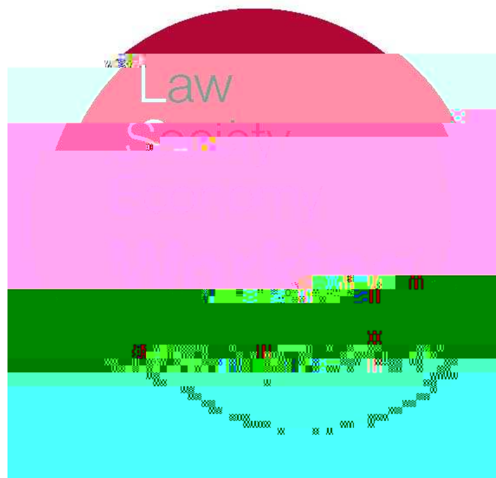

Forms and Paradoxes of Principles Based Regulation

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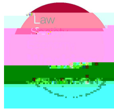
Forms and Paradoxes of Principles Based Regulation

Julia Black*

Abstract: Principles-based regulation is high on the regulatory agenda in a number of regulatory domains, most particularly financial regulation. Its supporters argue that it provides a flexible regulatory regime which can facilitate innovation; its detractors argue that it is simply lax regulation. This article explores the political rhetoric surrounding principles-based regulation. It identifies four forms of principles-based regulation: formal, substantive, full and polycentric principles-based regulation. It also identifies and explores seven paradoxes which principles-based regulation may encounter in its various forms. These relate to interpretation, communication, compliance, enforcement, internal management, ethics, and above all trust. PBR, in its full form, can provide an effective, durable, resilient and goal based regulatory regime; but at the same time its paradoxical nature means that it is vulnerable in many respects. Unfortunately for the detractors of principles-based regulation, many of these paradoxes are not necessarily avoided by using detailed rules instead of principles. Rather their resolution lies in trust. Yet, ;'=O1.3=TY*'YY1 3D6YT6YOmT**6N'1e3DIT**IN71t36T=;'=O1a3D7T;*NOoO7[1p37T'=O'I1r3O6N'



Financial Services Authority had just issued its paper on how it would operationalise its approach to principles based regulation and the challenges that the FSA, firms and their advisers would have to meet to make the approach work.[2] The EU Commission was trumpeting the benefits of a principles based approach,[3] although the FSA was arguing the EU still had a long way to go in this direction.[4] Politicians in the US were looking askance at the impact of Sarbanes-Oxley and extolling the virtues of principles based regulation. A report by McKinsey & Co, commissioned by the Mayor of New York, Michael Bloomberg and Senator Charles Schumer, recommended that the US adopt a 'two-tier' principles based approach, developing a set of principles to guide the regulators in performing their roles and a set of principles to guide firms.[5] US Treasury Secretary Hank Paulson echoed these recommendations in his suggestion that the US should move to a UK style approach to regulating capital markets, relying on principles rather than detailed rules.[6] This has now been formalized in the US Treasury's **Blueprint for a Modernized Financial Regulatory Structure**.[7] Combined with parallel debates on the role of principles in accounting regulation[8] and tax law in particular,[9] the issue of 'principles based regulation' was, and to an extent still is, high on the regulatory agenda in a number of regulatory domains, ranging from the familiar ones of tax,

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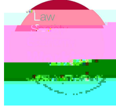
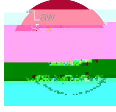


under PBR, but only if they are strong already. Resea



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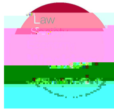


sufficient perspective on and understanding of the problems and issues that they confront to be selective and to identify the key issues on which regulation should focus, in which there is sufficient agreement on principles and purposes to be able to agree with firms a common framework, and in which regulated firms are given the flexibility and responsibility to develop their own systems for ensuring that the regulatory principles are adhered to, but in a way which means their businesses can operate efficiently and innovatively in a stable regulatory environment.

The rhetoric of PBR thus invokes, not deregulation, but a re-framing of the regulatory relationship from one of directing and controlling to one based on responsibility, mutuality and trust. Regulators and regulatees move from a directing relationship of telling and doing, to a relationship in which regulators communicate their goals and expectations clearly in principles and apply those principles predictably, regulatees adopt a self-reflective approach to the development of processes and practices to ensure that these goals are substantively met, and, critically, both trust each other to fulfil their side of this new regulatory bargain.

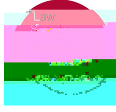
The rhetorical invocation of such a world under the moniker of PBR is beguiling not only to policy makers and business, but to academics as well. The world invoked by the rhetoric of PBR is one which accords with the strategies of the 'new governance'[26] or 'decentred regulation'.[27] The decentred, or polycentric, analysis of regulation has three dimensions: organisational, conceptual and strategic.[28] Organisationally, it draws attention away from individual regulatory bodies, be they at the national or global level, and emphasises instead the multitude of actors which constitute a regulatory regime in a particular domain. Conceptually, the decentring analysis has a particular understanding both of the nature of the regulatory problem and the nature of state-society and intra-state and intra-society relationships. It emphasizes the existence and complexity of interactions and interdependencies between social actors, and between social actors and government in the process of regulation. It has a dialectical conception of the regulatory relationships, in which regulator and regulatee are at once autonomous of and dependent on each other. It is also rejects the distinction between public and private: both state and non-state actors engage in the function of regulation, both separately and in different types of interrelationship, and indeed state actors may be regulated by non-state actors.[29] The third dimension is

[26] See n 19 above.

[27] J. Black, 'Decentring Regulation: Understanding the Role of Regulation and Self Regulation in a "Post-Regulatory" World' (2001) 54 **Current Legal Problems** 103; id., 'Critical Reflections on Regulation' (2002) 27 **Australian Journal of Legal Philosophy** 1.

[28] J. Black, 'Constructing and Constesting Legitimacy and Accountability in Polycentric Regulatory Regimes' (2008) 2 **Regulation and Governance** 1.

[29] E. Meidinger, 'Look Who's Making the Rules: International Environmental Standard Setting by Non-State Organisations' (1997) 4 **Human Ecology Review** 52-54; B. Cashore, 'Legitimacy and the Privatization of Environmental Governance: How Non-State Market Driven (NSDM) Governance Systems Gain Rule Making Authority' (2002) 15(4) **Governance** 503; M.E. Keck and K. Sikkink, **Activists Beyond Borders: Advocacy Networks in International Politics** (Ithaca, NY: Cornell University Press, 1998); T. Risse-Kappen (ed), **Non-State Actors, Domestic Structures and International Institutions** (Cambridge: Cambridge University Press, 1995);



context, the barb clearly stung the Exchange, which offered a swift repost that Campos had misunderstood its principles-based approach.[40] The deployment of PBR to fight political battles is not confined to securities regulation. In the context of accounting regulation, Kershaw has argued that in the wake of Enron's collapse, it was in part the ability of the UK accounting regulators to portray their approach as 'principles-based' which saved them from the political fallout which hit accounting regulation in the US. This was despite the fact that the relevant accounting provisions themselves in the UK and the US were almost identical.[41]

Using PBR as a weapon in a wider battle for institutional position is not new. An often forgotten fact is that the FSA's eleven Principles for Business, now taken as one of the hallmarks of a PBR regime, were themselves rooted in the ten Principles created by its predecessor (the Securities and Investments Board). These ten Principles were developed by SIB to mark out its institutional turf in a power battle with the self-regulatory organizations (SROs) in the pre-FSA regulatory regime.[42] When the initial regulatory regime was created under the 1986 Financial Services Act, the Act was deliberately vague as to which should be the dominant regulator, the Securities and Investments Board (named in the Act and in receipt of powers to recognize self regulatory organizations) or the SROs themselves. SIB could recognize SROs but had no powers to direct them. Both organizations were responsible for directly regulating firms themselves, and the SRO's rulebooks had to provide 'equivalent' levels of protection to those provided by SIB's rules. However the SIB could not require SROs to amend their rules post-authorisation; the only sanction was the nuclear option of derecognition. After lengthy battles as to the relative power, authority and roles of SIB and the SROs, the Government agreed to amend the legislation to permit SIB to issue principles which were applicable to all authorized firms, and so which had to be recognized by the SROs. In addition, SIB was given powers to designate a number of its own rules as 'core rules', SIB rules which the SROs were required to P

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part for the normal, pragmatic reasons relating to the imperfections of human and organisational behaviour, the dangers of bureaucratic sclerosis in both firms and regulators, the tendency for regulators to, as Schauer puts it, 'round off' the hard

this tells us little about the character of the regulatory regime. This is also true, and it is the reason for suggesting the distinction between different types of PBR.

the dimension of structure which is relevant in characterising a norm as a principle. A rule's structure has three elements: precision, complexity; and clarity. Each of these elements is a spectrum: at one end the rule may be extremely precise (30 days), at the other end it may be very general (in a reasonable time). It may range from being very simple (no entry) or highly complex (no admission for the following under the following circumstances). Varying the choices as to these elements of structure produces rules of three broad types: bright line rules, principles or detailed and complex rules. Table 1 illustrates how these different types could be used hypothetically (and in approximate terms) to communicate the requirements with respect to timely execution.[56]

Table 1: Rule types illustrated

Type 1: Bright line rule	Type 2: Principle	Type 3: Complex / detailed rule

A firm must execute ro6P=fUkD66T;tdk[1T3DNT;YO=771y3N6N*I1 3D6INT6N*I1q3DNT==YNI=1u3DNT==YN

)1g3DNT*='OI0T*IIjD=*T6OP–dk[1O61e7==T'I?kD67'T*=YPD=*T6OP–dk[1h3'T;1 36IN] –?kD

it looks simple to apply (there is just one condition to meet), in practice a whole range of factors will have to be considered, which may make it as complex to apply as a Type 3 rule.

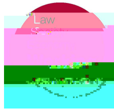
Type 3 is a detailed or complex rule. The list of conditions that have to be met for the rule to apply or be complied with can mean it has a higher congruence than a Type 1, bright line rule, but only if they are the appropriate criteria. It can thus potentially have the congruence of a Principle but provide more certainty than a Principle as it elaborates on what the conditions/factors are that have to be taken into account. That elaboration makes it complex to apply, however (more information is necessary, more factors have to be taken into account), and the creation of a list inevitably will leave gaps and again give scope for manipulation or creative compliance.

Principles thus have the benefit of congruence: of communicating the regulatory objectives and promoting behaviour which will achieve those objectives. Moreover, as far as regulators are concerned, they have the benefit of minimising the scope for “creative compliance”. Whether or

general terms and which express the reason for the rule, and if the norms are seen as expressing the fundamental obligations that all subject to them should observe.

Substantive PBR

As noted above, however, there can be more to PBR than just the presence of principles. The regulatory Utopia invoked by PBR is not one of a perfectly designed rulebook, but of a regulatory regime based on mutuality, trust and responsibility. The debate is not on issues of legal form for their own sake, but on the type of behaviour of both regulator and regulated firms that it is hoped that the use of principles will elicit. Contrary to the implicit assumptions behind much of the rhetoric of PBR, however, this behaviour does not automatically follow from the presence of principles. Kershaw's analysis of the relevant accounting



interpretations and consequentialist reasoning. The mode of interpretation adopted in substantive PBR, at least in the regulatory context, is thus at odds with the formal canons of traditional contractual interpretation, at least at common law, where interpretation has historically been formal, literal and non-consequentialist.[60] As will be suggested below, this difference in interpretive approach is probably one of the main reasons lawyers resist PBR, at least as practised by regulators, but probably one of the main reasons politicians, [illegible]

persisting and offenders going unpunished. The conventional wisdom is that neither extreme is an effective approach to take; instead regulators should do both: first negotiate, then if the firm still does not deliver substantive compliance regulators should gradually move up the enforcement pyramid, applying sanctions of increasing severity until they do.[64]

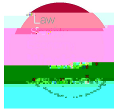
This 'responsive' enforcement approach is not contingent on any particular rule design, however. It can operate in systems of highly detailed rules, or where the rules are mainly principles, or where there is a combination of the two. That said, different rule types make it easier for regulatory officials to deal with certain types of regulated firm, as Baldwin has pointed out. Those who know what they are meant to be doing and are generally inclined to do it (the well intentioned and well informed) are best dealt with using a negotiating strategy, which is easier to do using principles. In contrast, those who do not know what they are meant to be doing and even if they did would not be inclined to do it (the ill intentioned and ill informed) are best dealt with using a strategy that escalates quickly up the enforcement pyramid, for which bright line rules are more effective. A supervisor can simply tell them: just do this because that is what the rule says.[65]

The point here is not what rule type is most effective for which type of regulated firm, though that is relevant, but the enforcement approach used. Substantive PBR requires a broadly 'responsive' mode of supervision and enforcement, in which negotiation as to the meaning, application and purpose of the rule plays a central role, and in which the focus is on the outcome that is to be achieved.[66] However, whilst a 'responsive' approach to enforcement may be facilitated by the rules of certain types, it is not contingent on them. So in the area of enforcement there can be, at least in this sense, substantive PBR without the form. The British Columbia Securities Commission provides a good example. As noted above, even though the BCSC has not been able to introduce principles, it has introduced the substantive aspect of PBR through changes to the manner in which it monitors and enforces its regulatory requirements.[67]

programme that would place sell orders simultaneously for a particular German government bond across a number of European markets. The strategy resulted in orders being sent for more bonds than existed, the closure of at least one market and the disruption of a number of markets for several days. They sold

up as a key example of PBR, is a long way from being a hallmark of unintrusive regulation. The TCF initiative is underpinned by Prin

Firms do not want to do the regulators' job for them; regulators do not want to become unpaid consultants. This tension in their relationship, as to what the



regulation of the London Stock Exchange's junior market, the Alternative Investment Market (AIM).[80] Nomads, or 'nominated advisors', have to be appointed by any firm seeking admission to AIM, and significantly firms have to retain a Nomad during the course of their admission. The role of the Nomads is essentially to guide firms on the meaning and application of the AIM rules, which themselves often take the form of principles. Thus they are to ensure that firms have 'appropriate' systems of corporate governance, for example. Those who participate in AIM, their regulators and advisors all talk of the 'AIM community', and it provides a good example of an interpretive community. Through numerous interactions between Nomads, advisors, firms and regulators, understandings as to appropriate standards of conduct and courses of action have developed over time. And like other interpretive communities, it is vulnerable to the introduction of outsiders who upset this homogeneity of implicit understandings. The intrusion requires the production of 'clarifications' to render explicit some of those implicit understandings, as occurred in AIM's restatement of its rules in 2007. But the dense network of actors and interactions which supports PBR remains more or less intact.

Finally, consultants and voluntarily appointed advisors, including legal advisors, can play a key role in shaping the form tha

PARADOX 1: THE INTERPRETIVE PARADOX: PRINCIPLES CAN BE GENERAL YET PRECISE

Principles, as explained above, are formally characterized by general, imprecise terms. This is meant to give flexibility. However, in practice principles can receive very specific interpretations. There can be benefits: certainty is produced through the development of an interpretive community which gives particular content and meaning to the principles. However, interpretive communities can fracture, and the regulatory regime may contain several interpretive communities, each with a different interpretation.

In particular, the interpretation which develops within the regulator may in practice be quite specific but not necessarily well understood. For example, the AIM rules do not specify the proportion of shares which should be made available on admission, but the LSE's rule of thumb is that at least 10% of the share capital has to be made available to the public.[81] In AIM's case, the AIM community is aware of this interpretation, but where interpretive communities are not as strong, this may not be the case. The tendency for rules to become formalized in practice is well-observed, to the extent that a significant gap can grow between the written word and the bureaucratic interpretation it receives. Dan-Cohen talked of this in terms of the 'acoustic separation' of law.[82] Specific interpretations may develop for reasons of bureaucratic ease (it saves supervisors having to think every time what conduct they should allow, enables consistent application), or because the regulator has taken a clear policy decision, not communicated in the rules themselves, that this is the interpretation that should be given. Whichever the reason, the operation of this interpretative paradox means that PBR exists only at the formal level, and in practice can be almost indistinguishable in places from a regime characterized by detailed rules.[83]

PARADOX 2: THE COMMUNICATIVE PARADOX: PRINCIPLES CAN FACILITATE COMMUNICATION BUT CAN ALSO HINDER IT

In using relatively straightforward language in expressing the purpose of the rule, PBR can facilitate communication. Indeed that is often one of the rationales for its introduction – to communicate better to regulated firms what their responsibilities are under the regulatory regime, as noted with respect to the FSA above.[84] However, PBR can hinder communication in practice: a communicative paradox. In part, this can arise if there is a proliferation of guidance, and particularly if regulators are undisciplined in their provision of guidance. This lack

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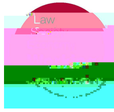
[81] ibid.

[82] M. Dan-Cohen, 'Decision Rules and Conduct Rules: On Acoustic Separation in Criminal Law' (1984) 97 Harvard L.R. 625.; see further Black, 'Talking about Regulation', n 33 aboveheh ;TN6I'1.O'*'NT'"7OPNPNP=P==7T*P=IOT7;P–mk

Each of these elements of regulatory reasoning and interpretation is an anathema to a lawyer. This is not to say they cannot engage in it: law firms have built lucrative businesses advising firms on how regulators will or will not respond in different situations. But it is rather that it is contrary to their training and one which some at least resist. In Luhmann's terms, the problem lawyers may have with regulatory interpretations of principles is principally that the 'programme' used by regulators for applying law is not one that they recognize[90] – hence, their heavy criticism of PBR and all who sail in her. How many times do we hear it said in relation to the FSA's principles based approach that managers like PBR; but lawyers and compliance do not. This resistance may be because PBR exposes lawyers and requires them to make judgements about what will constitute compliance (be lawful) and what will not. This vulnerability may lie at the root of some of the resistance, and may be exacerbated in particular organizational structures where heavy blame may be placed on those who turn out to have made the wrong call. But lawyers are frequently asked to advise on matters where the application of the law is uncertain; so why should uncertainty itself pose such an issue?

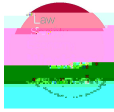
The answer, at least in part, it is suggested, is two



PARADOX 3: THE COMPLIANCE PARADOX: PRINCIPLES PROVIDE SCOPE FOR FLEXIBILITY IN COMPLIANCE YET CAN LEAD TO CONSERVATIVE AND / OR UNIFORM BEHAVIOUR BY REGULATED FIRMS

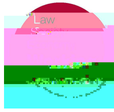
Principles can provide flexibility for regulatees as to how they reach the outcome that is expressed by the Principle. However uncertainty as to the interpretation of principles that enforcers will adopt can result in firms adopting conservative behaviour, as if they were bound by detailed rules. This paradox is Schwarz's

the role of consultants in reconstructing the conceptual architecture of risk management and exploiting opportunities arising from the perceived need for change led to the development and diffusion of risk management practices in areas ranging from corporate governance to the definition and management of operational risk. [94] Consultants ensure easy diffusion of their models by abstracting from specific practices, framing management issues in process terms which can then be aligned with the broader values bei



substantial change in supervisory strategies which has been facilitated by principles (though it pre-dated the FSA's self-characterised move to its 'more principles-based approach). The close engagement with firm's internal systems and processes which the FSA has adopted as part of the TCF initiative is a significant development of compliance and inspection strategies. The FSA is also leveraging its position as the holder of aggregate information of practices in a range of firms by disseminating examples of good and poor practices to help firms change their systems and benchmark themselves against industry norms.[99]

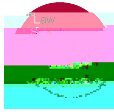
However, although principles can facilitate this negotiated mode of compliance, in which meaning and application can be negotiated through iterated regulatory conversations, PBR is also commonly criticized for facilitating retrospective interpretations of the norms. In the pensions misselling scandal, for example, the SIB relied on the suitability and know your customer requirements (technically classified as rules in the SIB rule book but with the form of principles) to require firms to engage in the pensions review, notwithstanding that pensions had been missold for years prior to the review without any regulatory action having been taken.[100] The SIB was accused of retrospectivity, but it had the will, and to an extent the political backing, to withstand those criticisms and order the review nevertheless. However in a different political climate, or with a different, less robust attitude amongst the regulators' senior management, regulators may be wary of taking enforcement action against firms' conduct, even if it could be interpreted as a breach of the principle. This is particularly likely where firms argue that enforcement action would be retrospective as the regulator had not mentioned any problems with their conduct bef beNT*II*O61ro3DNT*II*N6N*I1e3DNT771E1t3DNTY



highly punitive enforcement regime is likely to result in the transformation of PBR into a system of detailed rules.

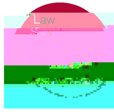
PARADOX 5: THE INTERNAL MANAGEMENT PARADOX: PBR CAN PROVIDE FLEXIBILITY FOR INTERNAL CONTROL SYSTEMS TO DEVELOP BUT CAN OVERLOAD THEM

Just as different types of rules can help or hinder the supervision and compliance



laundering, and under the TCF initiative, where firms have been advised to adopt a risk based approach to the compliance monitoring of their sales advisors.[113]

The potential ethical paradox is thus that PBR can facilitate the development of ethical approaches to compliance, but the greater interpretive risk that it



forms, to operate at all. PBR can help this relationship develop; but it needs it to exist before PBR can even begin to work. The final paradox is possibly the ultimate paradox of PBR. PBR is based on trust that it alone cannot create, though it can facilitate its development. Trust in turn can help to resolve many of the paradoxes identified above. Without trust, PBR will never be operationalised; it will exist only in the text of the rule books, not in the way they are implemented.

SUMMARY AND CONCLUSIONS

PBR is thus a highly complex form of regulation, belying its rhetoric of simplicity. Its attractiveness to politicians lies in its malleability and in the vision it evokes; for academics it accords with all the messages of the 'new governance' paradigm(s). The rhetoric of PBR masks, or deliberately confuses, its various forms. PBR can exist in form only; can exist in substance without the form; or where both are present can exist in its full form. Moreover, PBR may be polycentric where a range of actors other than the regulator and regulated firm are enrolled in the production of meanings and interpretations.

However PBR in its various forms is beset with a number of paradoxes, some of which are inherent within it, some of which arise from its juxtaposition or association with other practices, such as risk management. Delineating the nature of these paradoxes both within financial services regulation and in other regulatory regimes which could be characterized as PBR regimes requires further investigation. However, in delineating the different forms of PBR and identifying its paradoxes, this paper hopes to move the debate on both from the sweeping rhetoric of the political debates and the relatively stagnated policy and academic debate on advantages and disadvantages of principles over detailed rules. PBR, in its full form, can provide an effective, durable, resilient and goal based regulatory regime; but at the same time its paradoxical nature means that it is vulnerable. However, as many of these paradoxes are not necessarily avoided by using detailed rules instead of principles, it is only through recognizing and exploring the dynamics of these paradoxes that we can be fully aware of the potentials and limitations of the use of rules in any regulatory regime, whether it is principles-based or not. But the ultimate paradox is that which can hold the key to resolving many of the others, but which is the hardest itself to resolve. It is that PBR can help create trust, but it itself has to be founded on trust if it is ever to operate effectively, if indeed at all.