

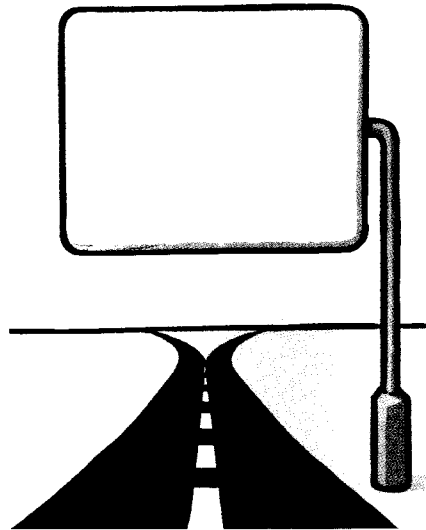
THE FINANCIAL PAGE PARSING PAULSON

In the wake of a crisis, the natural response of government officials is often to offer up new rules and regulations. So it came as no surprise when, a few weeks ago, Treasury Secretary Henry Paulson proposed a new regulatory scheme for the nation's stricken financial markets. What was surprising was the scope of the plan. Instead of simply trying to target the practices that helped spark the current crisis, the plan—which has actually been in the works for more than a year—calls for a major overhaul of the American approach to regulation.

As the press has noted, the plan would consolidate our myriad and overlapping regulators into fewer, bigger ones. But the most interesting thing about it is something subtler: a push to move from our current system of regulation—often known as “rules-based”—toward a “principles-based” approach. In a rules-based system, lawmakers and regulators try to prescribe in great detail exactly what companies must and must not do to meet their obligations to shareholders and clients. In principles-based systems, which are more common in the U.K. and elsewhere in Europe, regulators worry less about dotted “i”s and crossed “t”s, and instead evaluate companies’ behavior according to broad principles; the U.K.’s Financial Services Authority has eleven such principles, which are often deliberately vague (“A firm must observe proper standards of market conduct”). This approach gives companies more leeway in dealing with investors and customers—not every company needs to follow the same rules on, say, financial reporting—but it also gives regulators more leeway in judging whether a company is really acting in the best interests of shareholders and consumers.

In practice, of course, these distinctions aren't quite so neat: regulators in a rules-based system still have to interpret the rules, and principles-based systems are hardly rule-free. (The Financial Services Authority, for instance, has thousands of pages of rules and guidance.) But the models do represent genuinely different approaches. It's something like

the difference between football and soccer. Football, like most American sports, is heavily rule-bound. There's an elaborate rulebook that sharply limits what players can and can't do (down to where they have to stand on the field), and its dictates are followed with great care. Soccer is a more principles-based game. There are fewer rules, and the referee is given far more authority than officials in most American sports to interpret them and to shape game play and outcomes. For instance, a soccer referee keeps the game time, and at game's end has the discretion to add as many or as few minutes of extra time as he deems necessary. There's also less obsession with precision—players making a free kick or



throw-in don't have to pinpoint exactly where it should be taken from. As long as it's in the general vicinity of the right spot, it's O.K.

Wall Streeters must be soccer fans at heart, because they are huge supporters of the principles-based approach. That should, perhaps, make us skeptical: when the fox applauds ideas for henhouse security, watch out. Yet the European experience suggests that a principles-based system has real virtues. It can make life easier for honest corporations, since they have to spend less time complying with overly complex rules, and also thwart dishonest ones, since regulators can spend more time looking at the substance, rather than the minutiae, of corporate bad behavior. It

has been argued that Enron might have found it harder to get away with its shenanigans under a principles-based system, since many of the company's gambits, while following U.S. accounting rules, nonetheless violated fundamentals of financial reporting. More recently, bank regulators in Italy, following a principles-based strategy, succeeded in keeping big Italian banks from heavily investing in subprime derivatives, even though such investments wouldn't have broken any laws.

So what's the catch? Only this: a principles-based system relies on dedicated, well-funded regulators who are interested in regulating. And, lately, it's been hard to find those in Washington. In recent years, regulatory failures have occurred less because of bad rules than because of bad regulators. This is partly because Congress, following the Bush Administration's lead, has underfunded regulatory agencies. The Consumer Products Safety Commission, for instance, has the authority to regulate toys from China but is hard pressed to do so, having only half as many employees as it had in 1980. To make things worse, many regulators have been captured by the industries they're regulating, or are hostile to the regulations they're responsible for enforcing. The recently publicized maintenance problems at Southwest Airlines were discovered years ago, but supervisors discouraged inspectors from cracking down. Federal bank regulators had the power to discover and curb the fraud and deception that helped fuel the subprime boom, but they were apparently oblivious. In all these cases, the rules were fine—it was the regulators that were the problem.

This isn't to say that we don't need a regulatory overhaul. Simplifying the current thicket of rules makes sense. But it will only create more trouble if we're not willing to appoint the people—and commit the resources—needed to make the changes work. A principles-based system offers the potential for smarter regulation—the kind that helps markets work more efficiently. But the best principles in the world won't help much if those in charge aren't willing to enforce them.

—James Surowiecki