COMPLIANCE WEEK
The leading resource on corporate compliance and governance for U.S. public companies.

# The Principles vs. Prescriptive Rules Debate

**By Harvey L. Pitt, Compliance Week Columnist—March 28, 2006**

In the movie *Midnight Run*, Robert De Niro plays a tough Chicago ex-cop whose refusal to take mob bribes cost him his job. Instead, he becomes a bounty hunter because, as he says, when he finds someone who's jumped bail, he can just bring him in and "not worry about anybody taking a payoff." But when De Niro agrees to find and bring back an honest accountant—played by Charles Grodin—who has jumped bail, De Niro struggles with his strict rules-based approach to life, which has already cost him his police job, wife and family. Grodin was a Mob accountant before realizing he was working for criminals; once he realized for whom he was working, he stole $15 million of their money, as well as their incriminating books. De Niro's conflict is palpable: If he returns Grodin, it's almost certain the Mob will kill Grodin before he ever testifies against them; if he doesn't bring Grodin in, he'll be aiding him in evading his legal obligation to testify.

Harvey L. PITT
Columnist

*Midnight Run* puts the "principles versus prescriptive rules" debate in stark terms. People, especially in business, like prescriptive rules because they provide certainty and clarity, even when one doesn't like the substance of the prescriptive rules to be followed. But the problem with prescriptive rules is that they often can engender slavish adherence to the letter of the rule, rather than its underlying spirit or purpose. In De Niro's mind, bail-jumpers are criminals, and that's why he rounds them up: "You deserve where you're going and I'm gonna take you there," he tells Grodin. That was the applicable prescriptive rule. But the larger purpose of the rule is to effect substantial justice and promote the rule of law, and those purposes ultimately militated strongly against applying his prescriptive rule in a manner that would assist the Mob.

Accountants rarely find themselves portrayed in Hollywood as anything other than number-crunching nerds, so presumably they'll enjoy reference to a movie that features an accountant as at least a quasi-hero. The movie is also a launching point for a discussion of the principles versus principles rules debate so often centered on accounting issues, but relevant to all regulatory and compliance pronouncements generally. Here are some of the issues businesses must confront in coming to terms with prescriptive and principles-based rules and policies:

- **Easier said than done.**

Regulators say they're committed to creating a less complex, more consistent, principles-based approach to financial reporting. It's a move to be applauded, but easier to say than do. God was able to capture an entire set of rules for how people should live their lives in the Ten Commandments, yet the U.S. criminal code alone fills volumes and volumes, and the Internal Revenue Code is essentially indecipherable to mere mortals. Securities and Exchange Commission rules consume thousands of pages of turgid prose that often leaves those beholden to these requirements scratching their heads to figure out what is the best way to achieve compliance.

- **The need for convergence.**

The Financial Accounting Standards Board and the International Accounting Standards Board agreed two years ago to address accounting standards that are outdated, overly complex and in need of improvement, and to embrace principles-based standards to reduce complexity. It's not clear that they've made much progress, but they do continue to afford the public due process. Getting the dialogue going between the accounting profession and its regulators was an important first step. The SEC's acting chief accountant, Scott Taub, recently characterized the tenor of the dialogue as having changed from "Where does it say we can't do

this?" to "Are we sure that this treatment is all right?" This advice-seeking and cooperation is key to avoiding future problems for regulators, auditors and filers.

- **Be mindful of every rule's underlying purposes.**

No matter what regulatory body is involved, or what type of rule it issues, new situations are always going to arise that weren't contemplated when the rule was created. To avoid becoming tomorrow's front page cautionary tale, businesses and their advisers need to look beyond the language of a rule to the principles and spirit that underlie it. Consider KPMG and its recent tax shelter problems. It's a familiar dynamic: There was a rule that was set and a policy underlying it. You had an organization that thought it could argue it was adhering to the letter of the rule, and yet apparently was engaged in violating its underlying purposes.

- **In writing compliance policies, remember the "Sally Pitt" test.**

Sally Pitt is my beloved 14 ½-year-old. Like all adolescents, she's very adept at creating ambiguity out of directives and rules where none was intended. Recognizing this, we articulate our rules and directives simply, devoid of inherent ambiguity. The same approach applies to the creation of compliance policies and procedures. Many companies write their policies and procedures manuals as if they were drafting trust indentures, complete with six or ten pages of defined terms. There are really only two critical objectives for compliance manuals and policies: first, to sensitize employees so they'll be able to recognize when a problem may exist; and second, to provide guidance as to whom the proper resolution of questions should be directed. Policies written by lawyers for lawyers may look impressive, but they're self-defeating. Policies have to be written in language that can be readily and easily understood by those who must comply with them, and those who must assess them.

- **The shifting sands of regulation and enforcement.**

One of the biggest complaints I hear from businesses is that they're trying to follow rules systematically but, because something else happens out there, suddenly everything they've done has liability consequences. For example, after Enron imploded, any company that used special purpose entities found itself suspect. But it's axiomatic that enforcement and regulatory policies aren't static—they change because something occurs or implodes and garners a great deal of attention. Companies need to evaluate their approaches continuously and be sure they're satisfied they're doing things the right way.

- **Litigation, enforcement and crisis management.**

As we enter a period of decreasing reliance on prescriptive rulemaking, the essential corollary must be kept in mind: For every decrease in prescriptive rules there is an equal and significant increase in enforcement initiatives. Most companies spend little time worrying about from where the SEC's next initiatives will come. That's a mistake. Worrying about future enforcement trends is the best way of avoiding or minimizing a company's next crisis.

- **It's possible to prepare for a company's next crisis.**

Being public almost certainly ensures that a company will soon confront its next crisis. Many companies assume that they can't predict what their next crisis will be, but that's wrong. Companies should set aside time each quarter to hypothesize things that can go wrong, and to plan how they will respond should the unthinkable occur. Advance planning can save a company; the failure to engage in advance planning can spell a company's doom.

- **Spring is upon us and, with it, spring cleaning.**

Commissioner Cynthia Glassman recently spoke of the SEC's need to review its "existing rules—old and new—to see if they are accomplishing their objectives, doing so efficiently and effectively, and without serious unintended consequences." This is something I tried to initiate at the Commission when I joined it in 2001. Unfortunately we were preempted by other priorities. Hats off to former Director Alan Beller and the

Division of Corporation Finance for overhauling the rules under the Securities Act last year. Let's hope Commissioner Glassman can bring her economic expertise to this important initiative. There should be respect for regulations. If people must obey regulations that serve no purpose, it dilutes everyone's respect for following them.

It's been said that if Moses came down from Mount Sinai today, he'd still carry two tablets with him, but they'd both be aspirin! There's no question that navigating the myriad of regulations today is a complex and challenging task. But companies that identify and adhere to the purposes underlying every rule will find the path ahead far more clear.

---

The column solely reflects the views of its author, and should not be regarded as legal advice. It is for general information and discussion only, and is not a full analysis of the matters presented.