles-based (in Delaware or other states).

2. Securities Regulation — Many scholars (and judges) nevertheless promote Delaware corporate law as principles-based, especially when contrasting this with US federal securities regulation, which is alleged to be rules-based.<sup>118</sup> Others believe that the purpose of the asserted rules-density of federal securities regulation is to offset the

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<sup>114</sup> See *Hollinger Inc. v. Hollinger Int'l Inc.*, 858 A.2d 342, 386, n. 79 (Del. Ch. 2004) (emphasizing comparability of Delaware's § 271 with the Model Act's § 12.02(a) despite how they “differ verbally”), *aff'd* 872 A.2d 559 (Del. 2005).

<sup>115</sup> See *Northeast Harbor Golf Club, Inc. v. Harris*, 725 A.2d 1018 (Me. 1999) (drawing on synthesis of the corporate opportunity doctrine as codified by the American Law Institute as a way to provide clarity to this “murky area”); see also Harvey Gelb, *The Corporate Opportunity Doctrine: Recent Cases and the Elusive Goal of Clarity*, 31 U. RICHMOND L. REV. 371 (surveying various state tests in corporate opportunity doctrine, including factors of corporate capacity and information disclosure, showing both broad principles and specific rules at work); Eric Talley, *Turning Servile Opportunities to Gold: A Strategic Analysis of the Corporate Opportunities Doctrine*, 108 YALE L.J. 279, 208 (1998) (succinctly stating the doctrine in a simple algorithm bearing a rule-like quality and expressing regret that “this doctrinal algorithm has proven unwieldy in application”).

<sup>116</sup> See Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036 (1991).

<sup>117</sup> See Matthew G. Dore, *Statutes of Limitation and Corporate Fiduciary Claims: A Search for Middle Ground on the Rules/Standards Continuum*, 63 BROOKLYN L. REV. 695, 720-736 (1997).

<sup>118</sup> E.g., Griffith & Steele, *On Corporate Law Federalism*, *supra* note \_\_\_, at 20-23 (contrasting Delaware corporate law's “supple,” “flexible,” “subtle” and “responsive” corporate law to federal securities regulation which involves “issuing mandates,” “governance directives,” and “orders”); Kamar, *Jurisdictional competition Theory of Indeterminacy*, *supra* note \_\_\_, at 1921 (“It is instructive . . . to compare Delaware law with federal securities law, which [is] rule-based”); Faith Stevelman Kahn, *Rethinking Corporate Fiduciary Law's Relevance to Corporate Disclosure*, 34 GA. L. REV. 505, 512-513 (2000) (flexible corporate law is more effective than “comparatively rigid, rules-based systems . . . such as the securities laws”).

deficiencies of state corporation law's alleged penchant for principles.<sup>119</sup> US securities regulation also often is decried as being rules-based in contrast to other nations' securities regulations, especially Canada's, which are described as principles-based.<sup>120</sup> The following survey of US securities regulation supports none of these characterizations.

At the rules end of the securities regulation continuum are the vast majority of laws governing securities offerings. Entities, transactions and securities must be registered and prescribed prospectuses prepared and circulated. As with much of the structure of US federal securities regulation across all contexts, such provisions are subject to exemptions and exceptions to the exemptions and are protected by safe harbors. Section 5 of the Securities Act of 1933 Act requires registration unless an exemption exists.<sup>121</sup> Sections 3 and 4 of the 1933 Act provide exemptions and SEC regulations provide safe harbors, all of which contain precisely delineated boundaries<sup>122</sup>—although some also use vague provisions such as a condition of good faith<sup>123</sup> or depend on open-textured concepts such as whether an offering is “public” or “private.”<sup>124</sup>

Toward the rules end of the securities regulation continuum are many laws governing securities firms. While mostly rule-like, they are tinged with an overlaying texture best described as principle-like. Examples of broker-dealer *rules* are: net capital

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<sup>119</sup> See Mark J. Roe, *Institutional Foundations for Securities Markets in the West* (2002) (on file with the author and available at <http://www.econ.nyu.edu/user/frydmanr/Roe-AER2003.doc>).

<sup>120</sup> E.g., Kuras, *supra* note \_\_\_ (Canadian versus US); Robert Wright, *Enron: The Ambitious and the Greedy*, 16 WINDSOR REV. LEG. & SOC. ISSUES 71, 73 (2003) (Canadian versus US).

<sup>121</sup> Securities Act, §5(a)(1) (making it unlawful to use interstate commerce to sell a security unless a registration statement is effective); 5(a)(2) (forbidding using interstate commerce to carry an unregistered security for purposes of selling or delivering it); 5(a)(3) (prohibiting offering to buy or sell a security before a registration statement has been filed for it). Similarly, the Exchange Act exempts government and municipal securities and numerous others. See Exchange Act, §3(a)(12) (defining “exempted security” for purposes of otherwise required registration under Exchange Act §12(b)).

<sup>122</sup> Exempted classes of securities under the Securities Act include for self-employed benefit plans, commercial paper, charitable and other nonprofit issuers, insurance, compensatory benefit plans and small issues. Securities Act of 1933, §§ 3(a)(2)-(4), (8); Rule 701; Regulations A & D. Exempted transactions include exchanges with existing shareholders, intrastate issues, private offerings and transactions by dealers and brokers. *Id.*, §§ 3(a)(9), 3(a)(11), 4(1)-(4); Rules 144 & 144A. As to safe harbors, see, e.g., Securities Act Rule 135 (addressing §5(c) liability); *Chris-Craft Indus., Inc. v. Bangor Punta Corp.*, 426 F.2d 569, 574 (2d Cir. 1970) (en banc) (emphasizing rule-like character of the safe harbor, which it refers to as based on a “checklist of features” that provides guidance superior to any “judicially formulated ‘rule of reason’”); §10 (allowing tombstone advertisements).

<sup>123</sup> 17 C.F.R. 231.646 (eligibility for §3(a)(9)'s exemption for exchanges with existing shareholders must involve an exchange made in good faith and not one intended simply to evade the statute's requirements).

<sup>124</sup> See, e.g., SEC Rel. No. 33-4552, Fed. Sec. L. Rep. ¶¶ 2771-72 & 2275-76 (1962) (factors applied to determine whether the private offering exemption is available include the identity, number and sophistication of the offerees and size and manner of offer); 17 C.F.R. 231.285 (same).

rules,<sup>125</sup> credit extension rules,<sup>126</sup> short-sale rules,<sup>127</sup> trading practices rules,<sup>128</sup> customer confirmation rules,<sup>129</sup> and rules governing contingency offerings.<sup>130</sup> These rules are supplemented by broad anti-fraud principles of general applicability<sup>131</sup> and tailored to the broker-dealer context by prohibitions on misappropriating customer funds or securities, unsuitable or unauthorized trading, churning, and charging excessive markups.<sup>132</sup>

Why these rules (as supplemented by the principles)? As with corporate laws governing the hierarchy of sources of legal authority and addressing business combinations and divestitures, securities regulations stating filing requirements and firm conduct provide a baseline. They establish requirements that are fundamental to the existence of a regulated disclosure system and securities industry. True, these laws are not inevitable—the free market could be left to its own devices—but once a decision to regulate is made, it is not surprising that the attributes of the regulatory system at this basic level should be rule-like.

Nor is it surprising that such rules are mediated by associated principles. In fact, all broker-dealer regulations ultimately derive from principles that predate US federal securities acts as epitomized by the traditional “shingle theory” of securities professionals.<sup>133</sup> For example, the duty to obtain best execution for customer transactions is rooted in common law agency principles.<sup>134</sup> Other general principles that flow from these traditional concepts include the imposition of duties on firms to supervise employees.<sup>135</sup> Additional examples of principles include those that the SEC

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<sup>125</sup> 17 C.F.R. 240.15c3-1 (including specifying methods of computing net capital).

<sup>126</sup> See, e.g., Reg. T, 12 C.F.R. 220.1 to 220.132.

<sup>127</sup> 17 C.F.R. 240.10a-1.

<sup>128</sup> See Reg. M, 62 Fed. Reg. 520 (codified at 17 C.F.R. 242); Rules 101, 102, 62 Fed. Reg. 520, 546-548 (codified at 17 C.F.R. 242.1-10243.102).

<sup>129</sup> Exchange Act Rule 10b-10.

<sup>130</sup> 17 C.F.R. 240.10b-9, 240.15c2-4.

<sup>131</sup> See Exchange Act § 10(b), 15 U.S.C. 78j and Rule 10b-5, 17 C.F.R. 240.10b-5; Securities Act § 17(a), 15 U.S.C. 77(1).

<sup>132</sup> Exchange Act, Rules 15c1-2, 15c2-2, 17 C.F.R. 240.15c1-2, 240.15c2-2.

<sup>133</sup> See *Kahn v. SEC*, 291 F.2d 112, 115 (2<sup>nd</sup> Cir. 1961) (Clark, J., concurring); Roberta Karmel, *Is the Shingle Theory Dead?*, 52 WASH. & LEE L. REV. 1271 (1995) (explaining the concept as constituting an implied representation of fair dealing based upon holding oneself out to the public as a broker or dealer).

<sup>134</sup> SEC Rel. No. 34-37619A (1996), Fed. Sec. L. Rep. ¶ 85,837 (CCH); *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154 (3<sup>rd</sup> Cir. 2001) (en banc)

<sup>135</sup> Exchange Act §15(b)(4)(E); see Lewis D. Lowenfels & Alan R. Bromberg, *Broker-Dealer Supervision: A Troublesome Area*, 25 SETON HALL L. REV. 527 (1994); John H. Walsh, *Right the First Time: Regulation, Quality, and Preventive Compliance in the Securities Industry*, 1997 COLUM. BUS. L. REV.

has invoked to contest the inappropriate influence by investment bankers over research analysts<sup>136</sup> and the allocation of IPO shares to favored customers in exchange for inflated commissions or markdowns.<sup>137</sup>

Disclosure laws include both rules and principles. Laws governing the timing of filing disclosure documents are rule-like (including Section 13(d)'s requirement of disclosure at the 5% ownership level). General laws qualified by concepts of materiality are thoroughly and consciously principles-like.<sup>138</sup> The SEC's requirement that disclosure be written in "plain-English" is a principle, although it also contains specific rule-like components such as a prohibition against using "multiple negatives."<sup>139</sup> Disclosure concerning financial matters may bear attributes of rules or principles according to the qualities of the related accounting provisions. The SEC offers a typology and illustrates the categories by characterizing certain accounting provisions as rules and others principles.<sup>140</sup>

Toward the principles end of the securities regulation spectrum, US insider trading laws prohibit trading while in possession of material non-public information when occupying some capacity of trust or other special relationship.<sup>141</sup> As applied to corporate officers and directors, these laws derive from state fiduciary duty principles and become a federal violation when coupled to the anti-fraud provisions of federal securities statutes, which state broad principles.<sup>142</sup> The SEC accelerated the development of these

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165; *In re Prudential Bache Securities*, Rel. No. 34-22755, Fed. Sec. L. Rep. 83,948 (1986); *In re Matter of Prudential Securities, Inc.*, SEC Exchange Act Rel. No. 48149 (2003).

<sup>136</sup> See *Analyst Research Global Settlement*, SEC (Dec. 20, 2002).

<sup>137</sup> See *SEC v. Parnes*, Litig. Rel. No. 16877 (Jan. 31, 2001) (proceedings concerning Datek Securities).

<sup>138</sup> Congress, the SEC and courts have emphatically eschewed providing any bright-line content to the concept of materiality. See, e.g., *Basic v. Levinson*, 485 U.S. 224, 236 (1988) (rejecting agreement-in-principle test to trigger materiality of preliminary merger negotiations and stating that "A bright-line rule indeed is easier to follow than a standard that requires the exercise of judgment in the light of all the circumstances. But ease of application alone is not an excuse for ignoring the purposes of the securities acts and Congress' policy decisions."); SEC, Reg. FD, Rel. No. 34-43154, Fed. Sec. L. Rep. 86,319 (CCH) (2000) ("we do not believe an appropriate answer to [the difficulty of defining materiality] is to set forth a bright-line test, or an exclusive list of 'material' items"); SEC, Staff Accounting Bulletin No. 99 (Aug. 12, 1999) (for accounting, rejecting efforts to design rules of thumb, such as a threshold measure of 5% of earnings).

<sup>139</sup> SEC Rule 421(c) (all required prospectus information is to be written in clearly understandable prose); Rule 421(d)(2) (no multiple negatives).

<sup>140</sup> Securities and Exchange Commission, Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the US Financial Reporting System of a Principles-Based Accounting System (2003) [hereinafter, "SEC, SOX 108 Study"]. The SEC's typology is discussed in detail in the next Section.

<sup>141</sup> See *United States v. O'Hagan*, 521 U.S. 642 (1997).

<sup>142</sup> Four classes of persons are exposed to insider trading restrictions and hence liability: classical insiders (based on corporate positions), temporary insiders (often professionals providing services to the



laws in the mid-1980s when it began a vigorous campaign using the enforcement model described as ad hoc—meaning weighted towards enforcing broad abstract principles rather than specific detailed rules.<sup>143</sup>

Despite the genesis of insider trading laws as principles, resulting applications can yield expressions bearing rule-like attributes. At least in terms of their specificity and particularity, this famously occurs when attempting to state the law governing tipper-tipee liability, where vagueness dissolves into a dense rule-patterned framework.<sup>144</sup> Based on the extent of advance notice provided, the SEC offers rule-like certainty concerning non-business relationships that create liability risk<sup>145</sup> and concerning insiders who trade for reasons not based on their inside information.<sup>146</sup>

Some laws with principles-like qualities morph into multi-factor tests. Consider the law forbidding market manipulation.<sup>147</sup> All US market manipulation laws stem, in turn, from Section 10(b)'s principle proscribing “manipulative or deceptive devices or contrivances.” Establishing a market manipulation violation requires proving: (1) a misrepresentation or omission of material facts or other fraudulent device; (2) made in

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corporation), tippers and tpees in the flow of information that includes such insiders and misappropriators who essentially steal inside information. Ultimately, all these persons are restricted and liable based upon some ultimate connection to a breach of fiduciary duty. *See, e.g., SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (classic insider), cert. denied, 394 U.S. 976 (1969); *SEC v. Tome*, 833 F.2d 1086 (2<sup>nd</sup> Cir. 1987) (temporary insider); *Dirks v. SEC*, 463 U.S. 646 (1983) (tipping); *United States v. O'Hagan*, 521 U.S. 642 (1997) (misappropriation).

<sup>143</sup> *See* Harvey L. Pitt & Karen L. Shapiro, *Securities Regulation by Enforcement: A Look Ahead At the Next Decade*, 7 YALE J. REG. 149, 156-157 (1990). The foundations of this enforcement program were rooted in principles established two decades earlier. *See In re Cady Roberts*, 40 S.E.C. 907 (1961).

<sup>144</sup> *See* Douglas M. Branson, *Choosing the Appropriate Default Rule: Insider Trading Under State Law*, 45 ALA. L. REV. 753, 759-60 (1994) (dissecting the “complex” law of tippee liability stated in *SEC v. Dirks*, 463 U.S. 646 (1983)); *see also* Lawrence E. Mitchell, *The Jurisprudence of the Misappropriation Theory and the New Insider Trading Legislation: From Fairness to Efficiency and Back*, 52 ALB. L. REV. 775 (1988).

<sup>145</sup> 17 C.F.R. 240.10b5-2 (2006) (Rule 10b5-2, adopted in 2000, stating three non-exclusive circumstances in which a person receiving confidential information owes a duty of trust or confidence that would trigger application of the misappropriation theory). *See SEC v. Yun*, 327 F.3d 1263 1273 (11<sup>th</sup> Cir. 2003) (discussing background and scope of the SEC's rule).

<sup>146</sup> 17 C.F.R. 240.10b5-1 (2006) (Rule 10b5-1 stating that insiders may trade on inside information when it is clear that the information is not a factor in their decision to trade, as under a pre-existing plan, contract, or good faith instruction). *See* Alan D. Jagolinzer, *Do Insiders Trade Strategically within the SEC Rule 10b5-1 Safe Harbor?* (Aug. 29, 2005), available at <http://ssrn.com/abstract=541502> (providing evidence suggesting that insiders exploit the rule-like characteristics of this provision).

<sup>147</sup> Section 9 of the 1934 Act prohibits “manipulation of security prices. ”Securities Act of 1933 §9(a)(2) (it is unlawful for any person to effect transactions “creating actual or apparent trading activity . . . or raising or depressing [its] price . . . for the purpose of inducing the purchase or sale of such security by others”).

connection with the sale or purchase of securities; and (3) made with scienter.<sup>148</sup> This proof requires assessing multiple factors concerning the nature, timing, and context of the trades.<sup>149</sup>

At the ultimate principles end of the continuum are securities laws containing anti-fraud and anti-abuse provisions. The anti-fraud provisions encompass not only insider trading and market manipulation, but nearly every provision in federal securities regulation.<sup>150</sup> As noted, various regulations authorize exemptions from registration for certain transactions, so long as certain rule-like attributes exist. But these also provide that stated exemptions are unavailable if a transaction (or series of them) technically complies with the rules but otherwise is a scheme to evade the registration provisions.<sup>151</sup> For example, one anti-abuse principle broadly covers securities held in a form “used primarily to circumvent” the reporting provisions of the 1934 Act.<sup>152</sup> Broker-dealer regulations include principles that expose professionals to liability for violation of the anti-fraud provisions of Section 10(b) even if they comply to the letter with the disclosure requirements imposed under the customer confirmation rules.<sup>153</sup>

In light of the numerous rules and rule-like provisions in US securities regulation, it would be difficult to contend that such anti-fraud and anti-abuse provisions render the law principles-based rather than rules-based. But their presence, along with principle-like provisions of materiality, also makes it difficult to contend that the system is rules-

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<sup>148</sup> See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476-77 (1977) (“[Manipulation] refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity”).

<sup>149</sup> Factors include activity-related features (such as placing trades near the end of the day to exert price pressure and trading activity based on non-economic factors) and context-related features (such as the trader’s ownership concentration in the security and relative trading volume in it). *In re James T. Patten*, SEC Initial Decisions Rel. No. 303 (Dec. 12, 2005); see also *In re Vladlen “Larry” Vindman*, SEC Initial Decisions Rel. No. 285 (May 24, 2005); *In re vFinance Investments, Inc.*, SEC Securities Exchange Act Rel. No. 51530 (April 12, 2005) (also including failure to supervise). Apparent motivations are relevant, like efforts that maintain a market price exceeding the minimum required for continued listing (such as \$1.00 on the Nasdaq Stock Market). *In re James T. Patten*, SEC Initial Decisions Rel. No. 303 (Dec. 12, 2005). Evidence of market manipulation tends to be inferred from detailed facts, such as evidence of motive, placing orders for large numbers of shares and later canceling all or part of the order before it cleared, and matching of purchases by one participant in a scheme with sales by another.

<sup>150</sup> See SEC Annual Report (2005), at 8 (explaining that overall enforcement program must reach across *all areas* to achieve “Effective deterrence of securities *fraud*”) (emphasis added). The US federal securities laws contain numerous anti-fraud provisions, including §10(b) under the 1934 Act, §17(a) under the 1933 Act, Rule 14(a)(9) governing proxy solicitations and §14(e) and Regulation 14E governing tender offers.

<sup>151</sup> 17 CFR § 230 Prelim. Note 2 to Reg. S (2006) (off-shore transactions); 17 CFR § 230 Prelim. Note 6 to Reg. D (2006); 17 CFR § 240.144A Prelim. Note 3 (2006) (qualified institutional investor exemptions); 17 CFR 230.147 Prelim. Note 3 (2006) (single-state transactions).

<sup>152</sup> 17 CFR § 240.12g5-1(b)(3) (2006).

<sup>153</sup> See *Ettinger v. Merrill Lynch, Pierce, Fenner & Smith*, 835 F.2d 1031 (3<sup>rd</sup> Cir. 1987).

based.<sup>154</sup> The individual provisions across the range are applied and interact in ways that transform the system's overall complexion into one defying classification using the binary labels of rules-based or principles-based.

The foregoing discussion spanned much of the securities regulation syllabus. Additional securities regulations likewise combine rules and principles to address many other circumstances. While too vast to canvas fully,<sup>155</sup> one observes such a blend of provisions in contexts such as proxy solicitations<sup>156</sup> and tender offers, which also contain additional examples of factor tests.<sup>157</sup> Even the Sarbanes-Oxley Act, which many say is "rules-based,"<sup>158</sup> also can be read to exhibit an underlying basis in principles, making it plausibly "principles-based."<sup>159</sup> Notable critics of the Act as "rules-based" are accounting promulgators, whom the Act implicitly blamed for making US GAAP "rules-based."<sup>160</sup> As the next section shows, the Act's implicit charge that GAAP is rules-based also is of dubious validity.

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<sup>154</sup> Provisions concerning liability and defenses often hinge on principles too, such as scienter, knowledge, reasonable belief or investigation, privity, loss causation, and transaction causation.

<sup>155</sup> This discussion has not mentioned the Trust Indenture Act, the Investment Company Act, the Investment Advisers Act, or the Gramm-Leach-Bliley Act. But a study of these laws and related regulations reveal a mixture of rules and principles that likewise defy tidy classification of the overall systems as rules-based or principles-based.

<sup>156</sup> Proxy solicitation provisions, contained in Regulation 14A, involve (a) principles-like matters such as the definition of solicitation, exemptions, and safe harbors. (b) specific rule-like disclosure requirements for proxy statements, filing requirements, forms of proxy, (c) shareholder proposal provisions and grounds for exclusion which blend a mixture of rules and principles and (d) elaborate provisions encompassing the entire context in which proxy solicitations proceed, addressing the special roles of bankers, brokers and dealers.

<sup>157</sup> See *Wellman v. Dixon*, 475 F. Supp. 783, 823-24 (S.D.N.Y. 1979) (stating the test); *Hanson Trust PLC v. SCM Corp.*, 774 F.2d 47, 56-57 (2<sup>nd</sup> Cir. 1985) (reciting but rejecting the test); *SEC v. Carter Hawley Hale Stores Inc.*, 760 F.2d 945 (9<sup>th</sup> Cir. 1985) (applying the test). As with proxy solicitations, tender offer regulations encompass a full range of provisions spanning the spectrum from such principles to detailed rules concerning matters of filing, dissemination, disclosure, timing and other communications and activities occurring during the tender offer period.

<sup>158</sup> E.g., Wright, *The Ambitious and the Greedy*, *supra* note \_\_\_, at 73 (denigrating "rules-based" approach of Sarbanes-Oxley); Lyman P.Q. Johnson & Mark A. Sides, *The Sarbanes-Oxley Act and Fiduciary Duties*, 30 WM. MITCHELL L. REV. 1149, 1195 (2004) (Sarbanes-Oxley "adopts a wholly novel, rules-based approach to corporate governance").

<sup>159</sup> See Jeffrey Lipshaw, *Sarbanes-Oxley, Jurisprudence, Game Theory, Insurance and Kant: Toward a Moral Theory of Good Governance*, 50 WAYNE L. REV. 1083 (2004); see also *supra* note \_\_\_ (example of the Act's principles-like requirement that companies provide disclosure on a "rapid and current" basis).

<sup>160</sup> Katherine Schipper, *Principles-Based Accounting Standards*, 17 ACCT. HORIZONS 61 (2003) (FASB board member asserting that the Sarbanes-Oxley Act contains "detailed and prescriptive corporate governance at the federal level" being "markedly different from the principles-based approach that has historically been taken at the state level" and warning that this atmosphere will, in turn, stoke demand for more rules in accounting).

3. Accounting — Rhetoric holds that international financial reporting standards (IFRS) are principles-based and US GAAP is rules-based.<sup>161</sup> As with frequent descriptions of Delaware corporate law and common descriptions of US federal securities regulation, these characterizations are overstated. True, for given accounting topics, US GAAP employs bright-line rules (often numerical thresholds) while IFRS states a principle (using relatively vague concepts such as substantial or control). But both regimes ultimately show a combination of these attributes, preventing a conclusion that one is principles-based or rules-based in any meaningful sense.

Leases are a common example for which US GAAP favors rules and IFRS favors principles.<sup>162</sup> In both systems, leases are divided into two classes (capital and operating) and receive different treatment: costs and receipts under operating leases are recognized when incurred and those under capital leases are allocated over multiple periods. IFRS leases are capitalized when an arrangement transfers *substantially all* the risks and rewards of ownership; US GAAP leases are capitalized when one of four specific criteria exist, including a lease term that is *75% or more* of the item's useful life or the present value of lease payments is *90% or more* of its fair value.

Although one may quarrel over the relative appeal of these approaches, it is a stretch to infer from this example—or even an assortment of kindred examples—that US GAAP is rules-based or IFRS is principles-based, for numerous contrary examples could be given. Consider a paired example arising in the context of debates on two different but related accounting topics: callable debt and refinancing of debt. Both pose a question of classification as short-term or long-term debt, with considerable consequences for important financial ratios and an enterprise's financial condition and appearance. Long-term debt that is callable may better be seen as short-term debt; short-term debt to be refinanced on a long-term basis may better be seen as long-term debt. How should the classification be made?

Short-term debt to be refinanced as long-term debt is so reclassified if the enterprise intends to complete a refinancing, evidenced by an agreement with specified characteristics.<sup>163</sup> When this provision was adopted, a dissenter from it complained that its “intention” test was too open-ended (too principles-based in today's jargon). Callable debt is to be classified as short-term debt if due on demand within one year or if, because of debtor breach of the agreement, the creditor has the right to accelerate it (unless the lender has waived its acceleration right).<sup>164</sup> When adopted, dissenters from this provision complained that it was too restrictive (too rules-based in today's jargon). They said it

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<sup>161</sup> See *supra* note \_\_\_ (citing sources).

<sup>162</sup> See, e.g., Rebecca Toppe Shortridge & Mark Myring, *Defining Principles-Based Accounting Standards*, CPA J. (2004), <http://www.nysscpa.org/cpajournal/2004/804/essentials/p34.htm>.

<sup>163</sup> FASB, SFAS No. 6, Classification of Short-Term Obligations Expected to Be Refinanced, ¶ 11. The characteristics are essentially an expiration date beyond one year, limited lender cancellation rights, no covenants that are being breached and the lender having capacity to consummate the financing.

<sup>164</sup> FASB, SFAS No. 78, Classification of Obligations that are Callable by the Creditor, ¶ 5.

was a “further step to supplant judgment in financial reporting with arbitrary rules.”<sup>165</sup> These provisions endure in US GAAP, side-by-side. Generalizing systemic bases from such individual examples is thus unlikely to produce reliable characterizations.

US GAAP on derivatives contains excruciating complexity spanning hundreds of pages, with detailed treatment specified depending on whether a transaction is a hedge or not and, if a hedge, a cash flow hedge, foreign currency hedge, or other kind.<sup>166</sup> On the other hand, US GAAP is exactly as dense as IFRS, which is literally a copy of the US GAAP provisions (plus an additional 351 pages of implementation guidance).<sup>167</sup> Even though both systems exhibit this rule-like quality, moreover, the provisions also direct classifying a financial instrument as a hedge based on managerial intention in using the instrument.<sup>168</sup> That kind of vague test could justify describing accounting for derivative securities as principles-like.<sup>169</sup>

A widely-misunderstood accounting provision at the heart of the Enron debacle may explain why so many people facilely believe that US GAAP is rules-based. The provision concerns the definition of a subsidiary for purposes of preparing consolidated financial statements that include such entities. US GAAP defined this as ownership of at least a *majority* of the voting shares of another entity.<sup>170</sup> IFRS defines subsidiary for this purpose as *control* of the other entity. The concepts get at the same point—ability to influence the other entity so that the parent’s financial report should reflect its investee’s financial position and risk. But “majority” is a rule (it is not vague) and “control” is a principle (its use of factors in addition to arithmetic creates vagueness).

The confusion about Enron related the well-known provision on subsidiaries to an obscure provision concerning special purpose entities (SPEs). To avoid consolidation of an SPE (to obtain “off-balance sheet treatment”) meant satisfying the provisions of consolidation accounting (a majority of the SPE’s equity held by third parties), plus arcane provisions applied to SPEs that required at least 3% of the SPE’s *total capital* (equity plus debt) to be equity. This reduces associated risk to the owners by capping the ratio of debt-to-equity at 33:1. It does not change the basic consolidation provision

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<sup>165</sup> FASB, SFAS No. 78 (dissenting opinions).

<sup>166</sup> See SFAS No. 115.

<sup>167</sup> Compare PATRICK R. DELANEY, *ET AL.*, WILEY GAAP (2004), at 161-204 (US GAAP) with BARRY J. EPSTEIN & ABBAS ALI MIRZA, WILEY IAS (2004), at 159-201 (IAS); see Nobes, *Rules-Based Standards*, *supra* note \_\_\_, at n. 13 (“The IAS No. 39 file at the IASB records that the project director . . . considered 12 FASB Statements, 9 FASB Technical Bulletins, 7 APB Opinions, 19 AICPA Statements of Position, and 109 EITF consensuses”).

<sup>168</sup> See IAS No. 39, ¶ 9; SFAS No. 115, ¶¶ 7 & 12.

<sup>169</sup> Schipper, *supra* note \_\_\_ (FASB board member emphasizing that US GAAP on derivatives ultimately is based on a fundamental principle of managerial intent).

<sup>170</sup> A post-Enron revision expands the concept to require consolidation of so-called variable interest entities despite the basic rule. FASB Interpretation No. 46, Variable Interest Entities.

which requires more than 50% of the equity to be held by third parties. Yet many commentators suggested that SPEs could be excluded so long as a mere 3% of their *total equity* was held by third parties.<sup>171</sup> That would vitiate the basic consolidation provision and it is not the case.<sup>172</sup> It is absurd to allege that such a rule is to blame for the Enron debacle; it is also misleading to argue that it illustrates that US GAAP is rules-based.<sup>173</sup>

A common example of principles in accounting, under both US GAAP and IFRS, concerns loss contingencies. Liabilities for contingent events and circumstances must be recognized or disclosed but uncertainty makes it difficult to prescribe associated rules *ex ante*. So accounting relies on principles of probability and magnitude.<sup>174</sup> Even so, in application, participants seek to specify the meaning of probability and magnitude by descriptions such as “more likely than not” or assigning numerical measures benchmarked using other accounting concepts, such as materiality.

At the ultimate principles-end of the continuum, in both US GAAP and IFRS, are a series of broad general accounting precepts. Both systems require a fair presentation and emphasize substance-over-form. US GAAP also is based on an overarching concept

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<sup>171</sup> See, e.g., Jonathan R. Macey, *A Pox on Both Your Houses: Enron, Sarbanes-Oxley and the Debate Concerning the Relative Efficacy of Mandatory versus Enabling Rules*, 81 WASH. U. L. Q. 329, 337 (2003) (“Enron would create an SPE and ‘buy’ 97 percent of the equity in the entity in exchange for giving the entity some illiquid asset of highly uncertain value that Enron wanted to clear off its balance sheet. For SEC/GAAP purposes, this arrangement would permit Enron to move the asset off its balance sheet and even show a profit on its sale, so long as 3 percent of the equity in the SPE was owned by independent, outside investors.”) (citing Victor Fleischer, *Enron’s Dirty Tax Secret: Waiting for the Other Shoe to Drop*, 94 TAX NOTES 1045 (2002)); Marleen A. O’Connor, *The Enron Board: The Perils of Gropthink*, 71 U. CIN. L. REV. 1233, 1233 at n. 4 (2003) (“Firms using SPEs are not required to consolidate these entities on their financial statements providing that (1) an outside investor funds at least three percent of the SPE’s equity (2) the transferor does not ‘control’ the SPE, and (3) the transferor gives an opinion concerning the ‘bankruptcy remote’ status of SPE”); Susan P. Koniak, *When the Hurlyburly’s Done: The Bar’s Struggle with the SEC*, 103 COLUM. L. REV. 1236, 1239 (2003) (“If Enron could not find another outside investor to hold at least a three percent equity interest in JEDI, Enron would have to ‘consolidate’ JEDI on its balance sheet . . .”).

<sup>172</sup> See Edmund L. Jenkins, Chairman, FASB, Testimony Before the Subcomm. on Commerce, Trade and Consumer Prot. of the Comm. on Energy and Commerce (Feb. 14, 2002). Indeed, when the equity level is that low, 100% of it must be held by third parties. *Id.* See also Geoffrey P. Miller, *Catastrophic Financial Failures: Enron and More*, 89 CORNELL L. REV. 423, 428 (2004) (“Generally accepted accounting principles provided that a company doing business with an SPE may treat the SPE as an independent, outside entity if two conditions are met: ‘(1) an owner independent of the company must make a substantive equity investment of at least [three percent] of the SPE’s assets, and that [three percent] must remain at risk throughout the transaction; and (2) the independent owner must exercise control of the SPE’”) (citing William C. Powers, Jr. et al., Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp. 4 (Feb. 1, 2002)); Gary J. Aguirre, *The Enron Decision: Closing the Fraud-Free Zone on Errant Gatekeepers?*, 28 DEL. J. CORP. L. 447, 454-455 (“First, it could not be controlled directly or indirectly by Enron. Second, an equity investor, also independent of Enron, must put at risk at least three percent of the SPE’s capital.”).

<sup>173</sup> See Peter Jeffrey, *International Harmonization of Accounting Standards, and the Question of Off-Balance Sheet Treatment*, 12 DUKE J. COMP. & INT’L L. 341 (2002).

<sup>174</sup> SFAS No. 5.

of decision usefulness.<sup>175</sup> Both systems are imbued with conventions of aspirational qualities, including prudence and conservatism. All these may be denominated as principles. And the preceding illustrations—rules, principles and a mix—interact with these principles: all are simultaneously subject to the principles and influence their meaning.

The broad principles animating US GAAP lead a minority to claim that US GAAP is principles-based.<sup>176</sup> The principles are stated in a conceptual framework called Statements of Financial Accounting Concepts (SFACs). Promulgators use these as a guide when adopting accounting provisions for specific subjects. While not formally part of GAAP, the SFACs provide its foundation.<sup>177</sup> The most important of these are noted in the preceding paragraph (to provide a fair presentation and substance-over-form); they also include that financial statements should be both relevant and reliable.<sup>178</sup>

The case that US GAAP is “principles-based” is just as plausible as the more common claim that it is “rules-based.” Neither is clearly correct. For example, an SEC study classified US GAAP’s elements as rules-based,<sup>179</sup> principles-based<sup>180</sup> and principles-only<sup>181</sup> (and left some unclassified, including contingencies), thus finding a mix. True, many US GAAP provisions exhibit a rule-like quality compared to IFRS—like leases and subsidiaries. But there is also a mixture in IFRS, which also contains many rules, such as those pertaining to derivative securities.<sup>182</sup>

A further consideration in assessing the character of any accounting system concerns the scope of discretion reposed in targeted actors. Both US GAAP and IFRS offer numerous alternative approaches to accounting for a single transaction in many contexts. Choices exist in mundane settings such as inventory and depreciation and in more advanced subjects such as employee benefit plans and amortization of debt. While difficult to measure which system offers more choices, it is well-known that the political process of approving IFRS entails contending viewpoints and a supermajority approval

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<sup>175</sup> Bratton, *Private Standards, Public Governance*, *supra* note \_\_\_\_.

<sup>176</sup> Schipper, *supra* note \_\_\_\_; see William W. Bratton, Jr., *Rules Versus Principles Versus Rents*, 48 VILL. L. REV. 1023, 1043-44 (2003).

<sup>177</sup> See Schipper, *supra* note \_\_\_\_.

<sup>178</sup> Numerous other core principles can be identified. See Bratton, *Rules Versus Principles*, *supra* note \_\_\_\_, at \_\_\_\_.

<sup>179</sup> SEC, SOX 108 Study, *supra* note \_\_\_\_ (“rules-based” provisions address: real estate sales, receivables transfers, investments, derivatives, leases, pensions, retiree benefits, stock options, and income taxes).

<sup>180</sup> *Id.* (“principles-based” provisions address: foreign currency translation, interest capitalization, intangible assets, asset retirement obligations, long-lived asset impairment, inventory, business combinations and restructurings).

<sup>181</sup> *Id.* (giving only one example of “principles-only” provisions, historical cost of depreciable assets).

<sup>182</sup> See Nobes, *Rules-Based Standards*, *supra* note \_\_\_\_.

requirement that has led IFRS in many contexts to offer menus rather than definite prescriptions.<sup>183</sup> This feature may tempt one to characterize it as principles-based. Yet US GAAP likewise offers extensive menus.

Consider finally the SEC's enforcement actions in accounting.<sup>184</sup> Areas most susceptible to misconduct—measured by the SEC's enforcement action distribution—are among the most principles-like provisions in accounting: revenue recognition<sup>185</sup> and expense recognition<sup>186</sup> along with a sizable number of cases in the likewise principles-rich contexts of asset impairment, inventory, business combinations and restructurings.<sup>187</sup> These data strongly support the conclusion that it is a mistake to say that US GAAP is rules-based.

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To summarize, accounting systems, like corporate law and securities regulation, defy tidy classification as rules-based or principles-based. This review of selected legal and accounting systems supports the conclusion that it is at least imprecise to denominate any of the described systems as principles-based or rules-based. This does not prove that it is impossible to conceive of or design any system of law as rules-based or principles-based. But as to these subjects, at least, doing so seems doubtful, as the following discussion suggests.

## B. Proposed Systems

Theorists and lawmakers may consciously attempt to tilt a legal or accounting system in favor of one end of the rules-principles continuum or the other. But as the following discussion affirms, doing so is more difficult than it may seem, at least in corporate law, securities regulation and accounting.

1. Emerging Economies and Corporate Law — Professors Black and Kraakman draw lessons from their experience developing corporate law for post-Soviet Russia to

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<sup>183</sup> See GARY JOHN PREVITS & BARBARA DUBIS MERINO, A HISTORY OF ACCOUNTANCY IN THE UNITED STATES: THE CULTURAL SIGNIFICANCE OF ACCOUNTING (rev. ed. 1998).

<sup>184</sup> Section 704 of the Sarbanes-Oxley Act directed the SEC to prepare this study to identify areas of financial disclosure most susceptible to fraud and other improper conduct. SEC, REPORT PURSUANT TO SECTION 704 OF THE SARBANES-OXLEY ACT OF 2002 [*hereinafter*, SEC, SOX 704 REPORT].

<sup>185</sup> The requirement for revenue recognition is completion or substantial completion of the activity associated with the earnings process. See SEC STAFF ACCOUNTING BULLETIN NO. 101 (1999).

<sup>186</sup> SEC, SOX 704 REPORT, *supra* note \_\_\_, at 6. US GAAP's expense recognition principle is that expenses are to be recognized when incurred.

<sup>187</sup> SEC, SOX 704 REPORT, *supra* note \_\_\_, at 6. These accounting standards include SFAS 144 Long-Lived Asset Impairment, ARB 43, Ch. 4 Inventory, SFAS 141 Business Combinations, and SFAS 146 Restructurings. See *id.*, at 18-19.



fashion an intensely rule-rich system of corporate law.<sup>188</sup> The theory is the desperate need for certainty, desperate because of its absence in the Soviet regime upon which Russia was forced to build its emerging economy.<sup>189</sup> The model helps to show that even the most conscious effort to design a system of corporate law using rules, written from scratch, cannot escape including significant provisions recognizable as principles.

They refer to this as a “self-enforcing” model. It is “self-enforcing” in that its elements are designed to rely minimally on administrative or judicial enforcement—corporate participants following the provisions can enforce them internally. This is important for emerging economies because they lack a legal, economic and social infrastructure that supports enforcement of corporate law. The main feature of the self-enforcing model is an emphasis on the use of bright-line rules instead of principles.<sup>190</sup> However, Professors Black and Kraakman recognize that their resulting model is not purely based on bright-line rules because, as the following summary indicates, this is impossible.

The self-enforcing model imposes specific mandates by statute. Rules provide for supermajority shareholder voting on designated transactions.<sup>191</sup> Shareholder consent is required for an asset sale involving 50% or more of the company’s book value (not the typical US requirement triggered by a sale of “all or substantially all” assets).<sup>192</sup> Shareholder takeout rights arise when a third party acquires ownership of 30% of the voting equity. The model protects shareholder voting rights by a one-share, one-vote rule to prevent insiders from accumulating voting power disproportionate to economic stakes. This protection is reinforced by allowing shareholders to nominate directors or make other proposals. The model also mandates disclosure, confidential voting and cumulative voting.

At the board level, the model requires certain features, such as audit committees. To protect the value of cumulative voting, the model requires minimum board size and prohibits staggered director terms. A set portion of directors must be independent of the corporation. These directors are entrusted with exercising specified power over designated extraordinary transactions, including self-interested transactions. For self-interested transactions, the model follows closely the process provisions found in contemporary US corporate law statutes—approval by fully-informed, disinterested directors or shareholders.<sup>193</sup>

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<sup>188</sup> Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1916 (1996).

<sup>189</sup> See Jeffrey Kahn, *The Search for the Rule of Law in Russia*, 37 GEO. J. INT’L L. 353 (2006).

<sup>190</sup> Black & Kraakman, *A Self-Enforcing Model*, *supra* note \_\_\_\_, at 1916.

<sup>191</sup> *Id.* at 1933 & 1943.

<sup>192</sup> *Id.*

<sup>193</sup> *Id.* at 1933.

While the foregoing examples show maximum use of bright-line rules, numerous other contexts require principles. A good example of the need for principles concerns third-parties. Their rights are protected mostly by contract in the US, but contractual protection may be weak tea in developing economies lacking requisite enforcement infrastructure.<sup>194</sup> The self-enforcing model restricts corporations from distributing assets to shareholders in derogation of third-party interests through dividends and repurchases. These are permitted only so long as, after the distribution, the corporation can pay its debts when due and assets exceed liabilities.<sup>195</sup> Thus, the model polices both by applying the Model Act-type restrictions, which I earlier called principles-like in contrast to the dense rule-like Delaware provisions.<sup>196</sup>

In addition to relying upon Model Act-type principles, these distribution restrictions are limited because they police only dividends and repurchases. Corporations are inventive in distributing assets to shareholders using other devices in derogation of third-party rights. To police these, the self-enforcing model relies upon vague general principles found in US fraudulent conveyance law. That is, “a transaction is improper if (i) the company does not receive equivalent value, and (ii) the company fails an asset-based or liquidity-based solvency test after the transaction.”<sup>197</sup> Professors Black and Kraakman recognize that this is a principle not a rule, but note that this is the best that can be done.<sup>198</sup>

Appraisal rights offer another example of the inevitable need for principles. In the Black-Kraakman model, appraisal rights are required and apply to a broader range of transactions than in US corporate law.<sup>199</sup> As in US law, implementation of the appraisal remedy, even when contours are stated with rule-like particularity, requires judicial analysis using principles, including principles of financial valuation.<sup>200</sup> Professors Black and Kraakman appreciate these limitations but find that there is no alternative.<sup>201</sup>

As a final example, rather than endorse typical US style provisions concerning self-interested transactions, the Black-Kraakman model provides a specific rule that

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<sup>194</sup> *Id.* at 1966.

<sup>195</sup> *Id.* at 1969.

<sup>196</sup> *See supra* text accompanying notes \_\_\_\_-\_\_\_\_.

<sup>197</sup> Black & Kraakman, *A Self-Enforcing Model*, *supra* note \_\_\_\_, at 1969.

<sup>198</sup> *Id.* at 1969 (“we can do no better than the vague standard, familiar from fraudulent conveyance law”).

<sup>199</sup> *Id.* at 1934.

<sup>200</sup> *See supra* text accompanying notes \_\_\_\_-\_\_\_\_.

<sup>201</sup> Black & Kraakman, *A Self-Enforcing Model*, *supra* note \_\_\_\_, at 1943.

independent directors must apply when voting on such transactions.<sup>202</sup> The model favors such a specific directive because it relieves directors from struggling with questions of financial fairness. This is important for developing economies that lack norms that are prevalent in developed countries, where people understand financial fairness in terms of the relationship between price and value.

Although this achieves the desired rule-like feature, the explanation reflects an important challenge facing the self-enforcing model generally. All provisions depend ultimately on the production of norms, especially a norm of following rules. Without norms, why would anyone follow the rules? Without adherence to rules, how can productive corporate norms form? It is possible that bright-line rules alone can generate compliance norms. But it seems more likely that a system that combines rules with principles will do so.<sup>203</sup>

Indeed, while Professors Black and Kraakman outline many structural features of corporate law, they do not engage questions ordinarily entangled with fiduciary duties, other than self-interested transactions. Thus, for good reason, their model does not address hostile takeover bids (they are absent or rare in emerging economies). The self-enforcing model does not consider problems that arise under the corporate opportunity doctrine. Adding these features to the model would confirm the need for principles in creating a corporate law from scratch.<sup>204</sup> The scholars rightly opt for the term self-enforcing model rather than rules-based model, for the prescription shows the impossibility of fashioning a corporate law system that can fairly be called rules-based.

2. Canada and Securities Regulation — Lawmakers in the Canadian province of British Columbia (BC) are more emphatic than Professors Black and Kraakman in announcing that they have drafted a principles-based system of securities regulation. They propose this as an alternative to what they see as a Canadian trend, led by Ontario, to follow the US “rules-based” model. The BC lawmakers contended that their “new approach leaves behind the over-use of detailed and prescriptive rules in favour of an

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<sup>202</sup> *Id.* (independent directors shall approve an interested transaction “only if the company receives consideration, in exchange for property or services delivered by the company, that is worth no less than the market value of the property or services, and the company pays consideration, in exchange for property or services, that does not exceed the market value of the property or services”).

<sup>203</sup> Professors Black and Kraakman subsequently examined the forces contributing to the failure of the concurrent mass privatization program Russia undertook, attributing this largely to corruption enabled by insufficient protections against self-dealing by powerful corporate managers. Bernard Black, Reinier Kraakman & Anna Tarassova, *Russian Privatization and Corporate Governance: What Went Wrong?*, 52 STAN. L. REV. 1731 (2000). This is a problem that legal rules are ill-equipped to handle in cultures lacking requisite norms that can be promoted by elaborating principles.

<sup>204</sup> See also Rado Bohinc & Stephen M. Bainbridge, *Corporate Governance in Post-Privatized Slovenia*, 49 AM. J. COMP. L. 49 (2001) (account of Slovenia’s new corporate law, described as “property-rights based” and using the German co-determination model, without noting anything about the terms “rules-based” or “principles-based”); Uriel Procaccia, *Crafting a Corporate Code from Scratch*, 17 CARDOZO L. REV. 629 (1996) (account of Israel’s new corporate code, described as “market-based” also without using such other terms).

outcomes-based approach founded on time-tested principles of investor protection: disclosure to investors and the regulation of dealers and brokers.”<sup>205</sup>

The proposed BC Act strives to express securities regulation in broad general terms, but many rule-like features appear. In outline, the Act contains 12 parts, each divided into numerous sections and half divided first into multiple divisions then into numerous sub-sections.<sup>206</sup> Examples of provisions falling toward the principles end of the continuum include laws governing market participant conduct. The Act states general prohibitions (no engaging in manipulation, fraud or misrepresentation—as defined elsewhere with greater specificity) and then bans unfair practices (but must define these in a series of specific statements: no unreasonable pressure, no taking advantage of others, and no imposing inequitable terms).

The Act’s definition of “material information” is principles-like, as in the US and elsewhere. The Act defines material information as “information relating to the business, operations or securities of an issuer that would reasonably be expected to significantly affect the value or market price of the issuer or a security of the issuer.”<sup>207</sup> The Act uses the term material information 22 times. The Act supplies a different but parallel definition of “significant information” applicable to mutual funds. The Act uses the two terms together in numerous contexts but separately when prescribing prospectus disclosure requirements as between mutual funds and other issuers.<sup>208</sup> Principles alone are insufficient to implement that distinction.

Several examples of provisions falling toward the rules end of the continuum appear. The Act’s definitions section contains tight statements of the terms adviser, affiliate, associate, derivative, insider, market participant (listing 15 different categories of persons), offering and trade. Subsequent sections contain specific definitions of additional terms. The definition of security lists seven categories of instruments. Given historical experience with novel and unanticipated instruments, one wonders whether this definition of security, which in any event is rule-like not principle-like, would be sufficient to cover future circumstances.<sup>209</sup> The effort to define misrepresentation is particularly cumbersome, more nearly evincing attributes of rules than of principles.<sup>210</sup>

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<sup>205</sup> British Columbia Securities Commission, *Questions and Answers on New British Columbia Securities Act*, SBC 2004 c. 43, at 1.

<sup>206</sup> See British Columbia Securities Act, Bill 38 (2004) Legislative Session: 5th Session, 37th Parliament (not enacted as law) [hereinafter, BC Securities Bill].

<sup>207</sup> *Id.*

<sup>208</sup> BC Securities Bill, *supra* note \_\_\_\_, Part 4, § 20.

<sup>209</sup> See *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946); see, e.g., Shanah D. Glick, Note, *Are Viatical Settlements Securities within the Regulatory Control of the Securities Act of 1933?*, 60 U. CHI. L. REV. 957 (1993).

<sup>210</sup> It is: “(a) in relation to an issuer (i) an untrue statement of material information or significant information, (ii) the failure to disclose material information or significant information that is required to be disclosed, or (iii) the omission of material information or significant information from a statement, if that

All the BC Act's provisions concerning registration and offerings are stated in vague terms, exhibiting principles-like features. Even so, they also contain rules and many rely upon the securities commission to provide additional regulation. Thus registration provisions require registration or else a participant cannot trade or advise (a rule).<sup>211</sup> They must apply for registration (a rule). The securities commission can grant applications conditionally or restrictively (a principle). The offering provisions prohibit offerings absent filing and receiving a receipt for a prospectus (a rule). The prospectus must be "in the required form" (a rule, although the statute does not specify the form, presumably leaving this to the commission, which could use rules, principles or both).<sup>212</sup>

The Act's insider trading provisions also show effort to articulate pure principles but equally succumb, through pressure for certainty, to rule-like expression. Thus insiders must "within the prescribed time" (a rule) "file a report in the required form" (another rule).<sup>213</sup> The commission, again, is to establish the prescription and requirements. Subsequent insider reports are required under stated circumstances (rules).<sup>214</sup> The law bans insider trading and expressly states that this includes tipping. These provisions require defining the additional term "connected person."<sup>215</sup> This is a dense and complex definition bearing qualities of a rule, not a principle.<sup>216</sup> The stated ban on insider trading is likewise dense, resembling a synthesis of pre-Act case law or enforcement actions—less a rule or a principle and more nearly a summary of prior applications.

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information is necessary to prevent the statement from being false or misleading in the circumstances, or (b) in any other circumstance, a statement about something that a reasonable investor would consider important (i) in making a decision to trade a security, or (ii) in relation to a trading or advising relationship with a person, if the statement is untrue or omits information necessary to prevent the statement from being false or misleading in the circumstances." BC Securities Bill, *supra* note \_\_\_\_,

<sup>211</sup> *Id.* Part 3, § 14.

<sup>212</sup> *Id.* Part 4, § 18.

<sup>213</sup> *Id.* Part 4, § 25.

<sup>214</sup> *Id.* Part 4, § 26.

<sup>215</sup> *Id.* Part 4, § 30.

<sup>216</sup> *Id.* "Connected person is, in relation to an issuer, (a) an insider, officer, employee, affiliate or associate of the issuer; (b) a person that is making or proposing to make a takeover bid for the securities of the issuer; (c) a person that is proposing to (i) become a party to a reorganization or business combination with the issuer, or (ii) acquire a substantial portion of the property of the issuer; (d) a person engaging in or proposing to engage in any business or professional activity with or on behalf of the issuer or with or on behalf of a person referred to in paragraph (b) or (c); (e) an insider, officer, employee, affiliate or associate of a person referred to in paragraph (b), (c) or (d); (f) a person with inside information, if the information was obtained at a time when the person was a connected person under paragraph (a), (b), (c), (d) or (e), or (g) a person that obtained inside information from another person (i) who, at the time, was a connected person under this definition, including this paragraph, and (ii) whom the person knew or reasonably should have known was a connected person."

So notwithstanding conscious ambitions to create principles-based securities regulation, the BC approach does not quite live up to the billing. True, the Act contains extensive provisions written in principle-like fashion. But it cannot escape providing an express dose of rules, including specific action requirements, concept definitions and efforts at specification associated with rules. It also leaves many details to be written by the securities commission—meaning that the full-blown system of securities regulation likely would have many more rules than appear in the Act. Once applied in practice and allowed to interact, moreover, the result will be more rules yet and a systemic character that defies classification using the binary terminology of rules-based or principles-based.

3. United States and Accounting — The Congress and the SEC have adopted the rhetoric of principles-based systems as well. The Sarbanes-Oxley Act directed the SEC to conduct a “study on the adoption by the US financial reporting system of a principles-based accounting system.”<sup>217</sup> This directive implicitly suggests that the current US accounting system is “rules-based,” a mistaken but widely-shared belief.<sup>218</sup>

In its study, the SEC identified the typical trade-offs of rules versus principles. It then came down squarely on the side of promoting a principles-based system, although it dubbed it an *objectives-oriented* approach. Consistent with conceptions outlined in Part I of this Article, the SEC observed that accounting provisions reside along a continuum according to their “degrees of specificity,” “ranging from the abstract, at one end, to the very specific at the other.”<sup>219</sup> The SEC also denominated a class of principles-only provisions, defined as “high-level [provisions] with little if any operational guidance.”<sup>220</sup> The classic example of the latter is the concept of a reasonable speed in driving regulations. Such “principle-only” provisions require exercising judgment without a reliable framework for doing so—and risk ad hoc enforcement arbitrariness.

The SEC minted and endorsed the concept of an “objectives-oriented” approach to assert that resulting provisions would “land solidly between the two ends of this spectrum.”<sup>221</sup> Falling in line with contemporary global vocabulary, the SEC opined that an objectives-orientation would best be achieved using “principles-based” provisions.

The SEC explains that, in contrast to rules-based systems, a principles-based system uses concise statements of principle with the related objectives incorporated as an integral part. Ideally, its provisions contain no or few exceptions, a modicum of guidance, and no bright-line tests and they are derived from an underlying coherent conceptual framework.<sup>222</sup> Systems with these attributes are objectives-oriented because:

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<sup>217</sup> Sarbanes-Oxley Act, § 108(d), 15 U.S.C. § 7266.

<sup>218</sup> See *supra* note 1 (citing sources).

<sup>219</sup> SEC, SOX 108 Study, *supra* note \_\_\_\_.

<sup>220</sup> *Id.*

<sup>221</sup> *Id.*

<sup>222</sup> *Id.*

application entails fulfilling the objective and so minimizes strategic evasion; articulation entails coherence across the regulatory terrain; it eschews exceptions that produce inconsistencies; and it omits bright-lines that lead to different regulatory consequences for slightly different fact patterns.<sup>223</sup>

Although the SEC position is superficially appealing and forceful, some perspective is in order. As a background matter, there was an apparent dichotomy between complying with GAAP and providing a fair financial presentation.<sup>224</sup> With some fanfare, the SEC addressed this possible dichotomy after Enron Corp. imploded by saying that if complying with GAAP does not produce a fair presentation, then compliance with GAAP is subordinated to promoting a fair presentation.<sup>225</sup> In such cases, GAAP must be overridden. However, this stance threatened the existing financial reporting system, which for decades had assumed that complying with GAAP would yield a fair presentation.<sup>226</sup>

If too rule-bound, compliance with the GAAP rule-book would impair the possibility of meeting the fairly-presents principle. A crisis loomed: if the widely-held assumption of US GAAP as rules-excessive was accurate, then it had to be reinvented—*post haste*. True, it might be possible to rehabilitate the relationship between GAAP and fair presentation through techniques such as presumptions or qualifications or scope limitations. But at a broad level, if complying with rule-bound GAAP meant absence of

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<sup>223</sup> *Id.*

<sup>224</sup> See *United States v. Simon*, 425 F.2d 796 (2<sup>nd</sup> Cir. 1969) (Friendly, J.), *cert. denied*, 397 U.S. 1006 (1970); James D. Cox, *Reforming the Culture of Financial Reporting: The PCAOB and the Metrics for Accounting Measurements*, 81 WASH. U. L. Q. 301, 319-20 (2003) (discussing *Simon* in current context).

<sup>225</sup> SEC, SOX 108 STUDY, *supra* note \_\_\_\_; see also SEC, CERTIFICATION OF DISCLOSURE IN COMPANIES' QUARTERLY AND ANNUAL REPORTS, RELEASE NO. 33-8124 (Aug. 28, 2002) (auditors' certification is not limited to whether financial statements conform to GAAP); see also Floyd Norris, *An Old Case Is Returning to Haunt Auditors*, N.Y. TIMES, Mar. 1, 2002, at C1 (noting how the SEC Chairman has been touting *Simon*, *supra*).

<sup>226</sup> Early in its history, the SEC took the position that compliance with GAAP is not a defense to allegations of inadequate disclosure. See *In re Associated Gas & Elec. Co.* 11 SEC 975 (1942). Some cases from the 1970s, in addition to *United States v. Simon*, *supra*, did so as well. E.g., *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 378 F. Supp. 112 (S.D.N.Y. 1974), *aff'd in part, rev'd in part on other grounds*, 540 F.2d 27 (2d Cir. 1976); *McLean v. Alexander*, 420 F. Supp. 1057 (D. Del. 1976), *rev'd on other grounds*, 599 F.2d 1190 (3<sup>rd</sup> Cir. 1979). These cases were cited with moderate frequency in the latter 1970s and early 1980s but then fell into desuetude. Case law thereafter suggested that compliance with GAAP discharged one's obligations in financial reporting. E.g., *SEC v. Price Waterhouse*, 797 F. Supp. 1217, 1225 (S.D.N.Y. 1992). The old line of cases has been revived in the post-Enron era. See *In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp. 2d 319 (S.D.N.Y. 2004). An alternative means of imposing liability despite compliance with GAAP invokes an SEC rule that requires financial statements to include any information in addition to that expressly required necessary to avoid misleading. See Exchange Act Rule 12b-20; *SEC v. Caserta* 75 F. Supp. 2d 79 (S.D.N.Y. 1999).

a fair presentation and fair presentation is privileged, then GAAP can become functionally irrelevant.

Rhetoric notwithstanding, the assumption of GAAP's rule-bound nature was false. The SEC found that existing US GAAP is a combination of rules and principles. While expressing a modest appreciation for the principles end of the spectrum, the SEC declared the existing mixture to be substantially effective, and re-labeled it an objectives-oriented system. The SEC concluded that, under such a system, there should be limited need to use GAAP overrides. Complying with objectives-based GAAP yields financial statements that are fairly presented. This conclusion thus resolved what otherwise loomed as a crisis: that US GAAP would have to be scrapped if it could not satisfy the fair presentation principle.

The SEC's elaborate study of the rules-principles dichotomy shows the dichotomy's falsity. The SEC ultimately concluded that US GAAP is a mixture of principles and rules and, despite a modest gesture encouraging greater use of principles when possible, designates neither as inherently superior. Instead, it embraces what it believes to be a hybrid, which it calls an "objectives-oriented" system. It boils down to a different name for the prevailing variety of rules and principles, all intended to promote financial statements that "fairly present" financial condition and performance.

This resolution of the false dichotomy is correct and suggests that the struggle was more cathartic than substantive. The issue is not whether a rules-based system or a principles-based system is superior (since they probably do not exist). It is whether, for a given situation, a rule or principle is superior. That depends, in turn, on the factors commonly identified as trade-offs (such as certainty versus context) and on how rules and principles are applied and how they interact. The ideal form varies across subject matters within a system—in corporate law, securities regulation and accounting. The question is indeed one of objectives.

### III. THEORIES AND IMPLICATIONS OF THE RHETORIC

Many countries around the world—plus Delaware judges and their apologists in corporate law, British Columbia in securities regulation and even Congress and the SEC when addressing accounting—are invoking the terminology of principles-based systems. The foregoing discussion counsels skepticism about whether such systems are possible, let alone desirable. At best, it may be possible, within the universe of rules and principles, to weight a system heavily towards principles (or rules). Why leaders appeal to this characterization is a curiosity that the following discussion explores. It considers three possibilities summarized in the Introduction: the regulatory, ethical and political hypotheses.

#### A. *Regulatory*

A possible explanation for widespread talk of principles-based systems is to support regulatory resistance to otherwise powerful forces generating rules. In many



contexts in recent years, the trend has been towards rules and away from principles.<sup>227</sup> Offsetting these trends by emphasizing principles can promote more cautious compliance attitudes among regulated actors.

1. Trends Favoring Rules — Five trends favoring rules can be identified. First, people seek certainty, especially in financial markets. Risk-assessment tools increasingly enable defining and measuring a range of risks, from interest and currency rate fluctuations and commodity price changes to political and weather hazards.<sup>228</sup> This ability to measure such a variety of risks stokes an appetite to measure regulatory and enforcement risk too. The perceived certainty that accompanies rules compared to principles leads to demand for rules.

Second, the “new governance” paradigm within administrative law envisions regulators and compliers increasingly participating together in promulgation exercises.<sup>229</sup> The administrative state has evolved into one of open government, collaborative governance, and extensive private standard setting.<sup>230</sup> In such regulatory negotiations, it is not surprising that resulting articulations would be less vague, with constituents asserting needs for qualifications, exceptions and other features of rules.<sup>231</sup> When the process increases the prospect of regulatory capture, the probability of producing more rules than principles arises.

A third factor driving rules-proliferation is the ascendancy of “interpretive textualism.” This refers to the practice of emphasizing literal expressions, especially by judges, when interpreting statutory or regulatory language. It resists infusing those materials with penumbral principles.<sup>232</sup> Legislators and regulators may respond with increasing care and attention to selected words, entailing a quest to squeeze out vagueness when drafting that yields rules. This can, in turn, become a part of legal culture and lead practitioners to follow suit.<sup>233</sup>

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<sup>227</sup> See, e.g., Joseph P. Liu, *Regulatory Copyright*, 83 N.C.L. REV. 87 (2004); Gregory E. Maggs, *Karl Llewellyn’s Fading Imprint on the Jurisprudence of the Uniform Commercial Code*, 71 U. COLO. L. REV. 541, 564-72 (2000); William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891, 933-34 (2002).

<sup>228</sup> See, e.g., JEAN TIROLE, *THE THEORY OF CORPORATE FINANCE* (2006).

<sup>229</sup> See e.g., Jody Freeman, *The Private Role in Public Governance*, 75 NYU L. REV. 543 (2000); Jody Freeman, *Collaborative Governance in the Administrative State*, 45 UCLA L. REV. 1 (1997); see also Paul R. Verkuil, *Public Law Limitations on Privatization of Government Functions*, 84 N.C. L. REV. 397 (2006).

<sup>230</sup> See JAY A. SIGLER & JOSEPH E. MURPHY, *INTERACTIVE CORPORATE COMPLIANCE* (1988); IAN AYRES & JOHN BRAITHWAITE, *RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE* (1992).

<sup>231</sup> E.g., NASD Manual; Securities Act Rule 175 and Exchange Act Rule 3b-6; Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 77z-2 (§27A of the 1933 Act) and 15 U.S.C. § 78u-5(c) (§21E of the 1934 Act).

<sup>232</sup> See Caleb Nelson, *What is Textualism?*, 91 VA. L. REV. 347 (2005).

<sup>233</sup> See Richard Lavoie, *Subverting the Rule of Law: The Judiciary’s Role in Fostering Unethical Behavior*, 75 COLO. L. REV. 115 (2004).

Fourth, increasing specialization and fragmentation create incentives among proprietors and professionals to claim expertise and regulators to claim turf.<sup>234</sup> The value of rents that such groups can claim is greater when specialized rules govern rather than broad general principles. Such specialization and fragmentation arise in securities markets because old-fashioned industrial issuers differ markedly from mutual funds and these both differ from hedge funds; common stock and straight-debt differ markedly from preferred stock, call or put options, asset-backed debt, strips, and derivatives. Rules result.

Fifth, professional advisors participating in transactions demand rules, not principles. Sometimes they need support from specific rulebooks to cite when encouraging clients to take conservative or prudential approaches.<sup>235</sup> Litigation risk bolsters this demand, especially evident in accounting, where auditors demand rules rather than principles.<sup>236</sup> Across all settings where risks and pressures of rent-seeking are high—whether for those seeking clean audit letters, legal opinions or no-action letters—rules that limit or eliminate discretion help to deflect such appeals.<sup>237</sup>

2. A Need for Principles — These impressive forces may generate more complex and technical rules than is ideal with such volume that weakens the weight or vividness of associated principles. When more rules are produced and fewer or weaker principles are available to mediate them, the traditionally accepted trade-offs between rules and principles may be upset and the benefits of their iterative relationship impaired. An excess of rules makes it easier to treat rules as blueprints to achieve absurd results. A useful response to excessive rule production is a regulatory emphasis on principles, in fact and in rhetoric. This inclination provides a plausible explanation for prevailing inclinations to celebrate “principles-based systems” of law or accounting.

In this view, a “principles-based system” has a broad regulatory enforcement power able to police not just compliance with specific rules but fulfillment of broad

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<sup>234</sup> Illustrative are debates concerning derivatives regulation among the SEC, the Commodities Futures Trading Commission (CFTC), and the International Swap Dealers Association (ISDA). See Frank Partnoy, *The Shifting Contours of Global Derivatives Regulation*, 22 U. PA. J. INT’L ECON. L. 421 (2001).

<sup>235</sup> See Bratton, *Rules Versus Principles*, *supra* note \_\_\_; Michael Gibbins, Steve Salterio & Alan Webb, *Evidence About Auditor-Client Management Negotiation Concerning Clients’ Financial Reporting*, 39 J. ACCT. RES. 434 (2001); but see Donald C. Langevoort, *Technological Evolution and the Devolution of Corporate Financial Reporting*, 46 WM. & MARY L. REV. 1, 17 (2004) (“as the accounting norms themselves became more complicated and subjective, the ability to confidently say ‘no’ to a client diminished”).

<sup>236</sup> See, e.g., George J. Benston, *Public (U.S.) Compared to Private (U.K.) Regulation of Corporate Financial Disclosure*, 51 ACCT. REV. 483 (1976); Stephen A. Zeff, *A Perspective on the U.S. Public/Private Sector Approach to the Regulation of Financial Reporting*, 9 ACCT. HORIZONS 52 (1995).

<sup>237</sup> See Stewart E. Sterk, *Information Production and Rent-Seeking in Law School Administration: Rules and Discretion*, 83 BUL. REV. 1141 (2003).

general principles. It does so by equipping regulatory agencies that combine rule-making authority with enforcement power to emphasize principles rather than rules to bolster their enforcement arsenals.<sup>238</sup> This capability can elicit greater cautiousness among regulated actors and, by making this vivid, reduce temptation to exploit rules when doing so produces absurd results.

To illustrate, compare the rules-heavy self-enforcing model of corporate law with the principles-rich British Columbia securities regulation proposal and principles-encouraging SEC study on US GAAP.<sup>239</sup> The self-enforcing model is designed to minimize the role of external enforcement in favor of internal enforcement. To that end, it relies as much as possible on rules. The British Columbia proposal and SEC study reflect the opposite appetite. They favor principles. That approach takes seriously the possibility of expansive external enforcement powers based on those principles.

Regulators periodically rely on principles in their enforcement arsenal to address discrete bouts of deviance in which rules either do not exist or are not clearly applicable.<sup>240</sup> For example, the SEC used principles to launch its campaign against insider trading in the mid-1980s.<sup>241</sup> It did so to address plagues associated with junk bonds in the early 1990s and, along with states attorney general, research analysts and mutual fund market timing in the early 2000s.<sup>242</sup> It used principles in enforcement to address novel problems arising from technological innovation and political change at the dawns of the Internet<sup>243</sup> and globalization.<sup>244</sup>

These examples of principles-based enforcement support the regulatory hypothesis as an enforcement-expanding device, but simultaneously show a descriptive weakness in this hypothesis to explain the recent rise of principles-based vocabulary: they

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<sup>238</sup> See ROBERTA KARMELE, *REGULATION BY PROSECUTION* (1982); David L. Shapiro, *The Choice of Rulemaking or Adjudication in the Development of Agency Policy*, 78 HARV. L. REV. 921 (1965); Lon L. Fuller, *The Forms and Limits of Adjudication*, 92 HARV. L. REV. 353 (1978).

<sup>239</sup> See *supra* text accompanying notes \_\_\_\_-\_\_\_\_.

<sup>240</sup> See William R. McLucas, J. Lynn Taylor, & Susan A. Mathews, *A Practitioner's Guide to the SEC's Investigative and Enforcement Process*, 70 TEMP. L. REV. 53 at n.74 (1997).

<sup>241</sup> See *supra* text accompanying notes \_\_\_\_-\_\_\_\_.

<sup>242</sup> Renee M. Jones, *Dynamic Federalism: Competition, Cooperation and Securities Enforcement*, 11 CONN. INS. L. J. 107 (2004).

<sup>243</sup> E.g., *SEC v. Spencer*, SEC Lit. Rel. No. 14,856 (Mar. 29, 1996) (Internet solicitation of investors promising 50% returns); *SEC v. Frye*, SEC Lit. Rel. No. 14,720 (Nov. 15, 1995) (Internet solicitation of investor promising risk-free profits); *SEC v. Odulo*, SEC Lit. Rel. Nos. 14,591 (Aug. 7, 1995), and 14,616 (Aug. 24, 1995) (Internet solicitation promising 20% return).

<sup>244</sup> See *In re Candies, Inc.*, Sec. Act Rel. No. 7,263 (Feb. 21, 1996) (cease-and-desist proceeding against law firm assisting in scheme to violate registration requirements by distributing abroad unregistered stock that was promptly resold into US); *SEC v. Scorpion Technologies, Inc.*, SEC Lit. Rel. No. 14,814 (Feb. 9, 1996) (injunction to stop illegal Regulation S offering of stock in 20 countries).

show that such discretionary enforcement always exists as an option. A difference may be how, in the given examples, deviance was isolated and not closely connected to extant rules. In contrast, the Enron era created a perception that too many rules bred pervasive “creative compliance”—technical adherence to rules but lacking fidelity to their spirit.<sup>245</sup> As an example, people could design deals that met clearly applicable accounting rules expressed in numerical thresholds, such as 3% or 50%, despite absurd results that impaired the principle of fair presentation.<sup>246</sup>

However, the regulatory hypothesis faces other weaknesses as a descriptive matter. First, the rhetoric about “principles-based systems” is stronger than a mere shift in regulatory strategy. It does not speak to a balance between rules and principles but pronounces the emphatic superiority of principles. Second, while the explanation may appear plausible for the SEC and British Columbia, it carries little credibility in the case of Delaware, which is notoriously reluctant to impose liability on directors of its corporations.<sup>247</sup>

Third, regulators responded to the recent debacles with new rules as well as new principles and rhetoric. For example, in response to the Enron chairman Ken Lay’s disingenuous defense that he did not know the details of Enron’s financial statements, the Sarbanes-Oxley Act prescribed a rule that corporate officers must certify that they know the details of financial statements;<sup>248</sup> and in response to the era’s widespread accounting shenanigans, the SEC adopted rules to police the use of non-GAAP financial measures and off-balance sheet financing arrangements.<sup>249</sup>

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<sup>245</sup> See Doreen McBarnet & Christopher Whelan, *The Elusive Spirit of the Law: Formalism and the Struggle for Legal Control*, 54 MOD. L. REV. 848 (1991).

<sup>246</sup> Cf. *Lincoln Savings & Loan Ass’n v. Wall*, 743 F. Supp. 901, 913 & 920 (D.D.C.) (Sporkin, D.J.) (“an accountant must not blindly apply accounting conventions without reviewing the transaction to determine whether it makes any economic sense and without first finding that the transaction is realistic and has economic substance that would justify the booking of the transaction that occurred;” “It seems that the accounting firm was more concerned with attempts of conscientious regulators to deal with the savings and loans industry’s severe crisis than the ‘creative accounting’ of its ‘high flying’ client.”). My example is hypothetical, certainly not based on Enron, which flatly violated such rules. See Bratton, *Rules Versus Principles*, *supra* note \_\_\_, at 1041.

<sup>247</sup> See Black, Cheffins & Klausner, *Outside Director Liability*, *supra* note \_\_\_.

<sup>248</sup> See Sarbanes-Oxley Act, §§ 302(a) & 906, 18 U.S.C. § 1350; see SEC, CERTIFICATION OF DISCLOSURE IN COMPANIES’ QUARTERLY AND ANNUAL REPORTS, RELEASE NO. 33-8124 (Aug. 28, 2002); Michael Perino, *Some Reflections on the Deterrence Aspects of the Sarbanes-Oxley Act*, 76 ST. JOHN’S L. REV. 671, 681-85 (2002).

<sup>249</sup> See SEC, Cautionary Advice Regarding Use of Pro Forma Financial Information in Earnings Releases, Nos. 33-8039 & 34-45124 (Dec. 4, 2001); SEC, Conditions for Use of Non-GAAP Financial Measures, Nos. 33-8176 & 34-47226 (Jan. 22, 2003); SEC, Off-Balance Sheet Arrangements (Jan. 28, 2003); SEC, Reg. G, 17 C.F.R. 244.101(c). These are interesting specimens because the SEC describes the documents as taking “principles-based” approaches despite showing rule-like qualities. See Partnoy, *A Revisionist View of Enron*, *supra* note \_\_\_ at 1276.

The regulatory hypothesis poses two additional difficulties as a normative matter. Both arise from how this strategy can tip the balance unduly in the principles direction. First, this can induce excessively cautious compliance outlooks that impair the benefits of rules (which, in this context, could include deterring desirable risk-taking).<sup>250</sup> Second, a determined enforcement preference to focus on principles instead of rules could backfire when incongruent with accepted notions of fairness and legitimacy.

## B. *Ethical*

A second possibility is that the rhetoric of “principles-based systems” is part of a more general exhortation. What Enron-type scandals showed was not a failure of rules but the failure of a different set of principles: ethics. The global embrace of principles-based systems may be intended less as a description of the relative specificity or ex ante content of provisions as between rules and principles and more of an appeal to *ethics*. *Principles-based* regulation may be a call to *ethical principles*. This would also explain why the global rhetoric uses the term *principles* rather than the term *standards* so prevalent in the legal literature.<sup>251</sup> If so, labels may matter more than some think.<sup>252</sup>

1. Hortatory — The rise of enthusiasm for principles-based systems corresponds to the post-Enron discourse that lamented laxity in business ethics.<sup>253</sup> Some worried that professionalism had diminished in favor of pure profit-maximization and notions of the public good and public service among the professions needed reaffirmation.<sup>254</sup> The discourse exhibited a quest to restore a heightened sense of business and professional ethics.

The rhetoric of principles-based systems may be a by-product of this quest. This may be so because, while regulatory tools can contribute to promoting ethical norms, they cannot do so alone.<sup>255</sup> Consider again the practice of creative compliance: literal

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<sup>250</sup> See John E. Calfee & Richard Craswell, *Some Effects of Uncertainty on Compliance with Legal Standards*, 70 VA. L. REV. 965 (1984).

<sup>251</sup> See *supra* text accompanying notes \_\_\_\_-\_\_\_\_.

<sup>252</sup> See *supra* text accompanying notes \_\_\_\_-\_\_\_\_ (noting how some scholars dismiss the proliferation of labels to describe types of laws as nominalism with limited substantive import).

<sup>253</sup> E.g., Bill Witherell, *Corporate Governance: Stronger Principles for Better Market Integrity*, OECD OBSERVER (April 2004) (announcing release of OECD, Revised Principles of Corporate Governance, retaining previous “principles-based” approach but emphasizing need to reexamine the previous guidelines in response to global debacles).

<sup>254</sup> See Bevis Longstreth, *Problems in the Corporate Bar as it Appears to a Retired Practitioner*, 31 MONTANA LAWYER 22 (2006); William W. Bratton, Jr., *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275 (2002); Peter C. Kostant, *Sacred Cows or Cash Cows: The Abuse of Rhetoric in Justifying Some Current Norms of Transactional Lawyering*, 36 WAKE FOREST L. REV. 49 (2001); W. Bradley Wendel, *Professionalism as Interpretation*, 99 NW. L. REV. 1167 (2005).

<sup>255</sup> To paraphrase T. S. Eliot, regulators cannot realistically expect to fashion a system so perfect that no one needs to be good.

obedience to law while evading its spirit.<sup>256</sup> To an extent, creative compliance is unobjectionable, as when structuring a business combination to avoid triggering shareholder voting or appraisal rights or designing a lease to obtain capital treatment. When done overzealously, as during the Enron era, the practice of creative compliance is treacherous. Either way, however, law cannot do anything to punish compliance with itself (nor can accounting). True, in corporate law equitable principles can police mere technical compliance<sup>257</sup> and in securities regulation the broad-gauged anti-abuse principles contribute.<sup>258</sup> But, in general, regulatory pursuit of creative compliance is Quixotic—except perhaps through rhetoric.<sup>259</sup>

Recognizing this, regulators turned to codes of business ethics. The Sarbanes-Oxley Act required the SEC to promulgate rules requiring public disclosure of whether a company has a code of ethics for senior officers and, if not, why not.<sup>260</sup> Companies must promptly disclose changes to ethics codes, including waivers. The New York Stock Exchange contemporaneously imposed a requirement that listed companies adopt and disclose a code of business conduct and ethics.<sup>261</sup> The US Sentencing Guidelines were amended in 2004 to take express account of whether an enterprise promoted business ethics, including through adoption of formal codes.<sup>262</sup>

The resulting codes of ethics are fascinating: they are all brief, abstract, simple and similar, often emphasizing adherence to the “spirit of laws.”<sup>263</sup> The codes may be truly “principles-based”—they are vague and contain barely a trace of “rules.”<sup>264</sup> While

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<sup>256</sup> See McBarnet & Whelan, *The Elusive Spirit of the Law*, *supra* note \_\_\_\_.

<sup>257</sup> See *supra* text accompanying notes \_\_\_\_-\_\_\_\_ and \_\_\_\_-\_\_\_\_ (noting the *Schnell* doctrine in Delaware judicial administration).

<sup>258</sup> See *supra* text accompanying notes \_\_\_\_-\_\_\_\_.

<sup>259</sup> The limitations on general anti-abuse principles appear vividly in tax law, where the principles exist but rarely are enforced.

<sup>260</sup> See Sarbanes-Oxley Act, § 406, 15 U.S.C. § 726 (“code of ethics” are “such standards as are reasonably necessary to promote (1) honest and ethical conduct . . . (2) full, fair, accurate, timely, and understandable disclosure . . . and (3) compliance with applicable governmental rules and regulations”).

<sup>261</sup> See SEC, Self-Regulatory Orgs., NYSE, Inc. & NASDAQ, Inc., Order Approving Proposed Rule Changes, 68 Fed. Reg. 64,154, 64,180 (Nov. 12, 2003); NYSE Rule 303A(10) (2003).

<sup>262</sup> See David Hess, Robert S. McWhorter & Timothy L. Fort, *The 2004 Amendments to the Federal Sentencing Guidelines and Their Implicit Call for a Symbiotic Integration of Business Ethics*, 11 FORDHAM J. CORP. & FIN. L. 725 (2006).

<sup>263</sup> See Doreen McBarnet, *After Enron: Will “Whiter than White Collar Crime” Still Wash?* 46 BRIT. J. CRIMINOLOGY 1091 (2006).

<sup>264</sup> Why this is so requires speculation and competing explanations seem plausible, as neither Sarbanes-Oxley nor related SEC regulations give specific guidance or requirements. On the one hand, the codes are textual embodiments of aspirational corporate culture and thus would not likely contain detailed rules; on the other, companies must promptly disclose waivers of ethics codes, some of which likely will be

promulgators of law and accounting cannot create principles-based systems, using that vocabulary can reinforce the lessons in the codes. This interpretation of the rhetoric as emphasizing *ethical principles* also explains frequent talk among regulators and politicians of the need to fight “check-the-box” mentalities.<sup>265</sup>

2. Qualifications — The ethical hypothesis to explain the rise of principles-based rhetoric seems credible, but two qualifications are in order, one descriptive and one normative. Descriptively, such a call to ethical rejuvenation implicitly assumes a decline in ethics during the relevant period. Such periodic laments recur in history, and there is limited basis for believing that a golden age of high ethics marked earlier periods.<sup>266</sup> This is almost certainly so in the case of corporate, securities and accounting matters. While thoughtful scholars conclude that the Enron era exhibited a decline in business ethics,<sup>267</sup> it seems impossible to reach firm conclusions about that.

Normatively, this strategy of emphasizing principles in law and accounting could backfire. Ethics code exhortations to abide the spirit of laws—a call to principles that can curtail creative compliance—project a moral appeal that may be desirable. But for leaders to couple such codes with rhetorical stories of principles-based systems could generate false confidence that resulting law or accounting will cure the disease. The temptation, implicit in the celebration of principles-based systems, is to imagine that rules should be eliminated. My analysis suggests that this is neither possible nor wise.

### C. Political

A third possible explanation for rhetoric championing principles-based legal or accounting systems is political. Descriptively, this seems to be a stronger explanation for the prevalent campaign for principles-based systems compared to the regulatory and ethical hypotheses. Normatively, it is the most troubling of the three hypotheses—and

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uncomfortable to explain and broad general statements will minimize the frequency of waivers that must be disclosed.

<sup>265</sup> See, e.g., Usha Rodrigues, *Let the Money Do the Governing: The Case for Reuniting Ownership and Control*, 9 STAN. J.L. BUS. & FIN. 254, 280 (2004) (quoting SEC Chairman William Donaldson as saying that “A ‘check the box’ approach to good corporate governance will not inspire a true sense of ethical obligation.”); Nicholas Le Pan, *Financial Regulatory Outlook*, 23 CANADIAN NAT’L BANKING L. REV. 52 (Dec. 2004) (remarks of Canada’s Superintendent of Financial Institutions noting his office’s regulatory effort to “resist the temptation to put in place detailed new rules” and noting concern that “too many detailed new rules can be counter-productive. They risk becoming a checklist and then their benefit is, at best, greatly reduced. . . .”); Harvey Pitt, *Public Statement by SEC Chairman: Remarks at the Winter Bench and Bar Conference of the Federal Bar Council* (Feb. 19, 2002) (US GAAP is too “cumbersome and offer far too detailed prescriptive requirements [which], by necessity, encourages accountants to ‘check the boxes’—that is, to read accounting principles narrowly, to ascertain whether there is technical compliance with applicable accounting principles”).

<sup>266</sup> See ALASDAIR MACINTYRE, *AFTER VIRTUE: A STUDY IN MORAL THEORY* (1984); MOSES PAVA, *THE SEARCH FOR MEANING IN ORGANIZATIONS: SEVEN PRACTICAL QUESTIONS FOR ETHICAL MANAGERS* (1999); LAURA P. HARTMAN, *PERSPECTIVES IN BUSINESS ETHICS* (2<sup>nd</sup> ed. 2001).

<sup>267</sup> See TAMAR FRANKEL, *TRUST AND HONESTY: AMERICA’S BUSINESS CULTURE AT A CROSSROAD* (2006).

the most cynical, although it is not idiosyncratic.<sup>268</sup> Prescriptively, it contributes to debate concerning the merits of jurisdictional competition by raising questions not previously addressed in that literature.

The literature on the jurisdictional competition debate, which spans across numerous legal and other fields, is particularly robust in the contexts that this Article addresses of corporate law, securities regulation and accounting. Contested topics include whether competition exists, on what terms, and how to assess the results. The following discussion of recent political jockeying supports the view that competition exists among the actors in these contexts. Ensuing discussion explains how these observations contribute one new reason to question the efficacy of jurisdictional competition when the risk of rhetorical overstatement is significant.

1. Jurisdictional Competition — The following discussion considers how the principles-based rhetoric may be explained in terms of competition among (a) Delaware and Washington, D.C. in US corporate law, (b) British Columbia and Ontario in Canadian securities regulation, (c) international accounting promulgators and the SEC/FASB and (d) various countries in a more general geopolitical context.

a. Delaware versus Washington D.C. The jurisdictional competition debate was particularly vigorous concerning the production of state corporation law in the US.<sup>269</sup> Participants mostly now agree that, while there may have been some form of competition among states decades ago, that race largely is over and no or little current competition exists.<sup>270</sup> Delaware prevailed. The literature has turned attention to a race of a different sort, replacing the horizontal competition among states with a vertical competition between Delaware and Washington, D.C.<sup>271</sup>

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<sup>268</sup> See David Alexander & Eva Jermakowicz, *A True and Fair View of the Principles/Rules Debate*, 42 ABACUS 132 (2006) (concerning rules-principles debate in accounting, “much of the debate at the regulatory and policy level is at best vague and confused, more likely disingenuous, possibly intellectually dishonest”).

<sup>269</sup> See, e.g., Ralph K. Winter, Jr., *State Law, Shareholder Protection and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974); Joel Seligman, *The Case for Federal Minimum Corporate Law Standards*, 49 MD. L. REV. 947 (1990); FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991); Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709 (1987); Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437 (1992); Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987).

<sup>270</sup> See, e.g., William W. Bratton, *Corporate Law’s Race to Nowhere in Particular*, 44 U. TORONTO L. REV. 401 (1994); Lucian A. Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553 (2002); Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679 (2002); Lucian A. Bebchuk, Alma Cohen & Allen Ferrell, *Does the Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775 (2002).

<sup>271</sup> See Renee M. Jones, *Rethinking Corporate Federalism in the Era of Reform*, 29 J. CORP. L. 625 (2004).



In the new competition, Delaware corporate lawyers, including judges, fight a political battle with Washington for hegemony in the production of US corporate governance law.<sup>272</sup> While this battle has endured for decades,<sup>273</sup> serving as the fallback position to claims that state competition yields undesirable results, the stakes have risen since passage of the Sarbanes-Oxley Act when Washington preempted numerous areas of corporate law traditionally handled by states. Since provisions of that Act were widely lambasted as rules-based, a competitive political response would distinguish Delaware's corporate law as principles-based.<sup>274</sup>

Playing a leading role in this contest, Delaware's judges are unusual among courts, in at least the following ways that support the political hypothesis.<sup>275</sup> Delaware judges frequently write articles that are published in law reviews.<sup>276</sup> While some of these provide thoughtful analysis and reflection, in recent installations, the articles are increasingly promotional of the Delaware judiciary's expertise,<sup>277</sup> extol the virtues of Delaware corporate law (including the claim that it is "principles-based")<sup>278</sup> and harshly contrast those virtues with the vices of federal securities regulation (making their claim that it is "rules-based" seem reserved by comparison).<sup>279</sup> In at least some Delaware judicial opinions released since passage of the Sarbanes-Oxley Act, analysis shows that the courts are attempting to respond to the political and competitive climate that resulted.<sup>280</sup>

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<sup>272</sup> See Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 605 (2003) (quoting a statement made in 1988 by the Chair of the Delaware Bar Association Corporate Law Council that Delaware had to modify its anti-takeover laws to avoid federal incursion into the state's corporate law). For a rebuttal, see Roberta Romano, *Is Jurisdictional competition a Problem of Irrelevant for Corporate Governance?*, 2005 OXFORD REV. ECON. POL'Y 31 at n. 19 (March 2005).

<sup>273</sup> See Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 461 (1989).

<sup>274</sup> Cf. Kamar, *A Jurisdictional competition Theory Of Indeterminacy In Corporate Law*, *supra* note \_\_\_\_ (attributing Delaware's victory in the state-to-state competition, in part, to its use of principles in judicial decisions).

<sup>275</sup> See also Fisch, *Peculiar Role of the Delaware Courts*, *supra* note \_\_\_\_, at 1072-1082 (exploring how Delaware courts are unusual in other ways).

<sup>276</sup> See Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573, 1603 (2005) ("to a greater extent than is typical for members of the judiciary, Delaware judges propagate their vision outside the court room. Delaware judges publish an extraordinary amount of extra-judicial writing") (citing an "incomplete" list of some two dozen recent pieces).

<sup>277</sup> See Griffith & Steele, *On Corporate Law Federalism*, *supra* note \_\_\_\_, at 2. Steele is a Delaware judge.

<sup>278</sup> See William B. Chandler III & Leo E. Strine, Jr., *The New Federalism in the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 979 (2003) (trumpeting Delaware corporate law as "principles-based" and denigrating federal securities regulation as "problematic" because "not part of any overall system of corporate governance").

<sup>279</sup> Griffith & Steele, *On Corporate Law Federalism*, *supra* note \_\_\_\_, at 3.

<sup>280</sup> Jones, *Rethinking Corporate Federalism*, *supra* note \_\_\_\_, at \_\_\_\_.

These developments reflect a different tenor of competition in the vertical sphere between Delaware and Washington than obtained under the horizontal competition with other states. The horizontal competition among states, such as Delaware and New York, involved products that are substitutes. The competition hinged on the substantive products. Losses in the competition were not devastating, with some would-be Delaware customers simply choosing New York.

The vertical competition between Delaware and Washington does not involve substitutes but products akin to bundled goods: a US corporation wishing to be public must both be incorporated in a state and registered with the SEC. The stakes for Delaware in this vertical competition are considerably higher than in the horizontal competition because Washington can preempt Delaware. That means Delaware's leaders have stronger incentives to become not only entrepreneurs but a sales force.<sup>281</sup> This may help to explain the increasing exuberance that Delaware judges show in boasting of their state's products. In this competition, the SEC has lesser incentives to respond and, in any event, its ability to stake positions is constrained by limitations of the Data Quality Act that prevent it from engaging in the rhetorical overstatement that characterizes the Delaware courts.<sup>282</sup>

b. British Columbia versus Ontario. Unlike in the US, Canada lacks a central authority in securities regulation such as the SEC. Instead, laws are promulgated by the 13 provinces and territories and enforced by commissions and tribunals of the respective regions.<sup>283</sup> Each province uses governmental securities commissions or administrators to oversee respective provincial securities laws. The provinces may compete in these terms but not quite in the way that US states competed for charters. There are no charters to fight over but provinces contend for leadership in designing the regulatory system, power to promulgate and enforce law, and contribute to the national market system.

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<sup>281</sup> Delaware Supreme Court opinions have often been characterized by language more common to sales literature than to legal analysis. *E.g., Elf Atochem N. Am. Inc. v. Jaffari & Malek LLC*, 727 A.2d 286, 290 (Del. 1999) (Veasey, C.J.) (“Since 1983, the General Assembly has amended the LP Act eleven times, with a view to continuing Delaware’s status as an innovative leader in the field of limited partnerships;” “The Delaware Act has been modeled on the popular Delaware LP Act.”). The Delaware Supreme Court rarely reverses its Chancery Court. *See Griffith & Steele, supra* note \_\_\_, at 10, n. 50 (acknowledging contrary evidence in the post-Enron years noted in Jones, *Rethinking Corporate Federalism, supra* note \_\_\_). It almost always produces unanimous opinions. This is surprising for law so often called indeterminate and thus suggestive of an unusual unity of outlook.

<sup>282</sup> *See* Treasury and General Government Appropriations Act for Fiscal Year 2001 (Public Law 106-554; H.R. 5658), § 515; OMB, Guidelines for Ensuring and Maximizing the Quality, Objectivity, Utility and Integrity of Information Disseminated by Federal Agencies; Notice; Republication, 67 Fed. Reg. 8452 (February 22, 2002); SEC, Final Data Quality Assurance Guidelines (June 10, 2005).

<sup>283</sup> *See* DAVID JOHNSTON & KATHLEEN DOYLE ROCKWELL, CANADIAN SECURITIES REGULATION (3d ed. 2003) at xxxvii ff. (“Table of Concordance”); CONDON, ANAND & SARRA, *supra* note \_\_\_, at 265 (discussing variations in the laws and noting degrees of harmony).

Provincial autonomy is threatened by ongoing efforts to promote national consistency and harmonization of securities regulation across Canada.<sup>284</sup> Provincial securities commissions and administrators recently formed a national group, called the Canadian Securities Administrators (CSA) to provide a coordinating function. Current forces are strong in favor of moving Canada from its existing fragmented structure to a federal system with a single national regulator. This struggle implicates the balance of power between the provincial and central governments and among the provinces.

Some provinces, including British Columbia, resist the centralized model because of fear that it will be dominated by Ontario, the money-center province that is seen as inclined to follow the US and its allegedly rules-based securities regulation. The British Columbia principles-based securities regulation proposal can be seen as a political gambit to resist that power. Ontario's Securities Commission replied with a blistering comment letter which,<sup>285</sup> while substantively meritorious, likewise has overtones of a political response.<sup>286</sup>

c. US versus International Accounting. Some form of competition has existed for years between the SEC/FASB and IFRS promulgators.<sup>287</sup> The SEC historically provided international leadership on accounting matters, filling the lacuna that exists in the international arena which lacks a centralized power.<sup>288</sup> In this leadership, the SEC both bears the costs of international regime formation and places its cultural imprint on the process and results. In accounting, the SEC and FASB use unilateral and bilateral diplomacy and pressure to influence promulgators of alternative accounting systems in a process in which the SEC exerts and succumbs to political pressures.<sup>289</sup>

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<sup>284</sup> See CONDON, ANAND & SARRA, *supra* note \_\_\_, at 141-42; A. DOUGLAS HARRIS, ED., WPC—COMMITTEE TO REVIEW THE STRUCTURE OF SECURITIES REGULATION IN CANADA: RESEARCH STUDIES (Ottawa: Department of Finance, 2003).

<sup>285</sup> Letter from David Brown, Chair, Ontario Securities Commission to Doug Hyndman, Chair, British Columbia Securities Commission (June 27, 2003) (10-page outline of objections to BC proposal, saying it “has gone to far,” emphasizing the need for the securities commissions to work together and the importance of harmonization, but along different lines than those British Columbia proposed).

<sup>286</sup> See CONDON, ANAND & SARRA, *supra* note \_\_\_, at 352-53 & 388; Sukanya Pillay, *Forcing Canada's Hand? The Effect of the Sarbanes-Oxley Act on Canadian Corporate Governance Reform*, 30 MAN. L.J. 285 (2004).

<sup>287</sup> See Maureen Peyton King, Note, *The SEC's (Changing?) Stance on IAS*, 27 BROOK. J. INT'L L. 315 (2001). The organization has changed its name several times: formerly the International Accounting Standards Commission (IASC) and currently the International Accounting Standards Board (IASB) (this is itself a signal of the competition between IASB and FASB).

<sup>288</sup> See ROBERT O. KEOHANE, *AFTER HEGEMONY: COOPERATION AND DISCORD IN THE WORLD POLITICAL ECONOMY* (1984).

<sup>289</sup> See James D. Cox, *Regulatory Duopoly in U.S. Securities Markets*, 99 COLUM. L. REV. 1200, at 1237 & n. 119 (1999) (“adherence to GAAP has been a bully pulpit for the SEC and other policy makers to champion improving regulatory developments in many foreign markets” and summarizing numerous unilateral and bilateral SEC efforts to influence securities regulation and accounting worldwide).

Promulgators of IFRS have been a potent political force in these engagements and are an increasingly credible and influential competitor to FASB. The SEC nurtured this role by initially insisting that IFRS adhere to criteria that the SEC established. The SEC's strategy was competitive: designed as "a surrogate investigation of the prevailing culture of the [IFRS promulgators]."<sup>290</sup> IFRS promulgators responded by developing a robust accounting system, with one eye on those criteria and another on the substantive merits of particular provisions. In the process, they developed not only a system that the SEC takes seriously but one that constitutes a credible rival to US GAAP. Ultimately, these competitive political realities pressure the SEC to accept IFRS.<sup>291</sup> In this climate, the SEC has pushed increasingly for convergence, not divergence.<sup>292</sup>

This background sets the stage for a political account of prevailing rhetoric, which operates at two levels of competition between IFRS and US GAAP. A primary competition involves products that can be seen as substitutes: large multinational corporations may choose which system to treat as their primary means of financial reporting. To that extent, the promulgators compete by offering substantive alternatives from which companies can choose. The secondary competition arises from how consumers choosing US GAAP are assured that countries worldwide will accept their financial statements as complying with minimum standards whereas, at present, IFRS is not so widely recognized. As a result, large corporations throughout the world use US GAAP or face investor pressure to do so, giving the SEC and FASB dominion.<sup>293</sup>

IFRS must achieve more power both to attract new customers in the primary competition and to influence ongoing articulation of accounting provisions of the SEC and FASB in the secondary competition. It must both offer a different product and persuade consumers—and other regulators—that its product is superior. Helpful to doing so is denominating US GAAP as rules-based—and denigrating such an approach—while describing IFRS as principles-based. The SEC and FASB return the volley either by

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<sup>290</sup> *Id.* at 1251.

<sup>291</sup> Cox, *Regulatory Duopoly*, *supra* note \_\_\_, at 1208 (noting how rising stature of IASC during the mid-1990s presented the SEC with a difficult decision concerning whether to recognize its accounting standards for SEC filings and how the SEC therefore engaged with IASC, directly and through the International Organization of Securities Commissions (IOSCO), laying out basic criteria it would have to meet and providing a "stream of comment letters" on IASC proposals).

<sup>292</sup> Cox, *Regulatory Duopoly*, *supra* note \_\_\_, at 1202 (noting that "the SEC continues to promote convergence" between IFRS and U.S. GAAP but faces "political considerations" in doing so).

<sup>293</sup> See Richard W. Painter. *Convergence and Competition in Rules Governing Lawyers and Auditors*, 29 IOWA J. CORP. L. 397, 400 n.6 (2004) ("European companies generally use International Accounting Standards (IAS), which supposedly promote "standards based" instead of "rule based" accounting, but there is considerable pressure from U.S. investors for European companies to conform to U.S. Generally Accepted Accounting Principles (GAAP)").

explaining their version of a principles-based system (the objectives-oriented model) or claiming that US GAAP is principles-based too.<sup>294</sup>

d. Other Countries. Other countries may take up the principles-based banner as a result of broader geopolitical realities. First, principles-based sloganeering may reflect efforts to signal mature rather than developing country status. The self-enforcing model of corporate law designed by Professors Black and Kraakman makes the case for rules in corporate laws of emerging economies.<sup>295</sup> US governmental representatives make similar cases concerning securities regulation to countries such as China.<sup>296</sup> It would be unsurprising if countries publicized having principles-based legal and accounting systems to signal maturity beyond the rules-based stage of development.

Second, the label “rules-based” is used in national economic policy to designate things like fixed exchange rates, interest rate adjustments and budgeting policy (such as the rule against government borrowing to pay current costs but only to make investments).<sup>297</sup> In contrast are “discretionary policies,” flexible fiscal and monetary tools to influence economic demand and smooth business cycle vicissitudes. The International Monetary Fund and World Bank strongly favor rules, especially for emerging economies.<sup>298</sup> But individual countries like discretionary policies to retain autonomy. When rules are imposed on emerging economies, it would be unsurprising for countries to join a bandwagon boasting that they offer principles-based systems.

2. Limitations — If reports of principles-based systems are intended to distinguish legal/accounting products, the impossibility of offering such products makes the reports misleading. This by-product of jurisdictional competition is not explicitly addressed in prevalent debates concerning the merits of this phenomenon in corporate law, securities regulation or accounting. But if jurisdictional competition can produce misleading rhetoric, it is possible that the otherwise virtuous process of competition among regulators is impaired.

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<sup>294</sup> See *supra* note \_\_\_\_ (quoting FASB member Schiffer to this effect). In the SEC’s case, constraints imposed by the Data Quality Act limit its rhetorical freedom to compete. See *supra* note \_\_\_\_.

<sup>295</sup> See *supra* text accompanying notes \_\_\_\_-\_\_\_\_.

<sup>296</sup> See, e.g., Walter Lukken (CFTC Commissioner), Speech to China Financial Derivatives Forum (Shanghai, September 26, 2006) (reported in Securities Law Daily, Sept. 29, 2005) (advanced economies need principles as in recent CFTC codification (CFMA)—but for immature markets “a rules-based regulatory regime is essential”)

<sup>297</sup> See Richard A. Posner, *Creating a Legal Framework for Economic Development*, in WORLD BANK RES. OBSERVER 1, 3-4 (1998) (“rules-first strategy” of law reform); Middle East Policy Council, *Joining the Global Rules-Based Economy: Challenges and Opportunities for the GCC*, (available at <http://www.mepc.org/main/main.asp>).

<sup>298</sup> GEORGE KOPITS (ED.), RULES-BASED FISCAL POLICY IN EMERGING MARKETS: BACKGROUND, ANALYSIS AND PROSPECTS (2004); TERESA DABÁN, ET AL. RULES-BASED FISCAL POLICY IN FRANCE, GERMANY, ITALY, AND SPAIN (IMF, 2003); see also Pablo Zapatero, *Searching for Coherence in Global Economic Policymaking*, 24 PA. ST. INT’L L. REV. 595, 621-622 (discussing rule-based coordination among IMF and other international economic institutions)

The jurisdictional competition model is contested but, when its assumptions obtain, the model is plausible enough. The model, as applied to corporate law, securities regulation and accounting, envisions regulators as producers of goods and investors as consumers.<sup>299</sup> The model is appealing when a large number of producers offer a complete range of goods and consumers command perfect information about offerings and can switch between them with little cost.<sup>300</sup> Both visions require that perfect information about products be available to investors and understood accurately by them, plausible to the same extent that relatively efficient capital markets are plausible.<sup>301</sup>

But misleading regulatory characterizations weaken the information-based assumptions of the jurisdictional competition model. Ordinarily, imperfect information is ameliorated by intermediaries who charge fees to “channel information to consumers.”<sup>302</sup> For example, in the state corporation charter competition story, customers used corporate lawyers to provide truthful objective assessments of the alternatives.<sup>303</sup> They and securities lawyers and accountants can serve like functions within their respective specialties in the current competitions.

Yet regulatory misstatement diminishes expert ability to filter information effectively. Indeed, especially in a competitive climate, many professionals have stakes in the outcome, as where Delaware lawyers or IFRS-trained accountants have incentives to echo official regulatory pronouncements. Rhetorical overstatement also makes it more difficult for professionals to communicate information effectively to clients who are led, through public statements, to believe the rhetoric. There are limited mechanisms to constrain or filter regulatory misstatements. While the SEC is subject to the Data Quality

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<sup>299</sup> The roots of the prevailing model of jurisdictional competition reside in one originally focused on the production of public goods. William W. Bratton & Joseph A. McCahery, *The New Economics of Jurisdictional Competition: Devolutionary Federalism in a Second-Best World*, 86 GEO. L.J. 201 (1997) (exploring and refining original contribution of Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416 (1956)).

<sup>300</sup> Cox, *Regulatory Duopoly*, *supra* note \_\_\_, at 1231-32 ((citing Tiebout, *supra* note \_\_\_, at 419); Bratton & McCarey, *supra* note \_\_\_, at 222-236 (discussing the consequences of relaxing the assumptions of the Tiebout model)).

<sup>301</sup> In efficient capital markets, discounts are assigned to the securities of issuers in less-preferred regimes compared to prices of securities governed by more-preferred regimes. Issuers respond by relocating to regimes where no discounts are imposed. *See* Cox, *Regulatory Duopoly*, *supra* note \_\_\_, at 1230-1231 (summarizing but criticizing the argument).

<sup>302</sup> *See* Bratton & McCahery, *supra* note \_\_\_, at 275. Professors Bratton and McCahery discuss this point in the context of competition for factors of production, *id.* at 268-276, but this provides a lesson concerning information.

<sup>303</sup> *See* Bratton & McCahery, *supra* note \_\_\_, at 267.

Act limitations that command regulatory accuracy, promulgators of IFRS, Delaware and British Columbia are not.<sup>304</sup>

Regulatory mischaracterization is a problem for all philosophical dispositions implicated in debates over jurisdictional competition. Proponents assume that government actors exhibit business-like integrity; public interest theory views government as benevolent; and even public choice theory portrays government as responsive to private rent-seeking. Each of these accounts changes if regulatory competitors are susceptible to the same kinds of weaknesses of misleading statements that traditional business enterprises can engage in. Integrity, benevolence and responsiveness are impaired. Thus, jurisdictional competition debate may hinge, in part, on philosophical views concerning relative confidence in markets versus governments to promote social ends.<sup>305</sup> But this analysis adds a limitation to its efficacy when sloganeering is misleading and neither consumers nor their professional advisors can be counted upon to pierce it.

The additional argument does not mean that jurisdictional competition is never preferred. Rather, it means that the presence or risk of regulatory overstatement is a factor which deserves explicit recognition in the assessment. It appears to exist in the three specific contexts considered, making this a factor against unbridled jurisdictional competition in these contexts. It is uncertain whether that means that superior results would follow from alternatives to jurisdictional competition, such as harmonization. What is certain is the prudence of questioning the rhetoric invoking rules-based and principles-based systems.

## CONCLUSION

Rules and principles are imperfect categories to describe individual legal or accounting provisions. While some provisions may fit neatly into such categories, rational systems of law or accounting partake of both types and hybrids running across a continuum. Even when it is possible to classify individual provisions as rules or principles, fairly characterizing entire systems as rules-based or principles-based is an essentially impossible task. In addition to examining all the individual provisions within the system, one would have to account for how they are applied and how they interact. Once those stages of a system are accounted for, and the benefits appreciated, it is difficult to conclude that any system of corporate law, securities regulation or accounting

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<sup>304</sup> See *supra* note \_\_\_\_\_. Indeed, sovereign immunity likely would insulate states and state actors from exposure to liability for false advertising. See *College Sav. Bank v. Florida Prepaid Postsecondary Educ. Expense Bd.*, 527 U.S. 666 (1999).

<sup>305</sup> See Cox, *Regulatory Duopoly*, *supra* note \_\_\_\_, at 1231-32 (noting that arguments on behalf of jurisdictional competition's virtues made separately by Professors Romano and Mahoney all display mistrust of government such that the arguments are equally persuasive to support abolishing mandatory disclosure or privatization of regulatory functions); Frederick Tung, *From Monopolists to Markets?: A Political Economy of Issuer Choice in International Securities Regulation*, 2002 WIS. L. REV. 1363, 1367-68 (noting the market-preferring orientation of devotees of jurisdictional competition).

systems *can be* rules-based or principles-based. Surveys of these fields warrant skepticism about the accuracy of such descriptive claims.

Why global rhetoric championing principles-based systems is flourishing requires speculation. The phenomenon is possibly due to a combination of regulatory desire to provide a counterweight to demand for rules, a quest to rejuvenate ethics and a desire to distinguish a jurisdiction's legal-financial products. The first and second explanations seem credible and largely benign, although they pose some risk of backfiring if regulators become overzealous. The third seems most descriptively accurate but also most normatively troubling. If it is infeasible to establish a principles-based system of corporate law, securities regulation or accounting, then it is misleading to promote the possibility. Accordingly, the labels should be retired and regulators who use them greeted with skepticism that they are operating under unfortunate by-products of jurisdictional competition.

Another way of concluding this analysis is to observe that the rhetoric of "rules-based" versus "principles-based" as descriptions of complex regulatory systems is an instance of the common political habit of invoking binary classifications. Examples appearing in certain styles of political discourse include the stunningly oversimplified labels of "the right" and "the left" or use of the phrase "both sides of the debate" when reducing complex disagreements to oversimplified binaries (as in "both sides of the rationality debate" or "both sides of the Iraq War debate"). Political realities and positional complexities expose such labels as contextually false dichotomies. Unreflective invocation of binary labels in policy discourse retards rather than advances thoughtful dialogue. In the case of binary classifications of complex regulatory systems, this impairs weighing the relative advantages of using various forms of provisions to achieve varying objectives.

If so, then it would be appealing to allow the simple labels to represent extreme ends of a spectrum, so that complex regulatory systems could range across a spectrum denominated at its poles by extreme principles-density to extreme rules-density. A classificatory scheme could be constructed in which systems are located at descriptive positions across that spectrum. Descriptive locations could include some terms suggested above, such as principles-heavy, principles-rich, rules-rich and rules-heavy.<sup>306</sup> A challenge in devising such a descriptive spectrum, however, is that to establish such locations still requires highly-sophisticated classification and measurement tools that have not been developed (involving sorting individual provisions into notoriously unstable categories plus then accounting for how the individual provisions are applied and how they interact).

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<sup>306</sup> See *supra* text accompanying notes \_\_\_-\_\_\_ (discussing how Professors Black and Kraakman dubbed as "self-enforcing" the model of corporate law for emerging economies, which devotees of the binary labels would be tempted to call rules-based and I referred to as rules-rich or rules-heavy); *supra* text accompanying notes \_\_\_-\_\_\_ (discussing how the proposed British Columbia Securities Act advertised itself as principles-based and I referred to as principles-heavy or principles-rich).



On the other hand, if it were possible to develop a reliable classification and measurement method to support such descriptive classifications, the refined taxonomy could be appealing. It would displace the false binary. That offers the advantage of faithfully reflecting the realities that individual provisions reside along a rules-principles continuum that is sometimes unruly and that complex regulatory systems exhibit relative vagueness with even more systemic unruliness. So reflecting those realities in the discourse would rightly neutralize the rhetorical and political power of the false binary. That could improve capabilities in weighing the relative appeal of various forms of provisions in relation to objectives. The inherent limitations of a quest to do so likely would lead to the more ultimate prescription made in this Article, through a fizzling out of the vocabulary altogether.