BRITISH AMERICAN BUSINESS INC

“The Same – but Different: Hard Rules or Soft Principles: Perspectives from London on US and EU Capital Markets Issues”

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Good evening ladies and gentlemen.

Thank you for inviting me to speak this evening.

Given that:

- The UK and US are the largest investors in each other’s economies
- The New York and London financial centres have essentially the same customer base.
- And indeed, we - the London Stock Exchange - have 51 of the S&P500, and12 of the Dow30 constituents on our markets.... and *vice versa* for NYSE

… you'd have thought that the US and UK capital markets would look roughly the same, indeed might even be integrated into one market. No way. They are in fact very different.

But many believe they share one immediate issue that I want to address this evening. The issue is: unacceptable forms of behaviour by those to whom our scarce capital is entrusted.

Adam Smith, writing in 1776, identified what he thought was a fatal flaw in the corporate form of organisation. Managers of corporations are "managers rather of other people's money than of their own" and it seemed to him that they could not be expected to "watch over it with the same anxious vigilance" as if it was their own money".

Smith was pessimistic about the future of corporations, for they could not be well managed he thought. "Negligence and profusion", he warned, "must always prevail".

And sure enough from time to time negligence and profusion does prevail.

In the UK, as far back as the early 1700s – before Smith - there was feverish speculation in a number of amazing and foolhardy schemes.   One group, for example, sought to raise money for "a wheel of perpetual motion"; another solicited money, and I quote, "for carrying on an undertaking of great advantage, but nobody is to know what it is." OK. That was a satirical joke of the time. But they still got punters' money. And even the privatisation of the national debt. That was for real, and makes today's malefactors look like amateurs compared with their eighteenth century counterparts.

And on the by this time regulated London Stock Exchange the year 1825 witnessed 500 out of 624 new companies going bust. Among them the London Genuine Snuff Company, the Economic Funeral Company, as well as one intended to "combat the usury of pawnbrokers and pay dividends of 40 per cent."

Later in the century, in the US, the infamous age of corporate ill practice led to the passage of the Sherman Anti-Trust Act in 1890; followed forty years later after the Wall Street collapse, by regulation and the establishment of the SEC.

Back to the UK. In 1992, the discovery of Robert Maxwell's theft of over $1 billion from employee pension funds to support his crumbling business interests. BCCI and Polly Peck as well. A decade later and in the US alone, in one year, 537 internet companies failed. And the latest, but I'm sure not the last, Enron, Worldcom and the rest.

We've been here before. And capital markets have survived and prospered. Now, I don't think I or you, my audience, need to dwell too long on the benefits of capital markets. At least not amongst ourselves. With others, particularly the young, and especially outside the United States, the case has to be made.

I usually find myself making the case in the form: "the market system is a worse form of economy except for all the others that have been tried from time to time". In other words, to echo Winston Churchill's observation that "democracy is a worse form of government except for all the other forms that have been tried from time to time". The market system has solved some all but intractable problems, which have been successfully tackled by none of the alternative forms of economic organisation.

But it has its limits, because there are things that it cannot do. It doesn't necessarily always do even what it is supposed to. And it works well only if it's well designed.

It is, therefore, vitally important that the response of governments to failures and problems like Maxwell or Enron doesn't mean the loss of the merits of well designed markets. It should be recognised that the market economy "reflects the nature of life itself and cannot be contained or planned for, in its fullness and variability, by any central intelligence". Another quite elegant way of putting things, this time from the President of the ex communist Czech Republic.

I used the phrase: "Well designed" That is, clearly suggesting intervention by the State is necessary. I don't want this speech to be over-philosophical or overly long so let me acknowledge a debt to John McMillan, who in his book "Re-inventing the Bazaar" makes the case that markets need to be well structured if they are to do what they are supposed to do, and makes the case in a way that closely reflects my own views of what's required: Here's what we need:

- Information flows smoothly in well designed markets
- Property rights, especially intellectual property rights are protected
- People can be trusted to live up to their promises
- Side effects on third parties are curtailed
- And competition is fostered.

Tonight, I want to focus on how the State – the government – intervenes to design capital markets, particularly those of the United States and the UK.

In looking at the UK, I'll also talk prospectively about the single capital market that is slowly and painfully evolving across the European Union – a task, I may say, that has been made much more difficult because of the perceived failures in US capital markets.

My overarching observation is that there has been, and now more obviously is, a growing gulf between the US and UK - and prospectively the EU - in their approaches to well designed public capital markets. How damaging this gulf is and whom it damages is less clear. I'll come to that at the end. But it is there.

The gulf is caused by differing approaches on just two of the criteria for a well designed market - information flows and trust – and not, I believe on:

- differences of view on competition – yes, there are issues here between the EU and the US, but they are not material and the increasing cross-border activities of firms are obliging those responsible for policy in these areas to effect convergence. But note that this is because of the activity of firms, not capital markets

- nor differences on the protection of property rights. Again there are issues here between the US and the EU, especially as regards intellectual property rights, privacy and the like. Again they I would argue that are not material and crucially we share similar systems of law within which trade negotiations at WTO and elsewhere are sorting out, or will soon be sorting out, the differences

- and as to curtailing side effects – yes, I know that there are differences here, in the main stemming from the European philosophical start point for regulation, which is more about consumer protection. And the US and EU attitudes to environmental policy would seem to be at odds. But all that's for another speech, and doesn't particularly affect the capital markets

So I argue that the gulf is in these areas of information flow and trust and at its heart is the tension between what I call "soft principles and hard rules".

In trying to deliver effective information flow, and create trust between those with good information (managers of firms and their advisers) and those with poor access to information (investors), the US follows a hard rules-based approach, while the UK favours a system of over-arching principles. The difference is there across the key areas of corporate governance, transparency and financial market regulation.

The UK position – "soft principles" are the best policy framework – can be characterised as

"You don't need to tell them precisely what to do or not to do. They can be trusted, given that there is sufficient transparency, to deliver an acceptable outcome"

The "they" here are those to whom society entrusts its scarce capital. And an "acceptable outcome" is well functioning markets creating wealth, alleviating poverty and doing so with a widely shared sense of social justice.

The US position – "hard rules" are the best policy framework – can be characterised as

"You need to tell them precisely what to do or not to do. Otherwise they can't be trusted, however much transparency there is, to deliver an acceptable outcome"

Is this fair? Is it a useful observation? I believe it is, and I want to illustrate that across the three policy issues I mentioned of

- what corporate governance?

- what information (especially financial) accounting

- what financial market regulation?

However, before I do so let me be more precise about “soft principles” and “hard rules”, because of course there is British irony here. And that, one learns, doesn’t travel well.

What I actually mean, of course, is that principles, framed in a few, vague – soft – words or concepts are actually hard to deliver and hard to evade – and represent the better approach to designing a well functioning capital market. While rules framed in lengthy, specific legislation are not actually hard to deliver or hard to evade – and represent a weaker approach.

So “soft” is “hard”, and “hard” is “soft”!

Corporate Governance

Let me start with corporate governance, where this divergence of approach is at its starkest.

The value of good corporate governance is clear. According to McKinsey’s Global Investor Opinion survey, investors state that they are willing to pay a premium of 12-14% for US, UK and EU companies that exhibit good governance. A bit hard to quantify, but certainly a material premium.

Learning the lessons of Maxwell and Polly Peck a decade ago, the development of corporate governance principles has been lead by the UK. Beginning with the Cadbury Code in the early 1990s and now enshrined in the Combined Code, the non-statutory model has evolved over the decade.

As part of the Listing Rules of the Financial Services Authority – or FSA - the Code – 14 pages - establishes best practice principles that companies must either comply with or explain why not to their shareholders. The Code is made up of 17 core principles with guidance notes. As an example, Principle 1 reads: "Every listed company should be headed by an effective board which should lead and control the company." Simple enough! A few vague, soft concepts.

But we firmly believe that this approach strikes the right balance for listed companies, setting high standards of accountability, transparency and disclosure, adopted in best practice and sanctioned by the market – mainly investor groups – not, in the main - by the FSA or the Courts.

The system works to the point that UK corporate governance standards now lead the world. A range of different independent bodies say so – from Davis Global Advisors and Standard & Poor's in the US to Deminor Rating in mainland Europe. They do not identify any serious flaws in the system.

The European Union's Group of Company Law experts led by Jaap Winter is also looking to raise EU standards in this area by following the UK principles based "comply or explain" approach.

Meanwhile, and for the foreseeable future - Sarbanes-Oxley – or SOX - forms the backbone of the new US rule-based model.

Whatever the motives of Congress might have been, the Act exposes a core belief that some responsibilities are too important to be left to loose briefly stated concepts of fiduciary responsibility and that more severe treatment in the breach of detailed provisions can provide a strong incentive to avoid corporate failure and fraud.

While the trend towards independent directors and strengthening of the Audit Committee seem to be moving towards UK policy, there are stark differences between the US and UK models.

First, I would say that our model is easier to understand and follow. While the UK Combined Code is just 14 pages long, including bibliography, SOX alone is 66 pages and provides for the introduction of as many rules in the next six months as the SEC has made in the previous three years combined – and that's an SEC scoffer's estimate.

Second, in the UK there is a specific principle that advocates splitting the Chairman and CEO roles so that no one individual has "unfettered powers of decision." This principle aims to avoid the temptation toward the "imperial" CEO that epitomised Maxwell and other scandals. The split between Chairman and CEO and the specific role of Chairman that has evolved is fundamental to the success of our model of governance. SOX and the NYSE shy away from that, and unlike the UK code, say very little about the board as a whole.

In the UK, the responsibilities of the Chairman focus on forging and managing an effective Board, including ensuring that it has easy access to any information, and that strategic issues are addressed in a timely and thorough fashion.

The "independence" of the Chairman is also much valued. As the Chairman of the London Stock Exchange, I'm not independent because I was temporarily the CEO and I had, on appointment, a long-term incentive plan in part determined by the share price. While at SMG, as a Chairman I am independent of management because I have never been an employee of SMG and I've no long-term incentive plan. That's just how it is in the UK.

Third, while SOX requires CEO and CFO certification, in the UK the collective Board is responsible for the integrity of company accounts. I have to ask: How can you forge an effective Board if - directors have a variety of responsibilities and liabilities?

And fourth, while the regulator – the FSA - is responsible for all the rules in the UK, in the US the stock exchanges are also involved. I agree with Arthur Levitt when he writes: “[The exchanges] have the ultimate conflict of interest … [and] they are loath to tell companies to comply or leave.”

And overall, I would be concerned by the “legislate now, let the SEC pick up the pieces later” approach of SOX.

Any thoughts that this approach might converge with the UK approach to help give us an integrated capital market are pie in the sky.

Information Flows

Next, under the heading “Information Flows”, let me just focus on accounting. There are other aspects of information flow I could use, like the timely publication of price sensitive information or directors’ dealings in shares of their company, but financial accounting is the best example.

In the UK, the accounting governance regime was set up around a decade ago. The Financial Reporting Council is the over-arching body that oversees both the Accounting Standards Board, which is responsible for setting standards, and the Financial Reporting Review Panel, which is responsible for compliance.

In the UK, accounting standards apply to the annual financial statements of all limited liability companies and of other kinds of entities that prepare accounts intended to provide “a true and fair view”. In the US, there is no such statutory requirement unless and until the company is registered with the SEC.

The principles that guide the ASB in establishing accounting standards are set out in its Statement of Principles for Financial Reporting. The detailed accounting rules flow logically from the principles and have far less complex exceptions and exemptions than US GAAP.

UK standards setters believe that the UK approach emphasises substance over form and seeks to address the underlying economic reality in consolidated accounts, rather than staying close to the particular corporate and legal structure adopted.

In contrast to the UK model, US GAAP is largely a rules-based approach to financial reporting. It comprises tens of thousand pages of accounting rules accumulated over decades – most famously 600 pages on derivatives, more than 800 pages on special purpose vehicles.

The US model contains numerous “bright lines”, which in effect set out demarcation lines between the acceptable and the non-acceptable – hard rules, in any jargon. So what we’ve seen as management remuneration has become increasingly based on financial performance is growth in innovative financial engineering, and creative managers and lawyers developing products and accounting methods that have little economic purpose other than to fall within the letter of these “bright lines”. With disastrous consequences in too many cases.

The International Accounting Standards Board – the IASB – is trying to follow a similar principles-based approach to the UK. To quote Sir David Tweedie, Chairman of the IASB: “[We have] concluded that a body of detailed guidance encourages a rule-book mentality of ‘where does it say I can’t do this?”

The principles-based approach is winning the international battle for hearts and minds in the EU. The European Parliament has already ruled that the consolidated financial statements of all companies with public shares listed in the European market — some 7,000 companies currently using their home country's GAAP — must follow IAS standards no later than 31st December 2005. And Australia gave a similar commitment in the summer.

And there are sounds off stage that the US may budge. I just don't believe that. I wish David Tweedie, a fellow Scot, well, but I do think his efforts are doomed. Hard rules are hard wired into the US way of doing things.

Financial Markets Regulation

Finally, let me touch on the regulation of capital markets.

The US and UK have two of the broadest-based regulators in the world - the SEC responsible for securities trading, and the FSA responsible for banking, insurance, and derivatives and commodities as well as securities.

Their two approaches duly follow the principles vs. rules divergence.

The FSA Conduct of Business regulation is based on four statutory objectives, and six high level principles. Yes it's backed up by the rule book, but it creates a flexible and adaptable approach that allows timely decisions.

The SEC operates an extremely prescriptive rule-based approach that involves applications for rules, followed by open and lengthy consultations - witness the interminable period it took to approve and launch Nasdaq's SuperMontage, and the as yet open question of Nasdaq's status as an exchange.

In the UK, the Financial Services and Markets Act of 2000 now forms the basis for primary market regulation. In the US, the 1933 Securities Act and 1934 Securities Exchange Act along with three other acts from no later than 1940 perform that role.

There are two points of detail I want to highlight.

First, the UK has the most defined and extensive role for advisers to listed companies to act as an intermediary between the company and the FSA. The requirement for a sponsor is set out in the Listing Rules, although the role is also defined in UK law and by market practice. In the US, the investment bank has no direct obligations to the SEC.

This reliance on the intermediary in the UK is taken to the next level in regulation of AIM, our global market for smaller growth companies. The role of the Nominated Adviser – or NOMAD – is akin to the role of the sponsor on the main market, although the NOMAD is a continuing role required by the London Stock Exchange to be filled at all times.

I mention it because AIM provides an exceptionally interesting contrast with the US. In fact, there is no other market like it anywhere in the world. No trading record is required. There is no requirement for a particular percentage of shares to be in public hands. There is a less stringent regulatory regime, allowing businesses to learn to experience life as a public company without the full cost of compliance of a UK Listing. It fulfils a crucial role in the company growth ladder. And it hasn't seen scandal – that's not because the FSA or the London Stock Exchange crawl all over these companies - but because the principles within which intermediaries are licensed to go about their business are honoured.

In the US, the SEC does not differentiate regulation according to the size of issuer, the type of investor or the market on which the securities are to be traded.

Second, one of the UK's principles is to promote competition, whether that is from the UK or overseas. The SEC and the underlying legislation are clearly focused on the competitiveness of the domestic market.

In the UK, we have eight stock exchanges recognised by law to carry out investment business in the UK, including ones from the US, Germany and Australia. In the US, only one small foreign stock exchange is partially exempted under the Securities Exchange Act, and poses no threat to the domestic exchanges. I'm not sure how that promotes investor protection.

We believe the SEC should take a leaf out of the CFTC's book and facilitate a more level playing field. Foreign access in the derivatives field may have woken domestic US exchanges from their slumber, and fostered much needed competition and different approaches to doing business. Good for US investors.

Finally, under this heading of financial regulation, a word on the EU

The Report of the Lamfalussy Committee on European Regulation back in 2001 advocated the adoption of broad principles as a basis for EU-wide integration of securities markets. The Commission's Financial Services Action Plan, or FSAP, is seeking to implement this approach. In the round, while we have concerns that promotion of competition is being overlooked, the EU reform agenda is broadly on the principles-based track.

So, deep down in the bedrock of the approach of the UK and US to issues affecting information flow – I've touched on corporate governance, accounting and regulation, but there are others – there are, in my view, profound differences that are not going to go away, notwithstanding some of the voices we hear from policy makers.

My conviction stems, however, not from the sort of issue by issue comparisons of law, regulation and practice that I've just given you some of, but from my view that the fifth pillar of a well designed market matters enormously. It was, if you remember, that "people can be trusted to live up to their promises".

Remember my characterisation of the UK and US approaches. The UK, “You don’t need to tell them precisely what to do, or not to do, they can be trusted, given that there is sufficient transparency, to deliver an acceptable outcome”. The US, “You need to tell them precisely what to do, or not to do, they can’t be trusted, however much transparency there is to deliver an acceptable outcome.”

Was this fair, I asked. Is the real residual issue one of trust? Let me illustrate why I raise this contentious and sensitive issue.

Quite soon after the atrocities of September 2001 I attended the Annual Meeting of the Securities Industries Association of America.

They had, as one of the lunchtime speakers General Norman Schwarzkopf. Incidentally before I go on with my capital markets point, he illustrates perfectly Wellington’s observation that he didn’t know what effect his army had on the enemy, but by heaven they scared him.

Anyway, he gave a resounding defence of the American way of life - and its right to defend that way of life - he ended grasping a large American flag which towered above him – and he is a big man. Then he explained that his success, and by inference the success of every business leader, was embodied by the phrase: “Be trusted to do what is right”.

And pre-Enron, pre-everything that we are grappling with today, I looked around the lunchtime assembly of investment bankers, stockbrokers and company executives. I sensed no empathy here with that thought or any real understanding of how to “do what is right”. Maybe, I thought, ten years of boom time had dulled the capacity to calculate “what is right”.

Although – I see today that William Webster has resigned because he wanted "to do what was right". He didn't want to argue that his role at US Technologies was within the rules – that wouldn't matter – but to operate to the principle that reform of the accounting profession in ways that would generate trust was what mattered.

Incidentally, it's not just business leaders. I recently watched "Meet The Press" where I saw Marc Racicot [*Rass– ko*], Chairman of the Republican National Committee and Terry McAuliffe, Chairman of the Democratic National Committee discussing how they would get around the newly introduced campaign finance reform rules to raise as much money as they always have. Quite instructive. They seemed totally unaware that they were spitting in the face of what prompted the legislation – the need to improve public trust in politics and politicians.

And what about the next generation of investment bankers and corporate executives now leaving high school in America, and probably riding into Wall Street in time for the next boom?

Here's the sort of thing we hear from US high schools in the form of an audio diary unedited and broadcast nationwide on the BBC:

> "Probably one of the biggest pressures I see at school is the pressure to cheat, everybody wants to get the good grades, to get the As and so they will resort to whatever they need to, to get the As. It is a wide spread thing, and it is not just a few kids. It's the popular kids. It's kids in student council who should be leaders. It's everybody in all of the classes."
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> This is broadcast across the UK – possibly the world on BBC World Service – and jars so much in so many ears.

Now the State – Government - cannot legislate – it's not clever enough – to change this sort of behaviour just because there is a crisis. A much more long-term approach is needed. It would be nice to think that it's in place in America. I don't know. There's some evidence that it isn't. Let's hope it is.

Because until that different value system – best summed up in Schwarzkopf's "Be trusted to do what is right" - is in place, we are going to see only an extension of "hard rules" in the US, with all their flaws. That means a continued divergence, perhaps an even wider divergence, between the US and the UK in the way that capital markets are designed and regulated.

There are some obvious implications if I'm right. Just to mention two.

First, it means that for the foreseeable future, there will be no chance of US GAAP reconciling itself with the International Accounting Standards of the European Union.

We don't have the European IAS in place until 2005 and it will take time to evaluate its effect. And meanwhile, given the way that governments and legislatures work there will be a political commitment in the US to rely on and build on the current US initiatives. That's the way politics works.

And second, it would make the mutual recognition of capital markets law and regulation very unlikely. There was, once, just a possibility that there might be mutual recognition between the US and the UK, but with every step towards a European wide principles based legal and regulatory framework, and with every new US set of rules, the prospects for mutual recognition retreat rapidly.

In ending, let me be a bit subversive by asking: Does it matter? It doesn't seem to for US regulators and policy makers. After all, the US capital markets are the biggest in the world and, anyway, very domestic compared to the UK.

And the EU has so much to do to improve its own capital markets that convergence is hardly relevant for at least another decade.

So what we are left with is a degree of friction and higher transaction costs in the operation of public capital markets. But I doubt very much whether they are material to the cost of capital of firms.

And certainly within Europe there are reforms of the capital markets particularly in the infrastructure of clearing and settlement of trading, and uniquely in the UK, of the imposition of transaction taxes on share trading which will have much more impact on reducing the cost of capital of EU firms towards the level of their US competitors.

That is much more important for the EU than the differences between the operation of the US and the EU capital markets.

And, my last point is that isn't competition in ideas a good thing? Why converge? Why globalise?

The growing divergence may well turn out to be in the EU's favour.

To quote one UK commentator:

"The more Americans pass laws designed to clean up their markets, the more inefficient and unattractive they make them."

If our "soft principles" approach is better, then it will survive quite well for a long time and who knows, sometime in the 21st century may even prevail?

Thank you.

DGC

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