In pursuit of principles

THE ACT SPRING PAPER BROUGHT A FASCINATING INSIGHT INTO THE WAY THE CITY'S TOP REGULATOR VIEWS MARKETS AND REGULATION. **GRAHAM BUCK** REPORTS.

The debate over the very different regulatory approaches of the UK and the US has grown increasingly acrimonious in recent months. In particular, Clara Furse, the Chief Executive of the London Stock Exchange (LSE), has vigorously denied claims that the success of London's junior market, AIM, owes much to lax regulatory standards.

John Tiner, the outgoing Chief Executive of the Financial Services Authority (FSA), addressed the issue of the regulatory divide when he presented the ACT's Spring Paper in April, sponsored by the Bank of New York. He spoke about harnessing the markets through principles and disclosure, and stressed it was unhelpful to portray the debate as New York versus London.

Tiner said that the increasingly global nature of financial services, and particularly the capital markets, makes the fortunes of the world's main financial centres increasingly interlinked. This means the world has room for more than one major financial centre. Regulators have the task of balancing a strong regime with one flexible enough to respond to sudden and often unforeseen change. While the FSA has no statutory objective to help the UK's competitive position, it does have a duty to combine a regulatory framework with an approach that fosters innovation and competition.

SUPPORTING CORPORATE GOVERNANCE The FSA also has a limited role in the UK's corporate governance regime, beyond endorsing the corporate code that sets out best practice for companies. The code is enforced by institutional investors.

The FSA's view is that companies should not be burdened with unnecessary costs or overprescriptive regulation that prevents company managements from driving forward their entrepreneurial agenda.

This contrasts with a more rules-based corporate governance regime elsewhere in the world, principally in the US, which appears to deter many companies and works to the UK's advantage when companies decide where they want to list.

In many parts of the world, a principles-based regulatory regime is now recognised as preferable to a rules-based system. US Treasury Secretary Hank Paulson acknowledged as much in a recent speech, when he suggested that US regulators should move towards a more flexible structure.

The trend to a more flexible system extends to the accounting profession. Since 2005, EU-listed companies have adopted international financial reporting standards (IFRS) – which are less legal-based accounting rules and more principles-based than their US counterparts – for their consolidated annual accounts.

SIMPLIFYING THE CURRENT MODEL So far, the changeover has gone very well. The next task is for regulators to work with the Securities and Exchange Commission and achieve mutual recognition of IFRS and the US generally accepted accounting principles (GAAP) for cross-border offerers in both the US and EU markets. However, there is a danger that convergence between the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) could result in more costs than benefits, resulting in a financial reporting model far more complex than either body follows at present. Tiner suggested it would be better to focus on simplifying the current model, and offered offered seven main arguments in favour of a more principles-based financial regime:

- The growing volume of regulation in the UK didn't prevent the mis-selling of pensions, mortgage endowments, split capital trusts or high income bonds;
- As financial markets are dynamic and innovative, rule-based regulation struggles to keep up;
- Principles provide a way to promote competition and innovation;
- Sensible regulation helps the international competitiveness of a country's financial market, as capital becomes more mobile. But standards must be maintained, or the wrong type of business will be attracted;
- Company boards and managements should recognise their responsibility for making decisions rather than have the regulator tell them how to respond;
- Principles help the interests of customers, shareholders and management to converge; and
- As principles address the spirit of regulation, they are harder to

Executive summary

- In a thought-provoking Spring Paper, the Financial Services Authority's outgoing Chief Executive, John Tiner, looked at how to harness the markets through principles and disclosure.
- The global nature of markets interlinks the fortunes of the world's financial centres.
- The dynamism of both investors and the financial institutions has made the sector successful. The FSA's role is to design a regulatory framework and adopt an approach that does not hamper this success, even encouraging it wherever possible.

avoid than rules. The latter help maintain armies of lawyers, bankers and accountants merely to meet the letter of the rule.

But more principles-based regulation requires a cultural change. Boards and senior management must accept greater responsibility and encourage their staff to follow, while regulators must be more open and ready to explain their decisions.

PRINCIPLES-BASED RULES Tiner said the FSA drew up principles-based listings rules two years ago to promote "fair and orderly markets" that encouraged dialogue between the listed company and the regulator. The aim was that the company should reveal all material information an investor might require in making an informed investment decision. The EU had adopted a similar approach in its securities regulation.

As the authority for listing, the FSA was set three specific regulatory objectives by the Treasury: providing adequate protection for investors in listed securities, helping a broad range of business to gain access to listed markets, and maintaining the integrity and competitiveness of the UK market for listed securities. It was also required to heed the international nature of the capital markets, maintain the UK's competitive position and adhere to the EU's Financial Services Action Plan.

The regime is therefore disclosure-driven and principles-based, allowing market participants to make informed decisions based on the company's business model or the investor's risk appetite.

But the eligibility requirements also keep investor protection to the fore. To gain admission to the official list, a company must show a trading record of at least three years, evidence that it has sufficient working capital for the next 12 months, and enough liquidity for secondary trading (25% of its shares must be in public hands). A listed company must also disclose all relevant information in a prospectus before a listing of its securities can go ahead.

Tiner said: "The principles-based regime works because it encourages transparency through disclosure. More importantly, it provides flexibility in the way listed companies organise themselves and are regulated. This, in my view, is the only way to successfully approach ever more complex securities markets."

Another task is to ensure the listing regime keeps abreast of developments in the capital markets, such as overseas-listed companies issuing global depositary receipts (GDRs), and companies trading on AIM, the market for smaller, growing companies.

In March, the FSA announced that it wanted to canvass opinion on the structure and quality of the UK's listed markets, in view of the developing European single capital market and the growing number of non-UK domiciled companies listing in London. The FSA will particularly focus on greater clarity in the regulation of securities such as equities, GDRs, securitised derivatives and debt that overseas and UK issuers and investors are able to list and access.

THE GROWING ROLE OF HEDGE FUNDS Tiner also acknowledged the growing role of hedge funds and private equity in the capital markets. The active management of hedge funds means they can now represent up to 50% of daily liquidity on the LSE. The funds themselves lie outside the FSA's remit, but their managers are within it and more than 300 hedge fund managers are based in London, representing around 90% of EU hedge fund business.

"We have designed a sensible, fit-for-purpose regulatory approach for this sector," said Tiner. However, it is limited to UK prime brokers only and a number of questions remain. One is the impact that the transfer of risk to hedge funds, via credit derivatives and other financial instruments, has on the ability of regulators and central bankers to assess where risk sits in the financial system.

Other issues include the need to ensure adequate disclosure and accurate valuations. The FSA has been developing a regulatory regime to address these risks, such as whether hedge funds should be available to retail investors. The FSA doesn't oppose this development and has issued a consultation paper on retail funds of alternative investment funds.

UK private equity funds have attracted over £33bn in funds in the past two years – a figure that exceeds the rest of Europe combined. It can be argued both that private equity encourages market discipline through the push for shareholder value, but also that it reduces investor choice in the public markets as well as raising issues such as the impact on employees of deals.

In conclusion, Tiner said the dynamism of both investors and the financial institutions had created the sector's success. The FSA's role was to design a regulatory framework and adopt an approach that didn't hamper this success, even encouraging it wherever possible. This all-important balance had to be accompanied by strong oversight to maintain public confidence – a recently published City of London report into the competitive impact of London's financial market infrastructure praised the FSA for developing a regulatory system that was respected and appreciated by the market community. Further work is needed to fully embed more principles-based regulation, but so far the results have been very positive.

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