

Regulatory Insight—US Securities & Banking

In focus: ramifications of a more principles-based FINRA rulebook

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The securities industry is eagerly awaiting a new FINRA rulebook that will contain a uniform set of rules for FINRA-only and dual FINRA-NYSE member firms. According to public statements of its senior executives, FINRA plans not only to eliminate inconsistent, duplicative and obsolete rules, but also to reorganize the rulebook and to infuse it with a much greater emphasis on principles-based regulation. This development is expected to promote flexibility and effectiveness in regulation. However, the rulebook is only one element of the overall regulatory regime, and changes in the philosophy and approach of FINRA's rules will have important consequences for other components of FINRA's regulatory program, including examinations, rule interpretations and enforcement.

Background

Principles-based rules are not new to SRO rulebooks. A classic example is NASD [Rule 2110](#), which states that "A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade." Moreover, in recent years, FINRA and its predecessors have frequently used a principles-based approach when introducing new rule proposals, such as FINRA's proposed guidance on electronic communication supervision and business entertainment.

Yet, there are consistent drumbeats urging an even greater reliance upon this regulatory approach. For example, principles-based regulation has been the focus of several recent reports, including The Financial Services Roundtable's [Blueprint for U.S. Financial Competitiveness](#) and the January 2007 Bloomberg-Schumer report on [Sustaining New York's and the US' Global Financial Services Leadership](#), both of which cite the United Kingdom's success with a principles-based regulatory regime for financial services. As the Bloomberg-Schumer report acknowledged, "For many executives, London has a better regulatory model: it is easier to conduct business there, there is more open dialogue with practitioners, and the market benefits from high-level, principles-based standards set by a single regulator for all financial markets." In the view of Treasury Secretary Henry Paulson: "Our rules-based regulatory system is prescriptive, and leads to a greater focus on compliance with specific rules. We should move towards a structure that gives regulators more flexibility to work with entities on compliance within the spirit of regulatory principles."

What does a principles-based rule look like, and what are the potential benefits?

A specific illustration of a principles-based rule is a proposed amendment to NYSE [Rule 343](#) regarding office space-sharing. The proposed rule, [SR-NYSE-2007-68](#), recognizes that NYSE Rule 343 (which has no NASD equivalent) has become "unduly prescriptive," going so far as to specify architectural arrangements under which space sharing arrangements between member firms and certain other financial intermediaries (including other broker-dealers) will be approved, including whether space "is separated by ceiling-high solid walls" or "has direct access to a public hall, main corridor or street" and whether there are "connecting doors or windows between the space to be jointly occupied." The principles-based proposed amendment eliminates a requirement that member firms obtain prior approval before establishing space-sharing arrangements, and replaces it with a prior notice requirement as well as a general standard that "reasonable" steps be taken to ensure that employees are clearly identified so that the investing public is clear as to which entity they are conducting business with. Following SEC approval of the rule change, FINRA proposes to offer members guidance on what is considered "reasonable" by issuing an information memo that would retain a streamlined list of considerations from current Rule 343. In this principles-based manner, the proposed rule will achieve the goal of preventing confusion on the part of the investing public without forcing members into a single mode of compliance.

This example illustrates some of the potential advantages of principles-based regulation, including:

- flexibility to react and adapt to market changes, crises and opportunities;
- compliance systems proportionally tailored to a firm's business;
- decreased regulatory costs; and
- less confrontational relationship between firms and regulators.

Some countervailing considerations

Notwithstanding some of the obvious benefits of a principles-based approach, skeptics raise several general concerns:

- principles-based rules will likely complicate considerably the jobs of compliance professionals and securities lawyers, as they seek to provide clarity to clients who want specific guidance as to regulatory "dos" and "don'ts";
- the lack of bright-line rules makes it difficult for compliance officers to judge litigation and enforcement risks, and may lead to overly conservative compliance systems; and
- more general standards may result in a lack of transparency in the interpretation of rules.

In addition, there are a number of practical considerations regarding the effective implementation of an increasingly principles-based rulebook.

Examinations

Senior FINRA staff are heavily involved in developing rule interpretations, and hearing panels and appellate bodies serve as important checks and balances by reviewing staff interpretations of rules when challenged in the context of enforcement proceedings. However, in practice, very few rules are the subject of formal guidance by senior staff, and most violations or asserted violations are resolved without enforcement referrals or are disposed of in negotiated settlements. Many important questions of interpretation are, and will remain, effectively determined at the level of FINRA's front-line examiners.

FINRA must consider the impact of an increasingly principles-based rule set on the management of its examination program in order to ensure transparent, consistent and fair, yet flexible, application of rules across the range of member firms in terms of geography, size and business model. Sufficient guidelines and experience on the part of examiners will be required to prevent overly subjective interpretations of principles.

"Tick-the-box" regulations make for fairly straightforward examinations, since examiners have relatively little discretion in determining compliance. In a principles-based model, it is possible that reasonable persons may differ over whether specific behavior is compliant or not. Will an increased emphasis on principles-based regulation compel FINRA to hire examiners with higher (or different) educational standards than at present, or persons with demonstrated judgment in applying securities industry rules? Also, will examiner training and the examination "modules" that FINRA furnishes to examiners for their field work need to emphasize interpretive standards and the use of discretion by examiners?

In addition, FINRA will need to take steps to guard against a scenario in which examiners follow an informal set of "desk drawer" rules -- those that are not explicitly codified, but nonetheless are considered de facto rules of the game.

Filing, notice and comment requirements for rule interpretations

The need to provide guidance to examiners in the field, and to members, as to permissible rule interpretations raises some tensions with the statutory framework in which SROs, like FINRA, operate in regard to rule making. If FINRA's new principles-based rules prove to be too abstract and later require clarification, the procedures for SEC approval of proposed rule changes, even for "interpretations," could leave FINRA tangled in a complicated web of filings, notices and comment requirements, which could undermine the flexibility of a principles-based approach.

[Section 19](#) of the Securities Exchange Act of 1934 and the SEC's [Rule 19b-4](#) require the filing by SROs (and, in most cases, approval by the SEC) of "proposed rule changes," including rule interpretations, unless they are "reasonably and fairly implied" by the text of the rule. In general, SEC rules consider the following to be proposed rule changes of an SRO: (1) any material aspect of the operation of the facilities of the SRO; (2) any statement made generally available that establishes or changes any standard, limit, or guideline with respect to the rights, obligations, or privileges of members or their associated persons or the meaning, administration, or enforcement of an existing rule; and (3) rule interpretations that are approved or ratified by the governing body of the SRO and that are not fairly and reasonably implied by the rule. From time to time, the SEC and appellate courts have brushed back the efforts of SROs to apply general principles to new, specific fact patterns without complying with the SEC filing process – even where the SRO has given prior notice of its intent to do so through regulatory circulars. Thus, although the filing and approval mechanism for SRO rules can be lengthy, failure to file (and, where necessary, to secure SEC approval) can result in a rule's unenforceability and invalidation.

FINRA will need to balance the need to provide examiners and members with practical guidance on applying principles with the timing and procedural demands of the statutory requirements for SRO rule changes.

Fair enforcement

Principles-based regulation also raises questions about the fairness and efficiency of enforcement. While FINRA has always exercised discretion in determining which enforcement actions are brought, the enforcement of principles-based regulations raises concerns about the abuse of such discretion. Critics argue that vague principles may be used to justify enforcement actions, even where it may have been unclear that particular behavior was prohibited.

Furthermore, the introduction of more principles-based rules may result in increased appeals of FINRA disciplinary sanctions. In one sense, additional appellate "case law" on the interpretation of a principle can help flesh out its application. However, litigation is a long and inefficient way to accomplish what a prescriptive rule could have achieved in the first place.

Conclusion

The securities industry and FINRA are in the midst of a paradigm shift in regulation towards more principles-based rules and the hoped-for benefits of flexibility and efficiency. However, the rulebook does not exist in a vacuum, and a significant change in the structure of FINRA's rules will have practical implications for examinations, ongoing rule interpretation and enforcement. In order to realize the full promise of a principles-based approach, FINRA will need to be very thoughtful in introducing new rules in a way that does not compromise these other pillars of its regulatory program.

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