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

Lawrence A. Cunningham

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

Lawrence A. Cunningham

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This Article corrects widespread misconception about whether complex regulatory systems can be described fairly 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. Users show 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 the 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.

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

*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.”¹ The scandalous era epitomized by Enron Corp. drew worldwide attention to these labels. Many attributed the scandals to weaknesses in the United States accounting system, which they classified as “rules-based.”² The Sarbanes-Oxley Act directed the Securities and Exchange Commission

1. The phrase “standards-based system” is also used. *See infra* text accompanying notes 10-18.

2. *E.g., Written Testimony Concerning Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 107th Cong. (2002) (statement of Harvey L. Pitt, Chairman, SEC), available at <http://www.sec.gov/news/testimony/032102tshlp.htm> (asserting that U.S. accounting is “based on rules, and not on broad principles”); S. REP. NO. 107-205, at 13 (2002) (stating the reasons why Congress chose to conduct a feasibility study regarding the use of a principles-based accounting system); FIN. ACCOUNTING STANDARDS BD., PRINCIPLES-BASED APPROACH TO U.S. STANDARD SETTING, NO. 1125-001 (2002), available at http://72.3.243.42/proposals/principles-based_approach.pdf [hereinafter FASB, 2002 PROPOSAL] (proposing a principles-based approach to standard setting to improve the quality and transparency of financial accounting and reporting); *see also* 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) (noting the possible downsides to the U.S. rules-based accounting system that were recognized by Congress when passing the Sarbanes-Oxley Act); Anthony J. Luppino, *Stopping the Enron End-Runs and Other Trick Plays: The Book-Tax Accounting Conformity Defense*, 2003 COLUM. BUS. L. REV. 35, 161-62 (2003) (analyzing the desire of Congress to study the feasibility of a principles-based accounting system); Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 CORNELL L. REV. 394, 421 (2004) (stating that the plethora of “technical disclosure rules” makes financial fraud easier); William H. Widen, *Enron at the Margin*, 58 BUS. LAW. 961, 965 (2003) (noting the financial world’s “ethic of technical compliance”).

("SEC") to study this claim.³ Within and outside the United States, policymakers seize on these categories to self-classify their legal and accounting systems in order to use these labels as grounds for promotion, reform, or prescription.⁴ 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 two neat categories. Describing a system as principles-based or rules-based not only would require an inventory of all its provisions along that continuum, but also would 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 solely 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 with the benefits of the relationship among rules and principles and impairs tailoring the form of articulation to meet desired objectives.

Surveys of U.S. corporate law and securities regulation and of U.S. 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,

3. Sarbanes-Oxley Act of 2002 § 108(d), 15 U.S.C. § 7218 (Supp. II 2002) ("The Commission shall conduct a study on the adoption by the United States financial reporting system of a principles-based accounting system."); *see id.* § 7266 (requiring the SEC to review an issuer's filings at least once every three years); *see also infra* text accompanying notes 199-201.

4. *See, e.g.*, Nicholas Le Pan, *Financial Regulatory Outlook*, 23 NAT'L BANKING L. REV. 52, 53 (2004) (describing approach to corporate-governance regulation as addressing behaviors through "guidelines" that "are not rules," including "boards making sure they have the information they need in the form they need it"); Liam O'Reilly, Chief Executive, Irish Fin. Regulator (*Rialtóir Airgeadais*), Address at the Institute of European Affairs Seminar on Financial Services Regulation: Financial Services Regulation: Challenges and Burdens (June 21, 2005) (stating that the Irish Financial Regulator is "a principles-based regulator" and opposes "rules-based systems"); Cathy Quinn, Member, N.Z. Sec. Comm'n, Address at the Legal Teachers Forum: Corporate Governance Post-Enron (July 8, 2005) (advertising the country's "robust principles-based framework for good corporate governance" instead of a "more prescriptive rules-based approach").

they are mutually informative. Thus, corporate fiduciary duty laws bear principle-like attributes but interact with statutes and form a doctrinal structure with rule-like attributes through repeated applications in non-statutory contexts. 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.⁵ U.S. federal securities regulation is routinely criticized as rules-based, while the Canadian system is heralded as principles-based.⁶ Around the globe, many characterize the U.S. accounting system as rules-based while calling the international accounting system principles-based.⁷ Within the United States, regulators and compliers alike invoke such language when

5. See, e.g., STOCK EXCH. OF THAIL., THE PRINCIPLES OF GOOD CORPORATE GOVERNANCE FOR LISTED COMPANIES (2006), available at http://www.ecgi.org/codes/documents/cg_principles_thailand_2006_en.pdf (setting forth non-binding principles and best practices); William Baue & Graham Sinclair, *Johannesburg Securities Exchange Requires Compliance with King II and Global Reporting Initiative*, SOCIALFUNDS.COM NEWSROOM, July 16, 2003, <http://www.socialfunds.com/news/article.cgi/article1174.html> (describing the Johannesburg Securities Exchange as “principles-based,” not rules-based, so as to “encourage[] directors to perform in the spirit of the code rather than simply apply[] the tick box approach”). 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. Lawrence A. Cunningham, *Principles and Rules in Public and Professional Securities Law Enforcement: A Comparative U.S.-Canada Inquiry*, 6 CANADA STEPS UP 253 (2006), available at [http://www.tfmsl.ca/docs/V6\(5A\)%20Cunningham.pdf](http://www.tfmsl.ca/docs/V6(5A)%20Cunningham.pdf).

6. E.g., Allison Dabbs Garrett, *Themes and Variations: The Convergence of Corporate Governance Practices in Major World Markets*, 32 DENV. J. INT'L L. & POL'Y 147, 161 (2004) (saying that many of Canada's provinces, such as British Columbia and Alberta, employ a principles-based system of regulation); Ruth O. Kuras, *Harmonization of Securities Regulation Standards between Canada and the United States*, 81 U. DET. MERCY L. REV. 465, 472 (2004) (noting the differing factors between the United States's and Canada's economies that contribute to the selection of a rules-based or principles-based approach).

7. See Frederick Gill, *Principles-Based Accounting Standards*, 28 N.C. J. INT'L L. & COM. REG. 967, 973-80 (2003) (discussing the differences between rules-based systems and principles-based systems as set forth by the FASB); see also Matthew A. Melone, *United States Accounting Standards: Rules or Principles? The Devil Is Not in the Details*, 58 U. MIAMI L. REV. 1161, 1164-65 (2004) (describing the various bases for proposed accounting reform in the United States); Hervé Stolowy, *Nothing Like the Enron Affair Could Happen in France(!)*, 14 EUR. ACCT. REV. 405, 406-08 (2005) (reviewing responses to Enron Corp.'s fraud among French accounting scholars, practitioners, and policymakers); Kenneth Yong, *Exploring Rules-Based and Principles-Based Accounting Standards*, ACCOUNTANTS TODAY, Nov. 2004, at 32 (international accounting is “popularly considered as being principles-based” while U.S. GAAP is “branded with a rules-based reputation”).

campaigning for favored provisions⁸ or championing state versus federal primacy in regulating public corporations.⁹ 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 non-exclusive 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 *ex ante* 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. In addition, the rhetoric does not speak of a balance of principles and rules but trumpets "principles-based systems" and derides "rules-based systems."

A second possibility, the ethical hypothesis, is that the pro-principles rhetoric reflects a desire to promote ethical values rather than a concern for the form of articulated legal and accounting provisions. What the Enron-type frauds showed was not so much the danger of rules, but the 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 for targeted actors to abide by them. While also credible, two qualifications appear, one descriptive, one normative.

8. See, e.g., Executive Compensation and Related Person Disclosure, Exchange Act Release No. 8732A, Securities Act Release No. 54,302A, Investment Company Act Release No. 27,444A, 71 Fed. Reg. 53,158, 53,165 (Sept. 8, 2006) (adopting a less rules-based and more principles-based system of executive compensation disclosure, meaning disclosing all material items, whether or not they "fit squarely within a 'box' specified by the rules"); Cynthia A. Glassman, Comm'r, SEC, Remarks Before the Tenth Annual Corporate Counsel Institute: Priorities and Concerns at the SEC (Mar. 9, 2006) (reporting her effort in 2003 to make management's discussion and analysis disclosure less obscure by adopting an SEC "interpretive release that provided principles-based guidance").

9. See, e.g., Sean J. Griffith & Myron T. Steele, *On Corporate Law Federalism: Threatening the Thaumatrope*, 61 BUS. LAW. 1, 13-22 (2005) (arguing that the flexibility of state laws may prove preferable to the inflexible federal preemption of corporate law).

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. Exhortations to abide by 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 rules-based. British Columbia advances a principles-based system to challenge Ontario's dominance in Canadian securities regulation. Officials who claim that their country offers principles-based systems do so to signal a sufficiently mature state to honor principles without the need for detailed rules. International accounting promulgators promote their product as principles-based against the U.S. version, 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 undermining the hortatory aspirations of the ethical hypothesis, it exposes a negative byproduct of 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 also 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, revealing considerable tension 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 a 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 the most troubling. Not only does this hypothesis add a reason to doubt the virtue of jurisdictional competition, it also cements the case to retire as misleading use of 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, to 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, using 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 subsections discuss the literature concerning treatment of individual provisions as rules and principles. Rules and principles are best conceived as residing along a continuum according to a provision's relative vagueness. The choice of form along that continuum poses subtle trade-offs, such as between promoting certainty by providing guidance ahead of action versus promoting contextual analysis by evaluating action after it occurs. 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.¹⁰ Scholars often use 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 miles-per-hour 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*. The second is susceptible to discordant labels. Some legal scholars call the formulation a *standard*,¹¹ while others refer to it as a *principle* or use both terms interchangeably.¹² Some scholars who use the term *principle* do so to denominate the animating purpose of a stated rule.¹³ In turn, some scholars use the word *standards* to capture both rules and principles.¹⁴ Others reserve the label *principles* for the different idea of background justifications for laws or other commands (whether

10. See, e.g., Louis Kaplow, *Rules and Standards: An Economic Analysis*, 42 DUKE L.J. 557, 559 n.2 (1992) (discussing the confusion in the use of the terms “rules,” “principles,” and “standards”); Pierre Schlag, *Rules and Standards*, 33 UCLA L. REV. 379, 382 n.16 (1985) (stating that “rules” and “standards” do not have “fixed meanings”); 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) (describing the ambiguity among the terms “rules,” “principles,” and “standards”).

11. See RONALD DWORKIN, *TAKING RIGHTS SERIOUSLY* 22-28, 71-80 (1977) (differentiating “principles, policies, and other sorts of standards” and asking whether rules really are different from principles); John Braithwaite, *Rules and Principles: A Theory of Legal Certainty*, 27 AUSTRAL. J. LEGAL PHIL. 47, 47 n.1 (2002) (“[S]tandards are norms written in a way to measure performance.”); Ronald M. Dworkin, *The Model of Rules*, 35 U. CHI. L. REV. 14, 22-25 (1967) (expounding upon the use of “rules,” “principles,” and “standards”).

12. See Sullivan, *supra* note 10, at 58 n.231 (describing the use of terminology among Professors Dworkin, Schauer, and Radin); see also Kaplow, *supra* note 10 (“Outside the debate over formulation of the law, the terms [‘rules’ and ‘standards’] are often used interchangeably.”).

13. DWORKIN, *supra* note 11, at 22, 26 (defining a principle as a “requirement of justice or fairness or some other dimension of morality” and as a factor “that officials must take into account, if it is relevant, as a consideration inclining in one direction or another”). The concept of principles as performing an animating function derives from Dworkin’s theory of “law as integrity” that “instructs judges to identify legal rights and duties . . . expressing a coherent conception of justice and fairness.” RONALD DWORKIN, *LAW’S EMPIRE* 225 (1986). According to Dworkin, “[w]hen a judge declares that a particular principle is instinct in law, he reports . . . an interpretive proposal: that the principle both fits and justifies some complex part of legal practice, that it provides an attractive way to see, in the structure of that practice, the consistency of principle integrity requires.” *Id.* at 228. For a deeper discussion of the different roles of principles and rule in the “law as integrity” theory, see *id.* at 225-58.

14. 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. HORIZONS 91, 91 (2003) (“A ‘standard’ is the total body of principles and rules that apply to a given accounting issue.”).

rules, standards, or something else).¹⁵ 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).¹⁶

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 United States, 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 suggest simply that such labels mean little. Indeed, some dismiss the confusion as mere nominalism, which does not impair analysis.¹⁷ 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 in which these components interact so 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.¹⁸ 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.

15. *E.g.*, EVA H. HANKS ET AL., ELEMENTS OF LAW 44-45 (1994); Sullivan, *supra* note 10, at 57-59.

16. See Symposium, *Owning Standards*, 48 B.C. L. REV. 1, 1-4 (2007) (presenting a discussion of "standards" in relation to intellectual property, antitrust, and corporate law).

17. See Braithwaite, *supra* note 11 ("[T]his distinction [in the definition of 'standards'] is not relevant to the analysis in this essay.").

18. See *infra* text accompanying notes 298-303 (discussing how rhetoric promoting principles-based legal and accounting systems may be related to promoting principles of business ethics).

2. Classification

A more important difficulty is the problem of classifying given provisions as rules or principles. The common illustration of 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*.¹⁹ 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 guidance they provide to actors *ex ante*—how much certainty is provided. Notably, under this view, both rules and principles can be either complex or simple.

A weakness of 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 expressions according to whether one has been applied or not. Temporal classification thus carries an implicit assumption that an articulated provision can determine its future application, which it cannot.²⁰ True, there may be few or mostly trivial circumstances in which such differences between expression and application matter. Still, temporal classification 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 that are specific, concrete, and particular are rules. Provisions bearing a mix of these attributes are more or less principle-like or rule-like. Thus, as examples, a provision that is general and abstract, but not universal, is principle-like, while

19. See Kaplow, *supra* note 10, at 560 (“[T]he only distinction between rules and standards is the extent to which efforts to give content to the law are undertaken before or after individuals act.”).

20. Cf. Arthur L. Corbin, *The Parol Evidence Rule*, 53 YALE L.J. 603, 630 (1944) (stating that no writing can prove its own completeness).

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.²¹ 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.²² A directive that companies disclose information "on a rapid and current basis" is principle-like because it is general and universal, but also concrete.²³ A directive that brokers invest for clients only in high-grade securities is rule-like because it is particular and specific, but still abstract.²⁴

This conceptual approach thus results in provisions residing along a continuum from principle to rule, classified according to how many of the various attributes of rule or principle characterize a provision.²⁵ Although the continuum metaphor has considerable appeal, a few scholars question the usefulness or rigor of the imagery.²⁶ 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. 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.

21. See NAT'L ASS'N OF SEC. DEALERS, NASD MANUAL R. 2110 (2007) ("A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade.").

22. See Exchange Act Rule 15g-2, 17 C.F.R. § 240.15g-2 (2007) ("It shall be unlawful for a broker or dealer to effect a transaction in any penny stock for or with the account of a customer unless, prior to effecting such transaction, the broker or dealer has furnished to the customer a document containing the information set forth in Schedule 15G, Rule 15g-100, and has obtained from the customer a manually signed and dated written acknowledgement of receipt of the document.").

23. Sarbanes-Oxley Act of 2002 § 501, 15 U.S.C. § 78o-6 (Supp. II 2002).

24. See *Messer v. E.F. Hutton & Co.*, 847 F.2d 673, 679 (11th Cir. 1987) (determining that an element of scienter was not necessary where advisors were prohibited from " 'engag[ing] in any transaction, practice, or course of business which operates as a fraud or deceit upon any client' " (quoting 7 U.S.C. § 6o(1)(B) (2000)).

25. See, e.g., Margaret Jane Radin, *Presumptive Positivism and Trivial Cases*, 14 HARV. J.L. & PUB. POLY 823, 828-32 (1991) (using the continuum metaphor); Carol M. Rose, *Crystals and Mud in Property Law*, 40 STAN. L. REV. 577, 604-10 (1988) (synthesizing the virtues of "crystalline" and "muddy" articulations of legal provisions); Sullivan, *supra* note 10, at 57 (also utilizing the continuum metaphor).

26. See 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); James G. Wilson, *Surveying the Forms of Doctrine on the Bright Line-Balancing Test Continuum*, 27 ARIZ. ST. L.J. 773, 776-77 (1995) (arguing that the conception of a rules-principles continuum is an analytical dead-end bearing no normative significance).

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 when the number of actor groups increases.

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.²⁷

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.²⁸ For example, a law against market manipulation may be tested according to factors such as the timing, frequency, and structure of given securities trades.²⁹ Similarly, corporate laws and securities regulations can use presumptions that may be rebutted. These may or may not exhibit principle-like or rule-like qualities.³⁰ An entirely different question also arises concerning whether a provision, whatever its form, should be mandatory or optional (and, if optional, whether declining the option must be explained in disclosure).³¹

Any approach to classifying legal or accounting provisions as rules or principles is contestable and leaves room for refinement. Yet,

27. See Nelson, *supra* note 14, at 96-100 (describing how precise and imprecise standards can constrain "aggressive," or biased, reporting).

28. See Cass R. Sunstein, *Problems with Rules*, 83 CAL. L. REV. 953, 963-64 (1995) (analyzing situations where "several factors are pertinent to the decision, but there is no rule").

29. See *infra* text accompanying notes 163-66.

30. See Ruth Gavison, Comment, *Legal Theory and the Role of Rules*, 14 HARV. J.L. & PUB. POL'Y 727, 750-52 (1991) (discussing the rule-like qualities of two different types of legal presumptions).

31. See *infra* text accompanying notes 74-76 (noting how the mandatory versus enabling question differs from the rules-principles question in context of canvassing content of prevailing systems of corporate law).

uniting all the varying classification methods is a kind of superordinate attribute: vagueness. Principles are vaguer than rules. 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 the trade-offs of favoring one rather than the other. While the literature acknowledges some reasonable approximations of trade-offs, scholars still disagree about the specific costs and benefits associated with alternative forms of expressing individual provisions. 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 because of its relative certainty and predictability; the principle appeals because of its relative capacity to exploit advantageous circumstances and possibly avoid undesirable ones. Drawbacks include how 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).³² In rapidly changing environments, such as securities markets, rules can become obsolete faster than principles.³³ Principles may promote conservatism among regulated actors, protect other participants, and have longer shelf lives. However, they pose problems of uncertainty and *ex post*

32. 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, 562-63 (1999) (arguing that "seemingly neutral rules" may mask social biases).

33. See Frank Partnoy, *A Revisionist View of Enron and the Sudden Death of "May,"* 48 VILL. L. REV. 1245, 1265 (2003) ("[R]ules-based tabular disclosure is quickly outdated.")

surprise, which can impair achieving goals such as market efficiency and public perceptions of fairness in securities regulation.

Promulgation and compliance costs vary. In general, rules are more costly than principles to create, while principles can impose higher compliance costs.³⁴ When rules enable relatively cheap compliance, compliance is more likely. In contrast, when compliance with principles is relatively costly, the risk of non-compliance rises.³⁵

The desirability of a rule versus a principle depends on the clarity with which one can define the importance of relative objectives. This conventionally involves determining which are more important: predictability and certainty, or fairness and context. In general, devaluing discretion in order to promote predictability and certainty dictates adopting rules, while prioritizing fairness and contextual sensitivity leads to the formulation of principles.

The choice between articulating a provision more nearly as a rule or principle can be influenced by factors concerning prospective predictability, and these can cut many ways. Corporate law's fiduciary duty principles may be superior to rule-like approaches to managerial decision-making because promulgators cannot envision all future circumstances in which discretion is necessary to enable operational flexibility. In contrast, securities regulation's anti-fraud principles may be superior to rule-like approaches to disclosure matters because a rule approach could enable evasion by being too inflexible to catch newly conceived schemes. Accounting's reasonableness principle in assessing contingent liabilities functions better than any rule could because the domain of contingent liabilities is populated by a wide variety of circumstances lacking predictable characteristics.³⁶

The precise trade-off between certainty and context is not always clear. A principle can be more certain than a dense weave of rules.³⁷ A vague articulation can yield a well-understood meaning, while a densely specified series of articulations can yield competing understandings. For example, the Sherman Antitrust Act may be vague when using the terms "contract," "conspiracy," and "restraint of trade."³⁸ But a shared understanding of the meaning of these terms

34. See Kaplow, *supra* note 10, at 563 (noting that the frequency of behavior and the rate of adjudication may make rules more costly than standards).

35. See *id.* at 564 (stating that rules produce more compliance as the cost of learning the law is reduced through their clarity).

36. See Nelson, *supra* note 14, at 93-94 (surveying how accountants interpret less precise expressions of qualitative thresholds).

37. 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").

³⁸ 15 U.S.C. §§ 1, 3, 6 (2000 & Supp. IV 2004).

gives 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 propagate uncertainty in others. Principles may promote flexibility in given contexts, but also show "expansionist tendencies" that curtail flexibility in others.³⁹ However, the alternatives are not 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.⁴⁰ 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 provide more certainty for contexts that are simple, stable, and involve small stakes, but less certainty when addressed to complex, dynamic, high-stakes contexts.⁴¹ This is especially so when new rules are adopted and subject to change during implementation and evolution.⁴²

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 when 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.

39. Schlag, *supra* note 10, at 411-14.

40. See *id.* at 405-07 (noting the importance of context in determining the certainty or open-endedness of rules and principles).

41. See RICHARD A. POSNER, *THE PROBLEMS OF JURISPRUDENCE* 48 (1990) (citing "reduce[d] uncertainty about legal rights and duties" as an advantage of rules over standards); Braitwaite, *supra* note 11, at 75-76 (concluding that the certainty of rules is dependent upon the type of activity to be regulated).

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

B. Treatment of Entire Systems

The challenges 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 the individual provisions, but also how the provisions are applied and 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 characterize a system as "rules-based" or "principles-based" is to take 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, while a rules-based system is one in which such provisions are non-vague. In considering whether such systems are possible or desirable as a threshold matter, it is important to provide a theoretical or philosophical foundation for favoring either.

However, 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 is guided by a desire to detail law as efficiently as possible.⁴³ Theorists seek the optimal precision of law,⁴⁴ informed by formal characterization of associated costs.⁴⁵ An important objective in this tradition is to promote certainty. This translates into a general preference for stating posited law in the form of rules, rather than

43. See Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257, 262 (1974) ("A perfectly detailed and comprehensive set of rules brings society nearer to its desired allocation of resources by discouraging socially undesirable activities and encouraging socially desirable ones.").

44. See, e.g., Colin S. Diver, *The Optimal Precision of Administrative Rules*, 93 YALE L.J. 65, 71-79 (1983) (setting forth criteria to determine the appropriate level of regulatory precision).

45. See, e.g., Kaplow, *supra* note 10, at 564 ("If the benefit of learning the law's content are substantial and the cost . . . is not too great, individuals' behavior under both rules and standards will tend to conform to the law's commands."); see also Gavison, *supra* note 30, at 751-52 (proposing that a decision to follow a rule should necessarily constitute a statement that the decisionmaker thought the rule should be followed such that costs have been taken into account).

principles.⁴⁶ 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 that question how much certainty rules provide as compared to principles,⁴⁷ or by game theory, which explores how principles may be better than rules at facilitating bargaining and neutralizing strategic behavior.⁴⁸

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 of this point is how arguments favoring rules can resemble the form of arguments favoring individualism, while arguments favoring principles can resemble the form of arguments favoring altruism.⁴⁹ For example, arguments favoring principles include that they can promote contextual sensitivity, and, 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 is merely restating 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 likewise could be restated: people are rarely either

46. See, e.g., Clifford G. Holderness, *A Legal Foundation for Exchange*, 14 J. LEGAL STUD. 321, 322-26 (1985) (describing property law's preference for rules which create a closed class of assignees, allowing easier exchange than open, unidentifiable classes); Rose, *supra* note 25, at 590-95 (elucidating this position, but coming short of endorsing it).

47. See Tom Baker, Alon Harel & Tamar Kugler, *The Virtues of Uncertainty in Law: An Experimental Approach*, 89 IOWA L. REV. 443, 486-87 (2004) (concluding that levels of uncertainty can be manipulated in order to increase deterrence); Russell B. Korobkin, *Behavioral Analysis and Legal Form: Rules vs. Standards Revisited*, 79 OR. L. REV. 23, 30-43 (2000) (stating that an economic analysis leads to the identification of multiple factors that govern the selection of the appropriate legal form, although it can be concluded that standards are more appropriate than rules in this regard).

48. See Ian Ayres & Eric Talley, *Solomonic Bargaining: Dividing a Legal Entitlement to Facilitate Coasean Trade*, 104 YALE L.J. 1027, 1098-1103 (1995) ("[A] host of Solomonic entitlement divisions—including liability rules and fractional property entitlements—can induce pre-taking negotiations superior to those of undivided property rules."); Jason Scott Johnston, *Bargaining Under Rules Versus Standards*, 11 J.L. ECON. & ORG. 256, 272-73 (1995) ("Insofar as the law awards entitlements on the basis of an ex post determination of which party ought to have the entitlement, ex ante private bargaining may accomplish what the ex post legal standard desires.").

49. See Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685, 1685 (1976) (stating that individualism favors "clearly defined, highly administerable, general rules," while altruism supports the use of "equitable standards"); see also Duncan Kennedy, *The Stages of Decline of the Public/Private Distinction*, 130 U. PA. L. REV. 1349, 1350-57 (1982) (proposing a life cycle of legal distinctions).

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. Rules can also promote this virtue. 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 simply could inventory the character of individual provisions within a system to classify them as rules-based or principles-based and defend 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 U.S. securities regulation or accounting justifies 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 applied (including how they are interpreted, enforced, or suspended).

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.⁵⁰ 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 further dramatized when comparing descriptions of national legal systems. Consider the following example of alternative conceptions of such systems given by Professor Frederick Schauer:

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

50. See Meir Dan-Cohen, *Decision Rules and Conduct Rules: On Acoustic Separation in Criminal Law*, 97 HARV. L. REV. 625, 626-34 (1984) (proposing a separation between "conduct rules," which provide the general public with guidelines for conduct, and "decision rules," which seek to provide officials with guidelines for their decisions).

predictability are more important, especially within the legal system, than the virtues of flexibility in the face of changing or unforeseen circumstances.⁵¹

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."⁵²

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 U.S. legal system? In prevalent global classifications, especially in securities regulation and accounting, the U.S. system is depicted as rules-based, while other national systems and international accounting are dubbed principles-based.⁵³ Professor Schauer continues the foregoing passage as follows:

As should be apparent, there is a widespread view, supported by some moderately serious research, that the United States 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 United States.⁵⁴

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 United States).

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 skepticism about whether "rules-based" or "principles-based" can be analytically reliable descriptions of any comprehensive legal (or accounting) system.

True, institutional arrangements may influence the relative appeal of rules versus principles and shape the form that

51. Frederick Schauer, *The Convergence of Rules and Standards*, 2003 N.Z. L. REV. 303, 319-20 (2003).

52. *Id.*

53. *See supra* notes 2, 7 and accompanying text.

54. Schauer, *supra* note 51, at 320.

promulgations assume. All complex regulatory systems involve large numbers of actors who participate from numerous vantage points. Examples include governmental officials (who, in turn, may be members of various branches), regulatory actors (who may be part of government or act through other kinds of organizations such as accounting standard setters), corporate officers and employees, and partners or associates in professional firms (such as law or accounting firms). Promulgations, interpretations, and applications of provisions can occur throughout resulting hierarchies.

It would be difficult to delineate fully how the arrangements—which also can vary across jurisdictions—influence the system's resulting texture. But it likewise would seem incautious to generalize a model that supposes, for instance, that a system can be classified as rules-based or principles-based according to the level or range in a hierarchy at which a provision assumes its characteristic vagueness or non-vagueness. For instance, even if governmental and regulatory promulgations resulted in systems fairly classified as principles-based, participants down the hierarchy may nevertheless receive very non-vague rules to apply. Similarly, even rules that are non-vague upon promulgation by superiors may require lower-level personnel to make judgments that ordinarily appear to be problems arising from vagueness.

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 better 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 a rule or a principle as the law for all its roads.

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. Thus, 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 U.S. securities regulation. Section 16(b) provides a "short-swing profit" rule that penalizes certain kinds of insider trading by officers and directors;⁵⁵ Section 10(b) contains broad anti-fraud principles that have been interpreted to prohibit insider trading by officers, directors, and many other persons.⁵⁶ It is possible to conceive of the rule and the principle as substitutes.⁵⁷ 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 United States?

The two provisions interact in complex ways that prevent characterizing the system as either 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.⁵⁸ The principle of 10(b) makes it criminal for unspecified insiders to trade in securities on the basis of material, non-public information.⁵⁹ The two laws share a similar general purpose of prohibiting securities market profit-making based on selectively available information. However, 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.⁶⁰

55. 15 U.S.C. § 78p(b) (2000) (requiring designated insiders to disgorge profits from securities transactions occurring within a six-month window).

56. 15 U.S.C. § 78j (prohibiting the use of "manipulative or deceptive devices" in effecting fraud, manipulation, or insider trading); Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5 (2007) (prohibiting any act or omission resulting in fraud or deceit in connection with the purchase or sale of any security, including insider trading); *see also* United States v. O'Hagan, 521 U.S. 642, 649-65 (1997) (interpreting SEC Rule 10b-5); *infra* text accompanying notes 63-65.

57. *See* Schauer, *supra* note 51, at 321-25 (treating these provisions as substitutes).

58. 15 U.S.C. § 78p(b).

59. *Id.* § 78j; Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5.

60. *See* Merritt B. Fox, *Insider Trading Deterrence Versus Managerial Incentives: A Unified Theory of Section 16(b)*, 92 MICH. L. REV. 2088, 2201-02 (1994) (reconciling the overall framework); 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 section 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*

The rule's designation of specific corporate insiders and transactions promotes certainty that the principle's open-endedness otherwise prevents.⁶¹ 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 the principle.⁶² The presence of both provisions and their interaction demonstrate the limits of the simple method of inventorying all provisions within a system in order 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.⁶³

Under that definition, rules that mandate disclosure using mechanical tests can be understood to designate such information as material.⁶⁴ For instance, Section 13(d) requires owners of 5% or more of the voting power in registered equity securities of any company to

Prohibitions Against Insider Trading: Why a Property Rights Theory of Inside Information is Untenable, 59 BROOK. L. REV. 149, 160 n.51 (1993) (book review) (arguing that section 16(b)'s benefits not achieved by section 10(b) are promoting long-term rather than short-term outlook among management and discouraging them from manipulating events over the short term). *But see* Marleen A. O'Connor, *Toward a More Efficient Deterrence of Insider Trading: The Repeal of Section 16(b)*, 58 FORDHAM L. REV. 309, 358-80 (1989) (arguing that section 16(b)'s system of deterrence is irrational and inefficient).

61. *See* Steven R. Salbu, *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).").

62. *See* *Foremost-McKesson, Inc. v. Provident Sec. Co.*, 423 U.S. 232, 255 (1976) (stating that while section 16(b)'s scope is unaffected by whether other sanctions might inhibit abuse of inside information, section 10(b) addresses problems left unaddressed by section 16(b)).

63. *See* *TSC Indus., Inc. v. Northway*, 426 U.S. 438, 449 (1976) ("An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."); Joan MacLeod Heminway, *Materiality Guidance in the Context of Insider Trading: A Call for Action*, 52 AM. U. L. REV. 1131, 1137 (2003) (referring to materiality as "a broadly applicable judicial standard" that requires a court to assess "the likelihood that a reasonable investor (or stockholder) would consider a particular fact or particular information important in making an investment decision").

64. *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.

disclose specific information about their equity position and intent with respect to corporate control.⁶⁵ 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 creates systemic qualities that frustrate tidy categorization of the system as rules-based or principles-based.

4. Benefits

Even if one were to decide, after taking inventory of a system's provisions, that it 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, benefits include the following.

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 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

65. Securities Exchange Act of 1934 § 13(d), 15 U.S.C. § 78m(d) (2000); *see* *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49, 58 (1975) (emphasizing purposes of rule are to provide shareholders with information about the bidder and incumbent management and to provide additional information without any intention of aiding management in resisting a bid or tipping the balance of power between bidders and managers); Exchange Act Rule 13d-1, 17 C.F.R. § 240.13d-1 (2007) ("Any person who, after acquiring directly or indirectly the beneficial ownership of any equity security of a class which is specified in paragraph (i) of this section, is directly or indirectly the beneficial owner of more than five percent of the class shall, within 10 days after the acquisition, file with the Commission, a statement containing the information required by Schedule 13D.").

by events one through ten. Absent accompanying principles, rule-makers will operate by fiat. Managers will not need to think or exercise judgment, even when following those rules produces absurd results. Some may even exploit the rules as blueprints expressly 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.⁶⁶ If variations cannot be convincingly explained, then either the rules are not based on principles or they are based on the wrong principles.⁶⁷ 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.”⁶⁸

Third, the interaction among rules and principles reduces anxiety over whether an individual provision initially should 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 a general example, consider the separation of governmental powers. Legislatures may create laws residing toward either end of the rules-principles spectrum. However, when legislatures enact rules, judges often transform the rules into laws exhibiting principle-like features.⁶⁹ Conversely, when legislatures enact principles, judges can tighten them into laws with rule-like features.⁷⁰ This observation does not mean that the initial legislative choice is inconsequential; it may be of

66. See *TSC Indus.*, 426 U.S. at 448-49 (interpreting “materiality” in line with previous decisions in different contexts).

67. See Christopher W. Nobes, *Rules-Based Standards and the Lack of Principles in Accounting*, 19 ACCT. HORIZONS 25, 27-32 (2005) (identifying detailed, technical accounting rules that are required due to the absence of underlying standards or inappropriate underlying standards).

68. Brudney, *supra* note 64, at 734-35.

69. See *infra* text accompanying notes 123-24 (giving the example of statutory legal capital rules that are mediated by judicial invocation of reasonable accounting and valuation principles).

70. See Schauer, *supra* note 51, at 321-28 (citing SEC Rule 10b-5 as an example of a standard turned into a rule through judicial intervention); *infra* text accompanying notes 108-15 (example of the relationship between section 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).

considerable significance in given cases. However, it also suggests that the choice is not final—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 between 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. In short, the binary labels of rules-based and principles-based to describe complex regulatory systems likely are too crude to be faithful to the realities they must comprehend.⁷¹

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 be described fairly 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 a minimum, common conceptions are overstated and should be corrected.

71. Cf. Cristie L. Ford, *New Governance, Compliance, and Principles-Based Securities Regulation*, 44 AM. BUS. L.J. (forthcoming 2007) (recognizing the slipperiness of the two labels and navigating an analysis of comparative systems by developing a thick account going well beyond the form of provisions as rules versus principles to include such attributes as how law is promulgated, by whom, with what frequency, and with what level of enforcement).

1. Corporate Law

Scholars commonly describe corporate law, especially Delaware corporate law, as principles-based,⁷² although a few see a more rule-like quality to the principles.⁷³ 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 is distinct from the debate in corporate law scholarship concerning whether the law is or should be more mandatory or enabling.⁷⁴ Corporate law doctrines range along a rules-principles continuum, whether they are required by law or optional. Cumulative voting resides at the rules end of the continuum by providing a specific mathematical formula for casting and counting votes in director elections, but generally is permissive.⁷⁵ The duty of loyalty resides at the principles end of the continuum as vague and

72. *E.g.*, 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*.”); Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1914-15 (1998) (“Delaware [corporate] law is at one end of this continuum. It relies extensively on broad legal standards.”); Curtis J. 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.”).

73. Compare 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, 1133-34 (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.”), with Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1071 (2000) (“Delaware’s corporate law rules are standards based.” (emphasis added)), and Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1014 (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”).

74. See John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1653-89 (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. 984, 987-98 (1993) (surveying the arguments for and against mandatory rules for corporations).

75. DEL. CODE ANN. tit. 8, § 214 (2001) (stating that a certificate of incorporation may provide for cumulative voting); MODEL BUS. CORP. ACT § 7.28 (2002) (providing that “[s]hareholders do not have a right to cumulate their votes for directors unless the articles of incorporation so provide”). In the minority of states that require cumulative voting, disputes concerning its use may be resolved by applying principle-like tools such as fiduciary duty. See, e.g., *Humphrys v. Winous Co.*, 133 N.E.2d 780, 782-89 (Ohio 1956) (reconciling the tension in a jurisdiction which requires cumulative voting but also permits the classification of directors).

hortatory, but generally is mandatory. Similarly, the policy approach called "comply or explain," common in European practice, can refer to provisions that are either principle-like or rule-like (such as "we have independent directors" or "independence means x, y, and z," respectively).⁷⁶

Turning to the details, 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). As such, 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.⁷⁷ Courts treat provisions placed in the wrong document as dead letters.⁷⁸ When the charter and by-laws contain conflicting provisions, a corporate law rule provides that the charter controls.⁷⁹

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.⁸⁰ Corporation statutes provide that boards have this power. However, statutes grant shareholders power in specific situations, usually director elections, charter amendments, certain

76. See, e.g., HAL S. SCOTT & GEORGE S. DALLAS, MANDATING CORPORATE BEHAVIOR: CAN ONE SET OF RULES FIT ALL? 25-30 (2006), available at http://www.ahcgroup.com/pdfs/S&P_Dallas&Scott_CorpBehavior.pdf (dwelling on the rhetoric of rules as "prescriptive and legalistic" while inadvertently showing that any preference for the approach of "comply or explain" has no bearing on the rules versus principles question).

77. E.g., MODEL BUS. CORP. ACT §§ 7.27, 7.28, 8.24 (covering action by shareholders, the election of directors, and action by directors respectively).

78. See *Roach v. Bynum*, 437 So. 2d 69, 70 (Ala. 1983) (deeming unenforceable super-majority shareholder quorum and voting provision required to appear in charter when they instead appeared in by-laws); *Datapoint Corp. v. Plaza Sec. Co.*, 496 A.2d 1031, 1034-36 (Del. 1985) (declaring unenforceable a director-approved by-law amendment limiting shareholder action because it conflicted with Delaware Code section 228(b), which requires any limitations on this grant of authority to appear in the charter).

79. E.g., *Paulek v. Isgar*, 551 P.2d 213, 215 (Colo. Ct. App. 1976) ("Where bylaws conflict with the articles of incorporation, the articles of incorporation control and the bylaws in conflict are void."); *Benintendi v. Kenton Hotel, Inc.*, 60 N.E.2d 829, 831 (N.Y. 1945) (striking down by-laws contrary to statutory requirements applicable to all corporations).

80. See tit. 8, § 141(a) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors."); *Manson v. Curtis*, 119 N.E. 559, 561 (N.Y. 1918) (stating that even in the presence of voting agreements, shareholders do not maintain proxy over corporate business and affairs); MODEL BUS. CORP. ACT § 8.01 ("All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of, its board of directors.").

business combinations, and dissolutions.⁸¹ Yet even in specific cases where shareholders have power, they usually lack authority to initiate action, but only may consent to (or withhold consent from) board-made proposals.⁸²

Rules require that shareholders elect directors.⁸³ Rules granting managerial power to boards of directors 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.⁸⁴ Both statutory rules and judicial applications of them impose stringent formalities for board action. For example, statutes typically contain rules requiring notice and quorums.⁸⁵ They also authorize action both by written consent in lieu of meetings, but only if unanimous, and by use of teleconference connections, but only if specified requirements are met.⁸⁶

Why all these rules? They provide a baseline ordering mechanism necessary to create the formal entity called the corporation; they also begin to shape the balance of power among its participants.⁸⁷ Principles come into play to mediate these rules, provide rationales, and interact with them to complicate the system's overall character. Thus, while the hierarchy of corporate law sources contributes apparent rule-like clarity, it is possible to persuade a court to enforce, as a contract, a provision placed in a by-law when a statute directs it to appear in the charter.⁸⁸ Rules granting managerial power to boards and episodic consenting power to shareholders are relaxed considerably into a principle-like framework for closely held

81. *E.g.*, MODEL BUS. CORP. ACT §§ 8.03-.05, 10.03-.04, 11.03, 14.02-.03 (allocating power to shareholder in the election of directors, amendment of articles of incorporation, statutory mergers, and voluntary dissolution respectively).

82. *See* Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43, 43-46 (2003) (calling the supposed power of shareholders "largely a myth").

83. *See* tit. 8, § 211(b) ("An annual meeting of stockholders shall be held for the election of directors.").

84. *E.g.*, *Gashwiler v. Willis*, 33 Cal. 11, 18-19 (1867) (stating that an action taken by a group of shareholder-directors in their individual capacities is not effective as a valid action of the board of directors).

85. *E.g.*, tit. 8, § 141(b) (2001 & Supp. 2006) (requiring quorum); MODEL BUS. CORP. ACT §§ 8.22, 8.24 (requiring notice and quorum respectively).

86. *E.g.*, tit. 8, § 141(f), (i) (2001) (allowing action by unanimous written consent in lieu of a meeting and teleconferencing respectively); MODEL BUS. CORP. ACT § 8.21 (allowing action by unanimous written consent in lieu of a meeting).

87. *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).

88. *See* *Jones v. Wallace*, 628 P.2d 388, 391-93 (Or. 1981) (addressing the argument that otherwise invalid by-laws in effect upon the signing of a shareholder agreement can be enforced under a contract theory).

corporations, a context in which many traditional rules of corporate law similarly relax into principles.⁸⁹

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.⁹⁰ 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.⁹¹ Courts respect formal statutory rules, invoking the judicial doctrine of independent legal significance to reinforce them (in effect, a rule that denies the principle embodied in the judicially-developed *de facto* merger doctrine).⁹² To protect against hostile takeover bids, moreover, statutes offer rule-bound anti-takeover provisions that courts likewise respect.⁹³

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.⁹⁴ Courts respect statutory distinctions between redemptions and mergers, even when transactional alternatives present identical

89. See, e.g., *Zion v. Kurtz*, 405 N.E.2d 681, 684-88 (N.Y. 1980) (enforcing agreement despite noncompliance with statutory provisions); *Triggs v. Triggs*, 385 N.E.2d 1254, 1254 (N.Y. 1978) ("That an agreement between corporate shareholders includes illegal provisions with respect to the election of corporate officers and the fixation of their compensation does not preclude enforcement of the provision for a stock purchase option contained in the same agreement."); see also Larry E. Ribstein & Burce H. Kobayashi, *Choice of Form and Network Externalities*, 43 WM. & MARY L. REV. 79, 85, 89 (2001) (describing the difficulties presented by corporate rules intended to affect closely-held corporations).

90. E.g., tit. 8, §§ 241, 251, 271 (2001 & Supp. 2006) (allowing for redemptions, mergers, and asset sales respectively); see also MODEL BUS. CORP. ACT § 11.03 (governing share exchanges).

91. See *Hariton v. Arco Electronics, Inc.*, 188 A.2d 123, 124-25 (Del. 1963) (rejecting shareholders' claim that a sale of assets transaction having the same functional effect as a merger required shareholder approval under statutory merger rules); *Heilbrunn v. Sun Chem. Corp.*, 150 A.2d 755, 757-59 (Del. 1959) (similarly rejecting the so-called *de facto* merger doctrine).

92. See D. Gordon Smith, *Independent Legal Significance, Good Faith, and the Interpretation of Venture Capital Contracts*, 40 WILLAMETTE L. REV. 825, 831-40 (2004) (tracing the origins and development of the doctrine of independent legal significance).

93. E.g., tit. 8, § 203 (providing specific rules which lay out *ex ante* instructions to avoid hostile takeovers including extensive definitions of terms such as interested stockholder, and bright-line thresholds, such as 90-day and 3-year periods, 66.66% voting approval requirements, and 85% ownership stipulations).

94. See, e.g., *Equity Group Holdings v. DMG, Inc.*, 576 F. Supp. 1197, 1201-07 (S.D. Fla. 1983) (refusing to treat separate but related transactions having the functional effect of merger as a *de facto* merger under Florida law).

substantive consequences to shareholders.⁹⁵ The same rule-bound results follow in relation to third parties. In transactions structured as mergers, all assets and liabilities of the constituent corporations combine “by operation of law” with immutable implications for third-party consents;⁹⁶ but in asset or stock acquisitions, assets and liabilities transfer by operation of contract with changeable implications for third-party consents.⁹⁷

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.⁹⁸ Even the rule-like character of the doctrine of independent legal significance can be whittled away when courts decide that two parts of a transaction are integrally related rather than independent.⁹⁹

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 them, and then finally restore some of them depending on stated formal attributes of a transaction.¹⁰⁰ Yet courts awarding the appraisal remedy face numerous questions whose resolution requires applying vague concepts. These involve such matters as whether the appraisal remedy

95. See, e.g., *Rauch v. RCA Corp.*, 861 F.2d 29, 30-33 (2d Cir. 1988) (sharply distinguishing between merger and redemption transactions in accordance with technical details of separate statutory provisions despite substantively identical effects).

96. See *PPG Indus., Inc. v. Guardian Indus. Corp.*, 597 F.2d 1090, 1095-96 (6th Cir. 1979) (“The merger was effected by the parties and the transfer was a result of their act of merging.”).

97. See *Branmar Theatre Co. v. Branmar, Inc.*, 264 A.2d 526, 529 (Del. Ch. 1970) (holding that a transfer of a lease agreement in connection with a sale of stock transaction was not an “assignment” under the terms of the lease).

98. See, e.g., *Fall River Dyeing & Finishing Corp. v. NLRB*, 482 U.S. 27, 43-46 (1987) (determining, in the context of labor law, whether one company was the “successor” of another); *North Shore Gas Co. v. Salomon, Inc.*, 152 F.3d 642, 651-54 (7th Cir. 1998) (applying the *de facto* merger doctrine in the context of environmental law); *Ruiz v. Blentech Corp.*, 89 F.3d 320, 324-25 (7th Cir. 1996) (applying the *de facto* merger doctrine in the context of personal injury liability).

99. See *Louisiana Mun. Police Employees’ Ret. Sys. v. Crawford*, 918 A.2d 1172, 1191-92 (Del. Ch. 2007) (treating special dividend and stock-for-stock merger as integral components of single transaction rather than as separate transactions warranting independent legal treatment).

100. See, e.g., DEL. CODE ANN. tit. 8, § 262 (2001) (setting forth provisions governing appraisal rights in Delaware).

is exclusive or may be conjoined with other claims,¹⁰¹ the applicable valuation method,¹⁰² and identification of the business to be valued.¹⁰³ The resulting appraisal remedy doctrine can be described as rules-based or principles-based, but in fact, it is a mixture—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.¹⁰⁴ Many characterize Delaware fiduciary duty law as indeterminate, putting it squarely on the principles end of any continuum.¹⁰⁵ That location is unsurprising when one considers that Delaware courts conceive of themselves as courts in equity (a designation still formally retained by the state's Court of Chancery).¹⁰⁶ 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.¹⁰⁷

101. *E.g.*, *Glassman v. Unocal Exploration Corp.*, 777 A.2d 242 (Del. 2001) (stating that, absent allegations of fraud or illegality, appraisal is the exclusive remedy for a minority shareholder objecting to a short-form merger); *Rabkin v. Philip A. Hunt Chem. Corp.*, 498 A.2d 1099, 1104-05 (Del. 1985) (holding that an appraisal proceeding is not the exclusive remedy when minority shareholders allege nondisclosure or misrepresentation).

102. *E.g.*, *Weinberger v. UOP, Inc.*, 457 A.2d 701, 714 (Del. 1983) (overruling previous case law that limited monetary damages in a cash out merger to "a single remedial formula" and allowing plaintiffs to seek a fairness valuation by any method "in conformity with the principle applicable to an appraisal—that fair value be determined by taking 'into account all relevant factors'" (quoting tit. 8, § 262(h))).

103. *E.g.*, *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 367 (Del. 1993) (addressing whether the business to be valued is solely the business as it existed absent the transaction or that business taking account of value that arises in the first stage of a two-step acquisition).

104. *Rock*, *supra* note 73, at 1016 (referring to the product of Delaware courts as "corporate law sermons").

105. *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).

106. *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, 1618 (1994) ("[A]s judges in equity, [judges in Delaware courts] must also be concerned that the rules they are applying lead to fair and consistent results."); Lyman P.Q. Johnson & Mark A. Sides, *The Sarbanes-Oxley Act and Fiduciary Duties*, 30 WM. MITCHELL L. REV. 1149, 1193-94 (2004) ("Courts have long recognized that corporate officers and directors are fiduciaries and that equity, not law, is the source of their fiduciary obligations.").

107. *See* MODEL BUS. CORP. ACT § 8.30 (2002) ("The members of the board of directors . . . shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances."); D. Gordon Smith, *A Proposal to Eliminate Director Standards from the Model Business Corporation Act*, 67 U. CIN. L. REV. 1201, 1209-27 (1999) (arguing that the MBCA's statutory statement of the duty of care may alter the common law standards under which the standard has "thrived" to date).

Still, fiduciary duty cases addressing designated doctrinal subjects can be synthesized into recognizable rules.¹⁰⁸ In mundane cases of ordinary business decisions or activity, the “business judgment rule” presumes that directors met their duty of care. The few cases subjecting directors to liability for breaching the duty of care in ordinary contexts address egregious behavior, as when directors are inebriated or ill-informed, or commit illegal acts.¹⁰⁹ A rule thus emerges that directors are liable for breach of the duty of care in ordinary settings only in such narrow circumstances. Corporations also can opt for a statute-authorized rule against personal director financial liability for breaching the duty of care,¹¹⁰ a license created immediately after the Delaware Supreme Court held ill-informed directors liable for breaching the duty.¹¹¹

That license assumes the form of a rule: it concretely and prospectively authorizes exculpation. However, the rule has a limit. Exculpation does not extend to liability arising from “acts or omissions not in good faith.”¹¹² The vast majority of Delaware corporations took advantage of the rule, which in turn contributed to increasing judicial invocation of a principle of good faith.¹¹³ Resulting judicial opinions are complex and so difficult to reconcile that they provide little

108. See Paredes, *supra* note 73 (discussing how corporate law “should, to the extent possible, comprise bright-line rules, as opposed to more ambiguous open-ended standards”); see also Rock, *supra* note 73, at 1104 (noting and criticizing the tendency of scholars to pursue this route, as the more subtle approach of Delaware courts may prove preferable to bright-line rules in influencing the behavior of outside directors).

109. *E.g.*, Miller v. AT&T, 507 F.2d 759, 762-63 (3d Cir. 1974) (illegal campaign contributions); Smith v. Van Gorkum, 488 A.2d 858, 873-74 (Del. 1985) (ill-informed directors); Francis v. United Jersey Bank, 432 A.2d 814, 825-26 (N.J. 1981) (director prone to inebriation and other ills failing to read financial statements); see also *In re Caremark Int’l Inc.*, 698 A.2d 959, 972 (Del. Ch. 1996) (approving settlement agreement and elaborating, in dicta, on the duty of care’s bearing on maintaining a system of internal control).

110. DEL. CODE ANN. tit. 8, § 102(b)(7) (2001) (stating that a corporation’s articles of incorporation may set forth a provision “eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director”).

111. See *Van Gorkum*, 488 A.2d at 873-74 (holding directors liable for a breach of the duty of care when the court deemed their decision to accept a certain price per share in a merger transaction uninformed); see also Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1060 (2006) (noting that the *Van Gorkum* case represents the only instance where outside directors have made personal payments after a trial since 1980).

112. Tit. 8, § 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.*

113. See Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 DEL. J. CORP. L. 1, 4-6, 9-10 (2006) (describing the basis and history of the duty of good faith in light of attempts to insulate directors from liability for breaches of fiduciary duties); Hillary Sale, *Delaware’s Good Faith*, 89 CORNELL L. REV. 456, 466-82 (2004) (noting that director exculpation for due care breaches does not insulate directors from breaches of good faith and tracing the development of the duty of good faith through Delaware case law).

advance direction.¹¹⁴ The result is a vagueness that is characteristic of principles. This development illustrates not only how rules and principles interact, but also how a relatively tight statutory rule can be judicially transformed into a much more open-ended principle.¹¹⁵

The ultimate principle in corporate law is the duty of loyalty.¹¹⁶ It forbids corporate officers and directors from acting contrary to the interests of their beneficiaries, 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 involving "self-interested" transactions are mediated in many states by statutory safe-harbor rules delineating processes that officials can follow to protect their decisions from judicial rebuke—usually approval by a majority of disinterested and fully informed directors or shareholders.¹¹⁷

Although written as rules, the linguistic character of such statutes requires interpretation by judges in order to mediate between the principle of loyalty and the rules of process that the statutes articulate. Based on this interaction, cases produce results with varying degrees of vagueness (blending attributes of rules and principles). Thus, although the duty of loyalty is equity-like, it still carries hints of rule-ness. This hybrid quality manifests itself in the tests that Delaware courts use to evaluate breaches of the duty of loyalty in contexts outside self-interested transactions, especially respecting the entire fairness test in cash-out mergers and the heightened scrutiny applied in takeover contexts.¹¹⁸

114. 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, 1127 (2004) ("[T]he courts have not provided clear guidance as to whether section 102(b)(7) protects directors from personal liability arising from their reckless conduct."); John L. Reed & Matt Neiderman, *"Good Faith" and the Ability of Directors to Assert §102(b)(7) of the Delaware General Corporation Law as a Defense to Claims Alleging Abdication, Lack of Oversight, and Similar Breaches of Fiduciary Duty*, 29 DEL. J. CORP. L. 111, 140 (2004) (concluding that the Delaware Supreme Court must "clarify the standard or threshold required for allegations of abdication or lack of oversight to . . . implicate the duty of good faith"); David Rosenberg, *Making Sense of Good Faith in Delaware Corporate Fiduciary Law: A Contractarian Approach*, 29 DEL. J. CORP. L. 491, 492 (2004) ("Delaware courts . . . currently offer no coherent framework for understanding the most fundamental duties imposed on corporate directors."). For the Delaware Supreme Court's attempt at clarification, see *Stone v. Ritter*, 911 A.2d 362 (Del. 2006).

115. See *supra* text accompanying notes 66-71.

116. *E.g.*, *Schnell v. Christ-Craft Indus., Inc.*, 285 A.2d 437, 439 (Del. 1971) ("[I]nequitable action does not become permissible simply because it is legally possible.").

117. *E.g.*, tit. 8, § 144 (providing insulation from judicial review of self-interested transactions that are approved by a majority of disinterested directors or shareholders); MODEL BUS. CORP. ACT §§ 8.60-.63 (similar provision).

118. See Marcel Kahan, *Paramount or Paradox: The Delaware Supreme Court's Takeover Jurisprudence*, 19 J. CORP. L. 583, 592-605 (1994) (offering coherent account of Delaware

In cash-out mergers, judges endorse using an independent committee to mimic an arm's length transaction measured by fair value.¹¹⁹ In takeovers, courts define vague fiduciary duty to require boards to auction a company to the highest bidder if a sale is to be effected,¹²⁰ if a transaction does not amount to a sale, then associated defensive tactics must survive a reasonableness test.¹²¹ In both contexts, courts review whether directors were independent and followed a sufficient process to benefit shareholders, blending rules and principles.¹²²

If corporate law contains both rules and principles that are applied and interact in ways that defy systemic classification, 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 those in Delaware, are detailed rules that apply concepts of par value and legal capital.¹²³ In contrast, modern statutes, like the Model Act, use general principles, forbidding a distribution when it would prevent the corporation from paying its debts when due or reduce its assets below liabilities (measured using

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, 138-63 (2003) (offering coherent account of the cases using the theory of the firm).

119. *E.g.*, *Weinberger v. UOP, Inc.*, 457 A.2d 701, 709 n.7 (Del. 1983) (noting that among the strategies boards might use to approve a cash-out merger are independent negotiating committees); *see also* 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).

120. *E.g.*, *Paramount Commc'ns, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 46 (Del. 1994) (noting "directors' obligation to seek the best value reasonably available for the stockholders where there is a pending sale of control"); *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1280 (Del. 1989) ("[I]n the context of an auction for corporate control . . . directors commit themselves, inexorably, to obtaining the highest value reasonably available to the shareholders under all circumstances."); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 184 (Del. 1986) (discussing directors' obligation, as part of their enhanced duties in a takeover situation, "to bring the target's shareholders the best price available for their equity").

121. *E.g.*, *Paramount Commc'ns, Inc. v. Time, Inc.*, 571 A.2d 1140, 1152-55 (Del. 1989) (noting that the burden rests on the target's board of directors to show any defensive measures were reasonable); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955-57 (Del. 1985) ("If a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed.").

122. 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 J. Darnell, *Delaware's Duty of Care*, 31 DEL. J. CORP. L. 589, 591 (2006) (noting "the waning of the duty of care [to] a rule that now requires little more of a director than a ritualistic consideration of relevant data"); *infra* Part III.A.

123. *See, e.g.*, tit. 8, §§ 154, 160, 170, 171, 173, 244 (defining and using such technical and arcane terms as capital, surplus, and par value in elaborate detail to regulate a corporation's power to declare and pay dividends and make other distributions to its shareholders).

any methods that are reasonable under the circumstances).¹²⁴ Courts apply the traditional statutes liberally, allowing boards to measure statutory terms (such as assets and liabilities) according to reasonable valuations they choose.¹²⁵ Perhaps it matters whether one or the other is the starting point, but this evidence suggests that it matters only slightly.¹²⁶

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" of the corporation's assets.¹²⁷ Innovative statutes attempt greater refinement by requiring a shareholder vote only if the transaction leaves the corporation "without a significant continuing business activity."¹²⁸ Comparing the provisions, the traditional one is relatively more principle-like, while the innovative one is slightly more rule-like (a pure rule formulation would define the threshold numerically, and no U.S. corporate law statute does so). Yet, the alternative statutes lead to the same result.¹²⁹

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. While rule-like provisions address corporate formation, preemptive rights, director removal, and shareholder oppression and deadlock, principle-like provisions mediate each of these. Principle-like provisions also appear in the corporate opportunity doctrine, where case law enables synthesized

124. See, e.g., MODEL BUS. CORP. ACT §§ 6.21, 6.40 (2002) (using general tests of ability to pay debts when due and having assets exceed liabilities as limits on a corporation's power to declare and pay dividends and make other distributions to its shareholders).

125. See *Klang v. Smith's Food & Drug Centers, Inc.*, 702 A.2d 150, 152-58 (Del. 1997) (allowing the use of other reasonable measures to determine legality of shareholder distribution despite technical terms in Delaware statute); *Randall v. Bailey*, 23 N.Y.S.2d 173, 179-83 (N.Y. Sup. Ct. 1940) (construing traditional legal capital statute while recognizing potential departures from general accounting principles as reasonable).

126. See BAYLESS MANNING & JAMES J. HANKS, JR., *LEGAL CAPITAL* 194-97 (3d ed. 1990) (noting the evolution from old fashioned legal capital rules, which endure in Delaware statutory law, to a liberalized approach contained in modern statutes); Craig A. Peterson & Norman W. Hawker, *Does Corporate Law Matter? Legal Capital Restrictions on Stock Distributions*, 31 AKRON L. REV. 175, 178 (1997) (concluding, after empirical study, 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).

127. E.g., tit. 8, § 271(a).

128. E.g., MODEL BUS. CORP. ACT § 12.02(a).

129. See *Hollinger Inc. v. Hollinger Int'l, Inc.*, 858 A.2d 342, 386 n.79 (Del. Ch. 2004) (emphasizing comparability of Delaware's section 271 with the Model Act's section 12.02(a) despite literal linguistic differences).

statements bearing a rule-like character.¹³⁰ Limited liability is a rule subject to exceptions based on public-regarding principles. 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.¹³¹ In sum, these illustrations suffice to question the possibility of tidy classification of corporate law as rules-based or principles-based, in Delaware or in other states.

2. Securities Regulation

Many scholars and judges nevertheless promote Delaware corporate law as principles-based, especially when contrasting it with U.S. federal securities regulation, which they allege to be rules-based.¹³² Others believe that federal securities regulations' alleged rule-density serves the purpose of offsetting the deficiencies of state corporate law's alleged penchant for principles.¹³³ U.S. 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.¹³⁴ The following survey of U.S. securities regulation supports none of these characterizations.

130. See Eric Talley, *Turning Servile Opportunities to Gold: A Strategic Analysis of the Corporate Opportunities Doctrine*, 108 YALE L.J. 279, 279 (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"). See generally *Ne. Harbor Golf Club, Inc. v. Harris*, 725 A.2d 1018, 1021-23 (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); Harvey Gelb, *The Corporate Opportunity Doctrine: Recent Cases and the Elusive Goal of Clarity*, 31 U. RICH. 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).

131. Matthew G. Dore, *Statutes of Limitation and Corporate Fiduciary Claims: A Search for Middle Ground on the Rules/Standards Continuum*, 63 BROOK. L. REV. 695, 720-36 (1997).

132. *E.g.*, Griffith & Steele, *supra* note 9, 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); Faith Stevelman Kahn, *Transparency and Accountability: Rethinking Corporate Fiduciary Law's Relevance to Corporate Disclosure*, 34 GA. L. REV. 505, 512-13 (2000) (stating that flexible corporate law is more effective than "comparatively rigid, rules-based systems . . . such as the securities laws"); Kamar, *supra* note 72, at 1921 ("It is instructive . . . to compare Delaware law with federal securities law, which . . . [is] rule-based.").

133. *E.g.*, Mark J. Roe, *Institutional Foundations for Securities Markets in the West* 1, 5-7 (Dec. 17, 2002) (unpublished manuscript, on file with author), available at <http://www.econ.nyu.edu/user/frydmanr/Roe-AER2003.doc> (explaining that deficiencies of the state corporate law system drove the creation of the federal securities regulatory system).

134. See, *e.g.*, Kuras, *supra* note 6 (comparing Canadian securities regulation with U.S. securities regulation); Robert Wright, *Enron: The Ambitious and the Greedy*, 16 WINDSOR REV. LEGAL & SOC. ISSUES 71, 73 (2003) (same).

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; prescribed prospectuses must be prepared and circulated. As with much of the structure of U.S. federal securities regulation across all contexts, such provisions are subject to exemptions, which are subject to further exemptions and sometimes protected by safe harbors. Section 5 of the Securities Act of 1933 requires registration unless an exemption exists.¹³⁵ Sections 3 and 4 of the 1933 Act also provide exemptions. SEC regulations provide safe harbors, all of which contain precisely delineated boundaries¹³⁶—although some also use vague provisions, such as a condition of good faith,¹³⁷ or depend on open-textured concepts, such as whether an offering is “public” or “private.”¹³⁸

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 rules,¹³⁹ credit

135. *E.g.*, Securities Act of 1933 § 5(a)(1), 15 U.S.C. § 77e(a)(1) (2000) (making it unlawful to use interstate commerce to sell a security unless a registration statement is effective); *id.* § 77e(a)(2) (forbidding using interstate commerce to carry an unregistered security for purposes of selling or delivering it); *id.* § 77e(c) (prohibiting offering to buy or sell a security before a registration statement has been filed for it). Similarly, the Securities Exchange Act exempts government and municipal securities and numerous others. Securities Exchange Act of 1934 § 3(a)(12), 15 U.S.C.A. § 78c(a)(12) (West 1997 & Supp. 2007) (defining “exempted security” for purposes of otherwise required registration under § 78l(b)).

136. Exempted classes of securities under the Securities Act include 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), 15 U.S.C. § 77c(a)(2)-(4), (8) (2000 & Supp. IV 2004); Securities Act Reg. A, 17 C.F.R. § 230.251 (2007); Securities Act Reg. D, 17 C.F.R. § 230.501 (2007); Securities Act Reg. E, 17 C.F.R. § 230.701 (2007). Exempted transactions include exchanges with existing shareholders, intrastate issues, private offerings and transactions by dealers, and brokers. 15 U.S.C. §§ 77c(a)(9), 77c(a)(11), 77d(1)-(4) (2000); Securities Act Rule 144, 17 C.F.R. § 230.144 (2007); Securities Act Rule 144A, 17 C.F.R. § 230.144A (2007). As to safe harbors, see, for example, Securities Act of 1933 § 10, 15 U.S.C. § 77j, which allows tombstone advertisements; *Chris-Craft Indus., Inc. v. Bangor Punta Corp.*, 426 F.2d 569, 574 (2d Cir. 1970) (en banc), which emphasizes the rule-like character of the safe harbor, referring to it as based on a “checklist” of features that provides guidance superior to any “judicially formulated ‘rule of reason’”; Securities Act Rule 135, 17 C.F.R. § 230.135 (2007), which addresses 15 U.S.C. § 77e(c) liability.

137. Application of Securities Act § 3(a)(9), Securities Act Release No. 646, 11 Fed. Reg. 10,956, 10,956 (Feb. 3, 1936) (limiting eligibility for § 77c(a)(9)’s exemption for exchanges with existing shareholders to an exchange made in good faith and not one intended simply to evade the statute’s requirements).

138. *See, e.g.*, Non-Public Offering Exemption, Securities Act Release No. 4552, 27 Fed. Reg. 11,316, 11,316 (Nov. 6, 1962) (explaining that the 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 the offer); Exemption from Securities Act § 4(1), Securities Act Release No. 285, 11 Fed. Reg. 10,952 (Jan. 24, 1935) (listing similar factors).

139. *E.g.*, Exchange Act Rule 15c3-1, 17 C.F.R. § 240.15c3-1 (2007) (specifying methods of computing net capital).

extension rules,¹⁴⁰ short-sale rules,¹⁴¹ trading practices rules,¹⁴² customer confirmation rules,¹⁴³ and rules governing contingency offerings.¹⁴⁴ These rules are supplemented by broad anti-fraud principles of general applicability¹⁴⁵ and tailored to the broker-dealer context by prohibitions on misappropriating customer funds or securities, unsuitable or unauthorized trading, churning, and charging excessive markups.¹⁴⁶

Why these rules (as supplemented by 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 securities industry and disclosure system. 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 would 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 U.S. federal securities acts as epitomized by the traditional “shingle theory” of securities professionals.¹⁴⁷ For example, the duty to obtain best execution for customer transactions is rooted in common law agency principles.¹⁴⁸ Other general principles that flow from these traditional concepts include the imposition of

140. *E.g.*, Federal Reserve System Reg. T, 12 C.F.R. §§ 220.1-132 (2007).

141. *E.g.*, Exchange Act Rule 10a-1, 17 C.F.R. § 240.10a-1 (2007).

142. *E.g.*, Exchange Act Reg. M, 17 C.F.R. §§ 242.100-105 (2007).

143. *E.g.*, Exchange Act Rule 10b-10, 17 C.F.R. § 240.10b-10 (2007).

144. *E.g.*, 17 C.F.R. §§ 240.10b-9, 240.15c2-4 (2007) (regulating the transmission or maintenance of payments received in connection with underwritings).

145. *See* Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a) (2000) (prohibiting fraud in connection with the offer or sale of a security); Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (2000) (authorizing promulgation of anti-fraud regulations to prohibit use of manipulative or deceptive devices); Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5 (2007) (prohibiting the employment of manipulative or deceptive devices in connection with the purchase or sale of a security).

146. Exchange Act Rule 15c1-2, 17 C.F.R. § 240.15c1-2 (2007); Exchange Act Rule 15c2-1, 17 C.F.R. § 240.15c2-1.

147. *Kahn v. SEC*, 297 F.2d 112, 115 (2d Cir. 1961) (Clark, J., concurring); *see also* Roberta Karmel, *Is the Shingle Theory Dead?*, 52 WASH. & LEE L. REV. 1271, 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).

148. *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 173-74 (3d Cir. 2001) (en banc); Order Execution Obligations, Exchange Act Release No. 37,619A, 61 Fed. Reg. 48,290, 48,322 (Aug. 29, 1996).

duties on firms to supervise employees.¹⁴⁹ Additional examples of principles include those that the SEC has invoked to contest the inappropriate influence by investment bankers over research analysts¹⁵⁰ and the allocation of IPO shares to favored customers in exchange for inflated commissions or markdowns.¹⁵¹

Disclosure laws include both rules and principles. Most striking are provisions that require specific items to be disclosed and include open-ended requirements to disclose other information necessary to prevent these required statements from being misleading in light of the circumstances under which they are made.¹⁵² Laws governing the timing of filing disclosure documents are rule-like (including Section 13(d)'s requirement of disclosure at the 5% ownership level).¹⁵³ General laws qualified by concepts of materiality are thoroughly and consciously principle-like.¹⁵⁴ The SEC's requirement that disclosure be written in "plain English" is a

149. Securities Exchange Act of 1934 § 15(b)(4)(E), 15 U.S.C. § 78o(b)(4)(E); *see also* Prudential Securities, Inc., Exchange Act Release No. 48,149, 80 SEC Docket 1785, 1785-87 (July 10, 2003) (finding, on the basis of Prudential Securities, Inc.'s settlement offer, that Prudential Securities, Inc. violated § 78o(b)(4)(E) by failing to supervise an employee who committed fraud in connection with the sale of securities); Prudential-Bache Securities, Inc., Exchange Act Release No. 22,755, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,948, at 87,930, 87,945-48 (Jan. 2, 1986) (censuring Prudential-Bache Securities, Inc. for failure to supervise branch office managers). *See generally* Lewis D. Lowenfels & Alan R. Bromberg, *Broker-Dealer Supervision: A Troublesome Area*, 25 SETON HALL L. REV. 527 (1994) (discussing the recent focus on supervision and the lack of clarity in the regulatory duties that complicate the issue); John H. Walsh, *Right the First Time: Regulation, Quality, and Preventive Compliance in the Securities Industry*, 1997 COLUM. BUS. L. REV. 165, 169-206 (discussing the regulatory developments that encourage supervision).

150. *See, e.g.*, Press Release, Sec. & Exch. Comm'n, SEC, NY Att'y Gen., NASD, NASAA, NYSE, and State Regulators Announce Historic Agreement to Reform Inv. Practices, (Dec. 20, 2002), <http://www.sec.gov/news/press/2002-179.htm> (announcing a "global settlement" among brokerage firms, state regulators, securities exchanges, and prosecutors in which brokerage firms now must "insulat[e] research analysts from investment banking pressure").

151. *See* Parnes, Litigation Release No. 16,877, 74 SEC Docket 708 (Jan. 31, 2001) (proceedings concerning Datek Securities).

152. *E.g.*, SEC Reg. S-K, 17 C.F.R. pt. 229 (2007); Securities Act Reg. C, 17 C.F.R. § 230.408 (2007); Exchange Act Reg. 12B, 17 C.F.R. § 240.12b-20 (2007).

153. *See supra* text accompanying note 65 (discussing Section 13(d)'s requirements).

154. 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 while "[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 . . . ease of application alone is not an excuse for ignoring the purposes of the securities acts and Congress' policy decisions"); *Selective Disclosure and Insider Trading*, Securities Act Release No. 7881, Exchange Act Release No. 43,154, Investment Company Act Release No. 24,599, 73 SEC Docket 3, 10 (Aug. 15, 2000) ("[W]e 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, Release No. SAB 99, 64 Fed. Reg. 45,150, 45,151 (Aug. 12, 1999) (rejecting efforts to design rules of thumb for accounting, such as a threshold measure of 5% of earnings).

principle, although it also contains specific rule-like components such as a prohibition against using “multiple negatives.”¹⁵⁵ 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 as principles.¹⁵⁶

Toward the principles-end of the securities regulation spectrum, U.S. insider trading laws prohibit trading while in possession of material non-public information when occupying some capacity of trust or other special relationship.¹⁵⁷ As applied to corporate officers and directors, these laws derive from state fiduciary duty principles and become a federal violation when coupled with the anti-fraud provisions of federal securities statutes, which express broad principles.¹⁵⁸ The SEC accelerated the development of these laws in the mid-1980s when it began a vigorous campaign using the enforcement model described as *ad hoc*—meaning weighted towards enforcing broad, vague principles rather than specific, non-vague rules.¹⁵⁹

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, these expressions famously occur when attempting to state the law governing tipper-tipee liability, where vagueness dissolves into a

155. Securities Act Reg. C, 17 C.F.R. § 230.421(c), (d)(2) (requiring all prospectus information to be written in clearly understandable prose and prohibiting multiple negatives, respectively).

156. OFFICE OF THE CHIEF ACCOUNTANT, SEC. & EXCH. COMM’N, STUDY PURSUANT TO SECTION 108(D) OF THE SARBANES-OXLEY ACT OF 2002 ON THE ADOPTION BY THE UNITED STATES FINANCIAL REPORTING SYSTEM OF A PRINCIPLES-BASED ACCOUNTING SYSTEM (2003), *available at* <http://www.sec.gov/news/studies/principlesbasedstand.htm> [hereinafter SEC, SOX 108 STUDY]. The SEC’s typology is discussed in detail in the next Section.

157. *United States v. O’Hagan*, 521 U.S. 642, 651-53 (1997).

158. 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 corporation), tippers and tiplees 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., id.* (misappropriation); *Dirks v. SEC*, 463 U.S. 646, 659-60 (1983) (tipping); *SEC v. Tome*, 833 F.2d 1086, 1095 (2d Cir. 1987) (temporary insider); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848-49 (2d Cir. 1968) (classical insider).

159. Harvey L. Pitt & Karen L. Shapiro, *Securities Regulation by Enforcement: A Look Ahead At the Next Decade*, 7 YALE J. REG. 149, 156-57 (1990). The foundations of this enforcement program were rooted in principles established two decades earlier. *See Cady, Roberts & Co.*, 40 S.E.C. 907, 910-16 (1961) (describing anti-fraud rules—Securities Act section 17(a), Exchange Act section 10(b), and Exchange Act Rule 10b-5—as “broad remedial provisions aimed at reaching misleading or deceptive activities”).

dense rule-patterned framework.¹⁶⁰ Based on the extent of advance notice provided, the SEC offers rule-like certainty concerning non-business relationships that create liability risk¹⁶¹ and insiders who trade for reasons not based on their inside information.¹⁶²

Some laws with principle-like qualities morph into multi-factor tests. Consider the law forbidding market manipulation.¹⁶³ All U.S. market manipulation laws stem, in turn, from Section 10(b)'s principle proscribing "manipulative or deceptive devices or contrivances."¹⁶⁴ Establishing a market manipulation violation requires proving: (1) a misrepresentation or omission of material facts or other fraudulent device; (2) made in connection with the sale or purchase of securities; and (3) made with scienter.¹⁶⁵ This proof requires assessing multiple factors concerning the nature, timing, and context of the trades.¹⁶⁶

160. 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 *Dirks*); 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, 778-81 (1988) (criticizing the misappropriation theory developed by common law as a problematic blending of a "conduct" approach with an "effect" approach).

161. Exchange Act Rule 10b5-2, 17 C.F.R. § 240.10b5-2 (2007) (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 also *SEC v. Yun*, 327 F.3d 1263, 1273 (11th Cir. 2003) (discussing background and scope of the SEC's rule).

162. Exchange Act Rule 10b5-1(c), 17 C.F.R. § 240.10b5-1(c) (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) (unpublished manuscript, on file with author), for a discussion that provides evidence suggesting that insiders exploit the rule-like characteristics of this provision.

163. Section 9 of the Exchange Act prohibits "manipulation of security prices." Securities Exchange Act of 1934 § 9(a)(2), 15 U.S.C. § 78i(a)(2) (2000) (making it 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"). For another example of a factor test, see *supra* note 138 (distinguishing between public offerings and private placements of securities).

164. Section 10(b), 15 U.S.C. § 78j(b).

165. See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (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.").

166. 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. Patten, Release No. ID-303, 86 SEC Docket 2336, 2339 (Dec. 12, 2005); see also Finance Investments, Inc., Exchange Act Release No. 51,530, 85 SEC Docket 533, 534 (Apr. 12, 2005) (focusing on trading activity based on non-economic factors in finding market manipulation and also finding 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). Patten, Release No. ID-303, 86 SEC Docket 2336, 2350 (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

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.¹⁶⁷ As noted, various regulations authorize exemptions from registration for certain transactions, so long as certain rule-like attributes exist. But these regulations also provide that stated exemptions are unavailable if a transaction, or a series of them, technically complies with the rules but otherwise is a scheme to evade the registration provisions.¹⁶⁸ For example, one anti-abuse principle broadly covers securities held in a form “used primarily to circumvent” the reporting provisions of the 1934 Act.¹⁶⁹ 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.¹⁷⁰

In light of the numerous rules and rule-like provisions in U.S. 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, similarly makes it difficult to contend that the system is rules-based.¹⁷¹ The individual provisions fall along a continuum and 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 spans much of the securities regulation syllabus. Additional securities regulations likewise combine

before it cleared, and matching of purchases by one participant in a scheme with sales by another.

167. The U.S. federal securities laws contain numerous anti-fraud provisions, including Exchange Act section 10(b), Securities Act section 17(a), Exchange Act Regulation 14A governing proxy solicitations, and Exchange Act section 14(e) and Regulation 14E governing tender offers. See 2005 SEC PERFORMANCE & ACCOUNTABILITY REP. 8 (explaining that the overall enforcement program must reach across *all areas* to achieve “[e]ffective deterrence of securities *fraud*” (emphasis added)).

168. *E.g.*, Securities Act Rule 144A, 17 C.F.R. § 230.144A prelin. note 3 (2007) (qualifying the exemption for offers and sales to qualified institutional buyers); Securities Act Rule 147, 17 C.F.R. § 230.147 prelin. note 3 (qualifying the exemption for single-state transactions); Securities Act Reg. D, 17 C.F.R. § 230.501 prelin. note 6 (2007) (qualifying the exemption for offers and sales made under Regulation D); Securities Act Reg. S, 17 C.F.R. § 230.901 prelin. note 2 (2007) (qualifying the exemption for off-shore transactions).

169. Exchange Act Rule 12g5-1(b)(3), 17 C.F.R. § 240.12g5-1(b)(3) (2007).

170. *Ettinger v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 835 F.2d 1031, 1036 (3d Cir. 1987).

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

rules and principles to address many other circumstances. While too vast to canvas fully,¹⁷² one observes such a blend of provisions in contexts such as proxy solicitations¹⁷³ and tender offers, which also contain additional examples of factor tests.¹⁷⁴ Even the Sarbanes-Oxley Act, which many say is "rules-based,"¹⁷⁵ can be read to exhibit an underlying basis in principles, making it plausibly "principles-based."¹⁷⁶ Notable critics of the Act as "rules-based" are accounting promulgators, whom the Act implicitly blamed for making U.S. GAAP "rules-based."¹⁷⁷ As the next section shows, the Act's implicit charge that GAAP is rules-based also is of dubious validity.

3. Accounting

Rhetoric holds that international financial reporting standards ("IFRS") are principles-based and U.S. GAAP is rules-based.¹⁷⁸ As with frequent descriptions of Delaware corporate law and common descriptions of U.S. federal securities regulation, these

172. 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 reveals a mixture of rules and principles that likewise defy tidy classification of the overall systems as rules-based or principles-based.

173. 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, and 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. Exchange Act Reg. 14A, 17 C.F.R. §§ 240.14a-1 to .14b-2 (2007).

174. See *Wellman v. Dixon*, 475 F. Supp. 783, 823-24 (S.D.N.Y. 1979) (stating the test). Compare *Hanson Trust PLC v. SCM Corp.*, 774 F.2d 47, 56-57 (2d Cir. 1985) (reciting but rejecting the test), with *SEC v. Carter Hawley Hale Stores, Inc.*, 760 F.2d 945, 950-52 (9th 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.

175. E.g., Lyman P.Q. Johnson & Mark A. Sides, *Corporate Governance and the Sarbanes-Oxley Act: The Sarbanes-Oxley Act and Fiduciary Duties*, 30 WM. MITCHELL L. REV. 1149, 1195 (2004) (characterizing the Sarbanes-Oxley Act as "adopt[ing] a wholly novel, rules-based approach to corporate governance"); Wright, *supra* note 134 (denigrating the "rules-based" approach of Sarbanes-Oxley).

176. See Jeffrey M. Lipshaw, *Sarbanes-Oxley, Jurisprudence, Game Theory, Insurance and Kant: Toward a Moral Theory of Good Governance*, 50 WAYNE L. REV. 1083, 1085, 1090-95 (2004) (explaining how common law at times provided an underlying basis in principles for Sarbanes-Oxley).

177. Katherine Schipper, *Principles-Based Accounting Standards*, 17 ACCT. HORIZONS 61, 71 (2003) (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).

178. See *supra* note 7 (citing sources).

characterizations are overstated. True, for given accounting topics, U.S. GAAP employs bright-line rules (often numerical thresholds) where 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 U.S. GAAP favors rules and IFRS favors principles.¹⁷⁹ In both systems, leases are divided into two classes (operating and capital/finance) and receive different treatment accordingly: costs and receipts under operating leases are recognized when incurred, while those under capital/finance leases are allocated over multiple periods (i.e., capitalized). IFRS leases are capitalized when an arrangement transfers *substantially all* the risks and rewards of ownership; U.S. 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.¹⁸⁰

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 U.S. 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.¹⁸¹ When this provision was adopted, a dissenter complained that its “intention” test

179. Rebecca Toppe Shortridge & Mark Myring, *Defining Principles-Based Accounting Standards*, CPA J., Aug. 2004, at 34.

180. Compare BARRY J. EPSTEIN & ABBAS ALI MIRZA, WILEY IAS 2004: INTERPRETATION AND APPLICATION OF INTERNATIONAL ACCOUNTING AND FINANCIAL REPORTING STANDARDS 559 (discussing classification under IAS No. 17) with ACCOUNTING FOR LEASES, Statement of Fin. Accounting Standards No. 13, ¶¶ 7(c)-(d) (Fin. Accounting Standards Bd. 1976).

181. CLASSIFICATION OF SHORT-TERM OBLIGATIONS EXPECTED TO BE REFINANCED, Statement of Fin. Accounting Standards No. 6, ¶ 11 (Fin. Accounting Standards Bd. 1975). 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. *Id.*

was too open-ended.¹⁸² In contrast, callable debt is to be classified as short-term debt if due on demand within one year, or if the creditor has the right to accelerate the debt because of debtor breach of the agreement—that is, unless the lender has waived its acceleration right.¹⁸³ When adopted, dissenters from this provision complained that it was too restrictive. They said it was a “further step to supplant judgment in financial reporting with arbitrary rules.”¹⁸⁴ These provisions endure in U.S. GAAP, side-by-side. Generalizing systemic bases from such individual examples is thus unlikely to produce reliable characterizations.

U.S. 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 another kind.¹⁸⁵ On the other hand, U.S. GAAP is practically as dense as IFRS, which is substantially a copy of the U.S. GAAP provisions plus an additional 351 pages of implementation guidance.¹⁸⁶ Even though both systems exhibit this rule-like quality, the provisions also direct classifying a financial instrument as a hedge based on managerial intention in using the instrument.¹⁸⁷ That kind of vague test could justify describing accounting for derivative securities as principle-like.¹⁸⁸

A misunderstood accounting provision at the heart of the Enron case may explain why so many people say that U.S. GAAP is rules-based. The provision concerns the definition of a subsidiary for purposes of preparing consolidated financial statements that include such entities. U.S. GAAP defines this as ownership of at least a

182. *Id.* (dissenting opinion).

183. CLASSIFICATION OF OBLIGATIONS THAT ARE CALLABLE BY THE CREDITOR, Statement of Fin. Accounting Standards No. 78, ¶ 5 (Fin. Accounting Standards Bd. 1983).

184. *Id.* at ¶ 6 (dissenting opinion).

185. See ACCOUNTING FOR CERTAIN INVESTMENTS IN DEBT AND EQUITY SECURITIES, Statement of Fin. Accounting Standards No. 115 (Fin. Accounting Standards Bd. 1993).

186. Compare PATRICK R. DELANEY ET AL., WILEY GAAP 2004: INTERPRETATION AND APPLICATION OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES 161-204 (2004) (explaining U.S. GAAP treatment of derivatives accounting), with EPSTEIN & MIRZA, *supra* note 180, at 159-201 (explaining IAS treatment of derivatives accounting). See also Nobes, *supra* note 67, at 13 (“The IAS No. 39 file at the IASB records that the project director . . . considered twelve FASB Statements, nine FASB Technical Bulletins, seven APB Opinions, nineteen AICPA Statements of Position, and 109 EITF consensuses.”).

187. See FINANCIAL INSTRUMENTS: RECOGNITION AND DEVELOPMENT, Int’l Accounting Standard No. 39, ¶ 9 (Int’l Accounting Standards Bd. 2006); ACCOUNTING FOR CERTAIN INVESTMENTS IN DEBT AND EQUITY SECURITIES, Statement of Fin. Accounting Standards No. 115, ¶¶ 7, 12 (Fin. Accounting Standards Bd. 1993).

188. See Schipper, *supra* note 177, at 65-67, 71 (emphasizing that U.S. GAAP on derivatives ultimately is based on a fundamental principle of managerial intent).

majority of the voting shares of another entity.¹⁸⁹ 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, one must satisfy both the provisions of consolidation accounting, as well as arcane provisions applied to SPEs that require at least 3% of the SPE's *total capital* (equity plus debt) to be equity. The latter requirement 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 (more than 50% of the equity must 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.¹⁹⁰ This is not the case, as that would vitiate the basic consolidation provision.¹⁹¹ It is absurd to allege that such a rule is to blame for the Enron abuses; it is also misleading to argue that it illustrates that U.S. GAAP is rules-based.

Consider accounting for equity investments. Both U.S. GAAP and IFRS distinguish accounting for investments in equity securities by dividing them into categories based on the level of influence an ownership position enables the holder to exert. In addition to subsidiaries, as just discussed, both systems use a breakpoint of 20% to distinguish small stakes from medium stakes, a proxy for the level of

189. A post-Enron revision expands the concept to require consolidation of so-called variable interest entities despite the basic rule. CONSOLIDATION OF VARIABLE INTEREST ENTITIES, FASB Interpretation No. 46 (Fin. Accounting Standards Bd. 2003).

190. 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)).

191. See *Are Current Financial Accounting Standards Protecting Investors: Hearing Before the Subcomm. on Commerce, Trade and Consumer Protection of the H. Comm. on Energy and Commerce*, 107th Cong. (2002) (statement of Edmund L. Jenkins, Chairman, Financial Accounting Standards Board) (explaining that when the equity level is that low, 100% of it must be held by third parties); see also Gary J. Aguirre, *The Enron Decision: Closing the Fraud-Free Zone on Errant Gatekeepers?*, 28 DEL. J. CORP. L. 447, 454-55 (2003) ("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.").

influence an owner has over the other entity. When adopted as U.S. GAAP, several members of the standard setting board debated the provision, one arguing that the 20% trigger was too arbitrary.¹⁹² It is true that many people treat the breakpoint as a bright-line rule and design transactions to avoid triggering it.¹⁹³ But it was never intended to operate that way. While this may indeed be a rule, it appears in both U.S. GAAP and IFRS.

A common example of principles in accounting, under both U.S. 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*. Thus, accounting relies on principles of probability and magnitude.¹⁹⁴ Even so, in application, participants seek to specify the meaning of probability and magnitude by using 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 U.S. GAAP and IFRS are a series of broad general accounting precepts. Both systems require a fair presentation and emphasize substance over form. U.S. GAAP also is based on an overarching concept of decision usefulness.¹⁹⁵ Both systems are imbued with conventions

192. See generally THE EQUITY METHOD OF ACCOUNTING FOR INVESTMENTS IN COMMON STOCK, Accounting Principles Bd. Opinion No. 18 (Accounting Principles Bd. 1971) (Messrs. Broeker assenting with qualification), reprinted in FIN. ACCOUNTING STANDARDS BD., ORIGINAL PRONOUNCEMENTS: AS AMENDED: VOLUME III APB18 (2005/2006 ed. 2005) (opining that investors in non-majority investments "should always be required to demonstrate an ability to exercise significant influence over the operating and financial policies of an investee and that at no level of voting control under 51% should such significant influence be presumed to exist"). Another disagreed "with the arbitrary criterion of 20% combined with a variable test of 'significant influence' . . . because such an approach is not convincing in concept and will be very difficult to apply in practice." *Id.* (Messrs. Catlett & Horngren assenting with qualification). FASB Interpretation No. 35 clarifies:

If there is an indication that an investor owning 20 percent or more of an investee's voting stock is unable to exercise significant influence over the investee's operating and financial policies, all the facts and circumstances related to the investment shall be evaluated to determine whether the presumption of ability to exercise significant influence over the investee is overcome.

CRITERIA FOR APPLYING THE EQUITY METHOD OF ACCOUNTING FOR INVESTMENTS IN COMMON STOCK, FASB Interpretation No. 35 (Fin. Accounting Standards Bd. 1981).

193. *E.g.*, C. W. Mulford & E. Comiskey, *Investment Decisions and the Equity Accounting Standard*, 61 ACCT. REV. 519 (1986) (performing empirical study and concluding that the 20% trigger influences investment decisions).

194. ACCOUNTING FOR CONTINGENCIES, Statement of Financial Accounting Standards No. 5 (Fin. Accounting Standards Bd. 1975).

195. See William W. Bratton, *Private Standards, Public Governance: A New Look at the Financial Accounting Standards Board*, 48 B.C. L. REV. 5, 26-37 (2007) (noting that the FASB chose decision usefulness—or "external transparency"—as the primary goal of accounting theory).

bearing 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 broad principles: all are simultaneously subject to the principles and influence their meaning.

The broad principles animating U.S. GAAP lead a minority to claim that U.S. GAAP is “principles-based.”¹⁹⁶ 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 U.S. GAAP, the SFACs provide its foundation.¹⁹⁷ The most important of these principles 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.¹⁹⁸

The case that U.S. 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 U.S. GAAP’s elements as rules-based,¹⁹⁹ principles-based,²⁰⁰ and principles-only²⁰¹ (and left some unclassified, including contingencies). True, many U.S. GAAP provisions exhibit a rule-like quality as compared to IFRS—such as those concerning leases and subsidiaries. But there is likewise

196. *E.g.*, Schipper, *supra* note 177, at 61-63; *see also* William W. Bratton, Jr., *Enron, Sarbanes-Oxley, and Accounting: Rules Versus Principles Versus Rents*, 48 VILL. L. REV. 1023, 1043-44 (2003) (explaining how Enron misunderstood a “three percent rule of thumb test” for third-party equity investment to be a rigid rule despite the SEC repeatedly insisting that the test was a principle and not “to be taken as a one-size-fits-all test”).

197. Schipper, *supra* note 177, at 62.

198. *Id.* at 62-63, 66. Professor Bratton identifies at least seven other core principles in U.S. GAAP: (1) *realization principle* (revenue is recognized only when the earnings process is essentially complete); (2) *matching principle* (expenses are allocated to the period in which the related benefit contributes to generating revenue); (3) *conservatism principle* (prudent reaction to uncertainty as by using the least optimistic estimates); *cost principle* (assets are reported at historical cost, not at higher market prices); (4) *consistency principle* (using the same accounting methods over time); (5) *materiality principle* (information in financial statements should be meaningful to users and not trivial); (6) *objectivity principle* (information in financial statements should be verifiable); and (7) *disclosure principle* (full and fair disclosure should be made in financial statements). Bratton, *supra* note 196, at 1048.

199. SEC, SOX 108 STUDY, *supra* note 156 (noting provisions addressing real estate sales, receivables transfers, investments, derivatives, leases, pensions, retiree benefits, stock options, and income taxes).

200. *Id.* (noting provisions addressing foreign currency translation, interest capitalization, intangible assets, asset retirement obligations, long-lived asset impairment, inventory, business combinations, and restructurings).

201. *Id.* (giving only one example of “principles-only” provisions, historical cost of depreciable assets).

a mix in IFRS, which also contains many rules, such as those pertaining to derivative securities.²⁰²

A further consideration in assessing the character of any accounting system concerns the scope of discretion reposed in targeted actors. Both U.S. 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 it is 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 requirement that has led IFRS in many contexts to offer menus rather than definite prescriptions.²⁰³ This feature may tempt one to characterize it as principles-based. Yet, U.S. GAAP also offers extensive menus, although this may be due to substantive rather than political factors.

These examples suggest that it is difficult to say that an accounting system is principles-based or rules-based. What users may mean by these crude labels is a proxy for the relative density of each or of a perceived or actual promulgator preference for providing rules instead of principles when choices must be made. If it were true as an empirical matter that U.S. GAAP is more rules-based than IFRS, however, one reason may be simply the ordinary accretion that accompanies age. U.S. GAAP has been formally promulgated for almost a century; IASB is a fraction of that age. Accretion influences the content—and perception—of the bodies of knowledge along the rules-principles continuum.²⁰⁴ Another reason for GAAP's rule density is that, in response to demand, U.S. GAAP provides extensive implementation guidance, along with frequent exceptions and other limitations.²⁰⁵

Consider finally the SEC's enforcement actions in accounting.²⁰⁶ Areas most susceptible to misconduct—measured by the

202. See Nobes, *supra* note 67, at 29 (searching for an underlying principle in IAS No. 39).

203. Cf. GARY JOHN PREVITS & BARBARA DUBIS MERINO, A HISTORY OF ACCOUNTANCY IN THE UNITED STATES: THE CULTURAL SIGNIFICANCE OF ACCOUNTING 361-62 (1998) (recognizing a need for harmonizing accounting standards among nations while noting the obstacles presented by cultural and political differences).

204. See Nelson, *supra* note 14, at 92 ("IAS appear more principle-based [than U.S. GAAP in part because] they have not had as much time to accrete rules.").

205. Schipper, *supra* note 177, at 67 ("The only way to provide for treatment and scope exceptions is by means of rules. . . . [S]ome of the detail and complexity in U.S. GAAP stems directly from requests for clarification or expansion of scope and treatment exceptions.").

206. See generally SEC. & EXCH. COMM'N, REPORT PURSUANT TO SECTION 704 OF THE SARBANES-OXLEY ACT OF 2002 (2003), available at <http://www.sec.gov/news/studies/sox704report.pdf> [hereinafter SEC, SOX 704 REPORT] (studying SEC enforcement actions from

SEC's enforcement action distribution—include the most principle-like provisions in accounting: revenue recognition²⁰⁷ and expense recognition,²⁰⁸ along with a sizable number of cases in the likewise principle-rich contexts of asset impairment, inventory, business combinations, and restructurings.²⁰⁹ These data cast further doubt on the characterization of U.S. GAAP as rules-based.

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 or accounting as rules-based or principles-based. But, as the following discussion suggests, at least as to these subjects, doing so seems dubious.

B. Proposed Systems

Theorists and policymakers may attempt consciously 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

In a well-known article, Professors Black and Kraakman draw lessons from their experience developing an intensely rule-rich system of corporate law for post-Soviet Russia.²¹⁰ The crucial theory underpinning the system they created is the desperate need for certainty—desperate because of its absence in the Soviet regime upon

1997 to 2002, as directed by section 704 of the Act, to prepare this study to identify areas of financial disclosure most susceptible to fraud and other improper conduct).

207. 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, Release No. SAB 101, 64 Fed. Reg. 68,936, 68,936, 68,940 (Dec. 9, 1999) (explaining that “revenue should not be recognized until it is realized or realizable and earned,” and discussing the further requirement that distinct earnings processes must be separated).

208. SEC, SOX 704 REPORT, *supra* note 206, at 5. U.S. GAAP's expense recognition principle is that expenses are to be recognized when incurred. *Id.* at 14.

209. *Id.* at 14, 19. These accounting standards include SFAS 144—Accounting for the Impairment or Disposal of Long Lived Assets, SFAS 141—Business Combinations, and SFAS 146—Accounting for Costs Associated with Exit or Disposal Activities. See *id.* at 43 n.106.

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

which Russia was forced to build its emerging economy.²¹¹ The model that these scholars develop helps to show that even the most conscious effort to design a rule-rich system of corporate law, written from scratch, cannot escape including significant provisions recognizable as principles.

Professors Black and Kraakman refer to their model as "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.²¹² 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. In terms of shareholders, rules provide for supermajority shareholder voting on designated transactions.²¹³ Shareholder consent is required for an asset sale involving 50% or more of the company's book value (unlike the U.S. requirement triggered by a sale of "all or substantially all" assets).²¹⁴ 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 to 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 also be independent of the corporation. These directors are entrusted with exercising specified power over designated extraordinary transactions, including self-interested transactions. For such self-interested transactions, the model closely follows the process provisions found in contemporary U.S. corporate law statutes—approval by fully-informed, disinterested directors, or

211. See Jeffrey Kahn, *The Search for the Rule of Law in Russia*, 37 GEO. J. INT'L L. 353, 380-87 (2006) (discussing the absence of the "rule of law" in Soviet Russia).

212. Black & Kraakman, *supra* note 210.

213. *Id.* at 1933, 1943.

214. *Id.* at 1955.

shareholders.²¹⁵ These process provisions may make maximum use of bright-line rules, but the approval criteria (being fully informed and disinterested) can evince vagueness associated with principles.

Other contexts show an even broader range of provisions that must be principle-like. A good example of this concerns third parties. Their rights are protected mostly by contract in the United States, but contractual protection may be insufficient in developing economies that lack the requisite enforcement infrastructure.²¹⁶ The self-enforcing model restricts corporations from distributing assets to shareholders through dividends and repurchases in derogation of third-party interests. These distributions are permitted only so long as, after the distribution, the corporation can pay its debts when due, and its assets exceed its liabilities.²¹⁷ Thus, the self-enforcing model polices distributions using Model Act-type restrictions, which I earlier called principle-like, in contrast to the dense rule-like Delaware provisions.²¹⁸

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 U.S. fraudulent conveyance law, under which "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."²¹⁹ Professors Black and Kraakman recognize that this is a principle, not a rule, but note that this is the best that can be done.²²⁰

Appraisal rights offer another example of the inevitable need for principles. In the self-enforcing model, appraisal rights are required and apply to a broader range of transactions than in U.S. corporate law.²²¹ As in U.S. 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.²²² Professors Black and Kraakman appreciate

215. *Id.* at 1933.

216. *Id.* at 1967-68.

217. *Id.* at 1968-69.

218. *See supra* notes 123-25 and accompanying text.

219. Black & Kraakman, *supra* note 210, at 1969.

220. *Id.* ("[W]e can do no better than the vague standard, familiar from fraudulent conveyance law.").

221. *Id.* at 1934.

222. *See supra* notes 100-103 and accompanying text.

these limitations, but find that there is similarly no better alternative.²²³

As a final example, rather than endorse typical U.S.-style provisions concerning self-interested transactions, the self-enforcing model provides a specific rule that disinterested directors must apply when voting on such transactions.²²⁴ The model favors such a specific directive because it relieves directors from struggling with questions of financial fairness (although the meaning of "disinterested" can remain relatively vague). Relieving directors from struggling with the vagueness of financial fairness is important for developing economies that lack norms prevalent in developed countries, where people understand financial fairness in terms of the relationship between price and value.

This approach may promote the desired rule-like feature, but the explanation reflects an important challenge facing the self-enforcing model generally. All provisions depend 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? While it is possible that bright-line rules alone can generate compliance norms, it seems more likely that a system that combines rules with principles will do so.²²⁵

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

223. Black & Kraakman, *supra* note 210, at 1942-43.

224. *Id.* at 1935 (stating that 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").

225. *Cf.* Braithwaite, *supra* note 11, at 73 (citing Clifford D. Shearing & Richard V. Ericson, *Towards a Figurative Conception of Action*, 42 BRIT. J. SOC. 481 (1991)). 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, 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. *See generally* Kevin E. Davis, *Law-Making in Small Jurisdictions*, 56 U. TORONTO L.J. 151, 152-53 (2006) (exploring the possibility that smaller or less developed countries could find it more appealing to adopt relatively vague standards rather than bright-line rules).

scratch.²²⁶ The scholars rightly opt for the term “self-enforcing model” rather than “rules-based model,” for the prescription shows the improbability 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 (“B.C.”) are emphatic 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 U.S. “rules-based” model. The B.C. lawmakers contend that their “new approach leaves behind the over-use of detailed and prescriptive rules in favour of an outcomes-based approach founded on time-tested principles of investor protection: disclosure to investors and the regulation of dealers and advisers.”²²⁷

The proposed B.C. Act strives to express securities regulation in broad terms, but many rule-like features appear. In outline, the Act contains twelve parts, each part divided into numerous sections. Half of these sections are then further divided into multiple divisions, and then into numerous subsections.²²⁸ 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).²²⁹ It also bans “unfair practices”—such a vague concept that the drafters further delineated the principle in the following series of mandates: no unreasonable pressure, no taking advantage of others, and no imposing inequitable terms.²³⁰

The Act’s definition of “material information” is principle-like, as in the United States. The proposed legislation defines material information as “information relating to the business, operations or securities of an issuer that would reasonably be expected to

226. See Rado Bohinc & Stephen M. Bainbridge, *Corporate Governance in Post-Privatized Slovenia*, 49 AM. J. COMP. L. 49, 53 (2001) (providing an account of Slovenia’s new corporate law, described as “property-rights based,” and using the German co-determination model without using the terms “rules-based” or “principles-based”); Uriel Procaccia, *Crafting a Corporate Code from Scratch*, 17 CARDOZO L. REV. 629, 629 (1996) (providing an account of Israel’s new market-based corporate code, also without using such other terms).

227. B.C. SECURITIES COMMISSION, QUESTIONS & ANSWERS: NEW BRITISH COLUMBIA SECURITIES ACT 1 (2004), available at http://www.bsc.bc.ca/uploadedFiles/2004_New_LegislationQ-A.pdf.

228. British Columbia Securities Act, Bill 38, 5th Session, 37th Parliament (2004) (not enacted as law) [hereinafter BC Securities Bill].

229. *Id.* pt. 5, §§ 27-28.

230. *Id.* pt. 6, § 29.

significantly affect the value or market price of the issuer or a security of the issuer."²³¹ It uses the term "material information" twenty-two times. The Act, however, also supplies a different but parallel definition of "significant information" applicable to mutual funds. It uses the two terms together in numerous contexts but separately when prescribing prospectus disclosure requirements as between mutual funds and other issuers.²³² Principles alone are insufficient to implement that distinction.

Several examples of provisions falling toward the rules end of the continuum also appear in the Act. For instance, the Act's definitions section contains specific (non-vague) statements of the terms "adviser," "affiliate," "associate," "derivative," "insider," "market participant" (listing fifteen different categories of persons), "offering," and "trade." Subsequent sections contain specific definitions of additional terms.²³³ The definition of "security" lists seven categories of instruments.²³⁴ Given historical experience with novel and unanticipated instruments, one wonders whether this definition of security, which is, in any event, rule-like, not principle-like, is sufficient to cover future circumstances.²³⁵ The effort to define misrepresentation is particularly cumbersome, more nearly evincing attributes of rules than of principles.²³⁶

All the B.C. Act's provisions concerning registration and offerings are stated in vague terms, exhibiting principle-like features. Even so, they also contain rules, and many rely on the securities commission to provide additional regulation. Registration provisions require registration before a participant may trade or advise (a

231. *Id.* pt. 1, § 1.

232. *Id.* pt. 4, § 20.

233. *Id.* pt. 1, § 1.

234. *Id.*

235. See *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-301 (1946) (taking a broad, flexible approach to defining investment contracts, a subset of "securities"); 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, 968-84 (1993) (arguing that viatical settlements are not "securities" as defined under the Securities Act of 1933).

236. Misrepresentation is defined as:

(a) [I]n 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 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 228, pt. 1, § 1.

rule).²³⁷ 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 can use rules, principles, or both).²³⁸

The Act's insider trading provisions also demonstrate an effort to articulate pure principles, but equally succumb, through pressure for clarity, to rule-like expression. Thus insiders must "within the prescribed time" (a rule) "file a report in the required form" (another rule).²³⁹ Again, the commission must establish the prescription and requirements. Subsequent insider reports are required under stated circumstances (rules).²⁴⁰ The law bans insider trading and expressly states that this includes tipping. These provisions require defining the additional term "connected person."²⁴¹ This is a dense and complex definition bearing qualities of a rule, not a principle.²⁴² 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 than a summary of prior applications.

So, notwithstanding conscious ambitions to create principles-based securities regulation, the B.C. approach does not quite live up to its own characterization. While the Act contains extensive provisions written in principle-like fashion, it cannot escape explicitly incorporating 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 would likely include many more rules than appear in the Act. Moreover, once

237. *Id.* pt. 3, § 14.

238. *Id.* pt. 4, § 18.

239. *Id.* pt. 4, § 25.

240. *Id.* pt. 4, § 26.

241. *Id.* pt. 4, § 30.

242. The B.C. Act's definition of "connected person" reads as follows:

Connected person means, 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.

Id. pt. 6, § 30.

the provisions are applied, the result would be even more rules, creating a systemic character that defies classification using the binary terminology of rules-based and principles-based.²⁴³

3. United States and Accounting

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 U.S. financial reporting system of a principles-based accounting system."²⁴⁴ This directive implicitly suggests that the current U.S. accounting system is rules-based, a mistaken but widely shared belief.²⁴⁵

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 labeled 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."²⁴⁶ The SEC also denominated a class of principle-only provisions, defined as "high-level [provisions] with little if any operational guidance."²⁴⁷ 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, arbitrary enforcement.

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."²⁴⁸ Falling in line with contemporary global terminology, the SEC opined that an objectives orientation would best be achieved using "principles-based" provisions.

The SEC explained 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.²⁴⁹ Ideally, its provisions contain no or few exceptions, a modicum of guidance, and

243. Cf. HERMAN MELVILLE, *MOBY-DICK, OR, THE WHALE* 406 (positing a famous statement of two simple principles governing property rights when fishing—a "Fast-Fish belongs to the party fast to it" and a "Loose-Fish is fair game for anybody who can soonest catch it"—but lamenting that "what plays the mischief with this masterly code is the admirable brevity of it, which necessitates a vast volume of commentaries to expound it").

244. Sarbanes-Oxley Act § 108(d), 15 U.S.C. § 7266 (Supp. II 2002).

245. See *supra* note 2 (citing sources).

246. SEC, *SOX 108 STUDY*, *supra* note 156.

247. *Id.*

248. *Id.*

249. *Id.*

no bright-line tests. Instead, provisions are derived from an underlying coherent conceptual framework.²⁵⁰ Systems with these attributes are objectives-oriented because application entails fulfilling the objective and, in doing so, minimizes strategic evasion. Articulation entails coherence across the regulatory terrain; it eschews exceptions that produce inconsistencies and omits bright-line rules that lead to different regulatory consequences for slightly different fact patterns.²⁵¹

Although the SEC position is superficially appealing, some perspective is in order. As a background matter, there was an apparent dichotomy between complying with GAAP and providing a fair financial presentation.²⁵² 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.²⁵³ In such cases, GAAP must be overridden.

This stance threatened the existing financial reporting system, which for decades had understood, as a matter of law²⁵⁴ and

250. *Id.*

251. *Id.*

252. See *United States v. Simon*, 425 F.2d 796, 805-06 (2d Cir. 1969) (holding that an accountant is not insulated from liability solely on the basis of proving conformity to generally accepted accounting principles); 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).

253. SEC, SOX 108 STUDY, *supra* note 156; see also Certification of Disclosure in Companies' Quarterly and Annual Reports, Securities Act Release No. 8,124, Exchange Act Release No. 46,427, Investment Companies Act Release No. 25,722, 78 SEC Docket 875, 880 (Aug. 28, 2002) (stating that auditors' certification is not limited to whether financial statements conform to GAAP); Floyd Norris, *An Old Case Is Returning to Haunt Auditors*, N.Y. TIMES, Mar. 1, 2002, at C1 (noting how the incumbent SEC Chairman had been touting *Simon*).

254. Early in its history, the SEC took the position that compliance with GAAP is not a defense to allegations of inadequate disclosure. *In re Associated Gas & Elec. Co.*, 11 SEC 975, 1058-59 (1942). Some cases from the 1970s, in addition to *United States v. Simon*, did so, as well. *E.g.*, *McLean v. Alexander*, 420 F. Supp. 1057, 1085 (D. Del. 1976), *rev'd on other grounds*, 599 F.2d 1190 (3d Cir. 1979) (citing *In re Associated Gas & Electric Co.* and *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath* when holding that compliance with GAAP is "not a complete defense to charges of inadequate disclosure"); *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 378 F. Supp. 112, 122 (S.D.N.Y. 1974), *aff'd in part, rev'd in part on other grounds*, 540 F.2d 27 (2d Cir. 1976) ("The full disclosure by insiders, which is mandated by the securities laws, coincides with and reinforces the accountant's professional duty to investors who read his reports. This duty cannot be fulfilled merely by following generally accepted accounting principles."). 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) (finding that because Price Waterhouse's accounting procedures were in conformity with GAAP, they were not so defective as to support an inference of fraud). 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, 340 (S.D.N.Y. 2004) (holding that compliance with GAAP does not insulate

practice,²⁵⁵ that complying with GAAP would yield a fair presentation. Conversely, if too rule-bound, compliance with GAAP would impair the possibility of meeting the principle of "fair presentation." A crisis loomed: if the widely held assumption of U.S. GAAP as rule-excessive was accurate, then it had to be reinvented—post haste. True, it might be possible to reconcile the relationship between GAAP and fair presentation through techniques such as presumptions, qualifications, or scope limitations. But at a broad level, if complying with rule-bound GAAP meant absence of a fair presentation, and fair presentation is privileged, then GAAP would become functionally irrelevant.

Rhetoric notwithstanding, the assumption of GAAP's rule-bound nature was false. The SEC found that existing U.S. GAAP is a combination of rules and principles. While expressing some greater affection for the principles end of the spectrum, the SEC declared the existing mixture to be substantially effective, and simply re-labeled it an objectives-oriented system. The SEC concluded that, under such a system, there should be limited need to use GAAP overrides because complying with objectives-oriented GAAP yields financial statements that are fairly presented.²⁵⁶ This conclusion thus resolved what

accountants from liability under the securities laws). An alternative means of imposing liability despite compliance with GAAP invokes an SEC rule that requires financial statements to include, in addition to that expressly required, any information necessary to avoid misleading investors. *SEC v. Caserta*, 75 F. Supp. 2d 79, 92 (S.D.N.Y. 1999); Exchange Act Rule 12b-20, 17 C.F.R. § 240.12b-20 (2007).

255. This belief is embedded in the standard form for an independent auditor's unqualified opinion, which reads as follows: "In our opinion, the financial statements referred to above *present fairly*, in all material respects, the financial position of X Company as of (at) December 31, [20xx], and the results of its operations and its cash flows for the year then ended, *in conformity with generally accepted accounting principles*." See, e.g., Coca-Cola Co., Annual Report (Form 10-K), at 126 (Feb. 20, 2007). AICPA explains how these concepts of "present fairly" and GAAP relate to each other: "The independent auditor's judgment concerning the 'fairness' of the overall presentation of financial statements should be applied within the framework of generally accepted accounting principles." THE MEANING OF "PRESENT FAIRLY IN CONFORMITY WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES," Statement on Auditing Standards No. 69 ¶ .03 (Am. Inst. of Certified Pub. Accountants 1992), *reprinted in* AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, CODIFICATION OF STATEMENTS ON AUDITING STANDARDS AU § 411 (2007). This professional stance implies that there are not two separate requirements—of presenting fairly and in conformity with GAAP—but that the two are intertwined. On the other hand, professional standards authorized departures from GAAP when doing so was necessary to prevent financial statements from being "misleading." REPORTS ON AUDITED FINANCIAL STATEMENTS, Statement on Auditing Standards No. 58 ¶ .14 (Am. Inst. of Certified Pub. Accountants 1988), *reprinted in* AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, CODIFICATION OF STATEMENTS ON AUDITING STANDARDS AU § 508.14 (2007). Such opinions have been rare. See DAN M. GUY ET AL., WILEY PRACTITIONER'S GUIDE TO GAAS 361 (2004) ("Only a handful of such reports have ever been issued."); see also *id.* at 365 (excerpting an example from 1976).

256. FASB's 2002 proposal of a principles approach to standard setting contemplated elevating the requirement of fair presentation to overarching importance so that accounting choices would reflect underlying economic reality. FASB, 2002 PROPOSAL, *supra* note 2, at 1-2, 4, 7. The SEC's conclusion in its report may explain why this proposal did not appear to gain

otherwise loomed as a crisis: that U.S. 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 U.S. GAAP is a mixture of principles and rules and, despite a modest gesture encouraging greater use of principles when possible, designated neither as inherently superior. Instead, it embraces what it believes to be a hybrid, which it calls an "objectives-oriented" system.²⁵⁷ In sum, the system is 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; as such, categories are null sets for complex regulatory systems. It is whether a rule or principle is superior for a given situation, an outcome that depends on trade-offs (such as certainty versus context), 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 SEC correctly concludes the question is 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 non-exclusive possibilities summarized in the Introduction: the regulatory, ethical, and political hypotheses.

traction. British accounting experts describe such a stance as involving a "true and fair override," while that usage is not prevalent among U.S. accountants. See, e.g., David Alexander & Simon Archer, *On Economic Reality, Representational Faithfulness and the "True and Fair Override,"* 33 ACCT. & BUS. RES. 3, 3 (2003).

257. SEC, SOX 108 STUDY, *supra* note 156.

A. Regulatory

A possible explanation for the 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 moving towards rules and away from principles.²⁵⁸ 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.²⁵⁹ This ability to measure such a variety of risks stokes an appetite to similarly measure regulatory and enforcement risk. Accordingly, the perceived certainty that accompanies rules compared to principles leads to the demand for rules.

Second, the "new governance" paradigm in administrative law envisions regulators and compliers increasingly participating together in promulgation exercises.²⁶⁰ The administrative state has evolved into one of open government, collaborative governance, and extensive use of private organizations in setting standards.²⁶¹ In such regulatory

258. See, e.g., William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891, 933-34 (2002) (noting that while plaintiffs once had argued for a broad interpretation of the good faith standard in cases brought by bond holders and preferred stock holders, courts instead "invented a restrictive variant"); Joseph P. Liu, *Regulatory Copyright*, 83 N.C. L. REV. 87, 105-06 (2004) (stating that the 1976 revision of the Copyright Act "provides a highly detailed and specific set of rules," unlike previous acts, which had left the courts "to craft more via the fair use doctrine"); 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) (noting that while the original intent of the drafters of the Uniform Commercial Code was to facilitate a "purposive interpretation" of the Code, the growing trend has been toward a "textualist approach").

259. See, e.g., JEAN TIROLE, *THE THEORY OF CORPORATE FINANCE* 199 (2006) (discussing different methods of risk management).

260. See, e.g., Jody Freeman, *The Private Role in Public Governance*, 75 N.Y.U. L. REV. 543, 545-49 (2000) (arguing that administrative law is "a set of negotiated relationships" between the public and the private sector); Jody Freeman, *Collaborative Governance in the Administrative State*, 45 UCLA L. REV. 1, 3, 21-22 (1997) (advocating for a system of "collaborative governance" in the administrative process); see also Paul R. Verkuil, *Public Law Limitations on Privatization of Government Functions*, 84 N.C. L. REV. 397, 466-69 (2006) (arguing that, despite the increase in privatization, the public sector must retain its influence in order to provide private sector guidance and oversight).

261. See IAN AYRES & JOHN BRAITHWAITE, *RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE* 3 (1992) ("If we accept that sound policy analysis is about understanding

settings, it is not surprising that resulting articulations would be less vague, with constituents asserting needs for qualifications, exceptions, and other features of rules.²⁶²

A third factor driving rules-proliferation is the ascendancy of “interpretive textualism.” This refers to the practice of emphasizing literal expressions when interpreting statutory or regulatory language, a practice especially prevalent among judges.²⁶³ The practice resists infusing those materials with penumbral principles. Legislators and regulators may respond to this trend with increasing care and attention to selected words, consciously reducing vagueness when drafting, thereby yielding rules. This can, in turn, become a part of legal culture and lead practitioners to follow suit.²⁶⁴

Fourth, increasing specialization and fragmentation create incentives among proprietors and professionals to claim expertise and among regulators to claim turf.²⁶⁵ 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, which in turn differ from hedge funds.

private regulation . . . and how it is interdependent with state regulation, then interesting possibilities open up to steer the mix of private and public regulation.”); JAY A. SIGLER & JOSEPH E. MURPHY, *INTERACTIVE CORPORATE COMPLIANCE* 43-44 (1988) (arguing for a system of “interactive compliance” between government and business to avoid either rigid regulatory policy or excessive deregulation) .

262. *E.g.*, Private Securities Litigation Reform Act of 1995, 15 U.S.C. §§ 77z-2, 78u-5(c) (2000) (section 27A of the 1933 Act and section 21E of the 1934 Act) (detailing when one is liable for making a forward-looking statement); Securities Act Rule 175, 17 C.F.R. § 230.175 (2007) (detailing which statements made by an issuer or outside reviewer obtained by the issuer are deemed not to be fraudulent as long as they were made in good faith or with a reasonable basis); Exchange Act Rule 3b-6, 17 C.F.R. § 240.3b-6 (2007) (same); NAT’L ASS’N OF SEC. DEALERS, *NASD MANUAL* (2007) (specifying rules of broker conduct) .

263. *See, e.g.*, Saby Ghoshray, *To Understand Foreign Court Citation: Dissecting Originalism, Dynamism, Romanticism, and Consequentialism*, 69 ALB. L. REV. 709, 717 (“Anchored in the text, structure, and history of the [statute], textualism seeks the most literal meaning, free from the perceptive idealism of broader social purpose.”). For a further inquiry into the nuances between textualism and intentionalism, see Caleb Nelson, *What is Textualism?*, 91 VA. L. REV. 347, 376, which states: “[N]o mainstream judge is interested solely in the literal definitions of a statute’s words, and textualists are willing to deviate in certain ways from the baseline that conventional meaning provides. Still, textualists prefer such deviations to be guided by relatively rule-like principles.”

264. *See* Richard Lavoie, *Subverting the Rule of Law: The Judiciary’s Role in Fostering Unethical Behavior*, 75 U. COLO. L. REV. 115, 195 (2004) (“To the extent a GAAR is successful in changing judicial approaches to statutory interpretation in tax shelter cases, practitioners’ views will change to reflect the new legal landscape.”).

265. 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, 429-32 (2001) (noting that competition between the SEC and the CFTC has resulted in “a nasty and inefficient ‘turf battle’” as opposed to increased efficiency).

Similarly, common stock and straight debt differ markedly from preferred stock, call or put options, asset-backed debt, strips, and derivatives. In sum, 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.²⁶⁶ Litigation risk bolsters this demand, especially in accounting, where auditors demand rules rather than principles.²⁶⁷ 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.²⁶⁸

2. A Need for Principles

These impressive forces may generate more complex and technical rules than is ideal, weakening 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" provides broad regulatory enforcement power to police not just compliance with specific rules but fulfillment of broad general principles. It does so by

266. See Bratton, *supra* note 196, at 1049 (arguing that rules "should with some frequency lead the auditor to say no to aggressive treatments chosen by clients, on grounds of full disclosure and conservatism"); Michael Gibbins, Steve Salterio & Alan Webb, *Evidence About Auditor-Client Management Negotiation Concerning Client's Financial Reporting*, 39 J. ACCT. RES. 534, 539 (2001) ("Unambiguous standards or clear statutory powers increase the general influence of the auditor."). *But see* Donald C. Langevoort, *Technological Evolution and the Devolution of Corporate Financial Reporting*, 46 WM. & MARY L. REV. 1, 17 (2004) ("[A]s the accounting norms themselves became more complicated and subjective, the ability to confidently say 'no' to a client diminished.").

267. See, e.g., George J. Benston, *Public (U.S.) Compared to Private (U.K.) Regulation of Corporate Financial Disclosure*, 51 ACCT. REV. 483, 486-87 (1976) (explaining that the complex rules governing auditor activity are in part designed to avoid the significant cost of litigation); Stephen A. Zeff, *A Perspective on the U.S. Public/Private Sector Approach to the Regulation of Financial Reporting*, 9 ACCT. HORIZONS 52, 65 (1995) (discussing how auditors want to back up their clients' financial reporting with explicit provisions of GAAP).

268. See Stewart E. Sterk, *Information Production and Rent-Seeking in Law School Administration: Rules and Discretion*, 83 B.U. L. REV. 1141, 1148-50 (2003).

equipping regulatory agencies that have rule-making authority with enforcement power to emphasize principles rather than rules to bolster their enforcement arsenals.²⁶⁹ Making this capability salient can elicit greater cautiousness among regulated actors by curbing the 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 the principles-encouraging SEC study on U.S. GAAP.²⁷⁰ 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 and take 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.²⁷¹ For example, the SEC used principles to launch its campaign against insider trading in the mid-1980s.²⁷² It did so to address plagues associated with junk bonds in the early 1990s and, along with state attorneys general, research analysts and mutual fund market timing in the early 2000s.²⁷³ It used principles in enforcement to address novel problems arising from technological innovation and political change at the dawns of the Internet²⁷⁴ and globalization.²⁷⁵

269. See ROBERTA KARMEL, REGULATION BY PROSECUTION: THE SECURITIES AND EXCHANGE COMMISSION VS. CORPORATE AMERICA 301-02 (1982) (arguing that the SEC "can easily formulate new legal principles through *ad hoc* enforcement actions rather than through the rule-making process"); Lon L. Fuller, *The Forms and Limits of Adjudication*, 92 HARV. L. REV. 353, 355 (1978) (discussing the difficulties in assigning adjudicatory functions to administrative agencies); David L. Shapiro, *The Choice of Rulemaking or Adjudication in the Development of Agency Policy*, 78 HARV. L. REV. 921, 940-41 (1965) (discussing the amorphous principles that may result when administrative decisions are made in an adjudicatory context).

270. See *supra* notes 227-57 and accompanying text.

271. 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, 67-68 (1997) (describing the SEC's enforcement procedures with respect to investment companies).

272. See *supra* notes 157-59 and accompanying text.

273. Renee M. Jones, *Dynamic Federalism: Competition, Cooperation and Securities Enforcement*, 11 CONN. INS. L.J. 107, 118-21 (2004) (describing the analyst and mutual funds conflicts).

274. *E.g.*, Spencer, Litigation Release No. 14,856, 61 SEC Docket 1679 (Mar. 29, 1996) (relating to an Internet solicitation of investors promising 50% returns); Frye, Litigation Release No. 14,720, 60 SEC Docket 1787 (Nov. 15, 1995) (involving an Internet solicitation of investor promising risk-free profits); Odulo, Litigation Release No. 14,616, 60 SEC Docket 120 (Aug. 24, 1995) (pertaining to an Internet solicitation promising 20% return); Odulo, Litigation Release No. 14,591, 59 SEC Docket 2538-39 (Aug. 7, 1995) (announcing the filing of the complaint and consent to judgment in the same matter).

These examples of enforcing principles support the regulatory hypothesis as an enforcement-expanding device. However, they simultaneously show a descriptive weakness in this hypothesis to explain the recent rise of principles-based vocabulary: such discretionary enforcement always exists as an option.²⁷⁶ 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 that lacked fidelity to their spirit.²⁷⁷ 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.²⁷⁸

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.²⁷⁹

Third, regulators responded to the recent debacles with new rules, as well as new principles and rhetoric. For example, in response to Enron chairman Ken Lay's disingenuous defense that he did not know the details of the corporation's financial statements, the Sarbanes-Oxley Act prescribed a rule that corporate officers must

275. See *Candies, Inc.*, Securities Act Release No. 7,263, Exchange Act Release No. 36,865, 61 SEC Docket 758, 760-62 (Feb. 21, 1996) (invoking a cease-and-desist order against a law firm assisting in a scheme to violate registration requirements by distributing abroad unregistered stock that was promptly resold into the United States); *Scorpion Techs., Inc.*, Litigation Release No. 14,814, 61 SEC Docket 749, 750 (Feb. 9, 1996) (involving an injunction to stop an illegal Regulation S offering of stock in 20 countries).

276. Whether it should be exercised and how the choice should be made are open questions. See James J. Park, *The Competing Paradigms of Securities Regulation*, 57 DUKE L.J. (forthcoming 2007).

277. See Doreen McBarnet & Christopher Whelan, *The Elusive Spirit of the Law: Formalism and the Struggle for Legal Control*, 54 MOD. L. REV. 848, 848 (1991) (exploring how "[c]reative compliance thrives on a narrow legalistic approach to rules and legal control").

278. Cf. *Lincoln Sav. & Loan Ass'n v. Wall*, 743 F. Supp. 901, 913, 920 (D.D.C. 1990) ("[A]n 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. Bratton, *supra* note 196, at 1041.

279. See Black et al., *supra* note 111.

certify that they know the details of financial statements.²⁸⁰ Similarly, in response to the era's widespread accounting aggressions, the SEC adopted rules to police the use of non-GAAP financial measures and off-balance-sheet financing arrangements.²⁸¹

The regulatory hypothesis poses two additional difficulties as a normative matter. Both arise from how this strategy can tip the balance unduly towards the principles end of the continuum. First, this can induce excessively cautious compliance outlooks that impair the benefits of rules (which, in this context, could include deterring desirable risk-taking).²⁸² Second, a determined enforcement preference to focus on principles instead of rules could backfire when incongruent with accepted notions of fairness and legitimacy.

Additional qualifications concerning the regulatory hypothesis appear from isolating the specific case of accounting. Consider the requirement that financial statements both comply with GAAP and provide a fair presentation.²⁸³ One can imagine an accounting system weighted towards two ends of a spectrum: one that emphasizes compliance with GAAP and another that emphasizes a fair presentation. Part I of this Article mentioned a hypothetical regime that used solely a principle of fair presentation, questioning how that could be feasible absent at least some rules, such as those contained in

280. Sarbanes-Oxley Act §§ 302(a), 906, 18 U.S.C. § 1350 (Supp. II 2002); see SEC, CERTIFICATION OF DISCLOSURE IN COMPANIES' QUARTERLY AND ANNUAL REPORTS, RELEASE NO. 33-8124 (Aug. 28, 2002) (adopting rules as directed by section 302(a) of the Sarbanes-Oxley Act); Michael Perino, *Some Reflections on the Deterrence Aspects of the Sarbanes-Oxley Act*, 76 ST. JOHN'S L. REV. 671, 681-85 (2002) (discussing the advantages and disadvantages of the new securities fraud crime).

281. SEC Reg. G, 17 C.F.R. § 244.101 (2007) (defining non-GAAP financial measures and those registrants subject to the regulation); Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, Securities Act Release No. 8182, Exchange Act Release No. 47,264, Financial Reporting Release No. 67, International Series Release No. 1266, 79 SEC Docket 1251, 1254-68 (Jan. 28, 2003) (requiring the disclosure of off-balance sheet arrangements); Conditions for Use of Non-GAAP Financial Measures, Securities Act Release No. 8,176, Exchange Act Release No. 47,226, Financial Reporting Release No. 65, 79 SEC Docket 1057, 1058-62 (Jan. 22, 2003) (requiring the disclosure of non-GAAP financial measures); Securities Act Release No. 8,039, Exchange Act Release No. 45,124, Financial Reporting Release No. 59, 76 SEC Docket 896, 896-97 (Dec. 4, 2001) (cautioning public companies using pro forma financial information and alerting investors to the dangers of it). These are interesting specimens because the SEC describes the documents as taking "principles-based" approaches despite showing rule-like qualities. See Partnoy, *supra* note 33, at 1276 (discussing how the SEC "shifted the regulatory regime toward rule-based tabular disclosure").

282. See John E. Calfee & Richard Craswell, *Some Effects of Uncertainty on Compliance with Legal Standards*, 70 VA. L. REV. 965, 975-79 (1984) (analyzing uncertainty under a negligence standard to demonstrate how overcompliance with a certain standard may not optimize social costs).

283. See *supra* notes 252-55 and accompanying text.

GAAP.²⁸⁴ Part II explained that, in the decades before the Enron era, participants in U.S. financial reporting generally assumed that compliance with GAAP would automatically deliver a fair presentation.²⁸⁵

The former hypothetical privileges the principle while the latter may be seen to privilege rules. To the extent that privileging rules can prevent meeting the principle, the emphasis on principles-based systems is an effort to elevate the principles to a position of primacy. This explanation is consistent with the SEC's post-Enron emphasis on earlier case law that required overriding GAAP when necessary to provide a fair presentation.²⁸⁶

Viewing the rhetoric as enhancing the fair presentation principle is normatively appealing. But the effort has been half-hearted. Indeed, it may be a product of how the auditing industry would prefer not to debate whether it should assume more responsibility for discretionary accounting choices. Auditors steadfastly resist responsibility for exercising discretion over the selection of accounting treatments when choices are available. They instead insist that this is management's responsibility and that auditors should assess only whether managerial choice is within a range of acceptability—not whether it is the best treatment.²⁸⁷ It is better for auditors to generate an excited debate on the character of accounting provisions as rules versus principles than cast attention on the duties and liability risks of managers versus auditors in selecting and applying those provisions.²⁸⁸

B. Ethical

A second possibility is that the rhetoric of principles-based systems is part of a more general exhortation. What Enron-type scandals revealed 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

284. See *supra* notes 66-69 and accompanying text.

285. See *supra* text accompanying notes 189-91.

286. See *supra* text accompanying notes 252-53.

287. JOHN C. COFFEE, JR., *GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE* 371 (2006).

288. See Lawrence A. Cunningham, *Beyond Liability: Rewarding Effective Gatekeepers*, 92 MINN. L. REV. (forthcoming 2007) (exploring how to encourage auditor willingness to undertake duties that the current liability system discourages them from undertaking).

global rhetoric uses the term “principles” rather than the term “standards” that is more prevalent in the legal literature.²⁸⁹ If this hypothesis is correct, labels may matter more than some think.²⁹⁰

1. Hortatory

The rise of enthusiasm for principles-based systems corresponds to the post-Enron discourse that lamented laxity in business ethics.²⁹¹ 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.²⁹² The discourse exhibited a quest to restore a heightened sense of business and professional ethics.

The rhetoric of principles-based systems may be a byproduct of this quest. This may be so because, while regulatory tools can promote ethical norms, they cannot do so alone.²⁹³ Consider again the practice of creative compliance involving literal obedience to law while evading its spirit.²⁹⁴ 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. However, when done overzealously, as during the Enron era, the practice of creative compliance is treacherous. Either way, neither law nor accounting can do anything to punish compliance with itself. True, in corporate law, equitable principles can police mere

289. See *supra* text accompanying notes 11-14.

290. See *supra* note 17 and accompanying text (noting how some scholars dismiss the proliferation of labels to describe types of laws as nominalism with limited substantive import).

291. E.g., Bill Witherell, *Corporate Governance: Stronger Principles for Better Market Integrity*, OECD OBSERVER, May 2004, at 41 (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 corporate debacles).

292. See William W. Bratton, Jr., *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1283 (2002) (“Enron in collapse was wrought into the fabric of our corporate governance system”); 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, 63-78 (2001) (illustrating the role transactional attorneys play in promoting profit-driven corporate wrongdoing); Bevis Longstreth, *Problems in the Corporate Bar as It Appears to a Retired Practitioner*, 31 MONT. LAW. 22, 22, 32-33 (2006) (lamenting how the “gold standard of professional greatness turned to dross” and suggesting several solutions to the problem); W. Bradley Wendel, *Professionalism as Interpretation*, 99 NW. U. L. REV. 1167, 1170 (2005) (“Professionalism stands in opposition to the view of many lawyers that excellence in lawyering means engaging in ‘creative and aggressive’ structuring of transactions for the benefit of clients, even though the transactions are designed to evade regulatory requirements enacted to protect investors.”).

293. To paraphrase T. S. Eliot, regulators cannot realistically expect to fashion a system so perfect that no one needs to be good.

294. See McBarnet & Whelan, *supra* note 277, at 849 (“Creative compliance uses formalism to avoid legal control”).

technical compliance,²⁹⁵ and in securities regulation, the broad-gauged anti-abuse principles contribute.²⁹⁶ But, in general, regulatory pursuit of creative compliance is Quixotic—except perhaps through rhetoric.²⁹⁷

Recognizing this limit, regulators turned to codes of business ethics. The Sarbanes-Oxley Act required the SEC to promulgate regulations requiring public disclosure of whether a company has a code of ethics for senior officers and, if not, why not.²⁹⁸ Companies must promptly disclose changes, including waivers, to ethics codes. The New York Stock Exchange contemporaneously imposed a requirement that listed companies adopt and disclose a code of business conduct and ethics.²⁹⁹ The U.S. Sentencing Guidelines were amended in 2004 to take express account of whether an enterprise promoted business ethics, including through the adoption of formal codes.³⁰⁰

The resulting codes of ethics are fascinating: they are all brief, abstract, simple, and similar to each other, often emphasizing adherence to the "spirit of the law."³⁰¹ The codes may be truly "principles-based"—they are vague and contain barely a trace of "rules."³⁰² While 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

295. See *supra* note 116 and accompanying text (noting the *Schnell* doctrine in Delaware judicial administration).

296. See *supra* text accompanying notes 167-70.

297. The limitations on general anti-abuse principles appear vividly in tax law, where the principles exist but rarely are enforced.

298. Sarbanes-Oxley Act § 406, 15 U.S.C. § 7264 (Supp. II 2002) ("[C]ode[s] 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.").

299. NYSE, INC., LISTED COMPANY MANUAL § 303A(10) (2003); see also Order Approving NYSE and Nasdaq Proposed Rule Changes, Exchange Act Release No. 48,745, 68 Fed. Reg. 64,154, 64,180 (Nov. 4, 2003) (describing NASDAQ's changes to its Code of Conduct).

300. 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, 726 (2006) ("[T]he Guidelines require that organizations establish an effective compliance and ethics program that promotes an organizational culture that encourages ethical conduct and a commitment to compliance with the law . . ." (internal quotation marks omitted)).

301. Doreen McBarnet, *After Enron: Will "Whiter than White Collar Crime" Still Wash?*, 46 BRIT. J. CRIMINOLOGY 1091, 1105 (2006).

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

ethical principles also explains frequent talk among regulators and politicians of the need to fight “check-the-box” mentalities.³⁰³

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 laments recur periodically in history, and there is limited basis for believing that a golden age of high ethics marked earlier periods.³⁰⁴ 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,³⁰⁵ 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 by the spirit of laws—a call to principles that can limit creative compliance—project a moral appeal that may be desirable. But for leaders to couple such code exhortations with the rhetorical fiction 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.

Finally, the relationship between the ethical hypothesis and the regulatory hypothesis exposes another normative limitation. The ethical hypothesis applies normative pressure to prevent creative

303. See, e.g., Le Pan, *supra* note 4, at 52 (giving remarks of Canada’s Superintendent of Financial Institutions, which note his office’s regulatory effort to “resist the temptation to put in place detailed new rules” and express concern that such rules can be counter-productive in that they risk becoming a checklist . . . [at which point] their benefit is, at best, greatly reduced”); 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 then-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”); Harvey Pitt, Public Statement by SEC Chairman: Remarks at the Winter Bench and Bar Conference of the Federal Bar Council (Feb. 19, 2002) (stating that US GAAP is too “cumbersome and offer[s] 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”).

304. See ALASDAIR MACINTYRE, *AFTER VIRTUE: A STUDY IN MORAL THEORY* 259 (2d ed. 1984) (“[W]e still, in spite of the efforts of three centuries of moral philosophy and one of sociology, lack any coherent rationally defensible statement of a liberal individualist point of view.”).

305. See TAMAR FRANKEL, *TRUST AND HONESTY: AMERICA’S BUSINESS CULTURE AT A CROSSROAD* 37-39 (2006) (describing how the culture of fraud and abuse of trust in the Enron era showed a society seeking to eliminate wrong by “redefining” and normalizing it).

compliance and promote adherence to the spirit of the law. However, it operates in the realm of self-regulation, in contrast to the regulatory hypothesis that addresses external enforcement. In this realm, regulated actors are content with the vague principles contained in ethics codes, compared to the demand for rules that arises in the face of external enforcement risk. On this analysis, pursuit of the ethical hypothesis is unlikely to contribute greatly to increasing actual compliance.

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 than the regulatory and ethical hypotheses. Normatively, it is the most troubling of the three hypotheses—and the most cynical, although it is not idiosyncratic.³⁰⁶ Prescriptively, it contributes to debate concerning the merits of jurisdictional competition by raising questions not previously addressed in that literature.

Literature on the jurisdictional competition debate, which spans across numerous legal and other fields, is particularly robust in the contexts that this Article addresses: 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 give 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 U.S. 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.

306. See David Alexander & Eva Jermakowicz, *A True and Fair View of the Principles/Rules Debate*, 42 ABACUS 132, 161 (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.”).

a. Delaware Versus Washington, D.C.

The jurisdictional competition debate was particularly vigorous concerning the production of state corporation law in the United States.³⁰⁷ However, participants now mostly agree that, while there may have been some form of competition among states decades ago, the race largely is over and no or little current competition exists.³⁰⁸ Delaware prevailed. Thus, 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.³⁰⁹

In the new competition, Delaware corporate lawyers, including judges, are in a political battle with Washington for hegemony in the production of U.S. corporate governance law.³¹⁰ While this battle has

307. See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 212-18 (1991) (debating whether state corporation law is a “race for the bottom” and concluding that there may in fact be a “race for the top”); Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437, 1440 (1992) (“[S]tate charter competition produces a race for the top with respect to some corporate issues but a race for the bottom with respect to others.”); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 663 (1974) (“Delaware is both the sponsor and the victim of a system contributing to the deterioration of corporation standards.”); Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 473-83 (1987) (summarizing and critiquing the prevalent theories of jurisdictional competition); Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709, 709 (1987) (same); Joel Seligman, *The Case for Federal Minimum Corporate Law Standards*, 49 MD. L. REV. 947, 966 (1990) (“States will compete to design the most pro-incumbent management statutes as a device to attract or retain incorporations.”); Ralph K. Winter, Jr., *State Law, Shareholder Protection and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 289 (1977) (“The almost universal belief that the competition between states for corporate charters works to the disadvantage of shareholders is on its face implausible.”).

308. See, e.g., Lucian A. Bebchuk, Alma Cohen & Allen Ferrell, *Does the Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775, 1778 (2002) (noting that the “dominant view among corporate scholars” is that Delaware “has ‘won’ the race for incorporations”); Lucian A. Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 553 (2002) (“The dominant state in attracting the incorporations of publicly traded companies is, and for a long time has been, the small state of Delaware.”); William W. Bratton, *Corporate Law’s Race to Nowhere in Particular*, 44 U. TORONTO L. REV. 401, 402-03 (1994) (citing “Delaware’s position as the preferred state of incorporation of large American firms in terms of relational contracting”); Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 679 (2002) (challenging “the conventional wisdom that states compete for incorporations”).

309. See Renee M. Jones, *Rethinking Corporate Federalism in the Era of Reform*, 29 J. CORP. L. 625, 625 (2004) (“The federal government, however, can serve as a credible rival to Delaware.”).

310. 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

endured for decades,³¹¹ serving as the fallback position to claims that state competition yields undesirable results, the stakes have risen since passage of the Sarbanes-Oxley Act, where Washington preempted numerous areas of corporate law that states traditionally handled. Because provisions of that Act were widely lambasted as rules-based, a competitive political response would distinguish Delaware's corporate law as principles-based.³¹²

Supporting the political hypothesis, Delaware's judges, unlike their counterparts in other courts, played a leading role in this contest.³¹³ Delaware judges frequently write articles that are published in law reviews.³¹⁴ While some of these provide thoughtful analysis and reflection, in recent installations, the articles are increasingly promotional of the Delaware judiciary's expertise,³¹⁵ extol the virtues of Delaware corporate law (including the claim that it is "principles-based"),³¹⁶ and harshly contrast those virtues with the vices of federal securities regulation (making the claim that it is "rules-based").³¹⁷ In at least some Delaware judicial opinions released since the passage of the Sarbanes-Oxley Act, analysis shows that the

corporate law). For a rebuttal, see Roberta Romano, *Is Regulatory Competition a Problem for Corporate Governance?*, 21 OXFORD REV. ECON. POL'Y 212 at n.19 (2005).

311. See Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1513 (1989) ("One result of Delaware's attainment of market share and market power through the past adoption of suboptimal managerial rules is that Delaware now has a special incentive not to lead in the adoption of such rules: the desirability of avoiding massive federal intervention in corporate law.").

312. Cf. Kamar, *supra* note 72, at 1911-14 (attributing Delaware's victory in the state-to-state competition, in part, to its use of principles in judicial decisions).

313. See Fisch, *supra* note 73, at 1072-82 (exploring how Delaware courts are unusual in other ways).

314. See Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573, 1603 (2005) ("[T]o 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."). The authors cite an "incomplete" list of some two dozen recent pieces. *Id.* at 1603 n.117.

315. See Griffith & Steele, *supra* note 9, at 11 (citing the "greatest difference between state corporate law courts and a regulatory agency" as "the ability of the judiciary, in Delaware especially, both to make and apply the law"). Mr. Steele wrote the cited article while serving as Chief Justice of the State of Delaware. *Id.* at 1.

316. 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 it is "not part of any overall system of corporate governance"). The two authors wrote the cited article while serving as judges on the Delaware Court of Chancery.

317. Griffith & Steele, *supra* note 9, at 3.

courts are attempting to respond to the political and competitive climate that has resulted.³¹⁸

These developments reflect a different tenor of competition in the vertical sphere between Delaware and Washington than existed under the horizontal competition among states. The horizontal competition between 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.

In contrast, the vertical competition between Delaware and Washington does not involve substitutes, but products akin to bundled goods: a U.S. corporation wishing to be public must be incorporated in a state and be 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 also a sales force.³¹⁹ This may help to explain the increasing exuberance of Delaware judges 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 some Delaware judges.³²⁰

318. Jones, *supra* note 309 ("Recent Delaware court decisions indicate that Delaware's judiciary has begun to respond to [preemptive threats] by adjusting its corporate law jurisprudence.").

319. Delaware Supreme Court opinions often have 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) ("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 9, at 10 n.50 (acknowledging contrary evidence in the post-Enron years noted in Jones, *supra* note 309). It almost always produces unanimous opinions. This is surprising for law so often called indeterminate and thus suggestive of an unusual unity of outlook.

320. *See* Treasury and General Government Appropriations Act for Fiscal Year 2001, Pub. L. No. 106-554, § 515, 114 Stat. 2763, 2763A-72 (2000) (directing the OMB and federal agencies to implement procedural guidelines regarding information they disseminate to the public); OMB Guidelines for Information Disseminated by Federal Agencies; Notice; Republication, 67 Fed. Reg. 8452, 8453 (Feb. 22, 2002) (directing agencies "to develop information resources management procedures for reviewing and substantiating . . . the quality . . . of information before it is disseminated"); SEC. & EXCH. COMM'N, FINAL DATA QUALITY ASSURANCE GUIDELINES (2005), available at <http://www.sec.gov/about/dataqualityguide.htm> (describing the SEC's procedures for reviewing information to maximize its quality).

b. British Columbia Versus Ontario

Unlike the United States, Canada lacks a central authority governing securities regulation. Instead, laws are promulgated by the thirteen provinces and territories and enforced by commissions and tribunals of the respective regions.³²¹ Each province uses governmental securities commissions or administrators to oversee respective provincial securities laws. The provinces may compete in these terms but not in the same way that U.S. states competed for charters. In securities regulation, there are no charters to fight over. Instead, provinces contend for leadership in designing the regulatory system, power to promulgate and enforce law, and power to contribute to the national market system.

Provincial autonomy is threatened by ongoing efforts to promote national consistency and harmonization of securities regulation across Canada.³²² Provincial securities commissions and administrators recently formed a national group, called the Canadian Securities Administrators ("CSA") to provide a coordinating function. Current forces are strongly in favor of moving Canada from its existing fragmented structure to a federal system with a single national securities 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 the fear that it will be dominated by Ontario, the money-center province that is viewed as inclined to follow the United States, and its allegedly rules-based securities regulation. Accordingly, the British Columbia principles-based securities regulation proposal can be seen as a political gambit to resist Ontario's power and U.S. influence. Supporting this hypothesis, Ontario's Securities Commission replied to British Columbia's proposal with a blistering comment letter³²³ which, while substantively meritorious, had overtones of a political response.³²⁴

321. See DAVID JOHNSTON & KATHLEEN DOYLE ROCKWELL, CANADIAN SECURITIES REGULATION xxxvii ff (3d ed. 2003) ("Table of Concordance"); MARY G. CONDON ET AL., SECURITIES LAW IN CANADA: CASES AND COMMENTARY 265 (2005) (discussing variations in the laws and noting degrees of harmony).

322. CONDON ET AL., *supra* note 321, at 141-42. See generally WPC—COMMITTEE TO REVIEW THE STRUCTURE OF SECURITIES REGULATION IN CANADA: RESEARCH STUDIES (Douglas Harris ed., Ottawa: Department of Finance 2003) (containing a collection of articles discussing the securities regulatory structure in Canada).

323. Letter from David Brown, Chair, Ont. Sec. Comm'n, to Doug Hyndman, Chair, B.C. Sec. Comm'n (June 27, 2003) (on file with author) (outlining objections to British Columbia's proposal, saying it "has gone too far," emphasizing the need for the securities commissions to

c. U.S. Versus International Accounting

Some form of competition has existed for years between the SEC/FASB and IFRS promulgators.³²⁵ The SEC historically provided international leadership on accounting matters, filling the lacuna that exists in the international arena, which lacks a centralized power.³²⁶ In this leadership, the SEC bears the costs of international regime formation and places its cultural imprint on the process and results. In accounting, the SEC and FASB use diplomacy to influence promulgators of alternative accounting systems in a process in which the SEC both exerts political pressure and succumbs to it.³²⁷

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]."³²⁸ IFRS promulgators responded by developing a robust accounting system, with one eye on the criteria established by the SEC and another on the substantive merits of particular provisions.

In the process, the IFRS promulgators developed not only a system that the SEC takes seriously but also one that constitutes a credible rival to U.S. GAAP. Beginning in the 1990s, these competitive political realities pressured the SEC to accept IFRS³²⁹ and prompted

work together and the importance of harmonization, but along different lines than those that British Columbia proposed).

324. See CONDON ET AL., *supra* note 321, 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, 305 (2004).

325. See Maureen Peyton King, Note, *The SEC's (Changing?) Stance on IAS*, 27 BROOK. J. INT'L L. 315, 316 (2001) (noting that "[t]o date, the SEC has not accepted the IAS" promulgated by the IASC). 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.

326. See ROBERT O. KEOHANE, *AFTER HEGEMONY: COOPERATION AND DISCORD IN THE WORLD POLITICAL ECONOMY* 237 (1984) ("In a post-hegemonic world, the rules of international regimes cannot be reliably enforced through centralized organizations.").

327. See James D. Cox, *Regulatory Duopoly in U.S. Securities Markets*, 99 COLUM. L. REV. 1200, 1237 (1999) (noting that "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).

328. *Id.* at 1251.

329. *Id.* 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).

the SEC to push for convergence.³³⁰ In late 2007, the SEC formally announced an interest in allowing SEC registrants to report using IFRS rather than U.S. GAAP.³³¹

This background sets the stage for a political account of prevailing rhetoric that operates at two levels of competition between IFRS and U.S. GAAP. The 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 U.S. GAAP or IFRS are assured that countries worldwide will accept their financial statements as complying with minimum standards. The EU began mandating IFRS in 2005, and it is catching on elsewhere, but it remains less widely used than U.S. GAAP (and many countries that have formally adopted it, including EU Members, have done so by amending it to meet local needs). As a result, the majority of large corporations throughout the world still uses U.S. GAAP or face investor pressure to do so, giving the SEC and FASB continuing dominion.³³²

IFRS must achieve more power to attract new customers in the primary competition and to influence ongoing articulation of accounting provisions 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 denigrating U.S. GAAP as rules-based, while praising IFRS as principles-based. The SEC and FASB return the volley either by explaining their version of a principles-based system (the objectives-oriented model) or claiming

330. Cox, *supra* note 327, at 1202 (noting that “the SEC continues to promote convergence” between IFRS and U.S. GAAP, but faces “political considerations” in doing so).

331. Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards Without Reconciliation to U.S. GAAP, Securities Act Release No. 8818, Exchange Act Release No. 55,998, International Series Release No. 1302, 72 Fed. Reg. 37,962 (proposed July 2, 2007) (introducing a rule that would allow non-U.S. SEC registrants to file financial statements using IFRS without reconciling to U.S. GAAP); *see also* Concept Release on Allowing U.S. Issuers to Prepare Financial Statements in Accordance with International Financial Reporting Standards, Securities Act Release No. 8831, Exchange Act Release No. 56,217, Investment Company Act Release No. 27,924, 72 Fed. Reg. 45,600 (Aug. 7, 2007) (soliciting public comment on allowing U.S. SEC registrants to report under either IFRS or U.S. GAAP). For some of the author’s cautionary views on these proposals, *see* Lawrence A. Cunningham, *Beware the Temptation of Global Standards*, FIN. TIMES (London), Sept. 11, 2007, at 11.

332. *See* Richard W. Painter, *Convergence and Competition in Rules Governing Lawyers and Auditors*, 29 J. CORP. L. 397, 399 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).”).

that U.S. GAAP is principles-based as well.³³³ In pursuit of global standards, moreover, the SEC considers formal recognition of IFRS by offering registrants the option of reporting under either system—a move that is a partial political response to the EU's earlier move to mandate member-country use of IFRS.

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 the necessity of rules in corporate laws of emerging economies.³³⁴ U.S. governmental representatives make similar cases concerning securities regulation to countries such as China.³³⁵ 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 barring government from borrowing to meet current expenses as distinguished from funding longer-term investment projects).³³⁶ 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.³³⁷ But individual countries prefer

333. See *supra* note 177 (quoting FASB member Schipper to this effect). In the SEC's case, constraints imposed by the Data Quality Act limit its rhetorical freedom to compete. See *supra* note 320 and accompanying text.

334. See *supra* notes 212-25 and accompanying text.

335. See, e.g., Walter Lukken, CFTC Comm'r, Speech to China Financial Derivatives Forum (Sept. 26, 2006), in *International Developments: CFTC's Lukken Tells China Enforcement, Flexibility Among Keys to Developing Market*, SEC. L. DAILY, Sept. 29, 2005 (stating that advanced economies need principles as in recent CFTC codification (CFMA)—but for immature markets “a rules-based regulatory regime is essential”).

336. See MIDDLE E. POLICY COUNCIL, JOINING THE GLOBAL RULES-BASED ECONOMY: CHALLENGES AND OPPORTUNITIES FOR THE GCC, available at http://www.mepc.org/forums_chcs/20.asp (discussing whether the Gulf states are ready to adhere to the global rules-based economy); Richard A. Posner, *Creating a Legal Framework for Economic Development*, 13 WORLD BANK RES. OBSERVER 1, 3-4 (1998) (“rules-first strategy” of law reform).

337. RULES-BASED FISCAL POLICY IN EMERGING MARKETS: BACKGROUND, ANALYSIS AND PROSPECTS (George Kopits ed., 2004); TERESA DÁBAN ET AL., RULES-BASED FISCAL POLICY IN FRANCE, GERMANY, ITALY, AND SPAIN 13 (IMF 2003); see also Pablo Zapatero, *Searching for Coherence in Global Economic Policymaking*, 24 PENN. ST. INT'L L. REV. 595, 595 (“[T]he International Monetary Fund, the World Bank, and the World Trade Organization have

discretionary policies in order to retain autonomy. When rules are imposed on emerging economies, it is unsurprising that countries join a bandwagon, boasting that they offer principles-based systems.

2. Limitations

If rhetoric of principles-based systems is intended to distinguish legal/accounting products, the impossibility of offering such products makes the reports misleading. This byproduct 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.

The jurisdictional competition model is contested but, when its assumptions hold true, 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.³³⁸ The model is appealing when a large number of producers offers a complete range of goods, and consumers command perfect information about offerings and can switch between them with little cost.³³⁹ Both visions require that perfect information about products be available to investors and understood accurately by them, a plausible stance to the same extent that relatively efficient capital markets are plausible.³⁴⁰

However, 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

developed a coordination structure aimed at achieving coherence in global economic policymaking.").

338. 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, 201 (1997) (exploring and refining original contribution of Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416 (1956)).

339. Bratton & McCahery, *supra* note 338, at 222-36 (discussing the consequences of relaxing the assumptions of the Tiebout model); Cox, *supra* note 327, at 1231-32 (citing Tiebout, *supra* note 338, at 419).

340. 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, *supra* note 327, at 1230-31 (summarizing but criticizing the argument).

consumers.”³⁴¹ For example, in the state corporation charter competition story, customers used corporate lawyers to provide truthful, objective assessments of the alternatives.³⁴² Corporate lawyers, 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 Act limitations that command regulatory accuracy, promulgators of IFRS and officials in Delaware and British Columbia are not.³⁴³

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 plague traditional business enterprises. In such a case, integrity, benevolence, and responsiveness are impaired. Thus, the jurisdictional competition debate may hinge, in part, on philosophical views concerning relative confidence in markets versus governments to promote social ends.³⁴⁴ However, this analysis adds a limitation to the theory’s efficacy when sloganeering is

341. Bratton & McCahery, *supra* note 338, at 275. Professors Bratton and McCahery discuss this point in the context of competition for factors of production, *id.* at 268-76, but this provides a lesson concerning information.

342. *See id.* at 267 (observing that the literature on Tiebout’s thesis notes that “[v]erifiability . . . may be delegated to the judgment of a legal professional”).

343. *See supra* note 331 and accompanying text. Indeed, sovereign immunity likely would insulate states and state actors from exposure to liability for false advertising. *See Coll. Sav. Bank v. Florida Prepaid Postsecondary Educ. Expense Bd.*, 527 U.S. 666, 666-67 (1999) (holding that the state enjoys immunity despite making misstatements about a third-party’s product).

344. *See Cox, supra* note 327, 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).

misleading and neither consumers nor their professional advisors can be counted upon to overcome the rhetoric and uncover reality.

This 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 that 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.

* * *

The foregoing theories of the rhetoric extolling principles-based systems of corporate regulation are necessarily non-exclusive (as an exclusive roster of possible explanations is essentially impossible to state). But they are sufficiently capacious to be fairly comprehensive. For example, the rise of principles-based rhetoric could be a backlash against the evident demand for rules that existed during the period leading up to the various financial reporting scandals. If so, this is captured by the regulatory hypothesis, in that proponents seek to reverse pre-existing trends favoring rules. As another example, the rise of this rhetoric could be due to business leaders pursuing lobbying campaigns that seem most saleable when dressed in that rhetoric.³⁴⁵ This is captured by the political hypothesis, as these leaders promote and exploit prevailing political rhetoric for their own ends.³⁴⁶

345. See, e.g., COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT (2006) [hereinafter PAULSON REPORT], available at http://www.capmktreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf (report commissioned by U.S. Treasury Secretary Henry M. Paulson, Jr.); MCKINSEY & CO., SUSTAINING NEW YORK'S AND THE US' GLOBAL FINANCIAL SERVICES LEADERSHIP (2007), available at http://www.schumer.senate.gov/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf (study commissioned by New York City Mayor Michael Bloomberg and U.S. Senator Charles Schumer (NY)).

346. To illustrate, the PAULSON REPORT, *supra* note 345, strongly advocates "principles-based systems," and yet prescribes rules in contexts where rules are better for corporate managers than for investors or others. Examples include recommendations: (a) to abandon the SEC's recently-adopted principle that materiality is both a quantitative and qualitative concept, *supra* note 154, in favor of a rule that materiality means 5% of net income, PAULSON REPORT, *supra* note 345, at 19; (b) to reduce uncertainties associated with the principles underlying Rule 10b-5, *supra* note 164, by the SEC providing more detailed prescriptive rules, PAULSON REPORT, *supra* note 345, at 12; and (c) to stop using SEC enforcement actions to establish policy by principles, *supra* note 271, and instead adopt formal written rules, PAULSON REPORT, *supra* note 345, at 9. For general criticism of the PAULSON REPORT along these lines, see Lawrence A. Cunningham, *Report is Muddled*, NAT'L L.J., May 14, 2007, at 23.

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, resulting in hybrids located along 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 *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 despite this reality requires speculation. The phenomenon is possibly due to a combination of a 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 the most descriptively accurate, but also the 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.

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 simply 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. Political realities and positional complexities expose such labels as contextually false dichotomies. Unreflective use 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 available forms of provisions to achieve varying objectives.

If this binary classification hypothesis is correct, then a modified approach to the vocabulary usage would be to allow the simple labels to represent extreme ends of a spectrum. Complex

regulatory systems could then range across the spectrum denominated at its poles by extreme principles-density to extreme rules-density. A classificatory scheme could be constructed in which systems are identified by their descriptive positions across that spectrum. Descriptive locations could include some terms suggested above, such as principles-heavy, principles-rich, rules-rich, and rules-heavy.³⁴⁷ A challenge in devising such a descriptive spectrum, however, is that to establish such locations requires highly sophisticated classification and measurement tools that have not been developed.

If it were possible to develop a reliable classification and measurement method to support such descriptive classifications, the refined taxonomy could be useful. First, it would dislodge the contextually false binary oppositions. Second, it would offer 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. Reflecting these realities in the discourse would rightly neutralize the rhetorical and political power of the false binary. Third, it could improve capabilities in relating alternative forms of provisions to objectives. Yet the inherent limitations of a quest to develop such a model likely would lead to the more ultimate prescription made in this Article, a fizzling out of the vocabulary altogether.

347. See *supra* notes 210-25 and accompanying text (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* notes 227-43 and accompanying text (discussing how the proposed British Columbia Securities Act advertised itself as principles-based, and I referred to it as principles-heavy or principles-rich); see also *supra* notes 132-34 and accompanying text (referring to the "rules-density" of U.S. federal securities regulation); *supra* notes 206-09 and accompanying text (referring to principles-rich contexts in which the SEC pursues accounting enforcement actions).
